OPERATING PFI CONTRACTS
PROBLEMS, PITFALLS AND THEIR SOLUTION

CONSTRUCTION STUDY CENTRE

LONDON – 11 February 2010

BIRMINGHAM - 9 March 2010
PROGRAMME

0900-0930  Coffee and registration

0930-1015  Introduction to PFI
  - The origins of PFI and its future as a procurement vehicle within the UK.
  - Understanding the typical PFI structure.
  - Consideration of the different parties and contracts within PFI.

1015-1100  Understanding the Project Agreement
  - Overview of a typical Project Agreement.
  - Exploring the key provisions relevant to the operational period.
  - Understanding what the SPV is contractually obliged to provide.
  - Issues and Complaints that frequently arise during the operational period.

1100-1115  Coffee

1115-1215  Other Operational Issues
  - Instructing Variations and pricing issues.
  - The requirements for Benchmarking and Market Testing.
  - Relief Events and Compensation Events.
    - Breaches of Contract.
  - Changes in Law.
  - Termination.

1215-1300  Disputes
  - Understanding the mindset of the SPV.
  - Why things go wrong.
  - Review of typical Dispute Resolution Procedures.
    - The significance of Equivalent Project Relief.
  - The pros and cons of Joinder.
  - Achieving a successful outcome.
1300-1400  Lunch

1400-1515  Performance Monitoring and Payment Mechanisms

  - Understanding Performance based contracts.
  - Overview of a typical Payment Mechanism.
  - Performance Monitoring and Authority safeguards.
  - Payment and Deductions.
  - Securing improved performance at no cost.

1515-1530  Tea

1530-1645  Contract Management

  - The need for effective Contract Management.
  - Contract Administration.
  - The Management Team.
  - Managing Relationships.
  - The Operational Manual.
  - Maximising value for money.

1645-1700  Discussions and wrapping up

1700  Close
Matthew Dillon LL.B (Hons), Solicitor.

Matthew qualified as a solicitor in 1997 and has spent the majority of his career working as in-house counsel at leading construction, facilities management and pfi companies.

Matthew led legal and commercial negotiations on a number of PFI and PPP projects within the health, education, police, transport and local authority accommodation sectors. In addition Matthew has advised private sector consortium members on a range of PFI related disputes both during construction and operational phases.

In 2009 Matthew left industry with the intention of setting up his own legal practice.
SESSION 1 - AN INTRODUCTION TO THE PRIVATE FINANCE INITIATIVE

The origins of PFI and its future as a procurement vehicle within the UK

Where did PFI start? It is widely believed that PFI was a UK invention but in fact the first projects were signed in Australia in the late 1980’s where the PFI model was utilised to fund Railway Stations and Toll Roads, although the structure was somewhat different to that which developed within the UK. Although the Australians may lay claim to the dubious accolade of inventing PFI, there can be no doubt that it was the UK that really embraced the Private Finance Initiative.

Perhaps not surprisingly it was a Conservative government that brought the Private Finance Initiative to the UK. Many said that PFI was ideologically based, an extension of the Conservative party policy of outsourcing services previously undertaken by the public sector, such as cleaning and catering, refuse collection and the provision of leisure facilities. The Tories were said to be bringing about privatisation through the back door. Indeed this was certainly the view of Patricia Hewit when speaking in the House of Commons in December 1993. Further Alistair Darling warned that "apparent savings now could be countered by the formidable commitment on revenue expenditure in years to come".

However, notwithstanding the Labour Party’s resistance to PFI whilst in opposition, after their election win of 1997 the Labour Government wholeheartedly supported PFI as a procurement route to renew the UK’s ageing infrastructure. To put matters into perspective, prior to May 1997, approximately 78 projects had reached Financial Close with a Capital value of £3.6 billion. By January 2010 this had ballooned to 913 projects with a capital value of some £72 billion.

Ten years after Labour came to power there appeared to be no stopping the PFI. Yes, it had it critics, it always had, but there could be no mistake that it was a significant player within the Government’s procurement strategy. Although there were casualties within the private sector, most notably Jarvis, Amey, Metronet and Kajima, the private sector also found ways to make serious amounts of money, not least through refinancing the projects after they had been constructed and selling on their investments to the secondary market.

At the height of the PFI frenzy in 2006 Henderson bought John Laing for £1billion, obviously believing that the PFI had some considerable distance to run. Indeed at about this time a number of the UK leading players were exporting their success overseas and the opportunities seemed endless. Norway, Finland, USA, Canada, the Netherlands, Czech Republic, Singapore and India were just a few of the markets that the UK players were moving into.

So what was the attraction with PFI? In the UK it was clear. There was a desperate need to invest in ageing infrastructure but frankly the funds were not there. PFI enabled the Government to acquire new infrastructure today but to delay and stage payments over the next 30 or so years. Because the debt required to finance PFI was capable of being treated as “off the UK balance sheet” it enabled the Government to maintain the pretence that it was not breaching its Golden Fiscal Rules. Other arguments included that PFI removed the risk for delay or overspending on capital projects away from the taxpayer and it was also suggested that only the private sector could be trusted to deliver such complex high value capital projects on time and on budget.
The criticism levelled at PFI has not abated and the model of procurement is as controversial as ever. For some considerable time there was even concern that the “off balance sheet” status of PFI was to change in order to comply with new International Accounting Standards which arguably would have undermined one of the key drivers behind PFI. Quite unexpectedly however, the Treasury recently issued to Whitehall Departments a memo indicating that by adopting European Accounting Standards there was no longer a requirement for PFI projects to be “On- Balance Sheet”, at least in some circumstances. One of the main reasons to continue using PFI therefore remains.

The opposition to PFI has however been constant and unrelenting. The media has been all too quick to run stories of the “fat cats” of the private sector creaming in profits at the tax payers’ expense. At the same time the media appears disinterested in balancing the arguments by reporting on the private sector losses within PFI. As set out above, PFI almost broke Jarvis and Amey who were at one time both constituents of the FTSE 250. Kajima reportedly lost nearly £80 million pounds in one year under-bidding on School PFI projects and John Laing reportedly nearly £80 million on the National Physical Laboratory.

In 2006 Chanel 4’s Dispatches reported on the cost of a light switch change at a PFI Hospital as being a “cool £333” and of a local authority “shelling out tens of thousands of pounds a month for meals and cleaning services in a school which closed last year”.

In the same year the Public Accounts Committee released a scathing report into the refinancing of the Norwich and Norfolk Hospital and what it called the “unacceptable face of capitalism” with the 3i Group, (Barclays Infrastructure, Innisfree Partners, John Laing and Serco Investments) making a refinancing gain of some £116 million, albeit the Consortium did return £34 million to the NHS Trust, which it was not under any contractual obligation to do. There are plenty of other examples of private sector excesses and one only needs to type “PFI” into Google to find such examples. PFI has always been controversial but has had a remarkable ability to overcome any adverse media reporting.

However, in 2008 the credit crunch and subsequent recession severely affected the world of PFI and possibly irreversibly so. The PFI community got caught out; it did not see any end to the good times and continued to expand both in the UK and overseas. Although the PFI leaders foresaw a tightening in the availability of credit and the peak of the appetite for secondary investments, it did not see just how dire the public finances had become.

The PFI industry, even in early summer of 2008, did not see the evaporation of the credit markets; the finance for projects simply was not there. Whereas prior to 2008 finance for projects up to, say, £300m could be obtained on relatively favourable terms with one or two lenders or through bonding, the credit crunch meant that consortiums were having to negotiate with a pool of several lenders each lending no more, than, say, £50M to a Project. It was difficult enough for a consortium to control one risk adverse funder, but having to negotiate with several funders each taking a different line made matters virtually impossible.

The Government aware of the problems being faced by the private sector but being desperate to ensure certain projects proceeded to Financial Close set up a special Infrastructure Finance Unit to ensure funds were available, the existence of which was absolutely critical in securing Financial Close for the Greater Manchester Waste Project. The idea however of the Treasury lending to the private sector to ensure that private finance could still be provided on public projects is something that not surprisingly had its critics.
Liberal Democrat Treasury spokesman Vince Cable said the Government should consider going back to more traditional public financing structures rather than propping up PFI. "The whole thing has become terrible opaque and dishonest and it's a way of hiding obligations," he told BBC Radio 4's World at One. "PFI has now largely broken down and we are in the ludicrous situation where the government is having to provide the funds for the private finance initiative."

On the 10 May 2009 the Observer quoted Tony Travers, Director of the Greater London Group at the London School of Economics, as saying that using public money to finance a supposedly privately financed initiative was another example of the Government using "Alice in Wonderland economics".

The Credit Crunch and recession had a devastating impact upon the number of PFI Projects signed in 2009. According to PPP Bulletin, the industry magazine, “2009 was the worst year in over a decade for the public private partnerships industry” with only 35 deals signed at a value of just £4.2billion, compared to the 34 signed in 2008, although the 2008 projects had a value of some £6.8 billion. This was a significant decrease from the 60 plus projects that were signed in the decade leading up to 2008.

It now appears to be widely accepted that whoever wins the next General Election is going to have to make savage public sector cuts. The Tories have already said they wish to scrap PFI for the Health and Education sectors and there has been open discussion about the prospect of abolishing Partnership for Schools, the quango set up to run the somewhat over complex Building Schools for the Future Programme.

On the 19 January 2010 PPP Bulletin reported the Commons Environmental Affairs Committee saying that “PFI was too inflexible for the waste sector”. If the Government remove education, waste and health from the PFI then what is left?

A consensus appears to be developing that if the Conservatives win the next election PFI will more or less be abolished. Quite what this means however is less clear. There is no way that the Government could afford to “buy back” those projects already let and the suggestion that private sector partners will be sacked if they do not adequately perform is little more than political posturing.

The PFI industry believes that private sector involvement in public sector projects will continue in some form and there was even a suggestion from a PFI CEO that any changes that a Conservative Government would make will be simply “cosmetic” and to reflect his somewhat questionable view he has removed the letters “PFI” from the company’s mission statement. In view of the desire of a Tory government to distance itself from Labour policy.. It is not at all clear that any such changes will be purely cosmetic. In any event the real forces behind change will be the need to reduce government expenditure and from this point of view it is possible the use of PFI will be drastically scaled back whoever gets into power.

However, the need for investment in public infrastructure remains as does the need to keep debt “off balance sheet”. Although PFI may be in its final days it is not improbable that it will simply be replaced with something not so dissimilar.
Understanding a typical PFI structure.

The structure of a project can take a number of forms depending upon the sector in which the project is to be placed. Below is a typical structure of a PFI contract. Project structures within the BSF (Building Schools for the Future) scheme or LIFT schemes, although based upon the structure below, will be considerably more complex.

Bidding for and trying to secure a PFI contract is an extremely complex and expensive process and the market is dominated by a relatively small number of specialist companies. Often these companies will be offshoots of larger infrastructure groups, for example Balfour Beatty Capital and Catalyst Lend Lease are both investment divisions of their respective parent companies set up to win and operate PFI contracts. In addition there are some purely independent companies who neither build nor operate the facility but are simply in the deal for the returns on their investments, perhaps the best well known being Inisfree.

The SPV

Typical to every project however is the special purpose vehicle ("SPV") set up by the private sector to enter into the contract with the public sector. The SPV is what it says on the label; a newly formed company set up specifically for the project that it is to enter into with the public sector. The SPV is financed on a non-recourse basis, i.e its liabilities are without recourse to its shareholders; the SPV secures finance on the strength of the anticipated revenues from the project. If the project goes wrong such as the National Physical Laboratory or the London Underground then the SPV’s shareholders can walk away, and their only liability will be the loss of their investment.

The SPV’s role is to first secure the necessary finance to construct the facility that it has been contracted to build, to then design and construct the facility, and then once it is agreed that the
facility has reached practical completion to maintain and operate the facility for a number of years, usually somewhere between 25 – 30 years.

Ownership of the SPV varies. If the PFI contract is to be built and operated by one group then it is not uncommon for the shares of the SPV to be 100% owned by that Group. So, where for example Balfour Beatty are building and operating a hospital then it may well be that the Balfour Beatty Group would own 100% of the SPV. If however the service provision of the hospital were to be provided by Sodexo, then it would not be uncommon for Sodexo to have a minority shareholding in the SPV of perhaps 10 or 15%. In some cases a bank may own a shareholding in an SPV, a practice frequently adopted by HBOS and some of the other banks such as Barclays. It may well be that a bank owns both equity in the SPV and also provides the senior debt.

Finance

The SPV raises finance to build the facility in two ways:

(i) Junior debt and equity

Historically the SPV has requested its shareholders to provide loans equivalent to, say, 10% of the total financial requirement of the SPV. These loans are repayable to the shareholders together with interest, perhaps in the region of 12% per annum. The shareholders will also usually invest equity. It is common for the equity to be invested at Financial Close and the loan to be invested a little later, after the construction of the facility has been completed. The amount loaned or provided as equity represents the shareholders total liability in respect of the contract. So, if matters go wrong the shareholders can walk away knowing that their loss is capped at the level of their investment.

Note however the Building and Facilities Management Contractor do through their respective subcontracts and parent company guarantees retain a liability notwithstanding the SPV walking away from the project and therefore, although the liability of the SPV is non recourse to the shareholders, the wider group may still retain a degree of liability through its subcontracts.

(ii) Bank Finance or Bonding

The majority of the SPV’s requirements, say 90%, will however be financed through either bank loans or through the bond markets. In view of the credit crunch many Funders are looking to reduce their percentage of financing meaning that the private sector is required to finance a bigger slice of the project.

Bank debt is considered flexible and lends itself more readily re-financing. However, bonds are likely to be a cheaper option for large projects. Bond market tends to have more capacity, but the timing of fundraising in relation to that capacity and other projects in the market can be an issue. Indeed in 2009 it became virtually impossible to finance a project through the bond markets.
Key Subcontracts

The SPV will subcontract its obligation to design and build the facility to a Building Contractor on terms that are as near identical to the terms under which the SPV has agreed with the Authority to construct the facility, the idea being that any risk accepted by the SPV should be passed straight down to the Building Contractor. If therefore the facility is completed late, the Building Contractor must account to the SPV for any losses that the SPV suffers as a consequence of the late completion. Likewise if the building is defective then the liability of the SPV to the public sector client (“Authority”) should be identical to the liability of the Building Contractor to the SPV (“back to back contracting”).

Back to back contracting is a critical condition of project funding. Because the SPV has no significant assets, the Funders will only want to lend to the SPV if they are confident that the project will first work, and secondly that if anything goes wrong that the SPV can cover its liability by pursuing the Building Contractor. The SPV usually carries the liability for defects that arise after the expiration of the limitation period (twelve years) on the basis that it is unusual for latent defects to present themselves after this time.

Once the facility is complete the SPV then becomes responsible for maintaining the facility to an agreed standard for an agreed period of time, usually 25 - 30 years. As with the construction of the facility this obligation will be subcontracted on a back to back basis. The idea is that by the SPV maintaining the facility to an agreed standard, the facility can be handed back to the Authority at the end of the agreed period in a pre-defined condition. PFI is supposed to provide the taxpayer with a new facility at the outset, which is then maintained to an agreed standard for the next 25-30 years, and finally the facility is returned to the taxpayer in a well maintained condition at which point the SPV’s interest in the facility comes to an end.

The maintenance of the facility is commonly known as the “hard fm” or “hard facilities management” and includes such things as maintaining the fabric and systems of the building and repairing any defects that arise, such as a leaky roof or broken boiler. The SPV may also provide “soft fm services”, such as cleaning, catering, porterage or security. In recent years there has been a move away from the SPV providing soft fm services as it was found it did not provide value for money.

The SPV will subcontract both the hard and soft fm to a Facilities Management Contractor. Usually the same Facilities Management Contractor undertakes both hard and soft fm services but this is not always the case, particularly in some of the more complex projects where there may be a number of service providers.

When the SPV is bidding for the project and costing it from an operational perspective, a number of assumptions will have to be made on the need to maintain or replace various items of both the building fabric and the equipment. So, for example, if the SPV has assumed that a boiler will need replacing every 15 years or school chairs every 8 years, then this will have been incorporated into the price that the SPV seeks. The replacement of these items is more commonly referred to as “lifecycle” and the lifecycle obligations may be either subcontracted to the Facilities Management Contractor or retained by the SPV. The calculation of lifecycle is not an exact science and there is a fair amount of “guestimation”. As the operational continues there may well be tension between the need to replace (or lifecycle) an item and the SPV’s
desire to maintain, particularly if the lifecycle reserve is considered to be inadequate. Although it is usually the SPV that has an interest in any surplus within the lifecycle fund, this is not always the case.

As is common with much contracting in the UK, both the Building Contractor and, to a lesser extent, the Facilities Management Contractor, will subcontract various aspects of their obligations to sub-subcontractors and the criticality of these services may govern the extent to which the Authority and the Funders require certain rights or security against such sub-subcontractors.

Holdco

There is a number of other parties within a typical PFI structure. It is now relatively common for the SPV to be owned by a holding company “Holdco”, although essentially the purpose of such a vehicle is simply to enable the ownership of the project to be sold without the SPV itself being sold.

Payment and Completion

The golden rule of PFI is that the SPV does not receive any payment until the construction of the facility is complete as is certified by an agreed third party, the “Independent Tester”. If the facility does not get completed then the Authority is not required to pay for the facility and ultimately, if failure to complete becomes a breach of contract, the Authority can terminate the Project Agreement. In this situation compensation becomes payable to the SPV only in accordance with the provisions set out in the Project Agreement (addressed below).

The next issue to consider is how the Funder receives payment for the loans that it has advanced to fund the project and build the facility?

Provided the facility is completed and subject to the project becoming operational, the Authority is required to make a monthly payment to the SPV in respect of the provision of the facility and supply of services. When the project was being negotiated the term of the operational period will have been agreed and the obligation upon the Authority to make monthly payments, the fee being referred to as the “Unitary Charge” or “Unitary Payment”, will have been calculated on the basis of the agreed operational phase. The Unitary Charge will therefore have been calculated by reference, inter alia, to:

- the cost of repaying the finance secured for constructing the facility
- the cost of the SPV making the facility available for use throughout the term
- the cost of maintaining the facility to agreed standards
- the cost of providing the agreed services

The most simplistic way to understand PFI is to compare it to a mortgage. The Authority receives the facility on day 1 but pays for it over the next 30 years.
**Funder Risk**

The biggest risk to the Funders lies within the construction phase because if the facility is not certified as complete then the Funder is unlikely to recover payment of its loans. Likewise, if there is a delay in completion of the facility then this directly impacts upon the payment of the Unitary Charge and the ability of the SPV to meet its debt repayments (a risk that is usually addressed through the provision of liquated damages against the Building Contractor and insurance for delay).

Upon completion of the facility the revenue stream is switched on and the risks to which the Funder and SPV are exposed decrease markedly, albeit there is some risk through the ability of the Authority to make Deductions against the Unitary Charge in accordance with the Payment Mechanism. Deductions may be made if the facility does not continue to meet the pre-agreed standards and so becomes “Unavailable” or if the services to be provided by the Facilities Management Contractor do not meet the required pre agreed standard “Service Failure” (discussed below).

However, the risks to which the SPV is exposed during the operational phase are without doubt considerably less that those prior to practical completion. Hence the reason why after completion many SPV’s have been able to refinance their bank debt at a much reduced cost, creating a windfall profit for the SPV.
Consideration of the different Parties and contracts within PFI.

Above a simple PFI structure has been considered. However it is also beneficial to understand the other parties and contracts that are typical in PFI and which lie behind the SPV in order to appreciate the complexities of PFI. A typical structure is set out at Appendix 1 to these notes (page 90).

The principal document is the Project Agreement which is a contract entered into between the Authority and SPV in respect of the design, build, financing and operation of the facility. It is a wieldy and complex document but sets out exactly what the SPV is to provide and on what terms.

An Authority cannot expect to effectively operate a PFI contract unless it understands the Project Agreement, the party’s respective obligations thereunder, and makes reference to it on a regular basis. Bearing in mind the Agreement and its schedules will run to numerous A4 lever-arch files this can be a daunting task. The reality however is that vast parts of the Project Agreement may not be relevant on a day to day basis. Consideration of the Project Agreement is addressed in more detail later.

The SPV will subcontract its obligations in respect of the design and construction of the facility to a Building Contractor through the use of a bespoke “back to back” contract. In the early days of PFI it was not uncommon for an SPV to seek to use a standard form of building contract such as a JCT but to then amend with copious pages of amendments, finally saying that the provisions of the Project Agreement take precedence over the Building Contract in the event of any conflict. The modern approach is to simply take the Project Agreement and flow the relevant provisions down to the Building Contractor. Certainly the Funders prefer this approach as it helps to avoid any mismatch in the obligations between the SPV and the Building Contractor in respect of the design and build of the facility.

Although it is a general rule within PFI that the risks accepted at Project Agreement level should be flowed down to the Key Subcontractors, there are some risks which the SPV will seek to pass to the Subcontractors which it should not. For those interested in the best practice when negotiating such sub-contracts from a subcontractor perspective, further information can be found at Appendix 2 in this respect.

The performance of the Building Contractor will be backed up by either, and sometimes both, a parent company guarantee from the Building Contractor’s Holding Company and a performance bond from an independent third party. Dealing with the guarantee first of all, this will usually say that the Holding Company’s liability does not exceed that of the Building Contractor and so does not create any additional liability but simply prevents the Building Contractor’s Group walking away from a project by allowing its subsidiary to be wound up. The performance guarantee is usually provided by an insurance company and basically says that if the Building Contractor is in breach of contract and as a consequence the SPV suffers damage or loss, then the insurer will indemnify the SPV for its losses up to a pre-agreed amount of money. It is not uncommon for the performance bond to be for an amount equal to 10% of the Contract Sum and for the bond to expire at practical completion.

Both the Parent Company Guarantee and the Performance Bond will be made out in favour of the SPV, essentially providing protection to the SPV in respect of the Building Contractor’s
The Funder will take a legal charge over both forms of security so that it has a priority interest in the event that a claim arises, this protecting the Funders investment in the SPV. Arguably the guarantee and bond serve two different purposes and one is not a substitute for the other although it is not uncommon for Building Contractors to resist giving both forms of security.

The Building Contractor will subcontract all of its obligations to various subcontractors and professional designers. These subcontractors and designers will to differing degrees give collateral warranties to the SPV, Funder and Authority, guaranteeing the works that they perform and providing the recipient of such warranties security in the event that the Building Contractor does not perform or enters into insolvency. The Authority should not however need to call on these documents unless the SPV and Building Contractor fail.

The Building Contractor will likewise enter into a form of collateral warranty called a Direct Agreement with both the Funder and Authority. The precept behind such Direct Agreements is to provide the Funder and Authority with protection should the SPV not perform or itself enter into insolvency. The Direct Agreements, inter alia, give the Funder and the Authority the right to take over the Building Contract in order for the works to be completed in the event of SPV default. It should be noted that the Authority Direct Agreement usually ranks below the Funder Direct Agreement meaning that the Authority can only step-in if the Funder elects not to.

The Facilities Management Contractor will enter into almost identical contract arrangements as the Building Contractor, although no Performance Bond will be granted.

It is nowadays also common for the Building Contractor and Facilities Management Contractor to enter into an Interface or Cooperation Agreement. The form of agreement will vary enormously from project to project, but the most common purpose of the agreement from the SPV’s perspective is to enable any disputes that arise between the Building Contractor and Facilities Management Contractor to be resolved between themselves thus avoiding the involvement of the SPV.

Practical Completion of the facility will be certified by an independent third party or certifier pursuant to an “Independent Certifiers Appointment”. The parties to this appointment will usually be the SPV, Funder and Authority and the appointment gives the Authority the right to make representations about completion although not to direct whether certification can take place or not.

The SPV will also need to enter into financing agreement with the Funders for the debt required to fund the facility and agreements with the shareholders of the SPV for junior debt and equity.
Session 2 –
Understanding the Project Agreement and the SPV
OVERVIEW OF A TYPICAL PROJECT AGREEMENT & PROVISIONS RELEVANT TO THE PERIOD

In the early days of PFI it was common practice for Project Agreements to be negotiated on a project by project basis. The Project Agreement would have been put together by the Authority’s’ advisors, simply by cutting and pasting the best of those agreements that the advisors previously worked upon. The outcome was often unacceptable not only because the agreement rarely made complete sense, but because there was detailed and protracted negotiations on every single project as to the risks that the SPV thought should be accepted. There was also last minute changes of commercial positions, generally on the part of the private sector.

Alert to the problems of “reinventing the wheel”, HM Treasury released guidance in the form of SOPC (Standardisation of PFI contracts) which prescribed the risks that the private sector should accept when PFI contracts are negotiated. SOPC has been revised on numerous occasions throughout the years, the most recent being version 4 published in 2007 (subjected to regular revision). The problem however, with SOPC 4 is that although it does provide guidance as to allocation of risks, it still leaves provisions to be negotiated. To some extent there has been further standardisation particularly in the Health and Education sectors where entire forms of Project Agreements have been drafted, with the parties only being at liberty to negotiate projects specific issues.

In other sectors very often the Project Agreement will be based upon one of the standard forms, so for example a Fire and Rescue project which achieved Financial Close in 2009 was very much based upon the BSF (Building Schools for Future) Project Agreement. However, the individual who drafted the Project Agreement, whilst following BSF where it suited the public sector, deviated from the BSF form where there was any risks which they did not like. Such an approach really does not assist as the majority of organisations within the private sector and their lawyers are alert to such practice.

So, notwithstanding the fact that different sectors may have their own standard form of Project Agreement, and indeed as new sectors have developed the need for new or bespoke Project Agreements arises, due to SOPC the majority of Project Agreements now follow a similar form with a similar allocation of risk. Therefore, although we cannot today look at one form of Project Agreement and say that it is atypical to the entire industry, it is possible to look at a Project Agreement and consider the key risks and issues to which the parties need to be aware.

There is little doubt that the size of Project Agreement means that most people are intimidated by its complexity before they even turn its front page. The main body of a Project Agreement typically extends to 200 pages of text and the Schedules to 400 pages of text. The schedules when populated with the project specific information, such as Authority’s Requirements, Contractor’s Proposals, Service Specifications and the ancillary documents cause the contact to then span a dozen or more lever-arch files.

The reality is that very few people would be able to read and absorb the contents of such contracts. The reality is that both the Authority and SPV prior to Financial Close will have had a team of lawyers, financial advisors, insurance experts, building professionals and facilities management experts looking after their respective parts of the contract. Rarely however would these professionals be able to able to advise on one of their fellow professionals areas of
expertise. At Financial Close a number of these experts will disappear their job considered done. Likewise at Practical Completion and then Service Commencement. When the project is operational the Authority’s representative is then expected to understand an agreement that previously a team of professional advisors themselves had struggled to get to grips with. This is a fundamental problem of PFI, but a problem which is here to stay.

Notwithstanding this problem it is worthwhile briefly considering a Project Agreement in an attempt to demystify its contents and assist those that need to understand the same. The entire Project Agreement can never be dispensed with, there will always be a need to refer back to the contract one day, but an understanding of its structure enables one to appreciate that the majority of it can be put to one side for much of the time. Although there is no substitute for reviewing the entire agreement, the practical realities are that this cannot be done and indeed is generally not necessary.

The main body of the Project Agreement is split into a number of sections along the lines of the sample Project Agreement index at Appendix 3. The exact sections vary depending upon the form of the Project Agreement, but the key issues are often bundled together in the same way. Due to the fact that the Project Agreement is compartmentalised it is usually possible simply to go to the relevant section when an issue arises.

Below I set out the main sections of the Project Agreement clauses.

**Section A – Preliminary**

This section, usually relatively short, deals with the introduction to the project. It includes the recitals explaining the history to the project and why it has been entered into. There are very generic references to the obligations of the parties.

**Section B – General provisions**

This may or may not be wrapped into the “Preliminary” provisions and includes such things as warranties, indemnities, project terms and the parties’ representatives. Again they are very generic in nature and although relevant do not go to the core of the parties’ obligations.

**Section C – Land issues**

This usually simply deals with the SPV’s interest in the land which generally is by way of licence as opposed to ownership as is demanded for taxation reasons. Some of the earlier projects may provide something different.

**Section D – Design and Construction**

These are the obligations that relate to design and construction of the facility. From the sample index at Appendix 3, it will be seen that the obligations only stretch to about 20 pages which when compared to a standard building contract for a project of similar magnitude may be surprising. The wording is also relatively straightforward and certainly easier for the layperson to understand than a JCT contract.
These clauses will deal with such things as the obligation to construct and matters that must be taken into account by the Building Contractor during the construction phase, such as rights for the Authority’s representatives to attend site, dates for completion, and the process of certification by the Independent Certifier. This section may also deal with such things as extension of time, delaying events and entitlement to loss and expense i.e. Compensation Events. If not they will be addressed elsewhere.

Section E – Services

The next critical section is that of Services, being the services to be provided during the operational phase post Practical Completion. This section is far more detailed and typically stretches to 40 or 50 pages, although many pages do address employment and pensions.

For those in the Authority managing the operational phase of the project this section must be read and understood even if the majority of other sections in the Project Agreement are not. This section will deal with the services to be provided, the maintenance of the building, the monitoring of services and other such matters like Benchmarking and Market Testing.

Although the Authority’s representative needs to be aware of all the provisions in this section, on a day to day basis many will not be relevant. The Benchmarking and Market Testing clauses will only be applicable in the period running up to and around the Market Testing Date. The Authority’s representative will almost certainly require expert advice to understand the employment provisions which concern any tupe transfers, but again on a day to day operational basis may not be relevant.

Section F – Payment and financial matters

This section deals with the mechanics for payment and processes that must be followed by both the SPV and the Authority. This section deals with other matters relevant to finances. This section usually cross refers to the more detailed Payment Mechanism Schedule. It is critically important that the Authority is aware of these provisions to ensure compliance by the SPV and further to ensure that the Authority is able to challenge payment and secure best value.

Section G – Termination

Termination of the Project Agreement is a drastic step and one that has been rarely activated. However, under this section provision is made setting out the Default Events on the part of both the SPV and the Authority which entitle the non defaulting party to terminate the Project Agreement.

Although the most obvious ground for termination is inadequate performance, there are also other reasons for termination such as breach of the Prohibited Act provisions and Refinancing.
This section also addresses compensation that is due upon termination which is dependent upon the reason for the termination.

**Section H – Delay Events, Relief Events and Compensation Events**

These events may be dealt with elsewhere rather than inserted into their own specific section. It will invariably be the SPV that triggers the request for such event because it entitles the SPV to either an excuse for non performance or a claim for additional payment.

**Section I – Miscellaneous**

Various boiler plate and other provisions will be included within this section depending upon the sector Project Agreement.

Having broken down the above sections, it is immediately apparent that out of the 200+ pages of Project Agreement Clauses, for operational day to day purposes the Authority’s representative should usually be able to effectively manage the project by being familiar with only a fraction of the total number of clauses. The representative needs to know of the existence of the other clauses so that when an issue arises he or she can refer to them, but if the representative is new to PFI then he should concentrate first on becoming familiar with those provisions concerning the Services provision and payment. Over time the representative will become familiar with the other clauses, but familiarity will come a lot easier through practical application as and when matters arise.

The bulk of the Project Agreement will be made up by the schedules which are really where the important parts of the contract lie. It is the schedules which will determine whether the service that the Authority is anticipating is required to be supplied and which also determines the respective liabilities of the parties. Although it is sensible to familiarise oneself with all the different schedules, those critical to service provision in the sample Project Agreement are likely to be the following:

**Schedule 8 – Construction matters**

This section will set out in detail what is to be built by the SPV. The section will typically set out detailed design and information including the Authority’s Requirements and the SPV Proposals. It will set out the design that has been developed to date including room data sheets, 1:50 drawings and other standards that are to be met.

The construction schedules will typically amount to several boxes of files although provided completion has been certified and there are no subsequent issues with the building then it is unlikely that the majority of the schedules will be of any routine interest to Authority’s representative. If however a problem arises with the delivery of the service that is not being rectified then it may indeed be that the underlying reason is construction related and regard will then need to be given to these schedules.
Schedule 10 - Review Procedure

This has real significance to the Construction Phase. Although there may be times when it is applicable to the Operational Phases (and a key word search of “Review Procedure” will inform you of this), it will not be used on a day to day basis. A sensible solution may be to understand when it applies and to then ensure it is consulted at that time.

Schedule 13 - Equipment

This section sets out the equipment to be provided by the SPV. The contents of this section vary enormously from project to project obviously to meet the requirements of the Authority. Again the amount or quality of equipment will have been set at Financial Close although a difficulty within the Operational Phase is keeping track of the amount of equipment in a facility and liability for replacing missing equipment.

Schedule 14 – Services Specification

This sets out in detail the services to be provided by the SPV during the Operational Phase together with the standards to which they are being supplied and any method statements. Consideration of these schedules is critical to understand what the SPV is contracted to supply and where, if any, there is a deficiency within the services.

Schedule 17 – Benchmarking and Market Testing procedures

This is the process to ensure that the SPV continues to provide the services at best value. This requirement is addressed later in more detail.

Schedule 18 - Payment Mechanism

This is the mechanism which governs the payment to be made to the SPV and performance monitoring.

Schedule 21 – Insurance

It is important to understand how the finances of the Insurance interfaces with the Project because it may well be that significant savings or rebates are due but which the SPV has not advised of.
Schedule 22 Variation Procedure

This is the procedure that should be followed whenever a variation is instructed either by the Authority or SPV. Where a variation is contemplated then adherence to this schedule is necessary.

Schedule 26 Dispute Resolution Procedure

In the event of any dispute arising then regard should be given to this procedure.

Schedule 29 Re-financing

On a day to day basis this schedule is of little interest. However, if a refinancing is proposed or undertaken then obviously it will be in accordance with this Schedule.

There are of course other Schedules which will from time to time be of importance, such as Employment Schedules, control of the Financial Model and general information. Although awareness of these schedules is necessary, a detailed understanding for day to day operational issues is not required.
Understanding what the SPV is contractually obliged to provide.

There are of course two main and distinct obligations upon the SPV during the operational phase. These are firstly to make the facility and all of the components for which the SPV is responsible available, and secondly to provide the services that the SPV has contracted to provide. Failure to provide the former will lead to Unavailability and failure to provide the latter, Service Failure. To understand what services the SPV has agreed to supply and to what standards then regard must be given to the Services Specification which must also be read in conjunction with the Payment Mechanism.

If, for example, lighting does not meet the levels required in the Project Agreement, the heating of the building does not accord with the Project Agreement or for example, there is inadequate supply of drinking water then the facility could be said to be Unavailable (depending upon the stipulations within the Project Agreement).

If there is a requirement for the SPV to provide a service and it does not do so or it does not do so in accordance with the Services Schedule then there is a Services Failure. On occasions a single event may be both an event of Unavailability and a Service Failure.

Issues that commonly arise within the Operational Phase

Generally the issues that arise within the Operational Phase relate to a perception that the Authority is being over charged, perhaps by the incorrect application of the Payment Mechanism, or that the Authority is not receiving the service that it was anticipating.

The complaints that arise relate generally to an Authority’s perception which may or may not be correct. In both situations it is necessary to measure what the complaint is by comparing supply against the contractual requirements.

The issues that frequently arise throughout the Operational Phase invariably relate to a miss-match between the expectations of the Authority and that which the SPV is required to provide. In this respect, it is absolutely critical that the Authority is fully conversant with the obligations imposed upon the SPV by the Project Agreement. Essentially if the contract does not provide for the SPV to provide a given service or maintain to a given standard, then there is no contractual obligation upon the SPV to do so.

On occasions it may be the case that the SPV genuinely misunderstands a contractual requirement and hence does not give regard to the Authority’s position. If the Authority is adequately armed with the contract knowledge then the SPV will take note. If the Authority cannot back up its requests with contractual justification then the SPV will simply demand a change before it takes any action.
Section 3 –
Other Operational Issues
INSTRUCTING VARIATIONS AND PRICING ISSUES

The instruction of variations and the cost associated therewith is possibly one of the most controversial elements of PFI. Because PFI contracts are let over such long periods of time there will always be variations to the provision of services or extension/remodelling. Such variations invariably are more expensive under PFI than traditional procurement.

Although variations do occur within the construction phase they are less frequent to those within the Operational Phase. Indeed Authorities are discouraged from making variations within the construction phase because they can have a significant impact upon the funding requirements and very often make what was an affordable project, unaffordable.

So, let’s consider the issues dealing with variations and how to secure best value from such variations.

The Authority must appreciate that under PFI they have effectively purchased a building and the maintenance of that building for the duration of the Operational Phase, together with any services that are also to be provided. Any variation request will necessitate a change under the Project Agreement. However, the variation needs to be assessed by the SPV in the context of the 25 – 30 year term, and so in addition to the immediate cost of effecting a variation the SPV will also charge for the cost of providing a different service, for maintaining that variation for the Operational Phase and any lifecycle.

If we take the Dispatches example of the £333.00 cost of changing a light switch, invariably the cost included the SPV’s assessment of maintaining that light switch over the remaining term of the project. This is perhaps not a very good example, but becomes clearer in the context of a school requesting a new shed being built on the school grounds; the SPV may charge £1000 for its original construction but then a further £2,000 in respect of maintenance and lifecycle. The school is not just buying a new shed but rather a new shed that is required to be maintained to Project Agreement standards for the remaining project term. In addition the SPV will add management costs associated with managing this change and perhaps an element of profit.

Where a variation requires an amendment to the Project Agreement then the authority will also be required to pay the SPV’s legal costs and even those of the SPV’s Funders and subcontractors. As a consequence, what may initially have been seen as a minor change can suddenly incur substantial additional costs.

Change procedures have become increasingly complicated. It is important that those administering PFI contracts are familiar with the procedures and strictly adhere to the same in situations where the Authority wishes to instruct a variation, where the SPV seeks to instruct a variation or argues that it is entitled to additional payment because of a deemed variation.
In recognition of the disproportionate costs associated with relatively small variations both in terms of cost and contract administration, modern Project Agreements contain a provision to address the issue of small work variations. A typical provision may appear as follows:

“Small Works” means any change to the Authorities’ Requirements requested by the Authorities having an individual cost not exceeding one thousand pounds £1,000 (indexed), or as otherwise agreed from time to time, except for any request which will (if implemented) increase the likelihood of the Contractor failing to meet the Authorities’ Requirements or materially and adversely affect the Contractor’s ability to perform its obligations under this Agreement;

It should be noted that the threshold will change on a project by project basis. The £1000.00 referred to above which was extracted from a Fire and Rescue PFI is arguably far too low and it is not uncommon for Authorities to seek thresholds of £10,000 or even £100,000. There can be no doubt that an Authority obtains considerable advantage from such provisions.

The drafting for a small works variation may look something like the following:

1. **Small Works Changes**

   1.1.1 Twenty (20) Business Days prior to the Planned Services Availability Date for a Station and the commencement of each subsequent Contract Year for the first ten (10) years, and within forty five (45) Business Days of any request in any subsequent Contract Year, the Contractor shall propose a schedule of rates (such schedule to itemise any management fee proposed to be charged) to be agreed with the Authorities (the “Small Works Rates”), such agreed rates to be applied in respect of any request from the Authorities for Small Works to be completed during that Contract Year.

   1.1.2 The value of any Small Works shall be calculated on the basis that:-

   (a) the labour element (where such Small Works are not carried out by an existing on-site and suitably qualified Contractor or Contractor Related Party employee) shall be calculated in accordance with the Small Works Rates or, where such rates are not applicable, in accordance with rates which are fair and reasonable; and

   (b) for the first six instances of Small Works in each Station in each Contract Year, the materials element shall be charged at the cost of materials to the Contractor or to the contractor carrying out the work (net of all discounts) and there shall be no management fee in relation thereto; and

   (c) for the seventh and each subsequent instance of Small Works in any Station in each Contract Year the materials element shall be charged at the cost of materials to the Contractor or to the contractor carrying out the work (net of all discounts) plus seven and a half percent (7.5%)
Provided that wherever practicable the Contractor shall procure that such works are carried out by an existing on-site and suitably qualified Contractor or Contractor Related Party employee with no labour element being charged to the Authorities.

1.1.3 The Contractor and the Authority shall agree the timing of any Small Works, so as to minimise any inconvenience to the Authorities. The Contractor shall take all reasonable steps to minimise the duration of any Small Works.

Any dispute between the parties relating to Small Works shall be determined in accordance with the Dispute Resolution Procedure.

There are some difficulties with the above drafting. First, the Small Work Rates should always be an initial contract document to ensure a reasonable benchmark is initially set. However, apart from this it does seem a very efficient and fair way to procure Small Works.

If an Authority finds that it is instructing a lot of relatively small variations, say under £10,000, and yet is having to use the long winded variation procedure, then it is recommended that discussions be held with the SPV about amending the terms of the Project Agreement so that the small works threshold is increased.

It is however a matter of fact that many variations will fall to be assessed within the main variation procedure. The Authority must consider any variation proposed in terms of its Best Value obligations and should ensure that robust methods for costing are demonstrated by the SPV for all variations, and that the SPV has signed up to the Authority's procedures when providing quotes for works of any significance. The Authority should challenge information provided by the SPV to ensure they are satisfied with its robustness and also to demonstrate that they are achieving best value. The Authority must not just accept the SPV costings believing that it has nowhere else to go.

The procedures to be followed for enacting a variation will be stated in the Project Agreement. This will include timescales for responses from each party for approval and the documentation to be produced. Some Project Agreements require formal deeds of variations to vary the Project Agreement following a variation; in view of the costs associated with this, thought should be given as to how this requirement could be varied.

An example of a variation clause dealing with the fuller procedure of addressing variations is set out below.

The first requirement is for the Authority to serve a Notice of Change upon the SPV. The SPV is obligated to comply with the Change Notice save in the given specific examples.

**Authorities Change**

1.1 The Authorities have the right to propose changes in Service (other than Changes made in accordance with clause [ ] (Small Works Changes)) in accordance with this clause 1 (Authorities and Contractor Changes). If the Authorities require an Authorities’ Change, they must serve a notice (an “Authorities’ Notice of Change”) on the Contractor in accordance with clause 1.2 (Authorities’ Notice of Change) on the Contractor in
accordance with clause 1.2 (Authorities’ Notice of Change”). The contractor shall be entitled to refuse an Authorities’ Change which:-

1.1.1 requires the Works and/or the Services to be performed in a way that infringes any law or is inconsistent with Good Industry Practice;

1.1.2 would cause any existing consent to be revoked (or would require a new consent to be obtained to implement the relevant change in the Works and/or the Services which, after using reasonable efforts, the Contractor has been unable to obtain);

1.1.3 would materially and adversely affect the Contractor’s ability to deliver the Works and/or Services (except those Works and/or Services which have been specified as requiring to be amended in the Authorities’ Notice of Change in a manner not compensated pursuant to this clause 1);

1.1.4 would materially and adversely affect the health and safety of any person;

1.1.5 would increase the Contractor’s capital costs by more than fifteen percent (15%) (in aggregate);

1.1.6 would require the Contractor to implement the change in Works and/or Services in an unreasonable period of time;

1.1.7 would, if implemented, materially and adversely change the nature of the Project (including its risk profile); or

1.1.8 The Authorities do not have the legal power or capacity to require implementation of such Authorities’ Change.

The next step is for the Authority to ensure its notice sets out the requisite detail remembering the requirement to address the issue of capital expenditure. It should be noted that it is unlikely to ever be cost effective for an Authority to request that the SPV finance the capital expenditure due to the cost of finance and the additional management and legal fees to be added to the variation

1.2 **Authorities’ Notice of Change**

The Authorities’ Notice of Change shall:-

1.2.1 set out the change in the Works or Services required in sufficient detail to enable the Contractor to calculate and provide the Estimated Change in Project Costs in accordance with clause 1.2.3 (Contractor’s Estimate);

1.2.2 in the event that the Authorities’ Change will require Capital Expenditure, state whether the Authorities intend to pay the Contractor the costs involved in implementing the change or whether the Authorities require the Contractor to use its reasonable efforts to obtain funding in accordance with the clause [ ] (Funding for Capital Expenditure); and
require the Contractor to provide to the Authorities within fifteen (15) Business Days of receipt of the Authorities’ Notice of Change either:-

(a) confirmation as to when the estimate is to be provided to the Authorities (provided that the Contractor shall use all reasonable endeavours to obtain such information as is required expeditiously); or

(b) an estimate of the likely effects of the proposed variation (the “Estimate”).

The next step is for the SPV to serve upon the Authority the SPV’s estimate for undertaking the variation. These costs are almost always likely to be excessive in the first instance and the Authority should expect to interrogate and negotiate the same with the SPV, taking into account its obligation to secure best value.

The Authority should be alert to the fact that the SPV will doubtless in the first instance just forward its subcontractor’s estimate and add on its own costs without interrogating the same.

1.3 Contractor’s Estimate

As soon as practicable and in any event within fifteen (15) Business Days after having received the Authorities’ Notice of Change, the Contractor shall deliver to the Authorities the Estimate or confirmation as to when the Estimate is to be provided to the Authorities. The Estimate shall include the opinion of the Contractor on:-

1.3.1 whether relief from compliance with obligations is required, including the obligations of the Contractor to achieve the Start on Site Date, each Planned Services Availability Date and meet the requirements set out in the Authorities Requirements during the implementation of the Authorities’ Change;

1.3.2 any impact on the provision of the Works and/or the Services including whether the proposed change is in contravention of clause 0;

1.3.3 any amendment required to this Agreement and/or any Project Document, Ancillary Document or Financing Agreement as a result of the Authorities’ Change;

1.3.4 any Estimated Change in Project Costs that results from the Authorities’ Change;

1.3.5 any loss of or increase in revenue that results from the Authorities’ Change;

1.3.6 any Capital Expenditure that is required or no longer required as a result of the Authorities’ Change;

1.3.7 any regulatory approvals which are required; and

1.3.8 the proposed method of certification of any construction or operational aspects of the Works or the Services required by the proposed Authorities’ Change if not covered by the procedures specified in clause Error! Reference source not found. (Notification of Services Availability).
The next stage is for there to be discussions on the change in an attempt to agree a value. The Authority should be mindful of the points that are raised above.

1.4 Discussion

As soon as practicable after the Authorities receive the Estimate, the parties shall discuss and agree the issues set out in the Estimate, including:

1.4.1 providing evidence that the Contractor has used reasonable endeavours (including (where practicable) the use of competitive quotes) to oblige its Sub-Contractors to minimise any increase in costs and maximise any reduction in costs;

1.4.2 demonstrating how any Capital Expenditure to be incurred or avoided is being measured in a cost effective manner, including showing that when such expenditure is incurred, reasonably foreseeable Changes in Law at that time have been taken into account by the Contractor; and

1.4.3 demonstrating that any expenditure that has been avoided, which was anticipated to be incurred to replace or maintain assets that have been affected by the Authorities’ Change concerned, has been taken into account in the amount which in its opinion has resulted or is required under clause 1.3.4 (Contractor’s Estimate) and/or 1.3.5 (Contractor’s Estimate);

In such discussions the Authorities may modify the Authorities’ Notice of Change, and (if the estimated increase in Capital Expenditure in respect of the Authorities’ Change is expected to exceed fifty thousand pounds (£50,000) (indexed) and it is practical for the Contractor to do so) the Authorities may require the Contractor to seek and evaluate competitive tenders for the relevant capital works. In each case the Contractor shall, as soon as practicable, and in any event not more than ten (10) Business Days after receipt of such modification, notify the Authorities of any consequential changes to the Estimate.

The obligation to secure best value is usually also expressly set out within the Project Agreement. In some sector forms there will be considerable text on the requirement and solutions if the Authority requires a change in order to secure best value.

If the cost cannot be agreed then there can be a reference to Dispute Resolution to resolve the issue of what is a fair cost. The Authority should not be afraid to use this avenue if it has good reason to believe that the variation is not being priced reasonably. The SPV will be concerned that it may be compelled to effect the variation at a cost lower than that which the Authority would otherwise accept and may for this reason alone prefer to reach a compromise with the Authority. Further if the decision is not what the Authority expected then it can simply abandon the variation request, although it will in such circumstances acquire a liability in respect of the SPV’s costs of preparing the estimate.

1.5 Value for Money

If the Contractor does not intend to use its own resources to implement any Change it shall comply with Good Industry Practice with the objective of ensuring that it obtains best value for money (taking into account all relevant circumstances including, in particular, the requirements that the Contractor should not be worse off as a result of the implementation of the Authorities’
Change) when procuring any work, services, supplies, materials or equipment required in relation to the Authorities’ Change.

1.6 **Disputes**

If the parties cannot agree on the contents of the Estimate, then the dispute will be determined in accordance with the Dispute Resolution Procedure.

The next step is for the Authority to either confirm or withdraw the variation. Note in some contracts the Authority will be liable for the costs of the SPV preparing the variation estimate.

1.7 **Confirmation or Withdrawal of Authorities’ Notice**

As soon as practicable after the contents of the Estimate have been agreed or otherwise determined pursuant to the Dispute Resolution Procedure, the Authorities shall:-

1.7.1 confirm in writing to the Contractor the Estimate (as modified); or

1.7.2 withdraw the Authorities’ Notice of Change.

For the avoidance of doubt, the Authorities shall only be liable for the sum set out in the Estimate as confirmed by the Authorities in accordance with clause 1.7.1 above.

The Authority should always be alert to its liability for the costs of the estimate before proceeding with the variation request. In some contracts the Authority is liable for the costs of preparing the estimate but on others only if it has agreed to pay such costs. In other cases the Authority is only liable if it has agreed the variation but then chooses not to proceed or alternatively proceeds to dispute resolution and then decides not to proceed. In some projects the Authority is able to make a number of withdrawn requests before it is liable for costs. It really does vary on a project by project basis and so the Authority must check the particular provisions of a Project Agreement.

1.8 **Failure to Confirm Authorities’ Change**

If the Authorities do not confirm in writing the Estimate (as modified) within twenty (20) Business Days of the contents of the Estimate having been agreed in accordance with paragraph (d) above or determined pursuant to paragraph (e) above, then the Authorities’ Notice of Change shall be deemed to have been withdrawn. Where there is such withdrawal (either pursuant to this paragraph (h) or paragraph (g) above) the Authorities shall pay to the Contractor the reasonable additional third-party costs incurred by the Contractor in preparing such Estimate provided that:-

1.8.1 the Contractor has used all reasonable endeavours to submit a reasonably priced Estimate;

1.8.2 the Contractor has made available to the Authorities a cost breakdown of the Estimate including an estimate of third-party costs to be incurred by the Authorities if the Authorities’ Notice of Change is withdrawn or deemed to be withdrawn;

1.8.3 the Authorities have:-
(a) approved the estimate of third-party costs referred to in paragraph (ii) above and the type of third-party prior to any third-party costs being incurred; and

(b) agreed that, given the nature of the proposed Change, it is reasonable to expect the relevant third party to incur costs in preparing the Estimate on the basis of the extent of the proposed change to the Services or the Works and the work required in submitting an accurate Estimate in compliance with this Clause Error! Reference source not found.; and

1.8.4 the Contractor has provided the Authorities with such evidence as they may reasonably require in order to verify the additional third party costs incurred by the Contractor.

It is worth mentioning that The National Audit Office issued a report in 2008 entitled “Making Changes in Operational Contracts” which is a useful read. The NAO recognised that very often the public sector secured poor value for money when implementing changes under PFI Contracts. Within its reports it made a number of useful recommendations which if followed should assist Authorities. The summary of the NAO Report advised:

“The Treasury has recently produced guidance for new PFI projects coming to the market which sets out good practice in the management of changes. The value for money of individual changes to existing projects varies but value for money is not generally being obtained.

The following recommendations are intended to complement the new guidance published by the Treasury and are aimed at PFI projects that are already operational:

(a) Where there is a relevant contract clause, competitive tendering should be undertaken if Authorities deem this to be value for money and they should insist on at least three competitive tenders being obtained for larger changes. In the absence of a contractual clause requiring competition, Authorities should negotiate such a clause when the opportunity arises. For example, as part of negotiations needed during benchmarking or market testing exercises, which are part of regular reviews of PFI contracts.

(b) For existing deals, Authorities need to put in place consistent and robust means to validate the costs of small changes. Authorities should consider carefully the need to pay lifecycle costs for the replacement of small items and challenge inappropriate costs. They should also consider the advantages of bundling together the processing of small changes, including the negotiation of appropriate lifecycle costs, and agreeing any adjustments to the unitary charge once every six months or yearly.

(c) Public authorities should explore with their private sector partners the feasibility of clarifying earlier contracts to bring them into line with current best practice. For instance, Authorities could seek to re-negotiate SPV fees when discussing major asset changes, as happened at the Blackburn hospital.

(d) Information is not shared across locally managed PFI projects as widely as it needs to be. Authorities should develop forums whereby questions and answers on the handling of changes and their costs can be shared within and across sectors. Authorities should also make more use of central government resources already provided, for instance the training courses, helpline and websites run by
Partnerships UK (PUK) and 4ps who are the bodies which provide help and guidance to central and local government PFI projects.

(e) Contract management teams should be properly resourced in order to manage the change process. In general, it should be exceptional for a PFI contract not to be managed by the equivalent of at least one person full-time on the public sector side, and there should be more than this for larger contracts or where a lot of changes are anticipated. Authorities should also consider employing a quantity surveyor on a part-time basis specifically to check the cost of changes, where the number of changes processed is likely to justify it.

(f) Public sector authorities can also improve the value for money of changes by adopting the good practices used in some projects. These include:

   (i) Adopting a strategic approach to changes – for instance, bundling similar changes together to reduce costs or planning a change programme based on anticipated needs.

   (ii) Understanding the contract to be sure that a change request is actually a change and not covered under the existing agreement and pricing structures.

   (iii) Keeping good permanent records of changes and payments made, including whether new assets will need to be replaced at some point during the remainder of the contract and form part of the lifecycle cost element of the unitary charge paid to the SPV. Failure to do so risks paying for something twice at a later point in the contract when, for instance, works are already covered by lifecycle cost payments.

   (iv) Providing their private sector partners with proper briefs to make it clear what they want done. This is especially important for larger, more complex changes.

   (v) Using effective validation mechanisms to challenge costs when necessary, including the use of industry-wide benchmark prices and the experience of other PFI projects.

   (vi) Fostering open lines of communication with front-line users and other stakeholders, as well as the PFI contractor. This is necessary in the operational phase as head teachers, medical and nursing staff and other users have narrower scope to act autonomously in arranging for work to be done in the context of a contractual relationship than they may have had previously."
The requirements for Benchmarking and Market Testing

Due to the long term nature of PFI projects there has to be some mechanism built into the Project Agreement whereby checks are performed to ensure that the Authority continues to receive value for money from the SPV. This however is a double edged sword. Opponents to PFI argue that benchmarking enables the SPV to win a project on artificially low terms and to subsequently increase its costs through these procedures, thus turning a loss making contract into a profit making one at the expense of the taxpayer.

The Construction Phase of the project will be fixed with no entitlement to additional costs for indexation. Within the Operational Phase however there needs to be some form of provision for the increase in costs over the project’s life span. One method of doing this will be indexation, and the Project Agreement will provide within the Payment Mechanism for the indexation of costs on a yearly basis. Indexation may be pegged to RPI but as wage inflation is often above to RPI, it is not unusual for the Payment Mechanism to provide for a percentage increase in addition to RPI, e.g RPI +1. This really will change from project to project and so it is necessary for the Authority to consider the requisite provisions of the Project Agreement to ensure they are being correctly charged by the SPV for any increase in RPI (or indeed reduction). Incorrect application of the indexation provisions could result in a significant windfall for the SPV.

Market Testing and Benchmarking (the combined test referred to herein as “Value Testing”) work in addition to indexation but only relate to certain of the soft FM services as provided for within the Project Agreement, such as cleaning, catering and security. Hard FM services should not be Value Tested. It is an exercise that it usually carried out every five to seven years, with the exact details again being provided for within the Project Agreement.

Many of the projects that reached Financial Close in 2002 are only now becoming due for Value Testing. The complexities, time and cost required to undertake such exercise has reportedly deterred many Authorities from undertaking this process. However, the best value obligations placed upon the public bodies compel Authorities to undertake such processes.

Again the exact requirements for Market Testing and Benchmarking will be set out within the Project Agreement and the procedures vary in complexity from about fifteen pages of text in NHS Projects to about 2 pages seen in a recent Fire and Rescue Project. Generally however the more modern Project Agreements provide extensive and clear guidance for the process. In some of the older Project Agreements where the processes are not so clear the procedure to be followed will need to be negotiated and agreed.

Benchmarking has been defined as:

“an exercise undertaken by the SPV to compare the quality and cost of the Services on the basis of an objective and like for like comparison by comparing the standards and prices of the Benchmarked Services in question and the costs of providing them with the standards and prices of equivalent services and the costs of providing them in similar circumstances provided by reputable organisations possessing an appropriate degree of skill, resources, reputation and financial standing relative to the provision of the Benchmarked Services in question.”
It is usually the case that the SPV will disclose details of the benchmarking exercise to the Authority, say, three – twelve months, before the date stipulated for Market Testing with the idea being that the SPV and Authority can use this data to assess whether the charge being made by the SPV is fair and reasonable or whether there should be an adjustment to the Unitary Charge. The Project Agreement usually provides that if the benchmarked costs are between 95% -105% of the Unitary Charge then no change is made to the Unitary Charge. If however the costs are less than 95% or more than 105% of the Unitary Charge then the parties should meet to endeavour to agree the changes to the Unitary Charge.

A real flaw in the concept of Benchmarking within PFI contracts has been the lack of comparative data. Although the Project Agreement may provide for the SPV to compile the data, the Authority cannot adequately discharge its best value obligations unless it interrogates the data source and provides its own comparators and therefore in reality the Authority must share the burden of compiling data with the SPV. The sources of data collection is something that should be agreed with the SPV at the outset of the process when the methodology and timetable for benchmarking is agreed. The Authority should also note that Benchmarking is to be an open-book basis with the data and data source being open to review and challenge.

Market Testing is essentially a process whereby alternative tenders are requested for the Value Tested Services in order to ensure that the SPV continues to offer value for money. It is a far more comprehensive process than Benchmarking and one that is preferred by HM Treasury as providing better value for money because it enables requirements to be better matched with provision. Market Testing is often a process undertaken where either there is no agreement as to the adjustment of the Unitary Charge following Benchmarking or where no Benchmarking has been undertaken.

The Market Testing procedure usually requires the parties to agree a given number of days before the Market Testing Date the number and identity of prospective bidders that will be invited to submit tenders for the Value Tested Services.

The list of prospective bidders will be tightly controlled to include only those that posses the equivalent “skill, resources, reputation and financial standing relative to the provision of the Benchmarked Services in question”. The SPV is only required to compare like with like so if the soft services in question are performed by a leading service provider then bidders should arguably be of similar standing; it is not possible to compare the cost of services with a company of significantly weaker financial standard or one that perhaps is not such a reputable organisation. This is a fundamental problem when undertaking Market Testing.

The next step is for the SPV to prepare and deliver to the Authority a draft Market Testing Proposal describing in detail the SPV's proposed bidders and the Tender Documents for each of the Market Tested Services in question. The proposal has to be agreed by the parties before being put out to tender with any disagreement being resolved pursuant to the dispute resolution procedure.

The SPV should then progress the process of Market Testing by issuing the agreed tenders and collating responses and providing the Authorities with copies of the same. The Authority needs to be mindful of any intent of the SPV to instruct the Facilities Management Contractor to manage such Market Testing because a conflict of interest between the Facilities Management Contractor and the potential bidders clearly exists. It will be noted that HM Treasury
recommends that where a conflict is likely to exist then an “Independent Tender Process Manager” should be appointed.

Guidance issued by various public agencies refers to the need for there to be effective competition within the tender process and for the Authority to drum up interest in the tender process. This is sound guidance but the reality is that there just may not be a wide market of contractors willing to participate in the exercise in order to give Market Testing credibility. Whether or not Market Testing delivers real competition remains to be seen.

However, Market Testing and Benchmarking should also be seen as an opportunity for Authorities re-negotiate those parts of the Project Agreement that they either do not like or which do not work, and to further negotiate a change or reduction in the level or number of services to provide better value for money. The chances are that the SPV will be seeking considerable cost increases at or around the time of Value testing, much of which may be justified. However, by the Authority pushing back hard on its value for money obligations then now is the ideal time for the Authority to secure changes whilst wrapping them up into the Value Testing exercise.

Because so little Value Testing has taken placed there is scant data concerning the successful outcome or otherwise. In June 2007 the National Audit Office published a report “Benchmarking and Market Testing the ongoing services component of PFI Projects” which is a recommended read for those about to embark on the process of Value Testing. The Report commented that the average time taken to complete such process was 9 – 25 months with agreement on price adjustment being particularly difficult and there being a lack of equivalent projects against which to benchmark data. It is worth noting the comment that the movement of costs was generally upwards and mainly in the region of -2 to +6 % which compared favourably to the initial value tests which suggested price increases of up to 19% were required.

For further detailed information on Market Testing it is recommended that HM Treasury’s “Operational Taskforce Note 1: Benchmarking and Market Testing Guidance” of October 2006 be read.
Relief Events, Delay Event and Compensation Events, Force Majeure Events

The terminology is generally the same across sectors with the entitlements being as follows:

Compensation Events:

This is an event which entitles the SPV to compensation from the Authority in respect of the losses that it suffers as a consequence of the event which is classified as a “Compensation Event”.

Over time Compensation Events have been given an increasingly narrow definition so that they widely now usually only include breach of contract on the part of the Authority prior to practical completion. It is difficult to see what the Authority could do prior to practical completion that would constitute a breach of the Project Agreement, although obstruction or deliberate damage would obviously constitute a breach.

Note that the Compensation Event provisions rarely extend into the Operational Phase (save in respect of some of the older Project Agreements) as it is felt that there is little that the Authority could do to constitute a breach apart from non payment, which is remedied by the award of interest.

In addition to breach of contract there are a number of areas where the Authority could be liable to the SPV for compensation although the event that triggers compensation is not usually classified as a “Compensation Event”. These include generally the request to open up works prior to completion where the request was not warranted, certain changes in law, variations, execution by the Authority of non Project work and other risks that the Authority has explicitly accepted under the Project Agreement, such as defects in existing buildings.

Delay Events

Delay Events is a term used in certain Projects (particularly NHS) to give the SPV relief where completion of the facility is to be delayed as a consequence of an event that is classified as a “Delay Event”. This includes those items that entitled the SPV to compensation (as above) in addition to Force Majeure Events and Relief Events (addressed below).

It will be noted that the idea behind the granting of a Delay Event is simply to extend the Completion Date and any Longstop Date so that the SPV could not be said to be completing the facility late. If the Project Agreement provided for the application of liquidated damages (which is unusual) then the entitlement to such damages for the period equivalent to the delay is forgone.

It should be noted that although the Completion Date is extended there is no extension to the Project term so no further liability to the Authority; in fact as a consequence of the delay the Authority pays less for the facility than it would have paid had there been no delay. The fact of the delay will however be of concern to the SPV because it is still required to finance its debt and therefore unless it can pass liability onto its subcontractors it will suffer a financing shortfall as a consequence of the delay. Therefore in the event of a Delay Event both the Building Contractor and indirectly the SPV are incentivised to mitigate the effects of the Delay.
Relief Events

The category of Relief Event is wide ranging and usually includes the following matters:

Relief Event

any of the following:

(a)  Fire, explosion, lightning, storm, tempest, flood, bursting or overflowing of water tanks, apparatus or pipes, ionising radiation (to the extent it does not constitute a Force Majeure Event), earthquakes, riot and civil commotion;

(b)  Failure by any statutory undertaker, utility company, local Authority or other like body to carry out works or provide services;

(c)  Any accidental loss or damage to the Sites or any roads servicing them;

(d)  Any failure or shortage of power, fuel or transport;

(e)  Any blockade or embargo which does not constitute a Force Majeure Event; [or]

(f)  Any:

   (i)  Official or unofficial strike;

   (ii) Lockout;

   (iii) Go-slow; or

   (iv)  Other dispute,

   Generally affecting the construction or facilities management industry or a significant sector of it; [or

(g)  The discovery of fossils, antiquities or human remains requiring action in accordance with clause 18.8 (Fossils and Antiquities)],

Unless any of the events listed in paragraphs (a) to (g) inclusive arises (directly or indirectly) as a result of any wilful default or wilful act of the Contractor or any Contractor Related Party;

The effect of the Relief Event is similar to the Delay Event but the concept applies to both the Construction and Operational Phase. The occurrence of a Relief Event provides the SPV with relief from performing its obligations, which means that it can neither be held in breach of contract for not performing its obligations to the extent that the Relief Event prevents performance nor be at risk of the Project Agreement being terminated. The Relief Event does not entitled the SPV to compensation nor does it relieve the SPV from the application of Deductions for Unavailability or Service Failures.
**Force Majeure Event**

The definition of Force Majeure Event within PFI is extremely limited:

The occurrence after the date of this Agreement of:

a) War, civil war, armed conflict or terrorism;

b) Nuclear, chemical or biological contamination unless the source or cause of the contamination is as a result of any act by the Contractor or its sub-contractors or any breach by the Contractor of the terms of this Agreement; or

c) Pressure waves caused by devices travelling at supersonic speeds,

Which directly causes either Party (the **Affected Party**) to be unable to comply with all or a material part of its obligations under this Agreement;

In the event of Force Majeure then the SPV is likewise excused performance to the extent it is affected by such event, but again relief from Deductions does not apply. In the event that the event of Force Majeure continues for a period of time, usually six months, then the SPV can be given the opportunity to terminate the Project Agreement and the compensation provisions of the Project Agreement then apply.

**Processes**

In respect of all of the above events the Project Agreement will provide a process that must be followed in order for the relief/compensation to be granted. The onus is on the SPV to apply for such relief and so the Authority does not need to act until it receives the requisite notice from the SPV.

The actual procedure will vary from sector to sector and indeed will further depend upon the relief that is being applied for as will the consequences for not so complying, but a relatively standard provision for the requirement to serve notification for a Relief Event will look something like the following:

“If and to the extent that a Relief Event:

is the direct cause of either a failure by the Contractor

a) To commence the Works on or before the Start on Site Date; [and/or]

b) To achieve Services Availability on or before a relevant Planned Services Availability Date or (following the relevant Planned Services Availability Date but before the Longstop Date) is the direct cause of a delay in achievement of Services Availability; [and/or]

c) To achieve completion of the Post Completion Works on or before the relevant Planned Post Completion Works Acceptance Date or (following the relevant Planned Post Completion Works Acceptance Date but before the Post Completion Works Longstop Date) is the direct cause of a delay in completion of the relevant Post Completion Works]; or
d) Adversely affects the ability of the Contractor to perform any of its obligations under this Agreement,

then the Contractor shall be entitled to apply for relief from any rights of the Authority arising under clause (Termination on Contractor Default) [and its obligations under this Agreement].

The Project Agreement will also provide strict procedural requirements, although as a matter of law non compliance with the procedure does not necessarily bar the SPV from recovery. An example of procedural requirements follows:

Subject to clause [(Information), to obtain relief, the Contractor must: as soon as practicable, and in any event within twenty (20) Business Days after it becomes aware that the Relief Event has caused or is likely to cause delay and/or adversely affect the ability of the Contractor to perform its other obligations give to the Authority a notice of its claim for relief from its obligations under this Agreement, including full details of the nature of the Relief Event, the date of occurrence and its likely duration;

Within five (5) Business Days of receipt by the Authority of the notice referred to in clause [(Relief), give full details of the relief claimed; and

Demonstrate to the reasonable satisfaction of the Authority that:

a) The Contractor and its Sub-Contractors could not have avoided such occurrence or consequences by steps which they might reasonably be expected to have taken, without incurring material expenditure;

b) The Relief Event directly caused:

i. The delay in the commencement of the Works on or before the Start on Site Date; and/or

ii. The delay in the achievement of Services Availability on or before the relevant Planned Services Availability Date or (following the relevant Planned Services Availability Date but before the Longstop Date) any delay in the achievement of Services Availability; and/or

iii. Any delay in the completion of the Post Completion Works on or before the relevant Planned Post Completion Works Acceptance Date or (following the relevant Planned Post Completion Works Acceptance Date) any delay in completing the relevant Post Completion Works; and/or]

iv. The need for relief from obligations;

c) the time lost and/or relief from the obligations under this Agreement claimed could not reasonably be expected to be mitigated or recovered by the Contractor acting in accordance with Good Industry Practice, without incurring material expenditure; and
d) The Contractor is using reasonable endeavours to perform its obligations under this Agreement.”

When the SPV serves notice under seeking entitlement for relief then the Authority has no option other than to review the contract to ensure compliance with the contractual requirements. There then follows the award to the SPV of any entitlement, disagreements in respect of which will be referred to Dispute Resolution.
Breaches of Contract.

It is necessary to consider breaches of contract on the part of both the Authority and SPV.

Authority breaches

During the Construction phase the Authority could commit a breach of contract that constitutes a Compensation Event entitling the SPV to a compensation payment and extension of time. The potential liability to the Authority for a Compensation Event will be significant and almost equivalent to the Unitary Charge in respect of any delay caused. The Project Agreements is drafted in such a way however to make it difficult for the SPV to claim compensation for a breach of contract within the Operational Phase.

It should be noted that the ability of the SPV to terminate the Project Agreement for a breach is not aligned to Compensation Events meaning there are other breaches that could result in the SPV having a right to terminate the Project Agreement. The category of breaches do vary from sector to sector but may typically include such things as:-

(a) A failure by the Authority to make payment(s) of an amount of money exceeding (in aggregate) one month’s Unitary Charge (from time to time) before deductions that is due and payable by the Authority under this Agreement within twenty (20) Business Days of service of a formal written demand by the Contractor, where the amount fell due and payable one (1) (or more) months prior to the date of service of the written demand;

(b) A breach by the Authority of its obligations under this Agreement which substantially frustrates or renders it impossible for the Contractor to perform its obligations under this Agreement for a continuous period of [two (2)] months; or

(c) Unlawful transfer or assignment.

The reality however is that it will rarely make sense for the SPV to terminate the Project Agreement and in any event it will not be able to do so without the express consent and involvement of the Funder.

SPV breaches

The SPV on the other hand could quite easily breach one of the many obligations that are imposed upon it. The ultimate consequence of breach is the ability of the Authority to terminate the Project Agreement, although again the Authority will not be able to terminate without first serving notice on the Funder and giving the Funder the opportunity to “step in” and effectively take over the contract from the SPV. Such restrictions are contained in the Direct Agreement entered into by the Authority and the Funder.

Many breaches of contract can be excused if caused, for example, by one of the Relief Events and in this situation the SPV is held blameless for the breach (although does not benefit from any cessation in Deductions). Just because there is an event of Unavailability or a Service Failure it does not necessarily mean that there has been a breach of contract.
Again the categories of “breach” are relatively uniform across all sectors and common provisions defining a SPV breach may look something like the following:

a) Following the Service Availability Date for a Station a breach by the Contractor of any of its obligations and/or warranties under this Agreement which materially and adversely affects the performance of the Services at that [ ];

b) A Persistent Breach occurs;

c) A court makes an order that the Project Co or Holdco be wound up or a resolution or a voluntary winding-up of the Contractor or Holdco is passed;

d) Any receiver or manager in respect of the Contractor is appointed or possession is taken by or on behalf of any creditor of any property that is the subject of a charge;

e) Any voluntary arrangement is made for a composition of debts or a scheme of arrangement is approved under the Insolvency Act 1986 or the Companies Act 1985 in respect of the Contractor or Holdco;

f) An administration order is made or an administrator is appointed in respect of the Contractor or Holdco;

g) failure to comply with clause [ ] (Assignment and Sub-Contracting) or clause [] (Change in Ownership) occurs;

h) the Contractor Abandons the Project at any time;

i) the Contractor has not commenced the Works by the Start on Site Date;

j) the Acceptance Certificate for each Station has not been issued by the Longstop Date;

k) in any three (3) month period the Authorities have been entitled to reduce the amount of the aggregate of the Monthly Unitary Charge for that period by more than seventy five (75) per cent through Unavailability Deductions;

l) in each and every month of any three (3) month period the Authorities have been entitled to reduce the amount of the Monthly Unitary Charge by more than ninety (90) per cent through Service Failure Deductions;

m) in any three (3) month period an individual Station has been Unavailable for twenty(20) days or more;

n) subject to clause 2 (Risks that Become Uninsurable), a breach by the Contractor of its obligations to take out and maintain any of the Required Insurances;

o) the Contractor committing a material breach of its obligations under this Agreement (other than as a consequence of a breach by the Authorities of their obligations under this Agreement) which results in the criminal investigation, prosecution and conviction of the Contractor or any Contractor Related Party or the Authorities under the Health and Safety Regime (an “H&S Conviction”) provided that an H&S Conviction of a Contractor Related Party or the Authorities shall not constitute a Contractor Default if, within ninety (90) Business Days from the date of the H&S Conviction (whether or not the H&S Conviction is subject to an appeal or any further judicial process), the involvement in the Project of each relevant Contractor Related Party (which in the case of an individual director, officer or employee shall be deemed to include the Contractor Related Party of which that person is a director, officer or employee) is terminated and a replacement is appointed by the
Contractor in accordance with clause Error! Reference source not found. (Subcontracting) provided always that in determining whether to exercise any right of termination or right to require the termination of the engagement of a Contractor Related Party under this limb (o), the Authorities shall:

I. act in a reasonable and proportionate manner having regard to such matters as the gravity of any offence and the identity of the person committing it; and

II. Give all due consideration, where appropriate, to action other than termination of this Agreement.

III.

There are some interesting issues that arise from the above definitions including the definition of “Abandonment”, “Persistent Breach” and “Longstop Date”

Persistent Breach a breach for which a Final Warning Notice has been issued, which has continued for more than fourteen (14) days or recurred in three (3) or more months within the six (6) month period after the date on which such Final Warning Notice is served on the Contractor;

The definition of Final Warning Notice is linked into the Warning Notice regime of the Project Agreement. The important point to note is that it should usually exclude any breaches which could be the subject of a Deduction. The regime does however enable the Authority to leverage control over the SPV for other breaches.

Abandon not to carry out any Works contemplated by the Construction Programme at a Site for twenty (20) consecutive Business Days or during sixty (60) Business Days (whether consecutive or not) in any Contract Year;

Although it would be highly unlikely that an SPV would abandon a project the term has been defined to overcome the situation where an SPV leaves just a skeleton staff on site in order to argue that he has not abandoned site.

Longstop Date the date twelve (12) months after the [last] Planned Services Availability Date or such later date as may be allowed in accordance with the terms of this Agreement, provided that where in respect of any of the Schools, but for the terms of clause 20.2.2 the Acceptance Certificate for any School could have been issued prior to the date specified above, the Longstop Date shall be extended to the next date on which an Acceptance Certificate may be issued pursuant to clause 20.2.2;
It will be noted that the Longstop Date will be extended upon the occurrence of a Delay Event, Relief Event or Compensation Event so to provide the SPV with relief against termination.

There are other events which although may not be referred to as “SPV Events of Default” do entitle the Authority to terminate the Project Agreement. These include breach of the Refinancing provisions and the occurrence of a Prohibitive Act.
Changes in Law

What are Changes in Law? They are often defined as something similar to the following:

The coming into effect after the date of the Agreement of:

a) Legislation, other than any Legislation which on the date of the Agreement has been published
   i. In a draft Bill as part of a Government Departmental Consultation Paper;
   ii. In a Bill;
   iii. In a draft statutory instrument; or
   iv. As a proposal in the Official Journal of the European Communities

b) Any Guidance; or

c) Any applicable judgement of a relevant court of law which a binding precedent;

Essentially therefore they are changes in law that were not known about at the date of Financial Close. This very important safeguard ensures that the SPV’s price for all known possible changes in law and do not after Financial Close come knocking on the Authority’s door for extra payment in respect of risks that they could have managed.

Where a Change of law which is a “Qualifying Change of Law” occurs and that change will have an impact upon the Project, the Authority or the SPV, (e.g. require a change in services, or costs, or result in the need for capital expenditure), then the party who raises the issue must serve a Notice of the Change upon the other party.

Where there is a Qualifying Change in Law which impacts upon the project and causes costs to either increase or decrease then this will generally be addressed by an adjustment to the Unitary Charge. Note however that there may well be a de-minimis threshold under which the SPV carries the risk of any changes in law that impact upon the cost of providing the service and specific regard to the Project Agreement will be required in this respect. Further, where there is a requirement for capital expenditure then it is usual to find provisions within the Project Agreement whereby the SPV has agreed to take a share in the cost of additional capital expenditure, the exact details of which are again negotiated on a project by project basis.

An example of the definition of Qualifying Change in law follows:

Qualifying Change in Law

a) A Discriminatory Change in Law;

b) A Specific Change in Law;

c) A General Change in Law, which comes into effect after the final Services Availability Date and which involves Capital Expenditure; or

d) A Best Value Change in Law
Which was not foreseeable at the date of this Agreement.
**Termination**

There could be a number of different reasons for termination and the financial consequences of such termination differ significantly. The grounds for termination usually include:

(i) SPV Event of Default

(ii) Authority Event of Default

(iii) Authority Voluntary Termination

(iv) Force Majeure Termination

(v) Termination for breach of refinancing provisions or commission of Prohibitive Act

Termination of the Project Agreement by the SPV will always be subject to the provisions of the finance agreements entered into between the SPV and the Funder. Termination by the Authority will be subject to the Direct Agreement entered into between the Authority and the Funder.

The consequences of termination mean that it is rarely an option for either the SPV or Authority. If termination is being contemplated then it is critical that early advice is sought and that the party terminating complies strictly with the requirements of the Project Agreement. If a party incorrectly terminates, for example where there is no contractual entitlement to terminate or fails to follow the correct regime for serving of notices, then the party so terminating will himself be committing a repudiation of the contract and will expose the person who he represents to a claim for substantial damages.

The important point to note in respect of termination for Authority and SPV Default is that there are usually rectification periods entitling the party upon whom the Notice is served to rectify the breach or agree a plan to rectify the breach, compliance with which has the effect of removing the ability to terminate. Note however this procedure should not be used lightly unless termination is actually considered an option because in some situations there is no requirement for a second notice, i.e if the breach is not rectified termination automatically follows.

As above there can also be termination for Persistent Breach and breach of the Refinancing provisions and again the Project Agreement will stipulate the procedure to be followed.

Termination for Prohibited Acts is again prescribed by the wording of the Project Agreement and includes the actions of the SPV’s subcontractors and servants of any tier although note again the SPV can escape the consequences of termination by removing the offending Contractor or employee.

Upon the occurrence of an event of Force Majeure the SPV will be paid subject only to Deductions for Unavailability and Service Failures. However it is recognised that such a situation cannot continue indefinitely because the SPV will not be able to pay its subcontractors or finance its bank debts and so it is usual to find a provision that provides for termination by either party in the event that the event of Force Majeure continues for a period of 6 months or
more. This is also usually qualified by the Authority having the ability to refuse the SPV’s requests for termination if it is willing to pay the Unitary Charge without Deduction.

The Funder has of course loaned considerable monies to the SPV to enable the facility to be built on the assumption that it will receive return on its loan over the next 25 – 35 years. If the Project terminates early then the Funder may not recover its investment and so provisions of the Project Agreement deal with compensation upon termination.

There is also the issue of SPV employees that needs to be considered, particularly where staff were transferred from the public sector to the SPV upon commencement of the PFI Operation Phase

The provisions of the Project Agreement in this respect are complex but in very broad terms the compensation that may have to be paid upon termination is usually follows:-

Compensation for Authority Default and Voluntary Termination

- The cost of repaying the senior debt to the Funder (including all breakage charges).
- The costs incurred by the SPV in breaking its contracts with its subcontractors including redundancy payments.
- The cost of the junior debt and the value of the shareholders shares in the SPV.


- The only cost to be repaid is a revised amount to the Funder in respect of the senior debt although this is subject to certain deductions.
- There is no payment to the SPV in respect of junior debt, the value of its equity or subcontractor breakage costs.

Compensation for Force Majeure

- The entitlement to compensation is similar to that under Authority Default. The main difference however is that although the Authority will make a payment in respect of the junior financing agreement, there is often an abatement so that the junior funders do not make a return on their investment.

Compensation for SPV Event of Default

- The provisions in respect of compensation payable in this situation are complex and usually run to several pages. The entitlement of the SPV to payment will be dependent upon usually two procedures, the retendering of the contract in the open market or an expert determination.
- If there is a Liquid Market (i.e at least two suitable alternative contractors who are willing to bid for the Project) and the Authority elects to go down the retendering route, then the SPV will, by way of compensation, be paid an amount by reference to the highest compliant tender that is received in respect of the remainder of the
term. If the Authority elects for Expert Determination then the SPV will be paid an amount so assessed. Of course there are safeguards built into the procedure to ensure the SPV's interests are to some extent protected.

It is clear that the SPV stands to lose the most through a termination on the grounds of an SPV Default. Bearing in mind the Funder has the opportunity to step in prior to the Authority exercising its rights under this section, the risks to which the Funder is exposed are to some extent limited, i.e. it will only lose its investment in the event that it elects not to step in and rectify the breach.
Section 4 –
Performance Monitoring and Payment Mechanisms
Understanding Performance based contracts within PFI

What are Performance based contracts? Essentially they are contracts where payment for a service or good is directly linked to performance. The idea is simple; incentivise behaviour by linking payment to contract performance.

Performance based contracting has been said to typically incorporate some or all of the following:

- Results/Output driven as opposed to over reliance on methodology
- Defined objectives with timeframes
- Measures performance standards
- Provides performance incentives by linking payment to outcome

PFI Contracts are output based as opposed to having detailed prescriptive requirements. It is the end result that matters rather than how the contractor gets there. PFI Contracts are performance based contracts; the obligation upon the Authority is to generally pay the SPV based upon outcomes and performance rather than the processes or methods used to deliver the goods and services.

It has been said that performance based contracts deliver the following:

- Promotes innovation to deliver services in a cost effective way
- Promotes better performance
- Reduces ongoing expenditure
- Forces Contractors to control costs
- Creates better value and enhanced performance
- Transfers risk onto the contractor as it is responsible for achieving the specified outputs
- Incentives improved performance by linking payment to performance
- Provides faster results

In a PFI Contract there is no bonus or extra payment for good performance but rather a risk of reduction in payment for poor performance. However the principles of incentivisation equally apply; if the SPV wishes to receive full payment then it must perform. Substandard performance will result in payment deductions and persistent substantial deductions could lead to termination of the Project Agreement. As margins within Facilities Management contracts are relatively small and yet the Deductions for substandard performance disproportionately large (particularly for repeated or multiple failures), there is clearly an incentive for the SPV and Facilities Management Contractor to perform in accordance with the contract requirements.

A significant criticism of operational PFI contracts however is that there is no incentive on the SPV to innovate or to improve service post Financial Close because the price of the contract is already fixed (subject to Market Testing or Benchmarking). The SPV will not be rewarded for performance over and above the contractual specifications and so there is no reason why the SPV would want to perform better than that specified. It has been said that there is every reason why the SPV and Facilities Management Contractor would endeavour to do the minimum that is necessary to secure payment.

It is unfortunately the case that many of the performance regimes within PFI Contracts have been so poorly negotiated, and/or the “Deduction” regime lacks teeth and/or the monitoring Authority does not adequately apply the monitoring regime, that the SPV is rarely penalised
with anything other than nominal Deductions. In this situation the incentives that are present in more traditional performance based contracts just do not exist.

In a PFI Contract it is important to first understand exactly what it is that the SPV has contracted to supply. In respect of the design and construction of the facility the Authority will have produced a comprehensive set of “Authority Construction Requirements” or “Trust Construction Requirements”. This sets out what the Authority requires under the Project and it is for the SPV to satisfy these requirements, the methods by which it will usually stipulate within its “Contractors Proposals”. It is important to again recall the output nature of these Proposals as opposed to the input nature. In respect of a school library, for example, the Authority may well stipulate the requirement to comply with circulars or guidance produced but will not usually specifically say what is required. Obviously this can lead to difference in expectations as to the solution that was to be provided but this does not mean that the SPV has done anything wrong or is in breach of contract. Generally speaking, so long as the SPV can be said to have complied with the Authority’s Requirements and the Contractor’s Proposals then there are no further requirements upon it save in respect of other requirements that are specifically set out within the Project Agreement, e.g. thermal and energy efficiency.

Due to the manner in which the contracts are drafted it will be difficult to ascertain exactly what the SPV has contracted to construct unless the Authority is willing to spend considerable time reviewing its Construction Requirements as set out in the Project Agreement. This will very often require cross referring back to other circulars and guidance in order to secure a comprehensive understanding of the Authority’s Requirements. Obviously those who have been involved with the Project from inception will have an enormous advantage over those that join the team only once the Project is operational.

In respect of the Operational Phase of the Project Agreement, the requirements will again be set out in an output based model and in order to understand just what the SPV is required to provide, reference will again need to be made to the relevant schedules of the Project Agreement, specifically the Services Specification.

Typical provisions in Project Agreement in respect of services in an NHS Project Agreement may look something like:

Throughout the Operational Term, Project Co shall provide (or procure the provision by the Service Providers of) the Services:

(a) in accordance with the terms of this Agreement;

(b) in accordance with the Method Statements; and

as an obligation independent from, and in addition to, Clause 27.1(b), in such manner as ensures that the Service Level Specifications are met.
Typical provisions in a BSF Project Agreement will look something like:

**Standard of Performance**

The Contractor will at all times ensure that the Services at each School comply with and meet all the requirements of this Agreement, the Services Specification, the Service Delivery Proposals, Good Industry Practice, Guidance and all applicable Authority's Policies and Legislation with effect from the relevant Services Availability Date for that School.

The key variable requirements are to comply with the Service [Level] Specifications and the Service Delivery Proposals or Method Statements. The Service Specifications will set out the standards required in respect of each service and it is against these standards that the SPV’s performance should be judged. There is unfortunately no substitute for the Authority’s to understand the service specifications in detail and considerable effort will be needed to absorb the detail within these documents.

It was said earlier that what distinguished performance based contracts was the requirement for output to be measured and not how the contractor achieved that output. Notwithstanding this, as will be seen from the above, the standard wording does require the SPV to comply with its Method Statements, i.e., set out how it intends to achieve the Service Levels that it has contracted to supply and then comply with the same. Compliance with the Method Statements is contractual and gives the Authority a further layer of protection regardless of whether the Service Levels are being achieved or not. In some earlier projects it has been found that the Method Statements were either missing or somewhat deficient which can prejudice the Authority’s position where it does not believe that the SPV is adequately doing its job and yet the Service Levels are still being achieved.

The requirement to perform the Services is further reflected by the Payment Mechanism whereby a failure to comply with the stated Service Levels may well be found to be a Service Failure and entitle the Authority to press for improvements and/or levy Deductions.

In addition to the requirement to provide the Services, there is also a requirement in respect of proactive and reactive maintenance, failure of which could lead to an event of “Unavailability” under the Project Agreement.

The requirement for reactive maintenance occurs when a failing in the facility arises that requires rectification. This may be something relatively trivial such as blown light bulbs or something much more serious such as a failure of the main boiler. However, both of these failings may cause the facility to be “Unavailable” and again in this situation the Authority may be in a position to levy Deductions. There will be a contractual requirement for the SPV to rectify the event within a timeline set out within the Project Agreement and this may require a temporary rectification and a more permanent rectification. It is generally the case that the SPV must be given access to the part of the facility effected by the Unavailability in order to rectify the same failing which Deductions for Unavailability may not commence.

Pro-active maintenance is maintenance that is planned in advance to prevent Unavailability occurring in the first instance. Programmes of such maintenance are to be agreed with the Authority in advance usually through the use of annual maintenance plans and five year maintenance plans. The Project Agreement will provide detailed provisions for the agreement of such maintenance plans and variations thereto.
Overview of a typical Payment Mechanism and the procedure for applying for payment and the application of Deductions.

The Project Agreement clauses will set out the process of applying for payment and the procedures that must be followed. The actual payment to which the SPV is entitled will be determined by the Payment Mechanism but the Project Agreement will set out the timeline for payment and the process for agreeing the payment that is due. A typical Project Agreement clause in respect of the requirements to compile and agree the Reports in respect of performance and deductions follows:

1.1 Payment of the Monthly Unitary Payment

The Authority shall pay the Contractor the Monthly Unitary Payment in respect of each Payment Period, calculated in accordance with paragraph 2.1 of Schedule 6 (Payment Mechanism).

1.2 Report and Invoice

On the first Business Day of each Payment Period the Contractor shall submit to the Authority:

- a report showing for that Payment Period the Monthly Unitary Payment and, individually, each item taken into account in calculating the Monthly Unitary Payment pursuant to paragraph 2.1 of Schedule 6 (Payment Mechanism);
- an invoice for the amount (if any) shown by the report as owing by the Authority to the Contractor and for any VAT payable by the Authority in respect of that amount.

1.3 Final Payment Period

During the final two Payment Periods, in addition to the amounts referred to in clause [ ] the Authority may withhold an amount equivalent to the average per Payment Period of the sum of the Deductions made from the Monthly Unitary Charge in the previous six Payment Periods until such time as the Contractor shall have provided a report to the Authority in respect of those Payment Periods containing the information set out in clause [ ].

On receipt of the reports from the Contractor in respect of the final two Payment Periods the Authority may retain from the amounts withheld pursuant to clause [ ] a sum equivalent to the sum of the Deductions identified in the report or any other amount agreed by the Parties or determined pursuant to clause 68 (Dispute Resolution) as owing to the Authority. The Authority shall pay the balance of any monies withheld to the Contractor or if it is agreed or determined the Contractor owes monies to the Authority in excess of those sums withheld, the Contractor shall pay such additional amounts to the Authority, in each case with interest on that amount at the Prescribed Rate calculated on a daily basis and compounded quarterly from the date on which the payment was withheld by the Authority pursuant to clause [ ] or from the date on which over payment was made (in the case of excessive claims by the Contractor) until all relevant monies have been paid in full and whether before or after judgement.
1.4 Payment

Subject to clause [ ] (Disputed Amounts), the Authority shall pay the amount stated in any invoice submitted under clause [ ] (Report and Invoice) by the final Business Day of the Payment Period in question.

Where a report shows a net amount owed by the Contractor to the Authority, the Contractor shall pay that amount to the Authority on the final Business Day of the Payment Period to which the report refers, or, at the option of the Authority, carry forward that amount to the next report in reduction of amounts which would otherwise have been owed by the Authority to the Contractor.

1.5 Disputed Amounts

If the Authority disputes the Contractor’s entitlement to any part of the amount claimed by the Contractor pursuant to clause [ ] (Report and Invoice) in respect of any Payment Period the provisions of this clause [ ] shall apply.

The Authority shall notify the Contractor in writing within ten (10) Business Days of receipt by the Authority of the relevant invoice and supporting report of that part of the amount (insofar as at the time of such notice the Authority is reasonably able to quantify it) which the Authority (acting in good faith) disputes (a Disputed Amount) and submit to the Contractor such supporting evidence as the Authority may have.

The Authority may withhold payment of any Disputed Amount pending agreement or determination of the Contractor’s entitlement in relation to the Disputed Amount but shall pay on the due date any undisputed amounts.

1.6 Response to Authority Notice

Within five (5) Business Days following receipt by the Contractor of any notice served by the Authority pursuant to clause [ ] (Disputed Amounts), the Contractor shall respond by notifying the Authority as to whether or not it agrees with the statements made in that notice. If the Contractor indicates that it does agree, or if the Contractor fails to make such a response within that time limit, the Authority shall be entitled:

- to retain on a permanent basis any amounts withheld pursuant to clause [ ] (Disputed Amounts); and
- to reclaim from the Contractor the amount of any over-payment which may have been made to the Contractor together with interest on any such amount at the Prescribed Rate calculated on a daily basis and compounded quarterly from the date on which the over-payment was made until that amount has been paid in full and whether before or after judgment.

1.7 Dispute

If the Contractor responds (pursuant to clause [ ] (Response to Authority Notice)) that it does not agree with all or any of the statements made in any notice served by the
Authority pursuant to clause [ ] (Disputed Amounts), the matter or matters in question shall be determined under the Dispute Resolution Procedure.

1.8 **Determination of Dispute**

If the determination of any dispute conducted pursuant to clause [ ] (Dispute) shows that:

the Authority has withheld any amount which the Contractor was entitled to be paid; or

the Contractor has claimed under clause [ ](Report and Invoice) any amount which it was not entitled to be paid,

the Authority shall pay such amount to the Contractor or the Contractor shall repay such amount to the Authority with interest in each case on that amount at the Prescribed Rate calculated on a daily basis and compounded quarterly from the date on which payment should have been made (in the case of failure to pay by the Authority) or from the date on which over payment was made (in the case of excessive claims by the Contractor) until all relevant monies have been paid in full and whether before or after judgment.

1.9 **Rights of Set Off**

The Contractor shall not be entitled to retain or set off any amount due to the Authority by it, but the Authority may (subject to clause 55.2 (Set Off on Termination)) retain or set off any amount owed to it by the Contractor under this Agreement which has fallen due and payable against any amount due to the Contractor under this Agreement.

1.10 **Set Off and Disputed Amounts**

If the payment or deduction of any amount referred to in clause 37.9 (Rights of Set Off) is disputed then any undisputed element of that amount shall be paid and the disputed element shall be dealt with in accordance with the Dispute Resolution Procedure.

The Payment Mechanism sets out how payments and Deductions from the payment should be made and is interlinked with the Output Specification.

The Payment Mechanism is at the heart of the Project Agreement, as it puts into financial effect the allocation of risk and responsibility between the Authority and the SPV. It is important for the Authority to rigorously implement the Payment Mechanism and make the appropriate Deductions that will incentivise good performance from the SPV and secure best value. A typical Payment Mechanism will incentivise the SPV by using a combination of immediate deductions for serious failings, rectification period, the provision of penalty points and ultimately termination.

The Payment Mechanism is arguably one of the most complex aspects of the Project Agreement but it is critically important that the Authority understands and operates the same correctly.
Ipsos Mori in their report for PUK and commissioned on behalf of HM Treasury and published in 2008 stated:

“The findings indicate that the payment mechanism is an area that could benefit from simplification, greater clarity and explanation for managers and users of the mechanism. It may also be that developing greater consistency in the mechanism across sectors and between projects would be beneficial.”

In response to the question as to whether Contract Managers understood the Payment Mechanisms, Ipsos Mori reported that 92% of Contract Managers understood the Payment Mechanism. However, when asked whether they found the Payment Mechanisms difficult to operate, Ipsos Mori reported:

“two in five managers say that they find the payment mechanism difficult to use (42%), compared to a quarter who find it easy (26%)."

It is also worth noting the following finding by Ipsos Mori:

“Just over two in five projects have not been subjected to any performance or availability deductions over the last 12 months (42%). Of those that have, this is most commonly between six and 15 times (28%). The average total value of these deductions is £56,000, although this rises to £80,000 among projects that became operational between 2006 and 2008.”

Although the surveys commissioned by PUK in 2005 and repeated in 2008 tend to suggest that the Payment Mechanism, whilst a complex document, is generally understood and applied effectively, it is possible that the reality is something far removed. Although the surveys only report the responses that are returned to it, they make no allowance for the significant numbers of responses that were not returned or those Contract Managers who mistakenly believe that they understand the Payment Mechanism when they do not.

In order for an Authority to secure best value it is critical that it applies the Payment Mechanism vigorously and makes the proper Deductions. Failure to apply the Payment Mechanism correctly or not to levy Deductions due to a fear of upsetting the SPV or from a fear of damaging relations will be counter-productive and only serve to portray the Authority as weak in the eyes of the SPV.

Although there are now relatively standard Payment Mechanisms for BSF projects and NHS Projects, in the early days the Payment Mechanisms were frequently cobbled together on a project by project basis, being full of ambiguities and often not working as intended, simply because those putting them together have not understood how they operate in practice. For
this section consideration will be given to the BSF Payment Mechanism as it is in line with modern thinking and probably represents best practice (Appendix 4), addressing all the failures in earlier Payment Mechanisms. However, it is important that Authorities do consider the Payment Mechanisms specific to their own Project Agreements and if they have any concerns as to the same they seek advice.
Performance Monitoring and Authority safeguards.

Service performance is managed by monitoring the service outputs and ensuring that the appropriate payment deductions are made with the intention of encouraging the SPV to return performance to the required contractual level at the earliest opportunity.

The Output Specification will set out what the SPV's obligations are in respect of performance and service and any targets that it is required to make. Performance is measured against the extent to which the SPV meets its targets under the Output Specification. The Payment Mechanism addresses, inter alia, the consequences of the SPV failing to meet the targets within the Output Specification and so the two documents are inextricably linked.

The Project Agreement places prime responsibility for performance measurement on the SPV. Prior to Financial Close the methods that the SPV is to adopt to measure performance should be agreed and the processes should be easily audited by the Authority. On some older projects the method of how the performance is to be monitored is not addressed which leaves a problem as SPV monitoring becomes somewhat ad-hoc and un-auditable. Again the Performance Measuring System does interface with both the Output Specification and the Payment Mechanism and so a good working knowledge of all three is required.

In short, performance monitoring ensures:

- The performance of the SPV is measured to assess the standards provided against the required outputs specified in the Project Agreement
- Best Value is realised
- Change is monitored
- Risk is managed
- The correct level of payment is made
- Service improvements are implemented when service standards are not fulfilled

Notwithstanding the SPV's obligations to self monitor, the Authority must also undertake a degree of monitoring or auditing itself so that it is able to demonstrate best value and make payment based on performance. Authorities need to ensure that they have a robust and documented procedure in place to validate the SPV's reported monitoring, and the assessment of invoices and to ensure that they only pay for the level of service provided. If the Authority does not undertake its own auditing, including checking the validity of the SPV' Reports, then invariably over time performance will fall and the Authority will be paying for a service that it does not receive.

Processes and resources for auditing, monitoring and measuring the provision of the services should be identified by the Authority at an early stage, with training provided for those who will be involved to ensure that they understand all the issues and the level of measurement that is expected.

At Appendix 5 a chart (prepared by 4ps) setting out the required processes for monitoring and making payment can be found
**The Help Desk**

A key tool for checking contract management is the SPV’s helpdesk. It is beneficial for the Authority to have access to this at least on a “read only” basis to keep check of real time reporting and to ensure the SPV is properly monitoring. Some Helpdesks also allow the Authority to directly enter incidents rather than having to make a telephone call. The Authority will need to periodically audit that the information submitted by the SPV is correct and that it is not reporting matters as complete when they are not.

A simple Helpdesk procedure is set out below. Note where the Authority has the ability to report incidents other than to the Helpdesk then the procedure needs to provide for this by the SPV being required to log calls. There should also be a requirement for the SPV to log Unavailability or Failures even where these have not been reported by the Authority as this is a fundamental requirement of self monitoring.

Provided the Helpdesk data is correct then the Authority can use this to ensure that the monthly reports and invoices rendered by the SPV are correct. Below is a chart setting out the functions of a typical Helpdesk.
Section 5
Disputes
**Understanding the mindset of the SPV**

When negotiating with the Authority before Financial Close and indeed when discussing any issues that arise during the Construction or Operational Phase, the SPV will have little option but to reflect the views of its Key Subcontractors, i.e. the Building Contractor and Facilities Management Contractor, and also requirements of its Funders. It may at times seem that the SPV is simply the mouthpiece of these parties and to some extent that is correct.

The SPV must secure a position where all critical risk is or can be transferred to its Subcontractors. If, therefore, the SPV’s Subcontractors are content to assume a risk then the SPV will likewise accept such risk. If the SPV’s Subcontractor’s cannot assume a risk then the SPV has to consider whether such risk will be of concern to its Funders, and if so, the SPV must resist such risks or potentially find itself with a project in respect of which it cannot secure finance.

The SPV is essentially within the PFI market to make a return on its investment. In some cases the SPV is also in the market to secure work for other members within its Group, e.g. a construction and/or facilities management division. Perhaps in the early days of PFI one division would subsidise the other, so it did not matter if the construction contract made a loss because adequate returns could be made in the Operational Phase or from the investment. Such an approach is now somewhat old fashioned and it is usually the practice that each contract has to stand-up on its own right and make a profit.

The SPV’s main focus is therefore:

- To meet its financing obligations
- To make a return on its investment
- To manage risk by passing this down to its subcontractors
- To seek public sector approval so that further projects will be won

On the one hand therefore the SPV is simply the voice of its Subcontractors putting forward claims or complaints as they arise and relaying the Authority’s position back to its Subcontractors. The SPV in the early stages of a dispute has little option other than to act as this conduit not really interrogating the claims advanced by its Subcontractors to the Authority. This may well cause the Authority to become frustrated because it may seem that the SPV is simply “passing the buck”.

If matters continue in dispute however the SPV will start to take a harder line with its Subcontractors. If the SPV realises that the Authority will not simply “roll over”, the SPV may believe the easier option is to take a hard stance with its Subcontractors in order to protect its investment. The fact that the Subcontractor may also be a shareholder in the SPV does not necessarily mean the SPV will not or cannot take such a robust position against the Subcontractor. It is not uncommon for the Shareholders Agreement between the SPV and its Subcontractors to state that the Subcontractors are excluded from using their votes on issues that relate to Subcontractor disputes between the SPV and Subcontractor.
The Authority must understand the limitations and needs of the SPV but it can then use such limitations and needs to its own advantage to secure improvement of services.
Why things go wrong.

When significant issues arise in a PFI/PPP contract, it is usually due to either the materialisation of an operational risk or a relationship risk, or possibly the materialisation of a defect in the Project Agreement. There is no such thing as the perfect individual or the perfect team; people often promise to do more than they can actually achieve, and people make genuine mistakes.

There are a number of reasons as to why disputes arise within Operational PFI contracts.

Although there are certain individuals who are opposed to PFI on ideological grounds (and certain of the trade unions have entire sections of their web sites dedicated to bashing the PFI sector), disputes usually only ever arise because one party is unhappy with either the building that has been provided, the level of service supplied or the costs being charged.

Although there are exceptions, most problems arise within PFI contracts because one of either the Authority or SPV do not really understand the Project Agreement or what they are obliged to provide. It is the unfortunate reality that if the Project Agreement does not say the Authority is entitled to a gold standard of service then it will not get it, no matter how much energy the Authority expends in advocating its cause.

If an Authority is unhappy with an element of the service then the only way to resolve it is to invest time in reviewing the Project Agreement, taking advice where necessary, and identifying the contractual provision that assist its argument. Only when the Authority is armed with all of the key facts in support of its case will the SPV be likely to accept that the Authority’s interpretation is correct. If the Authority is not able to make reasoned arguments in support of its case then many SPV’s will simply pay lip service but not actually do anything. Very often an SPV will simply resist footing the bill for any required changes in the hope that the need will either go away or the Authority will agree to fund the same; experience suggests that when the Authority starts to “make the right noises” then the SPV will change its position to one which is more accommodating.

To understand what the Authority is entitled to receive the Authority must review the Project Agreement and particularly the Services Specification in relation to Services and, to the extent that a dispute exists as to the building, the Construction Requirements and Proposals. However, it should be appreciated that because the Project Agreement is written on the basis of Output Specifications as opposed to the Authority providing specific requirements, there is often a degree of choice for the SPV in how it delivers the project. So long as the SPV is complying with the Output Specification it may not be in breach of the Project Agreement.

Inadequate Contract Management on the part of the Authority will also lead to dispute. This may be because there is gradual deterioration of service upon the realisation that the SPV can get “away with it” or because the Authority suddenly believes that it is being short changed.

Formal dispute resolution is expensive and arguably there are no winners, save perhaps the lawyers. The Authority should try to avoid formal dispute resolution by ensuring that it has good and clear lines of communication open with the SPV, with appropriate procedures for escalation.
It is essential that Authorities have in place strong leadership to negotiate not only robustly but also sensibly with the SPV. However, Authorities should not be afraid to use the dispute procedures where the need arises and indeed there may be a number of indirect gains to be made from using such processes. Where an Authority opts for DRP then it obviously needs to manage costs to ensure that they remain proportionate to the issues in dispute and for small value items perhaps external solicitors should be dispensed with.

4ps have helpfully compiled a Trouble Shooting Table setting out the main causes of dispute. This table is reproduced at Appendix 6.
Review of typical Dispute Resolution Procedures.

The procedure that follows is taken from a typical BSF Project

2. DISPUTE RESOLUTION

2.1 Disputes

Any dispute arising in relation to any aspect of this Agreement shall be resolved in accordance with this clause 68 save for a dispute relating to the Code, which shall be resolved in accordance with Schedule 19 (Code Dispute Resolution Procedure).

The Code refers to the Code of Practice on Workforce Matters in Local Authority Service Contracts.

2.2 Consultation

If a dispute arises in relation to any aspect of this Agreement, the Contractor and the Authority shall consult in good faith in an attempt to come to an agreement in relation to the disputed matter.

2.3 Adjudication

Without prejudice to clause 68.2 (Consultation), either Party may give the other notice of its intention to refer the dispute to adjudication (the Notice of Adjudication). The Notice of Adjudication shall include a brief statement of the issue to be referred and the redress sought. The Party giving the Notice of Adjudication (the Referring Party) shall on the same day and by the same means of communication send a copy of the Notice of Adjudication to an adjudicator selected in accordance with clause 68.4 (Identity of Adjudicator) (the Adjudicator).

2.4 Identity of Adjudicator

The Adjudicator nominated to consider a dispute referred to him shall be selected on a strictly rotational basis from the relevant panel of experts selected in accordance with the following:

There shall be two (2) panels of experts, one (1) in respect of construction matters (the Construction Panel) and one (1) in respect of operational and maintenance matters (the Operational Panel). All the experts on each panel shall be wholly independent of the Contractor, the Authority, the relevant Sub-Contractor and any of the major competitors of the Contractor or relevant Sub-Contractor;

The Construction Panel shall comprise three (3) experts, who shall be selected jointly by the Contractor and the Authority. Such selection shall
take place within twenty (20) Business Days of the Commencement Date;

The Operational Panel shall comprise three (3) experts, who shall be selected jointly by the Contractor and the Authority. Such selection shall take place within twenty (20) Business Days of the Commencement Date;

If any member of a panel resigns during the Contract Period, a replacement expert shall be selected by the Contractor and the Authority as soon as practicable;

In the event that the nominated Adjudicator is unable or unwilling to confirm acceptance of his appointment as Adjudicator within two (2) Business Days of receipt of the Notice of Adjudication, then the Referring Party shall invite the person next in line to act as the Adjudicator. In the event that the second panel member is unwilling or unable to confirm acceptance of his appointment as Adjudicator within two (2) days or if the Parties disagree as to the relevant panel of experts to be used then the Referring Party may apply to the President for the time being of the Chartered Institute of Arbitrators who shall within three (3) Business Days of any such application nominate an Adjudicator to determine the issue set out in the Notice of Adjudication; and

If the Authority and the Contractor are unable to agree on the identity of the experts to be selected to the panels, the President for the time being of the Chartered Institute of Arbitrators shall appoint such expert(s) within thirty (30) days of any application for such appointment by either Party.

As a matter of fact the party instigating adjudication will invariably be the SPV. The selection of a panel may well work against the Authority and will also become dated over time. A preferred option may be to leave blank and agree the appointment of an individual on a case by case basis.

2.5 Referral of the Dispute

Within seven (7) days of the service of the Notice of Adjudication, or as soon thereafter as the Adjudicator is appointed, the Referring Party shall serve its statement of case (the Referral Notice) on the Adjudicator and the other Party (the Responding Party). The Referral Notice shall include a copy of this Agreement, details of the circumstances giving rise to the dispute as set out in the Notice of Adjudication, the reasons why the Referring Party is entitled to the redress sought, and the evidence upon which it relies.

2.6 Response to the Referral

The Responding Party shall serve its statement of case (the Response) on the Adjudicator and the Referring Party within a period of time to be directed by the Adjudicator. The Response shall include any arguments in response to the Referral Notice of the dispute set out in the Notice of Adjudication and any additional evidence on which the Responding Party relies.

The Authority should always seek at least 14 days
2.7 Procedure

Subject to clause 68.11 (Adjudicator's Powers), the Adjudicator shall have absolute discretion as to how to conduct the adjudication, including whether a meeting is necessary. He shall establish the procedure and timetable subject to any limitation within this Agreement. The Parties shall comply with any request or direction of the Adjudicator in relation to the adjudication.

2.8 Adjudicator's Decision

In any event, the Adjudicator shall provide to both Parties his written decision on the dispute, within twenty eight (28) days after the date of receipt of the Referral Notice (or such other period as the Parties may agree). The Adjudicator shall be entitled to extend the said period of twenty eight (28) days by up to fourteen (14) days with the consent of the Referring Party. Unless the Parties otherwise agree, the Adjudicator shall give reasons for his decision. Unless and until revised, cancelled or varied by the English courts, the Adjudicator's decision shall be binding on both Parties who shall forthwith give effect to the decision.

2.9 Adjudicator's Costs

The Adjudicator's costs of any referral shall be borne as the Adjudicator shall specify or, in default, equally by the Parties. Each Party shall bear its own costs arising out of the referral, including legal costs and the costs and expenses of any witnesses.

2.10 Adjudicator as Expert

The Adjudicator shall be deemed not to be an arbitrator but shall render his decision as an expert, and the provisions of the Arbitration Act 1996 and the law relating to arbitration shall not apply to the Adjudicator or his determination or the procedure by which he reached his determination.

2.11 Adjudicator's Powers

The Adjudicator shall act fairly and impartially and may take the initiative in ascertaining the facts and the law. The Adjudicator shall have the power to open up, review and revise any opinion, certificate, instruction, determination or decision of whatever nature given or made under this Agreement.

2.12 Confidentiality

All information, data or documentation disclosed or delivered by a Party to the Adjudicator in consequence of or in connection with his appointment as Adjudicator shall be treated as confidential. The Adjudicator shall not, save as permitted by clause 62 (Freedom of Information and Confidentiality), disclose to any person or company any such information, data or documentation and all such information, data or documentation shall remain the property of the Party disclosing or delivering the same and all copies shall be returned to such Party on completion of the Adjudicator’s work.
2.13 **Liability of Adjudicator**

The Adjudicator is not liable for anything done or omitted in the discharge or purported discharge of his functions as Adjudicator unless the act or omission is in bad faith. Any employee or agent of the Adjudicator is similarly protected from liability.

2.14 **Reference to the Courts**

Either Party may (within ninety (90) calendar days of receipt of the Adjudicator's decision or where the Adjudicator fails to give a decision pursuant to clause 68.8 Adjudicator's Decision) give notice to the other Party of its intention to refer the dispute to the courts of England and Wales for final determination.

Beware this appears to limit a party's right to refer a dispute to a court unless it is done so within 90 days of the Adjudicator's decision.

2.15 **Parties' Obligations**

The Parties shall continue to comply with, observe and perform all their obligations hereunder regardless of the nature of the dispute and notwithstanding the referral of the dispute for resolution under this clause and shall give effect forthwith to every decision of the Adjudicator and the courts delivered under this clause.

2.16 **Similar Disputes**

If any dispute arising under this Agreement raises issues which relate to:

any dispute between the Contractor and the Building Contractor arising under the Building Contract or otherwise affects the relationship or rights of the Contractor and/or the Building Contractor under the Building Contract (the Building Contract Dispute); or

any dispute between the Contractor and the FM Contractor arising under the FM Agreement or otherwise affects the relationship or rights of the Contractor and/or the FM Contractor under the FM Agreement (the FM Agreement Dispute),

then the Contractor may include as part of its submissions made to the Adjudicator or to the courts submissions made by the Building Contractor or by the FM Contractor as appropriate.

This provides for the subcontractors to provide submissions of its subcontractors.

2.17 **Jurisdiction over Sub-Contractors**

The Adjudicator shall not have jurisdiction to determine the Building Contract Dispute or the FM Agreement Dispute but the decision of the Adjudicator and/or
the courts shall, subject to clause 68.14 (Reference to the Courts), be binding on the Contractor and the Building Contractor insofar as it determines the issues relating to the Building Contract Dispute and on the Contractor and the FM Contractor insofar as it determines the issues relating to the FM Agreement Dispute.

This bizarre clause appears to seek to bind the subcontractors into a decision in an Adjudication to which they were not a party. It is acceptable to Subcontractors to varying degrees. However, unless similar provisions exist in the Subcontracts then it will not be binding upon the Subcontractors.

2.18 **Sub-Contractors' Submissions**

Any submissions made by the Building Contractor or the FM Contractor shall:

Be made within the time limits applicable to the delivery of submissions by the Contractor; and

Concern only those matters which relate to the dispute between the Authority and the Contractor under this Agreement.

2.19 **Costs**

Where the Building Contractor or the FM Contractor makes submissions in any reference before:

The Adjudicator, the Adjudicator's costs of such reference shall be borne as the Adjudicator shall specify, or in default, one-third by the Authority and two-thirds (2/3) by the Contractor; and

The courts, the costs of the litigation shall be in the discretion of the court.

2.20 **Authority's Liability**

The Authority shall have no liability to the Building Contractor or the FM Contractor arising out of or in connection with any decision of the Adjudicator or courts or in respect of the costs of the Building Contractor or the FM Contractor in participating in the resolution of any dispute under this Agreement.

2.21 **Access to Documents**

The Contractor shall not allow the Building Contractor or the FM Contractor access to any document relevant to issues in dispute between the Authority and the Contractor save where:

the document is relevant also to the issues relating to the Building Contract Dispute or the FM Agreement Dispute as the case may be; and

the Contractor has first delivered to the Authority a written undertaking from the Building Contractor and/or the FM Contractor (as appropriate) addressed to the Authority that they shall not use any such document otherwise than for the
purpose of the dispute resolution proceedings under this Agreement and that they shall not disclose such documents or any information contained therein to any third party other than the Adjudicator or the courts or any professional adviser engaged by the Building Contractor or the FM Contractor (as appropriate) to advise in connection with the dispute.

The above procedure taken from a BSF project is relatively straightforward. Other sectors may have slight variations. The NHS Dispute Resolution Procedure makes provision for liaison committees, mediation, expert determination, and arbitration (which may provide for the appointment of more than one Arbitrator). Again however the provisions are relatively straightforward.

Problems do however exist in some of the early Project Agreements where it was not uncommon for the dispute resolution procedures to be negotiated on a project by project basis. When therefore a dispute arises, careful regard to the procedure is required. In some circumstances the procedures are quite ambiguous and it may be necessary to follow certain procedures before formal dispute resolution commences.

Of course it is well known that the Housing Grants Construction and Regeneration Act 1996 does not apply to PFI Project Agreements, although does apply to the subcontracts. Notwithstanding this most Project Agreements do contain provisions that comply with the Act including some form of adjudication.
The significance of Equivalent Project Relief and issues of joinder

Equivalent Project Relief is a concept contained in the contracts between the SPV and its subcontractors. Although not directly relevant to the Authority it needs to be appreciated when dealing with the SPV.

The SPV is a thinly capitalised vehicle and it is a condition of its funding that the majority of risk to which it is exposed is passed down to its subcontractors. The Funders are very concerned to ensure that the subcontractor does not have a claim against the SPV which the SPV cannot in turn pass onto the Authority. This is where Equivalent Project Relief (“EPR”) steps in.

EPR was a wheeze dreamed up by the lawyers which effectively says the subcontractor will only get paid what the SPV gets paid. Because “pay when paid” clauses within Construction Contracts (which include PFI subcontracts) were deemed unlawful by the Housing Grants Construction and Regeneration Act 1996, EPR was invented to overcome this restriction imposed by the Act. There has always been some concern that this attempt to circumvent the Act was unlawful, and the case of Midland Expressway v Carillion 2005 did little to ease such fears. Following the Midland Expressway case many SPV’s have again reverted to the Parallel Loan Agreement in an effort to circumvent the Act (which again may fail depending upon drafting).

Regardless of its legality, the principle of EPR is that the subcontractors will not be paid anything over and above what the SPV is paid. Therefore whenever there is a dispute in respect of the construction of the facility or in respect of the operational phase of facility, although on the face of it the dispute is between the Authority and the SPV, the real dispute will invariably be between the Authority and its subcontractors, with the SPV acting no more as a conduit through which the dispute is channelled.

Where therefore the Facilities Management Contractor seeks additional payment perhaps because of damage for which it says the Authority is responsible, the SPV will simply act as postman and pass the dispute onto the Authority. In some cases the SPV may take a hard line with the subcontractor where it does not consider there is any merit in the claim, but generally speaking the easier option is for the SPV just to pass the claim up the chain without any scrutiny itself. Indeed, in many cases the SPV’s contract with its subcontractor will simply require it to act as the subcontractor’s “agent” in this respect.

It was in recognition of the concept of EPR that many early Project Agreements provided for joinder of dispute, i.e the subcontractor was joined into the dispute between the SPV and the Authority in recognition that it was in reality a dispute between the subcontractor and Authority. HM Treasury is firmly opposed to joinder of disputes and indeed such provisions have been absent from Project Agreements for some time. The current position is to enable the subcontractor to make submissions and for the subcontractor to be bound, as against the Authority, into the dispute decision. This is something which certainly causes subcontractors a concern because it effectively bars them from pursuing the SPV due to the principles of EPR.
HM Treasury’s stance on joinder is most sensible. It is said the justification is that the Authority should not be embroiled in disputes which are really matters between the SPV and its Subcontractors but there are enormous tactical advantages of separating the disputes making it very expensive for the subcontractors to commence claims and hence the Authority benefits from a reduction in disputed matters.
Achieving a successful outcome

Advisors

PFI dispute work is a little different to other forms of litigation because of the complex contractual documents and supply chains. It is critical to the Authority that it engages a legal representative who not only is a sound tactical litigator but also has a firm grasp of PFI contracts. Such combined skills are however rare.

Generally the legal field is split into contentious and non-contentious lawyers, the exception perhaps being in respect of construction lawyers who often, certainly outside of London, have experience of both contract work and dispute work. In fact in construction law it becomes difficult to separate the two fields; a good disputes lawyer needs to understand the terms of the contracts inside out in order to do justice for his clients. Unfortunately, however, there are few Construction Dispute lawyers who have real experience of working with PFI Contracts and so what often happens is that the client is at an immediate disadvantage because his lawyer whilst an accomplished dispute lawyer, does not understand PFI contracts or the underlying complexities. The first step therefore is engaging the right team, both technical and legal.

Authority advantages

The next step is to understand the many advantages that the Authority possesses in any claim against the SPV. These include:

- The SPV will be wary of picking a fight with the public sector
- The SPV will be concerned with its need to maintain a long term relationship
- The SPV will be concerned with adverse publicity
- The SPV may not have any real financial interest in the claim
- The Subcontractor will have provided an indemnity to the SPV to pursue the claim and so the cost of litigation to the Subcontractor will be extremely expensive
- The Authority controls cash flow
Authority strategies

The majority of SPV’s form part of wider infrastructure groups that frequently work with the public sector and need to maintain good working relations with the public sector and wider Government. The Authority can therefore manipulate the need of such Groups to maintain good working relationships to its advantage. An example of this is a situation that arose where notwithstanding the SPV being in dispute with the Authority, the SPV’s shareholders were bidding for a new project with the same Authority. The dispute rumbled on for many years until finally the Chief Executive of the Authority contacted a Senior Director of the SPV’s Group and basically informed the Director that his company had no chance of winning the new bid whilst it continued its aggressive stance in litigation. The dispute with the Authority was settled within about three weeks of that discussion, with the SPV and its Subcontractors taking a significant multi-million pound hit. Incidentally, the Group did not go on and win the project so it lost on both fronts.

SPV’s are generally unwilling to commence claims against their client unless the claim is so large that they have no option, such as the claim for bid fees on the aborted Leicester Hospital PFI. This gives the Authority an immediate advantage when a dispute arises.

In general the main focus of the SPV is to be seen as being the public sector’s partner of choice. The SPV does not want criticism from the public sector: it wants to work with it to deliver that which is needed to secure the Authority’s approval. The need for client approval has of course to be balanced with the need to make a profit, but the Authority should always use its position as a public sector body to its full advantage when disputes arise.

There are a number of ways in which the SPV may agree with its subcontractors that a claim is to be advanced against the Authority. It may be progressed simply in line with the procedure above in which case the SPV will almost certainly have received an indemnity from the subcontractor in respect of its legal costs. In this situation the subcontractor may be incurring two sets of legal costs, being both his own and that of the SPV. This makes litigation prohibitively expensive for the subcontractor.

There is much talk about the benefits to the SPV of “name borrowing”, i.e the subcontractor simply takes a claim against the Authority in the name of the SPV, again with appropriate indemnities having been given. However, an SPV should be extremely concerned about allowing its subcontractors to “name borrow”. Indeed the SPV’s lawyers will frequently advise the SPV’s against such action, particularly where the dispute concerns a Building Contractor, because there is a clear conflict of interest between the immediate objectives of the subcontractor and the long term need of the SPV to maintain good working relations with the Authority. This is something that Authority should consider raising if it is considered that the SPV is considering name borrowing.

Once it appears that a dispute is of substantial magnitude or simply will not go away, the Authority should consider maintaining the stance that it must always deal with the SPV and not the subcontractors. The Authority should consider attempting to isolate the subcontractor as the problem party when discussing matters with the SPV and even go as far as refusing to liaise with the subcontractor on the issue of the dispute. By doing this the Authority will be criticised by the SPV as not appreciating the reality of
PFI, but such a stance is little different to that envisaged in the formal Dispute Resolution Procedure. The Authority is taking such an approach is forcing the subcontractor to put its case through the SPV and for the SPV to report the Authority’s position back to the subcontractor. Such an approach whilst not really inconveniencing the Authority, causes maximum inconvenience and work for the SPV and its subcontractors which is necessary for them to eventually consider the dispute is not one worth fighting.

Also by taking such an approach the real hostility remains between the Authority and the subcontractor. Over time the SPV may start to consider that its problem lies with its subcontractor and begin to realise that it must take more of an active role if the dispute is to be resolved and working relations maintained.

Authority response to SPV balance sheet arguments

It has been said that the SPV is a thinly capitalised vehicle and that it will seek to pass on any liabilities from the Authority to the SPV and will itself seek to avoid retaining any liability. This could be seen as an obstacle to settlement. However, the Authority needs to consider the reality of how the SPV is structured and its financing obligations.

The SPV will in addition to its senior funding liabilities, also have liabilities to its own shareholders in respect of junior debt repayments and then dividends. The obligations to make the junior loan repayments are of course contractual, but the SPV is in a position to agree with its shareholders either to suspend or reduce the capital and/or interest repayments or to inject further shareholder loans. On a big dispute it is not uncommon for an SPV to argue that it just does not have the funds to meet the Authority’s claims but the reality is that there is ample scope for the SPV to find such funds without involving the Funder. Although it is possible that an SPV would allow itself to collapse rather than finding additional funds, the reality is something very different both because of damage to the reputation of its wider group and the fact that there is residual value in the SPV, in terms of future loan interest, refinancing possibilities and the significant dividends that usually begin to be paid to the shareholders during the last ten years of the project.

The SPV’s main priority is to be in a position to meet its financing obligations with the senior Funder. It is critical that the SPV is able to meet such obligations, and so long as it can, it will endeavour to keep the existence of a dispute away from the Funders on the basis that it does not affect the viability of the SPV. The last thing that an SPV wants is for a Funder and its plethora of advisors to be crawling over the business affairs of the SPV and charging the SPV for the privilege of doing so. However the SPV will normally take a different approach to its own investment and for this reason the Authority should not be overly concerned with the SPV’s complaints of affordability.

The SPV and its subcontractors may perceive the Authority as weak and lacking the appetite for a fight. The Authority should make quite clear to the SPV however that it cannot compromise any dispute without being able to justify the reason to its members and therefore, regardless of whether the Authority wishes to engage in a protracted and costly dispute, its corporate governance obligations make it harder for an Authority to justify a commercial settlement as opposed to a settlement that its advisors endorse.

The Authority must not be afraid of standing up to the SPV to insist that the SPV delivers that which it is contractually obliged to supply. The Authority must demonstrate
an understanding of the Project Agreement, of Private Finance and of the long term value of the SPV to its investors. The Authority should not shy away from raising a counterclaim where appropriate and even when it pays the Unitary Charge in full, reserve its position in respect of clawing back Deductions. Although there is less room for manoeuvre in the modern standard form Project Agreements, some of the older agreements are full of ambiguities and the Authority should not hesitate to interpret the Project Agreement to take advantage of such ambiguities.
Section 6 - Contract Management

The need for effective Contract Management

Why is Contract Management required? Essentially to ensure the following is achieved:

- Risk is allocated as intended
- Output Specification is adhered to
- Services are supplied in accordance with the Project Agreement
- Services are monitored to ensure compliance against Output Specification
- SPV is paid only that which it is contractually entitled to
- To maintain good working relations and secure improvements
- Achieve Best Value

If the Authority does not demonstrate itself to be able to effectively manage the SPV then over time there will be deterioration in the services provided, the SPV will become complacent in its offering and eventually the project will fail.

The Authority cannot rely on the principles of partnering to assume it is getting what it has contracted to buy. Partnering works by inflating costs with the typical contractor being happy to partner so long as he does not lose money. In these difficult economic times the private sector will be looking to maximise returns whilst the public sector needs to reduce expenditure. If there was ever a partnering ethos in PFI then I suggest it will be tested to the extreme over the next 10 years.

The Authority should not assume that the SPV will deliver or that it even understands its contractual obligations. If left to its own devices the SPV will deliver and do what it believes it is required to do rather than what it is contractually obligated to do.

Experience of PFI Operational contracts demonstrates that the Authority underestimates the resources necessary to manage its PFI Contracts and that it is tempted to sacrifice resource in order to reduce overhead. Such an approach is false economy, most certainly does not provide best value, and may result in PFI being an abuse of tax payers money.

It may first assist to look at the resources available to the Authority at Financial Close and to also consider the resource available to the SPV.

Throughout the tender stage the Authority will have appointed an army of financial, legal and technical advisors to assist in the negotiation of the Project Agreement to ensure that the Project delivers that which the Authority requires and further that it is delivered within the financial constraints under which the Authority is operating.

At Financial Close much of the Authority’s resource may well disappear. There may well be a further dilution of resource throughout the lengthy construction phase so that by the time the contract becomes operational, the Authority is only left with a skeleton management team which consists of none of the experienced personnel that the Authority retained prior to Financial Close. Further, the Authority may not have
extensive experience of operating PFI contracts and so is not able to draw on an extensive pool of talent as and when required.

Now compare this to the SPV. Throughout the bid stage the SPV will have engaged bid managers, commercial managers, lawyers and accountants (in – house and external) all of whom have several years experience of PFI and who doubtless will remain with the SPV’s sponsors for several years. The SPV and its sponsors will further retain technical advisors experienced in buildings and facilities management. Throughout the build stage and upon the project becoming operational the same people within the SPV may retain responsibility for the project, or responsibility may be transferred to a dedicated operations team who in any event will be experienced in operating similar PFI contracts. The SPV will maintain an army of accountants again specialised in PFI Contracts, and again their aim will be to charge the Authority for the anticipated Unitary Charge, ensuring that the project secures the intended returns for the shareholders of the SPV.

Although PFI is a partnership, the SPV needs to maximise profits and this it does by seeking to recover all it possibly can under the PFI Contract. The Facilities Management Contractor does not want its profit to be eroded by Deductions and although there will be instances where it can only but apply Deductions, there may well be other situations where, for whatever reason, it is not alert to Service Failures and Unavailability and therefore does not apply them.

The need for an effective Contract Management Team is compelling.
Setting up the Management Team

The Authority must consider the composition of the Management Team at an early stage and appoint appropriately skilled members to carry out the management duties, being careful not to under resource which will result in the project commencing on the wrong footing and costing more to rectify and re-assert relationships than had the job been done right in the first place.

When appointing a Contract Manager to lead the team, the Authority should bear in mind that which has been said about its counterparts in the private sector. The Contract Manager must have the necessary ability to manage the SPV without being too adversarial or compliant.

When selecting the individual to lead Contract Management team then the following attributes are vital:

- Sufficient seniority and experience commensurate with the complexity and importance of the contract.
- Adequate skills and experience in contract management
- Experience of performance related contract
- Experience of working with the private sector and understand its key drivers
- Knowledge of the end user requirements
- Able to forge good personal relationships

The Authority needs to consider the size and composition of the Contract Management team. This will depend upon:

- Available finances
- Size and complexity of the project
- Willingness to invest in long term relationships and requirement to monitor.

On a straightforward project it may be possible for a single individual to take on the responsibility of monitoring performance, attending relationship meetings and approving payment. This individual may even be spread across a number of sites. However, the Authority needs to consider the need for continuity. If this individual either leaves the Authority, is promoted to another role or is sick or on annual leave then the Authority is left with a problem. Over reliance on one individual can be dangerous and should be resisted. Therefore it is suggested that the Contract Manager will require at least one assistant.

If an Authority operates more than one PFI or PPP project then it is possible for one individual to take ultimate responsibility for all of the projects but to be assisted by a team of subordinates, any of whom should be capable of taking control should the need arise. Indeed structuring the team in this way ensures that knowledge and resources are shared and that costs are not duplicated.

Consideration also needs to be given as to how the Contract Manager interfaces with
the end user and where the Contract Manager should be based. This is not such a problem with a hospital where the Contract Manager will invariably be located in the hospital, but where the project is a school, should the Contract Manager have a permanent presence in the school? Is there any allocated accommodation for the Contract Manager within the School?

The reality is that the Authority must not only undertake Contract Management but needs to be seen to undertake Contract Management which means he or she must have a permanent base at the facility. It may be that the Contract Manager needs to only spend part of his time at the facility; it is suggested that he or she should be based full time at the facility for the first 6 – 12 months post Service Commencement and then decrease hours depending upon the need for his presence at the facility.

It is also important that the Contract Manager forges the necessary relations with the necessary officers, managers or head teachers at the facility. The Contract Manager must work with these individuals to both manage expectations in line with the contract requirements and to act as the conduit through which their concerns are passed through to the SPV. There will be occasions where the Contract Manager disagrees with the manager or head teacher, but it is critical such disagreements are resolved in private and away from the SPV. The Contract Manager should in no circumstances inform or intimate to the SPV that there are differences of opinion between the Contract Manager and, say, the head teacher, or that it is considered the head teacher is incorrect or a difficult individual. Although the Contract Manager may believe this will assist his relationship with the SPV, the reality is that the SPV will over time begin to disregard the views of the head teacher or perceive him or her as a trouble maker and in the long term the provision of services will suffer. The best performing contracts are those where the SPV respects the views of both the Contract Managers and the end user and will therefore go out of their way to assist the demands of the head teacher, even where there is no contractual requirement to do so.
Structure of Management Team and Meetings

This will vary according to the specific project and Authority’s existing structures and governance arrangements. It is always useful for the SPV to be aware of the reporting structures put in place by the Authority.

Regular meetings should be held between the Authority and SPV to resolve operational matters that arise on a daily basis and also longer term operational matters.

The Contract Manager should meet with the SPV’s advisors on a monthly basis to agree or resolve the following issues:

- review the monitoring report and matters arising from it
- review the payment report and agree payments due
- resolve issues regarding production of information
- take a forward view of the project
- identify efficiencies and necessary change
- record / discuss issues affecting the contract
- review areas of conflict

The Contract Manager will also need to keep informed those within the Authority who have ultimate responsibility for the workings and direction of the project. The persons or persons within the Authority responsible for such matters would normally meet with senior directors of the SPV at least four times a year to discuss project performance and any future issues that need to be addressed. The meetings between the SPV’s management team and the Authority’s management team should be designed to:

- provide a strategic overview to ensure long-term issues are properly considered
- ensure that the objectives of the contract are met over the full term of the contract
- ensure effective communication is taking place at all levels
- agree proposed efficiencies and changes
- set year-on-year improvement targets if appropriate
- promote Best value through the management of whole life costing, through innovation and service improvements
**Knowledge and training**

A real problem within some public sector organisations is that the individuals that they appoint have little experience of PFI and therefore do not really understand what the contract provides or what is required of them. The same also often applies to the senior personnel charged with running such organisations. This is not a problem if there are others in the team from whom they can learn and/or they put in the necessary time to learn the processes. There are a number of providers that provide courses on PFI, benchmarking and performance monitoring. If generic courses are not suitable then it is possible that tailor made courses may be provided, something that provides excellent value for money where an Authority has training requirements for a number of individuals. Suggested training includes:

- contract and contract management principles
- project management
- communication and respect
- the payment mechanism and its application
- helpdesk function and performance monitoring
- the application of the contract
- contractual change and variation management
- benchmarking and market testing

However, equally important is the requirement for an Operations and Training Manual.

Contract Managers will be advised that they need to read and understand the entire Project Agreement. This is an unrealistic expectation. Even those within the private sector rarely read the Project Agreement; indeed many of the problems that the Authority will experience will be caused simply because the SPV has not read or does not understand the Project Agreement. This is particularly so with those on the ground with whom the Authority has daily or weekly contact; the chances are that they have absolutely no idea of what is in the Project Agreement.

If the Authority’s representatives are familiar with the requirements of the Project Agreement then arguably half the battle is won. In order to facilitate this the first part of the Operations Manual should be a concise summary of the key provisions of the Project Agreement (if further specifics are required then the summary will point the Authority to the right place). This is quite a time consuming exercise and the Authority may require external assistance. This summary of the Project Agreement is a document that will be put to frequent use over the 25-30 years of the operational period and should be capable of adaption where more than one project exist.
A recommended Operations Manual should include the section set out below:

- **Introduction**  
  Purpose of document

- **Project Summary**  
  Overview of the Project

- **Parties**  
  Details of parties to contract. Details of key individuals within each party

- **Authority**  
  The Authority contract management structure, including reporting lines and scope of Authority

- **The PA**  
  Summary of the key contractual requirements

- **The Pay Mech**  
  Summary of key requirements for payment, reporting of failure and deductions, and application of deductions and service points

- **Payment**  
  Summary of key payment provisions, dates and requirements etc information inter linked into the Payment Mechanism.

- **Service Spec**  
  Summary of key service and specification requirements including method statements

- **Monitoring**  
  Procedures to be followed in respect of both SPV and Authority monitoring

- **Payment Checklist**  
  A list of matters to be checked each time an application for payment is submitted to ensure that the correct payment is applied for.

- **Changes**  
  Records of any changes that have been implemented and their effect on the Project

- **Value Testing**  
  Record of the Benchmarking and Value Testing

- **Records**  
  Details of all Records to be retained and their whereabouts

- **Key Dates**  
  Key dates of matters in connection with payment meetings, indexation, benchmarking, customer surveys and other best value requirements.
Contract Administration and Managing relationships

A PFI/PP contract is a long term venture and there must therefore be long term understandings and relationships. Advocates of PFI will talk about the necessity for partnering but it needs to be understood that partnering within PFI should not mean paying a high fee in return for a poor service. The Authority should appreciate that notwithstanding the partnering ethos of PFI, the private sector will extract maximum profit out of the contract. The public sector should ensure that it only pays that which it is required to pay and that it receives all that it should receive.

In the sense that the parties are bound into each other for the long term then PFI is a partnering contract, however, partnering should not mean that the Authority simply forgoes the contractual and management checks that it would take on projects procured in a more conventional manner. Insisting on contractual entitlements is not an adversarial approach and will actually result in better performance not deterioration in relationships.

Authorities should rigidly apply the Payment Mechanism and applicable Deductions from day one of the contract, to give a clear message of the way in which poor performance standards will be dealt with. The development of “cosy” relationships needs to be avoided; as such conditions will eventually lead to opportunism and a decrease in service.

There is much often said about the need to forge close personal working relationships for a project to succeed. However, relationships are built on trust and respect. Trust being that when a person says he will do something he can be trusted to do it within the timescales advised. Respect being professional respect and acknowledgement that the Authority and SPV are different animals seeking different goals. The SPV and Facilities Management Contractor wish to maximise profit whilst the Authority’s overall goal is customer satisfaction and best value.

One reason why relationships may deteriorate is where the Authority retains personnel who are simply ideologically opposed to PFI or are unable to accept that the SPV will only provide that which they contracted to provide. If the Authority’s complaints are genuine and based upon the requirements of the contract then it will, in the end, get a favourable response from the SPV, even if dispute resolution is necessary. If the Authority on the other hand is simply out to score points or misunderstands the contractual requirements then expectations will not be met and the service will suffer.
Maximising value for money

There is no doubt that PFI Contracts are extremely complicated and difficult to operate by the Authority. Research commissioned by PUK (Partnerships UK) tends to suggest that Authorities understand Project Agreements and have no difficulty operating such contracts or the Payment Mechanisms. PUK is of course however itself a Public Private Partnership and its shareholders (which include PFI Funders themselves) have vested interests in showing PFI to work.

It is possible the reality is something different. It is possible that the public sector does not know how to operate its PFI contracts and those which it considers are operating satisfactorily may not be at all.

SPV’s form part of groups that are extremely sophisticated in PFI investments. Individuals within these organisations understand not only the Project Agreements extremely well but also the fact that the Authorities rarely complain about the services that are being delivered. It is not uncommon for SPV’s to dismiss Authority concerns simply because the Authority is not basing its concern upon contractual entitlement or upon raw data.

Too many Authorities are frankly intimidated by their PFI Contracts believing that which they signed up to is a given for the duration of the contract term and that they cannot re-negotiate in order to achieve better value or even extract savings by undertaking detailed audits to ensure that the correct payment is being made for the correct service delivery. It is often the case that better value can be secured simply by the authority acquiring a better understanding of the contract terms, correctly monitoring performance to ensure the specifications are met and properly applying the Payment Mechanisms.

The Authority needs to look at the service that it is receiving, to look at the provision of FM service and consider whether there a better way for the service to be performed. Often this can be done without any added cost to the Project and often by reducing the cost over the lifetime of the project. True partnership is not about cosying up to the SPV but rather about looking for savings and seeking their implementation and working with the SPV to achieve this. The Authority should not be afraid to seek cost saving variations and to measure exactly how the SPV is costing such service variations.

The Authority is under a constant obligation to secure best value. The SPV’s obligations to assist the Authority to achieve best value are usually limited to any requirements set out in the Project Agreement. However in most Project Agreements there will be obligations placed upon the SPV in respect of customer satisfaction surveys. Because people like to complain these will often contain negative statements and they should be used to secure better performance.

In some contracts the SPV is required to prepare and issue annual service reports and these may be used in order for the Authority to determine that “the provision, performance or delivery of the Services (or any part) may be more effective, efficient and economic having regard to the Annual Service Report and the Best Value Duty” which would entitle the Authority to serve a Change Notice, the contents of which can be either agreed or determined by dispute resolution. Even in those contracts that do not provide such provisions there is always the ability to change the level of services by consent and if the Authority is receiving poor value for money then such should be considered.
Too many Authority’s wrongly believe that what they signed up to is a given for the duration of the contract term and that they cannot re-negotiate in order to achieve better value. Value Testing is the perfect time to negotiate changes so that the Authority receives a service better aligned to its needs and which it can afford.
Disclaimer

These notes have been produced to assist in the understanding of operational PFI contracts and reflect the views of the writer.

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