

31 DIRECT AGREEMENT AND SENIOR LENDERS

31.1 INTRODUCTION

31.1.1 A Direct Agreement referred to in this guidance is an agreement between the Authority and Senior Lenders that deals with the relationship between these interested parties following a termination or threatened termination for Contractor Default (see Section 21.2 (Termination on Contractor Default)). As stated in Section 29 (Authority Step-In), it is entirely different to the rights described in that Section.

31.1.2 The concern of the Senior Lenders is that they have financed the Project on the basis of projected cash flows and if the Contract (under which these cash flows are agreed to be paid) is terminated, they will only have rights against the Sub-Contractors and to amounts in the bank accounts of the Contractor as security for their financing. They will not, typically, have any rights to sell the Assets, as would be the case in many types of secured financings. In many projects, recovery of amounts by the Senior Lenders making claims under the Project Documents will not lead to full repayment. Typically the Senior Lenders will only recover the amount invested after acceptance of the facility by the Authority, and through the successful operation of the project and the payment of Unitary Charge over the life of the project. The Senior Lenders, and their technical advisers, will closely monitor the Works to ensure they are built on time and to specification, and will monitor the delivery of Services, to ensure the Unitary Charge is paid without deductions. In this way the interests of the Senior Lenders, to ensure that the Contractor performs its obligations, are broadly aligned with those of the Authority.

31.1.3 Direct Agreements should be used for project financed projects (but should not be needed for corporately financed projects) and such documents can be seen as advantageous to the public sector, in that they give Senior Lenders an opportunity to “revive” the Project and, therefore, to avoid the disruption that invariably follows termination. If the Project can be restored with minimal disruption to the Service and there is no need for the Authority to get involved to ensure that this occurs, then both the Authority and the Senior Lenders benefit.

31.1.4 The key issues are: when the Senior Lenders should be permitted to step-in, the extent to which the Senior Lenders should be obliged to assume liabilities that have been or are being incurred by the Contractor and the extent to which they are given the opportunity to rectify a breach on behalf of the Contractor. The approach taken in this guidance is very closely related to the approach taken in Section 21.2 (Termination on Contractor Default).

31.1.5 Other issues relating to this arise, such as for how long any liability of the Senior Lenders should continue, what rights of termination exist on a step-in and what rights of “sale” or replacement of Sub-Contractors the Senior Lenders should have.

31.2 LIABILITY OF SENIOR LENDERS

31.2.1 It could be argued that to the extent the Senior Lenders “step-in” (i.e. obtain rights under the Contract) then they should be liable for obligations to the same extent as the Contractor. On some early projects this led to the development of “step-in undertakings”, under which Senior Lenders agreed to accept a degree of liability (invariably capped) as the price of their attempt to save the Project.

31.2.2 Other projects attempted to follow more closely the then existing structure for insolvencies and work-outs in the UK, namely that of an administrative receivership appointment

and sale, on the basis that the interests of all parties were best served by following a well established procedure that allows an entity to be appointed to take over the decision making rights of the Contractor without immediately being forced to sign up to either a limited quantified or unlimited liability.

31.2.3 A standard approach has now been developed, to the effect that the Senior Lenders should be given an opportunity to rectify any defaults and maximise any realisation without having to provide a “step-in undertaking” to the Authority. This approach is very closely linked to the approach taken in Section 21.2 (Termination on Contractor Default) as if the situation worsens to a sufficient degree (e.g. claims arise) during the Senior Lenders’ period of “step-in”, the Authority may terminate the Contract and such liability will be reflected in the termination compensation payable to the Contractor.

31.3 REQUIRED APPROACH

31.3.1 This approach distinguishes between the Contractor and the Senior Lenders even on step-in. The Senior Lenders must agree to sign up and pay for any liability (e.g. any amounts owing to the Authority) at the time of step-in and take steps to rectify breaches. In implementing rectification of breaches under the Contract some time and flexibility should be given. Nevertheless, the Contractor will always remain liable under the Contract and, to the extent a new breach occurs during the period of step-in, then termination can still occur.

31.3.2 Following, or simultaneously with, the issue of a Termination Notice under the Contract, the Authority will issue a Termination Notice to the Agent. This will trigger the running of a period which, if the Senior Lenders decide not to step-in, will allow the Contract to terminate. Within 30 days of issuing the Termination Notice, the Authority must also notify the Agent of the liabilities to be discharged by the Senior Lenders on step-in. If the Senior Lenders wish to step-in, then the liability to be discharged must be paid to allow step-in to occur (see Clause 6(b) of the Direct Agreement for detailed provisions).

31.3.3 A similar procedure can apply if no Termination Notice is in fact issued, but the Senior Lenders have accelerated the maturity of their debt and demanded repayment. These provisions are set out in Clauses 3 (No Termination Without Notice), 5 (Representative) and 6(b) of the Direct Agreement.

31.3.4 During the step-in period, the Senior Lenders are incentivised to ensure that a remedial programme is implemented in relation to antecedent breaches and that no new breaches occur. If antecedent breaches are not remedied or new breaches occur, then a right to termination can arise again.

31.3.5 The Direct Agreement also provides that the effects of the step-in can come to an end if the Senior Lenders step-out or a novation occurs. If the Contract continues by way of a novation, this does not mean that the parties will not amend the Contract in certain respects. For example, the parties may agree that the performance and payment mechanism are not incentivising the parties correctly (see Section 7.5 (Calibration)) and so require it to be amended. This will depend in part on the extent to which the mechanism concerned is untested and/or capable of automatic recalibration (see Section 7.7 (Flexibility)).

31.3.6 If the Senior Lenders cannot rectify the default or save the Project, then termination will occur in accordance with Clauses 21.2.8 (Retendering Procedure) or 21.2.9 (No Retendering Procedure) of the Contract, depending on what steps have been taken by Senior Lenders to realise a value from the project. If any undischarged claims are owing from the Contractor, then they can be set off under Clause 12 (Set-off).

31.3.7 The advantage of the above approach is that the Senior Lenders are clearly aware when they make the decision whether or not to step-in what liabilities are being accepted.¹ At the same time, the Authority retains the right to terminate if any breach occurs or the Senior Lenders are not making sufficient effort to rectify the antecedent breaches and so it is in substantially the same position after step-in as it was before.

31.3.8 In return for a payment being made to the Contractor (whether under Clause 21.2.8 (Retendering Procedure) or Clause 21.2.9 (No Retendering Procedure)), the Senior Lenders should agree to release any security over the Assets (other than charges over bank accounts and counterparty claims (including claims against the Authority under the Contract and the Sub-Contractors under the Sub-Contracts)). See further Section 31.6 (Direct Agreement).

31.4 PERFORMANCE POINT ACCRUAL WHEN STEPPED IN

31.4.1 One key point is the extent to which performance points can continue to accrue when the Senior Lenders have stepped in.

31.4.2 The relevant approach depends in part on the issues referred to in Section 24.6 (Damages Claims) and the likelihood of any claims arising. To the extent the performance points accrual rate reflects the loss to the Authority, then by performance points being incurred, the Authority is protected. Its main concern in such circumstances is to ensure that it is not paying for the Service if it is not being provided.

31.4.3 To the extent this is the case, then relief from termination should be given for an extended period to allow rectification to occur, so that a significant period can be given to allow implementation of the rectification programme. Sufficient flexibility should be included in the Step-In Period so that default is not an inevitable consequence (for example, if one more penalty point triggers a termination, the Senior Lenders will be reluctant to step-in) and time is given to rectify, so allowing the Senior Lenders the opportunity to rectify.

31.4.4 The approach taken is that performance points should continue to accrue during the Step-In Period but that during any Step-In Period there should be a suspension (but not cancellation) of any performance points that accrued prior to the Step-In Date, but only for the purposes of triggering a termination (i.e. not in accruing deductions from the Unitary Charge). Although performance points will accrue during the Step-In Period, the Authority should not be able to terminate the Contract if the Senior Lenders are using reasonable endeavours to rectify any breach that arose prior to the Step-In Date but which is continuing. If the Senior Lenders subsequently step-out, the suspension of those performance points should be lifted.² If the Authority does not have this protection and the Senior Lenders step-out because they no longer wish to rescue the Project, the Authority will need those points that accrued prior to the Step-In Date to be taken into account so as to ensure that the Authority has the ability to terminate the Contract. If the Step-In Period ends because of a transfer of the Contract to a Suitable Substitute Contractor, any accrued performance points will be cancelled for the purposes of triggering a termination.

¹ Unlike in some other models, the Senior Lenders have no liability to the Authority during the step-in period (but the step-in period may end and the Contract may be terminated if new payment or other defaults arise during the step-in period, or if "post notified" debts are not paid – see Clause 6(b)). Similarly, the Senior Lenders can step out at any time without having any liability to the Authority. This does not prejudice the Authority as it is protected in the knowledge that if the situation worsens (e.g. claims arise) as a result, then this will be reflected in compensation payable on Contractor Default.

² See Section 9.5 (Consequences of Poor Performance). The "wipe clean" of deductions for termination purposes should be limited to two occasions during the life of the Contract.

31.4.5 To the extent that a rectification programme is being implemented (and so no termination right exists) it is possible that a refinancing may be required to incorporate, for example, new working capital.

31.5 LIABILITY FOR INDEMNITY CLAIMS OR CLAIMS FOR DAMAGES

31.5.1 It has been argued in some cases that the Authority should at least retain the right to recover against the Senior Lenders (when stepped-in) for any damages the Senior Lenders caused when stepped-in. To the extent that any damage or claims (e.g. from third parties) arise in relation to the Contract, then the damage or claims concerned will, in most cases be reflected in the termination compensation payable.

31.6 DIRECT AGREEMENT

31.6.1 Required minimum drafting for a direct agreement is set out below. Explanatory guidance is set out in the footnotes.

THIS AGREEMENT³ IS MADE ON [], []

BETWEEN:

- (1) [RELEVANT DEPARTMENT OR GOVERNMENT BODY] (the “Authority”);
- (2) [] (the “Agent” for the Senior Lenders⁴); and
- (3) [PROJECT COMPANY] (the “Contractor”).

IT IS AGREED AS FOLLOWS:

1 INTERPRETATION

(a) In this Agreement, unless the context otherwise requires:

“Appointed Representative”

means a Representative that has assumed the Contractor’s rights under the Contract under Clause 5(a).

[“Credit Agreement”

means the [] credit agreement dated [] between the Contractor, the Agent and various Senior Lenders and financial institutions.]

“Contract”⁵

“Contractor Default”

shall have the meaning given to it in the Contract.

“Event of Default”

shall have the meaning given to it in the Credit Agreement.

³ This draft deals with the step-in mechanics and novation. Other issues may also require inclusion in Direct Agreements if appropriate (such as specific detail relating to specific accounts into which payments are to be made and payment of insurance proceeds (see Section 25 (Insurance)). The Direct Agreement may not be used however as a device to reallocate risks which have already been allocated between the Authority and its bidder in the Contract.

⁴ The reference to “Senior Lenders” is intended to track the definition in the Financing Agreements. To the extent bonds are used, minor drafting changes will be needed (for example to refer to the “Trustee” rather than the “Agent” and to “Bondholders” rather than “Senior Lenders”). The approach taken will not otherwise differ. When a monoline insurer is involved as part of the Project, key decisions taken will be taken by the monoline insurer, rather than the bondholders and the drafting should reflect this. Similarly, it may be that the security is held by a trustee for the financiers (usually called the “Security Trustee”). If so, then the drafting will require conforming.

⁵ As defined in Section 1.7 (Interpretation).

“Fair Value”

means the amount at which an asset or liability could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced liquidation or sale.

“Liquid Market”

shall bear the meaning given to it in the Contract.

“Representative”⁶

means

- (a) the Agent, any Senior Lender and/or any of their Affiliates;⁷
- (b) an administrator, administrative receiver,⁸ receiver or receiver and manager of the Contractor appointed under the [Security Documents];⁹
- (c) a person directly or indirectly owned or controlled by the Agent and/or any Senior Lender(s); or
- (d) any other person approved by the Authority (such approval not to be unreasonably withheld or delayed).

“Required Period”

means,¹⁰ subject to Clause 4 (No Liquid Market) the period starting on the date of a Termination Notice and:

- (a) during the construction phase ending [120] days later; and
- (b) during the operating phase ending [90] days later.

“Step-In Date”

means the date on which the Agent takes any action under Clause 5(a).

“Step-In Period”

means the period from the Step-In Date up to and including the earlier of:

- (a) the Step-Out Date;
- (b) the date of any transfer under Clause 8;
- (c) the date of any termination for breach under Clause 6; and
- (d) the date of expiry of the Contract.

“Step-Out Date”

means the date falling [30]¹¹ days after the date of the notice given under Clause 7 (Step-Out).

⁶ In the past, some Authorities have taken the view that it is inappropriate to have an administrator, receiver, manager or an administrative receiver over the Contractor or its assets. Provided that the right to terminate the Contract for non-performance is preserved during this period and the operational assets of the Project are protected and preserved for the Authority (see Section 31.6.5 any such concern is misplaced.

⁷ See the definition in Clause 1.7.1 (Definitions).

⁸ This assumes the Senior Lenders have valid security over all or substantially all of the assets of the Contractor, entitling them to appoint an administrative receiver.

⁹ To be defined, but Senior Lenders will expect the security referred to in footnote 8 above.

¹⁰ The time periods will be subject to the specific requirements of particular projects, but these are likely to be appropriate for many projects that have a split between these phases. In practical terms, since the Senior Lenders will be funding the Project while they are making the decision whether or not to step-in and the liability of the Senior Lenders while stepped-in is clearly limited in this agreement, provided the Project is not technically complex or does not involve a large banking syndicate 90 days may be sufficient even during the construction phase.

“Suitable Substitute Contractor”

means a person approved by the Authority (such approval not to be unreasonably withheld or delayed) as:¹²

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

“Termination Notice”

means a notice given by the Authority to the Agent under Clause 3(a).

- (b) [Relevant parts of Clause 1.7.2 (Interpretation) of the Contract should be included here with suitable amendments where necessary].
- (c) Capitalised terms defined in the Credit Agreement have the same meaning in this Agreement.

2 CONSENT TO SECURITY

- (a) The Authority acknowledges notice of, and consents to, the security interest granted over the Contractor’s rights under the Contract effected by the Contractor in favour of the Senior Lenders under the Security Document.¹³
- (b) The Authority confirms that it has not received notice of any other security interest granted over the Contractor’s rights under the Contract.¹⁴

3 NOTICE OF TERMINATION AND EXISTING LIABILITIES

The Authority shall not terminate or give notice terminating the Contract¹⁵ on the grounds of Contractor Default without giving to the Agent.

- (a) at least the Required Period of prior written notice stating:
 - (i) the proposed Termination Date; and
 - (ii) the grounds for termination in reasonable detail, and
- (b) not later than the date falling 30 days after the date of a Termination Notice or (if earlier) the date falling 30 days after the date on which the Agent informs the

¹¹ This will depend on the time required by the Authority to put in place alternative measures to provide the Service.

¹² This definition applies to the criteria required for a new Contractor. To the extent there are rights of veto for the Authority in the Contract on replacements to Sub-Contractors and transfers of shares (see Sections 16.1 (Control over Sub-Contractors) and 18 (Change of Ownership)), Senior Lenders will seek to impose criteria (such as the above). Thought should always be given to including any such criteria in the Contract and, to the extent they are included, these are appropriate limits. Criteria that are not objective are very unlikely to be “bankable”. Other criteria may be appropriate in particular cases (for instance, if security or national security is an issue). Departments may require, for example, that directors of the Contractor have not committed a criminal offence. These requirements should focus on key requirements for a Contractor in that project (as, for example, a road traffic offence or a spent conviction may have little or no relevance). Similar considerations apply to those in Section 16 (Sub-Contracting, Employees and Documentary Changes).

¹³ This should restrict the ability of the Senior Lenders to transfer in breach of Clause 9 (Novation).

¹⁴ Departments will sometimes argue that they may not be aware of such notices. The correct view is that they should be and so should be able to make this confirmation.

¹⁵ The termination events in the Contract can be distinguished between for these purposes (for example, treating an insolvency default differently from a performance default), but if the Project can be rescued by the Senior Lenders then there is no good reason to draw such a distinction. This agreement also assumes that if the Contract is to be terminated in circumstances in which the Senior Lenders will be repaid in full (e.g. for corrupt gifts or force majeure) then the Senior Lenders will not want to exercise their rights under this Agreement. The Direct Agreement should also restrict the Authority’s right to terminate other agreements ancillary to this Agreement (e.g. a lease of land on which the Project is built).

Authority that an Event of Default.¹⁶ has occurred, a notice containing details of any amount owed by the Contractor to the Authority, and any other existing liabilities or unperformed obligations¹⁷ of which the Authority is aware (having made reasonable enquiry):

- (i) at the time of the Termination Notice or the notification of an Event of Default; and/or
- (ii) which will fall due on or prior to the end of the Required Period, under the Contract.¹⁸

4 NO LIQUID MARKET

- (a) At any time during the Required Period¹⁹ the Agent may issue a written notice (the “**No Liquid Market Notice**”) to the Authority setting out the reasons why the Agent does not believe that a Liquid Market exists.
- (b) On or before the date falling 14 days after the date on which a No Liquid Market Notice is received by the Authority, the Authority shall notify the Agent of its opinion as to whether or not a Liquid Market exists. Where the Authority believes that a Liquid Market does exist, such notice shall set out the reasons for the Authority's belief. If the parties do not agree whether or not a Liquid Market exists, then either party may refer the dispute to be determined in accordance with Clause 28 (Dispute Resolution).²⁰
- (c) If the parties agree or it is determined in accordance with Clause 28 (Dispute Resolution) that no Liquid Market exists, the Contract shall automatically terminate and the provisions of Clause 21.2.9 (No Retendering Procedure) shall apply.²¹
- (d) If any dispute relating to this Clause 4 is determined under Clause 28 (Dispute Resolution), the Required Period shall be extended by the period of time spent determining such dispute under Clause 28 (Dispute Resolution).

5 REPRESENTATIVE

- (a) Without prejudice to the Agent's rights under the Security Documents, at any time:
 - (i) during which an Event of Default²² is subsisting (whether or not a Termination Notice has been served); or
 - (ii) during the Required Period,²³

¹⁶ See footnote 22, as to whether this reference should be to an Enforcement Event.

¹⁷ Both parties should have a clear understanding of what these liabilities are, as it is likely that an increase in debt facilities will be needed to rectify defaults or cover interest that accrues. Care should be taken to ensure that the Authority does not intervene to specify how unperformed liabilities should be performed (e.g. following a request for conditions surveys), but instead give information on the default that led to termination and any other breaches of which it is reasonably aware.

¹⁸ This method is used instead of requiring a step-in undertaking. A step-in undertaking is an undertaking from the Senior Lenders or other financiers to meet certain obligations, usually existing as at the date of step-in (and in some cases those that arise later). Even a capped liability during the Step-In Period could discourage the Senior Lenders or other financiers from stepping-in and for that reason this approach is not taken here.

¹⁹ The Agent should only be permitted to issue a No Liquid Market Notice to the Authority during the Required Period. Any dispute as to whether or not a Liquid Market exists after the last day of the Required Period should be determined in accordance with Clause 21.2.7 (Retendering Election) of the Contract.

²⁰ Any dispute should be determined under the dispute resolution procedure (see Section 28.2.3). The dispute resolution procedure in the Contract will need to apply *mutatis mutandis* to the Direct Agreement.

²¹ The compensation payable to the Contractor in such circumstances will be determined in accordance with the procedure set out in Clause 21.2.9 (No Retendering Procedure).

²² This should be defined in the Credit Agreement and this drafting assumes that the occurrence of an Event of Default will allow the Senior Lenders to enforce their security. If the Contractor has negotiated that the security is not enforced until the debt is actually accelerated, the Contractor should be permitted to change references from Event of Default to “Enforcement Event”. It is, in any event, unlikely that Senior Lenders will wish to step-in unless the Project is in serious difficulties.

the Agent may procure that a Representative assumes, jointly and severally with the Contractor, all of the Contractor's rights under the Contract.

- (b) The Agent shall give the Authority [5]²⁴ days prior notice of any action to be taken by it referred to in this Clause 5.

6 STEP-IN PERIOD

- (a) Without prejudice to Clause 3 (No Termination Without Notice), but subject to paragraph (b) below, the Authority shall not terminate the Contract during the Step-In Period on grounds:

- (i) that the Agent has taken any action referred to in Clause 5 (Representative) or enforced any Security Document(s); or
- (ii) arising prior to the Step-In Date²⁵ of which the Authority is aware (having made reasonable enquiry and whether or not continuing at the Step-In Date); or
- (iii) arising solely in relation to the Contractor,²⁶

unless, in the case of paragraph (ii) above:

- (A) the grounds arose during the [construction phase],²⁷ and construction is not completed on or before the date falling [12]²⁸ months after the date on which the Authority would have been entitled to terminate the Contract for non-completion;²⁹ or
- (B) the grounds arose during the [operation phase], and neither the Appointed Representative nor the Contractor is using all reasonable endeavours (including implementation of any remedial programme)³⁰ to remedy any breach of the Contract that:
- (1) arose prior to the Step-In Date; and
 - (2) is continuing (and capable of remedy); and
 - (3) would have entitled the Authority to terminate the Contract.

²³ The Authority should ensure that during this period it has preserved the right in the Contract to enter on the property and restore problems that need an emergency fix (through rights of access). Its rights of termination against the contractor with the Senior Lenders "stepped-in" are sufficient to protect it during the "step-in" period (provided the Contract has been negotiated correctly).

²⁴ It is unlikely that a longer period will be needed.

²⁵ To the extent a right to terminate would otherwise arise, a right to terminate should arise for a 'latent defect' (i.e. one that could not reasonably be expected to have been discovered) becoming an 'actual defect'. That is, notwithstanding the discovery of a latent defect that existed prior to the Step-In Date, it should be treated as arising after that date. Latent defects are likely to be dealt with in the Contract (see Section 6.5 (Latent Defects Risk)) and are project specific.

²⁶ For example, insolvency of the Contractor.

²⁷ It is acknowledged that in the provision of the Service it is not always clear when the construction phase ends as the construction of an asset will be to facilitate the provision of the Service and without the ancillary support (for example, in a prison the regime being set up and approved) the Service will not be ready to start. Similarly in a phased development, the two phases will usually overlap. The key determinant will, of course, be the extent to which failure to complete construction of either phase will lead to termination (thereby preventing Service Commencement), in which case paragraph (A) will apply. If the failure is in the delivery of the Service from a completed facility then paragraph (B) will apply.

²⁸ Time periods will depend on a number of issues, including the nature of the Project and the length of the construction phase. If there is no critical need for the project to commence by a certain date or parties believe the financial incentives are sufficiently strong, then (B) can also apply to terminations in the construction phase.

²⁹ See footnote 27 above.

³⁰ Prior to any step-in by the Senior Lenders, it is likely that the Authority will be asked to approve a remedial programme in respect of rectification works that the Senior Lenders are proposing in an attempt to rescue the Project. Such an approach is only acceptable provided that the Authority does not assume any additional risk by virtue of giving such approval, i.e. the purpose of the remedial programme should be purely to assist the Senior Lenders in a defence of a claim by the Authority that the Senior Lenders are in breach of Clause 6(a)(iii)(B) as they are not using reasonable endeavours to rectify the relevant breach of the Contract.

- (b) The Authority shall be entitled to terminate the Contract by written notice to the Contractor and the Appointed Representative:
 - (i) if any amount referred to in Clause 3(b)(i) above has not been paid to the Authority on or before the Step-In Date;
 - (ii) if any amount referred to in Clause 3(b)(ii) has not been paid on or before the last day of the Required Period;
 - (iii) if amounts, of which the Authority was not aware (having made reasonable enquiry) at the time of the Termination Notice or the Event of Default, subsequently become payable and are not discharged on or before the date falling [30] days after the date on which the liability for these amounts is notified to the Agent; or
 - (iv) on grounds arising after the Step-In Date in accordance with the terms of the Contract provided that for the purposes of termination under the Contract, [warning notices, deductions and/or penalty points] that arose prior to the Step-In Date shall not be taken into account during the Step-In Period but shall be taken into account after the Step-Out Date.³¹
- (c) The Authority shall deal with the Appointed Representative and not the Contractor during the Step-In Period.

7 STEP-OUT

- (a) The Appointed Representative will, on [30] days' prior written notice from the Agent or the Appointed Representative to the Authority, be released from all of its obligations and liabilities to the Authority under the Contract arising prior to the Step-Out Date and rights of the Appointed Representative against the Authority will be cancelled.³²
- (b) The Contractor shall continue to be bound by the terms of the Contract, notwithstanding the occurrence of the Step-Out Date.³³

8 NOVATION

- (a) Subject to Clause 8 (b), at any time:
 - (i) during which an Event of Default³⁴ is subsisting; or
 - (ii) during the Step-In Period,

the Agent may, on [30] days' prior written notice to the Authority and any Appointed Representative, procure the transfer of the Contractor's rights and liabilities under the Contract to a Suitable Substitute Contractor.
- (b) The Authority shall notify the Agent as to whether any person to whom the Agent proposes to transfer the Contractor's rights and liabilities under the Contract is a Suitable Substitute Contractor, on or before the date falling [30] days after the date of receipt of all information reasonably required by the Authority to decide whether the proposed transferee is a Suitable Substitute Contractor.³⁵

³¹ See Section 31.4.4 (Performance Point Accrual when Stepped-In).

³² Any undischarged liabilities are reflected in the payments under Clause 21.2.8 (Retendering Procedure) and Clause 21.2.9 (No Retendering Procedure).

³³ See Section 31.4.4 (Performance Point Accrual when Stepped-In).

³⁴ See footnote 22 above. The same point applies here.

³⁵ The Authority would be reasonable in withholding its consent if there are outstanding unremedied breaches with no proposed remedial programme.

- (c) The Authority shall not unreasonably withhold or delay its decision on whether the proposed transferee is a Suitable Substitute Contractor.³⁶
- (d) On any transfer referred to in Clause 8(a) becoming effective:
 - (i) the Contractor shall be released from any obligations arising under or in connection with the Contract from that date and the new Contractor shall become liable for obligations arising on or after that date;
 - (ii) any accrued [performance points and/or warning notices] incurred under the Contract shall, for the purposes of termination only, and without prejudice to the rights of the Authority to make financial deductions, be cancelled;
 - (iii) any then subsisting ground for termination of the Contract by the Authority shall be deemed to have no effect and any subsisting Termination Notice shall be automatically revoked; and
 - (iv) the Authority shall enter into a direct agreement with the Senior Lenders lending to the new Contractor on substantially the same terms as this Agreement.

9 INSURANCE PROCEEDS

Notwithstanding the other provisions of this Agreement and the terms and conditions of the Senior Financing Agreements, the Agent shall only permit amounts to be released from the Joint Insurance Account in accordance with the requirements of [Clause 25.6 (Reinstatement)] of the Contract³⁷ and shall not exercise any rights under the Senior Financing Agreements or take any other steps to prevent amounts being released from the Joint Insurance Account in accordance with [Clause 25.6 (Reinstatement)] of the Contract.

10 MISCELLANEOUS

- (a) The Authority shall at the Contractor's expense, take whatever action the Agent, an Appointed Representative or a Representative taking a transfer in accordance with Clause 8(a) may require for perfecting any transfer or release under Clauses 5 (Representative), 7 (Step-Out) and 8 (Novation) including the execution of any transfer or assignment, and the giving of any notice, order or direction and the making of any registration which, in each case, the Agent, Appointed Representative or Representative reasonably requires.
- (b) The Authority shall not take any action to wind up, appoint an administrator or sanction a voluntary arrangement (or similar) in relation to the Contractor.
- (c) This Agreement shall remain in effect until the date on which all amounts which may be or become owing by the Authority to the Contractor under [Section 21 (Early Termination)] of the Contract have been irrevocably paid in full, [whereupon the Agent agrees on behalf of itself and the Senior Lenders to release any security granted in their favour over the Assets which has not previously been assigned to the Authority].³⁸

³⁶ At the time of any proposed novation, the Authority should ensure that it is a condition of the novation that any unpaid amounts owed to it by the Contractor (e.g. amounts claimed under the indemnity provision) are satisfied in full.

³⁷ Under the terms of the Senior Financing Agreements, the Senior Lenders will take security over all of the assets of the Contractor, including the Contractor's interests in the Joint Insurance Account. However, the Senior Lenders should accept that any proceeds standing to the credit of the Joint Insurance Account should be applied in reinstatement of the assets except where no reinstatement is required as a result of Section 25.6 (even if the Contract has terminated) and accordingly the Authority should not agree to any request from the Senior Lenders for the Authority to grant security to the Senior Lenders over its interests in the Joint Insurance Account.

³⁸ If the Assets revert to the Authority on early termination of the Contract and the Authority has the right and elects to pay early termination compensation amounts in instalments, the Senior Lenders should release any security held over the Assets on termination so as to allow the unencumbered Assets to be transferred to the Authority. See Section 31.3.8 in relation to which Assets the Senior Lenders should not be required to release their security over.

- (d) The Agent, in respect of paragraphs (i), (ii) and (iii), and the Contractor in respect of paragraph (iv), shall promptly notify the Authority of:
 - (i) any decisions to accelerate the maturity of any amounts owing by the Contractor to the Senior Lenders under the Credit Agreement and/or demand repayment;³⁹
 - (ii) the date referred to in paragraph (c) above on or before the date falling 30 days after its occurrence;
 - (iii) the details and amount of any proposed Additional Permitted Borrowing, including:
 - (a) the circumstances giving rise to it and reasons for it; and
 - (b) the terms on which it will be borrowed; and
 - (iv) on the first Business Day of each calendar month during which any Additional Permitted Borrowing is, or may be, subsisting, the amount outstanding under the Senior Financing Agreements (as the same may be amended (whether or not with the approval of the Authority)), and, to the extent it is aware (having made reasonable and proper enquiry):
 - (a) the amount of any Distribution made by the Contractor; and
 - (b) the amount of any credit balance on any account of the Contractor;⁴⁰
- (e) The Contractor joins in this Agreement to acknowledge and consent to the arrangements set out and agrees not knowingly to do or omit to do anything that may prevent any party from enforcing its rights under this Agreement.⁴¹
- (f) For the avoidance of doubt, if there is any conflict or inconsistency between the provisions of this Agreement and the Contract, the provisions of this Agreement shall prevail.⁴²
- (g) The Agent agrees on behalf of itself and the Senior Lenders that [include relevant “boiler plate” from the Contract].⁴³

11 ASSIGNMENT

- (a) No party to this Agreement may assign or transfer any part of its rights or obligations under the Agreement, save that:
 - (i) the Agent may assign or transfer its rights and obligations under this Agreement to a successor Agent in accordance with the Senior Financing Agreements without the consent of the Authority;
 - (ii) any Senior Lender may assign or transfer its rights under the Senior Financing Agreements in accordance with the terms of the Senior Financing Agreements; and

³⁹ See footnote 22 above. Even if the trigger for step-in is demand for the repayment of Senior Debt, earlier enforcement steps should be notified.

⁴⁰ For a bond transaction, 10(d)(iv) may be replaced by a new clause if the Authority thinks this appropriate. See Section 36 (Bond Finance).

⁴¹ It is also good practice for the Contractor to appoint the Authority as its attorney to sign any required novation documentation so that, if novation occurs, it does so as smoothly as possible.

⁴² For example, provisions relating to termination and compensation will cut across the provisions of this Agreement.

⁴³ These provisions should be consistent with the provisions of the Contract and impose an equivalent but separate liability on the Senior Lenders to that to which the Contractor is subject.

- (iii) the Authority may assign, novate or otherwise transfer its rights and/or obligations under this Agreement to any person that the Authority assigns, novates or otherwise transfer its rights and/or obligations under the Contract in accordance with Clause 17.3 of the Contract.
- (b) If paragraph (a)(i) applies then the Authority shall enter into a direct agreement with the new Agent on substantially the same terms as this Agreement.

12 GOVERNING LAW

This Agreement is governed by the laws of England and Wales.⁴⁴

31.7 SUBORDINATION AND RELATED PROVISIONS

31.7.1 A number of projects have been closing in the PFI market where Senior Lenders have sought to add blanket subordination provisions to the form of the Direct Agreement which, in extreme cases, might act to negate the benefit of the Authority's own direct agreements with key Sub-Contractors and consultants.

31.7.2 An Authority should have no wish to upset the normal arrangements which Senior Lenders enter into or to upset the Senior Lenders' incentives to take responsibility for monitoring the Contractor (and where necessary to take control of its affairs and sub-contracts); equally however it will wish to be able to preserve continuity of services and build, and will not want the benefit of its own step-in arrangements negated. There should ordinarily be no conflict between the interests of the Senior Lenders and of the Authority - both of whom will want to ensure continued Service provision.

31.7.3 If, however, for some reason Senior Lenders do not choose to exercise their rights under their direct agreements with key Sub-Contractors and consultants, or having exercised such rights have stepped out, the Authority may wish to exercise its own rights under its own direct agreements to preserve continuity of Service, for instance, with a valued non-defaulting Sub-Contractor. Blanket subordination provisions, preventing the Authority from exercising its rights until the Senior Debt is fully paid out, might preclude this.

31.7.4 Set out below is some suitable drafting which Authorities may find helpful. For periods after Project termination, where notice periods allowing Senior Lenders to step in have elapsed and they have chosen not to step in to Sub-Contracts, the Authority may step-in (though the Senior Lenders' own claims against sub-contractors may be preserved). In the period prior to project termination before the notice period to Senior Lenders may have elapsed, the Authority may agree not to step in to subcontracts but may still wish to be able to fund them to prevent their termination. This is likely to be a remote and short term contingency prior to Project termination.

31.7.5 An Authority will also wish to ensure that the operational assets which the Authority needs to complete or operate the Project pass across from the Contractor to the Authority on a termination – so as to ensure continuity of service. These principles are set out in Section 31.3.8 and Section 21 (Early Termination) and the Senior Lenders' security arrangements should not overturn them. This should not be a concern for the Senior Lenders (whose main interest should be the Termination Sum or the cash sum paid in the market for the Project on a default). It is in the interests of the Senior Lenders that the Project remains operational and can be sold in the market for its maximum value. Their real security is in the cash flow (or termination sum) rather than in assets. The operational assets involved are not likely to be major items in most Projects.

⁴⁴ Scottish PFI projects will have direct agreements governed by Scottish law since they are widely regarded as operating in parallel with Scottish law governed Contracts (even if the Financing Agreements are English law governed). Northern Ireland projects will also normally be governed by local law.

Suitable drafting is as follows:

31.7 Authority rights under Direct Agreements [and Appointments]

31.7.1 Notwithstanding any provision in the Authority Direct Agreements [and/or the Appointments] to the contrary, the Authority agrees that, subject to Clauses 31.7.2 and 31.7.3, it will not, in respect of any particular Authority Direct Agreement [or Appointment], exercise or seek to exercise any of its step-in rights or other rights under such agreement or until the earlier of:

- (a) the Senior Debt Discharge Date; or
- (b) the date on which the Agent has given its written consent to such exercise; or
- (c) the time when in respect of any such Authority Direct Agreement [or Appointment] either:
 - (i) the Senior Lenders have failed to exercise any corresponding right to such Authority Direct Agreement [or Appointment] under their own Security Documents and the time for exercising such right has ended in accordance with the terms thereof; or
 - (ii) the Agent has confirmed in writing to the Authority (following any request from the Authority for such confirmation, to which the Agent shall be obliged to respond promptly) that it does not intend to exercise any of its rights under the relevant Security Document or that it has no further claim thereunder; or
 - (iii) the Senior Lenders have stepped in to, or otherwise, directly or indirectly, taken control over the rights of the Contractor under, such agreement (in accordance with their rights under their Security Documents) and then stepped out from, or otherwise relinquished control of such rights under or in connection with such agreement.

31.7.2 In addition to its rights under Clause 31.7.1, where the Contract has not been terminated but a counterparty has a right to terminate its sub-contract [or Appointment] for breach by the Contractor of the terms of such sub-contract [or Appointment], the Authority may pay directly, or undertake to make a payment directly to the counterparty concerned, amounts due pursuant to the sub-contract [or Appointment] and may set off any such sums against any payments payable by the Authority to the Contractor under the Contract, so as to satisfy them pro tanto, provided always that the Authority shall not exercise its rights under this clause 2.2 in respect of any particular such sub-contract [or Appointment] in circumstances where the Senior Lenders have stepped in to, or otherwise, directly or indirectly, taken control over, the relevant sub-contract [or Appointment] and not stepped out of it or otherwise relinquished such control.⁴⁵

⁴⁵ This provision deals with the period prior to any project termination, and may include, for instance, a period when the Authority wishes to terminate and has given the required period of notice to Senior Lenders (e.g. 90 or 120 days) under Clause 3. It will be for Authorities or Departments (as relevant) to determine on a Project or sector basis the provisions of this Clause 31.7.2 and of the Direct Agreement whether or not they think it appropriate to further qualify or limit their ability to set off such payments. Clearly the preferred position for the public sector will be to retain the ability to "set off" any such payment to sub-contractors so as to reduce the unitary charge, (and avoid "double payment") and Authorities will want to achieve this. Senior Lenders, may however argue that set off should be limited or qualified, for example, by reference to a period, or made dependent on the Senior Lenders' own attempts to preserve continuity of Service (see below).

31.7.3 In addition to its rights under Clause 31.7.1, where the Contract has been terminated, the Authority shall from the Termination Date be able to exercise any of its step-in rights or other rights under or in respect of any of the Authority Direct Agreements [or the Appointments]; however, notwithstanding the terms of the Authority Direct Agreements [or Appointments] or any other provisions of this Clause 31.7.3, each of the relevant sub-contractors [or the counterparties to the relevant Appointment] (and any guarantors thereof as relevant) shall remain responsible, and be liable, to the Contractor in respect of all costs, claims, damages, losses and liabilities which shall have arisen out of or in connection with the relevant sub-contracts [or Appointments] in respect of the period prior to the Termination Date in relation to which the Agent acting on behalf of the Contractor or the Senior Lenders shall retain the benefit of all and any rights to all such costs, claims, damage, losses and liabilities.

31.7.4 Except in accordance with the provisions of Clauses 31.7.1 to 31.7.3 (inclusive) and 31.6 the Authority shall not, prior to the Senior Debt Discharge Date:

- (a) claim, recover, retain or receive (or seek to claim, recover, retain or receive) any amount under the Authority Direct Agreements [or the Appointments] in respect of a loss for which a sub-contractor or relevant counterparty is also liable to the Senior Lenders;
- (b) take any action to wind-up, appoint an administrator, seek an interim order appointee (under paragraph 3(b) Schedule B1 of the Insolvency Act 1986 (as amended)), or sanction a voluntary arrangement (or similar) in relation to the Contractor; or⁴⁶
- (c) save with the prior written consent of the Agent, compete on grounds (whether in whole or in part) relating to the Project (by virtue of a claim under any of the Authority Direct Agreements, [the Appointments], the Contract or any other Project Document or otherwise) with the rights of the Senior Lenders on any formal insolvency of any sub-contractor, [any counterparty to any Appointment] or the Contractor, nor claim to be subrogated to any rights of any Senior Lenders.

31.7.5 The Authority agrees and undertakes that if it receives any amount in contravention of the provisions of Clause 31.7 above, it will promptly turn the same over to the Agent and pending such payment, hold the same on trust for the Agent and the Senior Lenders.

31.7.6 Notwithstanding the terms of the Contract and Security Documents, the Agent agrees that the Authority may exercise its rights to have transferred to it or its nominee any Unrestricted Assets following the Termination Date and the Agent

"[or unless the Authority reasonably believes that the Senior Lenders are not seeking to preserve continuity of service or build obligation (as relevant) under the relevant Sub-Contract [or continuity of [] under the Appointment] with reasonable diligence (or under any equivalent service or build obligation under the Contract)]"

Any further subordination protection in any event should never extend beyond senior debt service (so as to benefit junior lenders or equity) or to impinge on the Authority's rights to step into the Project Agreement under Section 29 (Authority Step-in).

For periods after project termination Authorities will have the benefit of the standard netting and rectification cost provisions (See Section 12 (Set-off)).

⁴⁶ Note: this would be instead of Clause 10(b) of the Direct Agreement - See Section 31.6 (Direct Agreement and Senior Lenders).

will not exercise or seek to exercise any enforcement rights, and shall, on or before the date any Unrestricted Assets are transferred to the Authority or its nominee, as the case may be, release its security over them.

31.7.7 Notwithstanding any terms of the Financing Agreements, the parties agree and shall, to the extent it is within their power, direct that all insurance proceeds receivable or received by the Contractor under the insurances referred to in Clause [] of the Contract (Insurance) shall be paid directly into the Insurance Proceeds Account and applied in accordance with the Contract.⁴⁶

Definitions

"Authority Direct Agreements"

means [•];⁴⁷

"Senior Debt Discharge Date"

means the date on which all amounts owing by the Contractor to the Senior Lenders under the Senior Financing Agreements have been irrevocably paid in full;

"Unrestricted Assets"

means those Assets, excluding any revenues or cash balances or claims outstanding at the date of transfer under any Sub-Contract [or Appointment], which are required by the Authority or its nominee or any replacement of the Contractor for the purposes of the construction, operation or maintenance of the Facilities following termination assuming such construction, operation or maintenance is carried out on terms substantially the same as the terms of the Contract;

The following terms have the meaning given to them in the Contract:

["Appointments"]⁴⁸

["Facilities"]

The following term shall have the meaning given to it in the Credit Agreement:

["Security Documents"]

⁴⁶ If preferred, this could be inserted in paragraph 9 of the Direct Agreement.

⁴⁷ Reference Authority's direct agreements with sub-contractors.

⁴⁸ Reference Authority's direct agreements, if any, with members of the professional team.

32 COMPETITIVE DIALOGUE AND COMMITMENT LETTERS

32.1 EU PROCUREMENT LAW

32.1.1 The European law relating to public procurement, including PFI, was changed by the European Council's Directive on the Co-ordination of Procedures for the Award of Public Contracts, Public Supply Contracts and Public Service Contracts dated 31 March 2004.¹ This directive introduced the competitive dialogue procedure for use in particularly complex contracts like PFI. Regulations implementing this directive into English law came into effect from 31 January 2006.²

The main features of the competitive dialogue procedure are:

- dialogue is allowed with selected suppliers to identify and define solutions to meet the needs and requirement of the Authority;
- dialogue may be conducted in successive stages, with the aim of reducing the number of solutions/bidders;
- the award is made only on the most economically advantageous tender criteria; and
- there are explicit rules limiting post-final tender and post-award changes to the bid.

The OGC produced guidance³ on the competitive dialogue procedure in January 2006. This set out that competitive dialogue is intended for use in complex projects and that the competitive negotiated procedure should only be used in very exceptional circumstances. Further guidance is becoming available on a sector by sector basis.⁴

32.1.2 The competitive dialogue procedure will be used for most mainstream PFI procurements in mature markets whilst negotiated procedure remains available for exceptional circumstances⁵. Authorities should in future do greater "front end" work: engaging and informing the market; developing robust project governance; planning their procurement; developing their specification; being clear of their requirements; preparing their data; checking their property interests; commissioning relevant surveys (which may be relied upon by bidders); issuing well developed contracts at the start of the dialogue; and, ensuring they have in place adequate project governance arrangements such that relevant internal approvals are obtained prior to closing the dialogue. Not only is this likely to lead to a more efficient quicker procurement, it will help achieve compliance with the requirements of the competitive dialogue process.

32.1.3 Under the new competitive dialogue procedure, all substantial aspects of the bid need to be agreed before conclusion of the dialogue. The dialogue process should be used to identify the best means of satisfying the Authority's needs. The dialogue should continue until the Authority

¹ Directive 2004/18/EC.

² The Public Contract Regulations 2006 (S.I. 2006 No5), regulation 18.

³ See www.ogc.gov.uk/documents/guide/competitivedialogue.pdf.

⁴ See (a) "How to Conduct a Competitive Procurement" January 2006 on Partnerships for Schools website, (b) The Department of Health "The Private Finance Initiative How to Conduct a Competitive Dialogue Procedure" November 2006 consultation draft on the DoH web site, (c) 4ps A Map of the PFI process using Competitive Dialogue June 2006 (and related Competitive Dialogue Process diagram November 2006) on the 4ps website.

⁵ Authorities should however seek their own legal advice on a project by project basis and should refer to any relevant guidance from their Private Finance Units.

has identified and defined its requirements with sufficient precision to enable final bids (which meet those requirements) to be made. At that time the Authority should be able to identify one or more solutions to its requirements (since, as a result of the separate dialogues, different solutions may have been developed). A call for final bids should then be made and the winning bidder selected. After final bids have been submitted, it is only permissible to clarify, specify and fine tune. This does not necessarily mean that the Contract has to be complete in every detail at this stage, but it does mean that, after this time, no changes may be made to the basic features of the bid which are likely to distort competition or have a discriminatory effect. It is just as important that the Authority adheres to this rule as the bidder. This means that effectively, the Authority's own project decision-making must be complete by the call for final bids and there can be no further changes to the Project arising from further approvals process.

32.1.4 Effective project governance arrangements will help to minimise the risk of failure to comply with the requirements of the competitive dialogue procedure. Maintaining project governance structures and forums throughout the procurement will provide project direction and should ensure that approvals – for example with regards to the requirement and affordability – are in place at the required points in the competitive dialogue process. Additionally project governance structures will assist with project reporting and stakeholder management and hence reduce the likelihood that late changes will need to be introduced. If Authorities implement appropriate project governance frameworks, prepare for their procurements as outlined in Section 32.1.2, and manage their dialogues effectively, they should not need to budget any more time to complete a competitive dialogue procurement than a competitive negotiated procurement.

32.1.5 It is to be expected that some parts of the Contract will still need to be clarified or confirmed post-award. This is permissible provided that it does not have the effect of modifying substantial aspects of the bid, distorting competition or causing discrimination. For example, at award discussion the final detailed design may not be completed, detailed planning permission may not yet have been granted, detailed site surveys may still need to be done, and the final swap rate (which determines the Unitary Charge) may not be fixed until Financial Close. Where such aspects remain to be completed it is important that the Contract, or rules of the tender, lays down a clear and non-discriminatory mechanic governing the finalisation of these issues. Further guidance on this may be available on a sector-by-sector basis.⁶

33.1.6 Under the standstill provisions contained in The Public Contracts Regulations 2006 (regulation 32), an Authority must allow a mandatory minimum ten-day standstill⁷ period between the notification of a contract award decision and the entry into of the Contract. In addition, the rejected bidder may request a debrief and conditions relating to the provision of information apply within this standstill period.⁸

32.2 ENSURING COMMITMENT

32.2.1 The Authority must manage and control the final stage to Contract close following the appointment of the winning bidder. In the past, this has been the stage where project timetables have been most vulnerable to slippage. The Authority will be under pressure to adhere to timetables for Contract signature that are expected (by the end user and/or the relevant Government department) to be delivered on time.

⁶ See footnote 2 above.

⁷ See OGC guidance on the standstill period on its website at www.ogc.gov.uk.

⁸ Good practice would see projects maintaining a "procurement file" of key decisions and information which could then form the basis for the debrief.

32.2.2 To address the above concerns, the Authority should seek to ensure that each final bidder provides sufficient information so that the Authority can evaluate the length of time that it is likely to take to achieve Contract signature following appointment of the winning bidder. Accordingly, each bidder's final bid submission should set out:

- any final changes to the Contract (and any other draft contracts provided to the bidders) and the reasons for them (although the dialogue procedure should ensure there are no surprises here);
- representations as to how well developed the bidder's Sub-Contracts and finance documents (to the extent relevant where a funding competition is being held) are, and confirmation that, in any event, finalisation of the Sub-Contracts and finance documents (to the extent relevant where a funding competition is being held) will not result in any request to amend the Contract; and
- an estimate of the amount of time that the bidder and the Senior Lenders (to the extent relevant where a funding competition is being held)) believes it will take to reach Financial Close following the appointment of the winning bidder.

If a funding competition is being held, the bidder will, at this stage, then be in a position to launch its pre-planned funding competition. Where a funding competition is being held the parties should refer to HMT's Draft Outline Guidance "*Preferred Bidder Debt Funding Competitions*" dated August 2006.⁹

32.2.3 To reinforce the above, Authorities should require a written commitment, from all parties, to the Contract terms and in particular the payment mechanism. This is achieved by the Authority providing a letter to the winning bidder, to be countersigned by the bidder, its lenders (to the extent relevant where a funding competition is being held) and Sub-Contractors in which the parties confirm their acceptance of and commitment to the draft Contract. The letter will also set out any issues of clarification or confirmation, which remain (though no points of negotiation should remain – see Section 32.1.2). Appointment of the winning bidder will be conditional on signature of the commitment letter.

32.3 REQUIRED APPROACH

32.3.1 The form of commitment letter to be included in ITPD documentation to be countersigned by the winning bidder, its lenders (if relevant) and Sub-Contractors is set out below as required drafting:

[ON LETTERHEAD OF AUTHORITY]

[Date]

[Name and Address of Bidder]

Dear [BIDDER CONTACT]

[PROJECT HEADING]

Following our letter to you of [] [and our subsequent conversations] I am writing to you to set out the position which has now been agreed between us.

Subject to receiving confirmation from you [and [LENDER]] and [Sub-Contractors] on the points addressed in this letter, the decision has been taken by the Authority to appoint [BIDDER] as its selected bidder.

⁹ See HMT website at www.hm-treasury.gov.uk.

1. The Unitary Charge set out within your bid is fixed by reference to your design and services proposals and on the assumption that financial close occurs on or before [●] (“Expected Date of Financial Close”). If financial close occurs after that date then your construction price will be increased only by movements in the [●] index from (but excluding) the Expected Date of Financial Close up to (but including) [●] and thereafter increased in accordance with your proposal included in [REFERENCE] of your Bid submission of [DATE]. The Authority will take the risk of any movement in [LIBOR][applicable interest rates] [relevant index] between [DATE OF BID SUBMISSION] and financial close.¹⁰ The benefit of any reduction in [LIBOR] [applicable interest rates] [relevant index] (including the buffer) will be passed in full to the Authority.
- 2.(a) Subject to paragraph (b) below the Unitary Charges set out within your bid as representing the price payable for taking out and maintaining the [Required Insurances] as that term is used in the draft contract terms (“Insurance Costs”) is fixed up to and including the Expected Date of Financial Close. From but excluding the date of Expected Financial Close Insurance Costs may be increased but only to the extent required as a consequence of any increase in the sum insured following any increase in the construction price allowed in accordance with paragraph 1 above. Any adjustment will be at the following rate [Bidder to specify].

(b) Insurance Costs may also be revised if (i) any risk to be insured under the Required Insurances becomes Uninsurable (as such terms are used in the draft Contract terms).
3. As regards the draft Contract terms, we are pleased that, [subject to the points of clarification and confirmation specified at paragraph 4 below], you have confirmed your acceptance to these terms. Again, we would ask for your confirmation by way of countersignature of this letter that, subject to the points of clarification and confirmation specified at paragraph 4 below, you have accepted the draft Project Contract [*refer to version and date*] [and [*refer to other relevant project documents*]] as issued to you.
4. The points of clarification and confirmation that remain are set out below:
5. As regards the draft payment mechanism, we would ask you to confirm, again by counter signature of this letter, that you have accepted the current draft in its entirety [subject only to any points specified at paragraph 4 above].

Yours sincerely

.....
[SIGNED ON BEHALF OF AUTHORITY]

.....
[SIGNED ON BEHALF OF BIDDER]

.....
[SIGNED ON BEHALF OF LENDER]

.....
[SIGNED ON BEHALF OF SUB-CONTRACTORS]

¹⁰ Unless otherwise agreed (see further HMT’s Application Note *Interest Rate and Inflation Risk in PFI Contracts* (May 2006)). Where a funding competition is being held this may need amendment depending on arrangements between the Authority and the bidder.

33 DUE DILIGENCE OVER SUB-CONTRACTS AND FINANCING DOCUMENTS

33.1 INTRODUCTION

33.1.1 Although the Authority should not generally seek to interfere in the management of the Contractor's affairs,¹ the Authority should ensure that it understands how the Contractor is seeking to deliver the Service (both in terms of sub-contractual arrangements and financing), and be comfortable that those arrangements are (on an ongoing basis) sufficient to allow the Contractor to deliver the Service. Ultimately, termination of the Contract will always be the last resort for the Authority and such a remedy is no substitute for a thorough understanding and assessment by the Authority of how the Contractor proposes to deliver the Service to it.

33.1.2 Accordingly, the Authority (and its advisers) should conduct thorough due diligence over the Sub-Contracts and financing documents which the Contractor is seeking to put in place at the financial close. This is essential for several reasons, including the following:

- the amount of compensation payable to the Contractor on early termination will (except in the case of Contractor default) have reference to the amounts owed by the Contractor to its lenders under the financing documents. The Authority should therefore understand what those amounts will be and, in particular, understand how any breakage costs will be calculated.²
- the Authority may be seeking to retain the right to take over the Contractor's Sub-Contracts in the event of termination of the Contract or, more significantly, may have the benefit of a collateral warranty from the relevant Sub-Contractor. The Authority should conduct due diligence under the relevant Sub-Contracts to ensure that the principles agreed in the Contract are not undermined in the Sub-Contracts (i.e. the Sub-Contracts and the Contract are consistent); and
- the financing documents should reflect the terms of the financial model agreed at Financial Close. To the extent that there are discrepancies between the two, the Authority should make itself comfortable that the discrepancy is justified.

33.2 FINANCING DOCUMENTS

33.2.1 The Authority should require copies of financing documents from the winning bidder in advance of Financial Close, to allow it sufficient time to conduct its due diligence over the documents. The Authority's advisers should understand the areas to be focussed on in the due diligence process, which will include (amongst others) the following:

- **Interest rate ratchets** – it is common for the interest rate margin to reduce after the Service Commencement Date. The Authority should ensure that any reduction in margin reflects that set out in the financial model.
- **Maintenance and other reserving mechanisms** – the Authority should review the Senior Lenders' requirements in respect of the funding of the maintenance and other reserve accounts and be comfortable with the levels required. Moreover, the Authority

¹ But see Clauses 16.4 (Changes to Project Documents and Financing Agreements).

² See Section 21.1.3.7 (Compensation on Termination for Authority Default).

should confirm that upon early release of reserving requirements, such release would be caught by the refinancing sharing mechanism.³

- **Letters of Credit** – financing documents frequently allow the Contractor to withdraw the proceeds of reserve accounts and replace them with letters of credit (in a form agreed at financial close). Whilst the Authority should not object to such mechanisms in principle, it is important to ensure that the benefit of any such letters of credit are taken into account in the calculation of compensation on termination and that:
 - (a) the amount capable of being claimed under the relevant letter of credit is set-off from the amount paid by the Authority to the Contractor. Without such protection, the Contractor will effectively be paid twice; and
 - (b) the letter of credit does not automatically terminate on termination of the Contract. The effect of automatic termination of the letter of credit will be that the Authority pays a higher compensation amount.

Accordingly, the Authority should require a pre-agreed form of letter of credit to be included in the financing documents if the Senior Financing Agreements contain a mechanism for replacing reserve accounts with letters of credit. Releases of letters of credit should be treated in the same way as releases of funds from reserve accounts under the Refinancing provisions.

- **Breakage Costs** – the Authority must understand how any breakage costs are calculated under the financing documents. Breakage costs under interest rate hedging agreements (typically documented under the ISDA standard form agreement) should be calculated using the “Second Method and Market Quotation” formula which ensures that the breakage cost payable by the Authority is the “net” amount payable by the Contractor to the bank(s) after taking into account amounts owed by the bank(s) to the Contractor (“Second Method”) and competitive (“Market Quotation”). Excessive break costs on termination of hedging arrangements should be avoided (see further Section 1 footnote 8)⁴. In addition, Authorities should understand and approve the amortisation profiles of the Contractor’s finance arrangements, since this will determine the level of potential termination payments applicable across the life of the Contract.

33.3 SUB-CONTRACTS

33.3.1 Without prejudice to any agreement in respect of market testing of soft services, the Authority should review the Contractor’s sub-contractual arrangements prior to Financial Close to ensure that the Contractor is providing a solution to the Authority that is reasonably likely to meet the performance requirements set out in the Contract and that the price set out in the financial model is that set out in the relevant Sub-Contract. As discussed above, the Contractor should be permitted to manage his delivery of the Service but best practice is for the Authority not to sign the Contract until the Sub-Contracts are agreed and ready for execution. In particular, the Authority should review the terms of the Sub-Contracts for the following:

- **Term of Contract** – without prejudice to any market testing mechanism set out in the Contract, if the term of the relevant Sub-Contract does not reflect the period that the Service is required to be provided for under the Contract, the Authority should consider the level of protection it has in the Contract relating to controlling the identity of any Sub-Contractors⁵

³ See Section 34 (Refinancing).

⁴ See also HMT Guidance “*Interest rate and Inflation risks in PFI Transactions*” of April 2006, at www.hm-treasury.gov.uk.

⁵ See Section 16.1 (Control over Sub-Contractors).

- **Liquidated Damages** – if the Contract requires the Contractor to pay liquidated damages to the Authority for late delivery of the Service, the Authority should ensure that the Contractor is sufficiently financially robust so as to meet such obligations, taking account of terms of Sub-Contracts and claims of the Senior Lenders. This is essential because if the terms of the Contract and the Sub-Contracts are materially different, the Authority could be exposed (i.e. if the Contractor is unable to claim from the Sub-Contractor then the Contractor may be unable to pay the Authority).
- **Collateral Warranties** – if the Authority has the benefit of collateral warranties from Sub-Contractors then it will need to ensure that it is comfortable with the terms of the relevant Sub-Contract. To the extent that the Authority is able to pursue the Sub-Contractor under the collateral warranty for failure to perform the Sub-Contract, the Authority will, by definition, only be able to pursue the Sub-Contractor for non-performance of the Sub-Contract, and not non-performance of the Contract by the Contractor. Accordingly, the Authority should consider the extent of any risks which are not passed to a Sub-Contractor by the Contractor and ensure that the Contractor is sufficiently financially robust so as to meet any liabilities that may occur if such risks occur.
- **Breakage Costs** – The Authority should review carefully any break costs payable on early termination of the Sub-Contract since it is potentially liable for these in various termination scenarios. If it is not satisfied with these, then its exposure to them under the Contract should be capped. See further Section 21.1.3.7, the definition of Sub-Contractor Breakage Costs at Clause 21.2.2 and the limit on termination payments at Clause 22.3.

34 REFINANCING

34.1 INTRODUCTION

34.1.1 The key principles underlying the Government's approach to Refinancing are as follows:

- Refinancings carried out in accordance with this guidance can be of benefit to both the Contractor and the Authority; accordingly, proposals for refinancings made by the Contractor should be welcomed and considered positively by the Authority.
- A refinancing will normally constitute a material change to the financial and economic structure of a PFI project as originally agreed at Financial Close between the Authority and the Contractor. An Authority should therefore have the right to be fully informed of any refinancing, and approval rights over refinancings other than those which were part of the original Financial Close Base Case financing plan or do not lead to a gain for investors compared to the original Base Case.
- A long term contractual commitment by an Authority to purchase a service, at a pre-determined price, with contractual certainty for financiers through, for example, the operation of termination provisions, is likely to be central to the original financing of the Project and to any refinancing gain arising. The Contractor could not itself achieve such fine terms of finance, particularly as regards gearing and pricing, without such Contract terms. The Authority has a natural right to share in gains which are made possible by the strength of this contractual credit.
- An increase in returns to investors in the Contractor due to improved efficiency or performance, over and above what was anticipated when the Contract was let should be for the investors' account unless it falls within the scope of benchmarking, market testing, upside sharing or similar provisions of the Contract. However, improvements to loan margins, and beneficial changes to the term and leverage of any debt finance raised to fund the project are not viewed as mainly due to efficiency improvements and, consequently, any benefits that arise from such changes should be shared between the Authority and investors.
- As the PFI/PPP market matures and its stability is assured, finer terms have and should continue to become available. In the broadest sense, both the public sector and the private sector will contribute in bringing about this improvement. Through refinancings, projects are able to gain access to these finer terms as they become available and, given their joint contribution to this state of affairs, both the public sector (in this case the Authority) and the private sector (in this case investors in the Contractor) should share in the benefits arising. The Public Accounts Committee has highlighted the importance of the public sector sharing equitably in "windfall gains" associated with a PFI project. This has particular relevance to changes in available terms of finance which are often heavily influenced by factors external to the Project.
- A 50:50 sharing of refinancing gains between the Authority and the Contractor gives a reasonable balance between these factors.
- Refinancing gains should be measured by reference to the Project as it is performing at the time of refinancing, to enable the investors to benefit from improvements in efficiencies achieved by the Contractor to date and forecast to be achieved in the future; but if the Project is performing below the levels projected in the original Financial Close Base Case financial model, the investors are entitled to apply the benefits of refinancing to restore this Base Case projected performance prior to sharing with the Authority.

34.1.2 This Section takes account of the NAO report "The Refinancing of the Fazakerley PFI Prison Contract" published in June 2000, as well as subsequent recommendations of the House

of Commons Public Accounts Select Committee and HMT's Application Note dated 9 February 2005 entitled "*Value for Money in Refinancing*" on the HMT website.

34.2 WHAT IS A REFINANCING?

34.2.1 During the life of the Project, the Contractor may wish to replace, augment or change the structure, nature or terms of the financing solution that it put in place at Financial Close for the purposes of financing the Project. Where such restructurings or changes will have the effect of increasing or accelerating Distributions to investors or of reducing their commitments to the Project, these effects are individually and collectively referred to as Refinancing Gains.

34.2.2 A non-exclusive list of transactions which could be undertaken by the Contractor following financial close and which could give rise to a Refinancing Gain is set out below:

- reduction in interest margins;
- reduction or release of reserve accounts;
- release of contingent junior capital;
- extension in the maturity of debt;
- increase in the amount of debt; and
- refinancings undertaken without the direct involvement of the Contractor, for example through a special purpose or holding company, but which rely upon rights being granted in respect of the cash flow, assets, or contracts of the Contractor.

34.2.3 Authorities should ensure that they review all finance documents prior to Financial Close and are provided with conformed copies of these at Financial Close. Authorities should further ensure that, if the Project is financed through an intermediate holding or associated company structure, the contractual restrictions on Refinancing are drafted to reflect this.

34.2.4 Refinancing is likely to be a matter for consideration by the Authority at different times during the life of a Project, notably when developing Contract terms in advance of the competition, when appraising bids submitted in response to the ITPD and during the Contract period itself. The complexity of refinancings means that it is important that Authorities seek appropriate advice when considering the subject and they should consult with their respective sponsoring Departments, Private Finance Units or HMT if there is any doubt about how the principles can best be applied in individual projects. It is also very likely that Authorities will need to seek the assistance of appropriate external advisers in respect of the financial and legal issues arising from refinancings both to ensure that this Guidance is properly reflected in project documentation and in any negotiations with the private sector on proposed refinancings.

34.3 AUTHORITY CONSENT

34.3.1 An Authority should have approval rights for refinancings other than those which were part of the original Financial Close Base Case financing plan or which do not lead to a gain for investors compared to the original Base Case. The latter will include refinancings undertaken to rescue a Contractor from financial difficulty – so called "rescue refinancings".

34.3.2 Refinancing of PFI projects is one way in which both the Authority and investors in the Contractor can share in the benefits of a successful project. Accordingly, Authorities should be receptive to proposals from the Contractor to refinance, and are encouraged to consent to such proposals. However, when evaluating a refinancing proposed by the Contractor, an Authority should consider carefully whether the effects of such proposal could:

- increase the risk facing the Authority without conferring on it commensurate reward;
- reduce incentives for the Contractor to achieve sustained service standards, particularly in later years;

- undermine the financial stability of the Contractor, thereby endangering the provision of services.

34.3.3 When considering a request for consent to a refinancing the Authority should assess the Contractors' proposals objectively. There may be occasions where, for good reasons, the Authority refuses to consent to a refinancing, despite the Contractor offering to share the gain arising in line with the principles set out above. In this situation, the Authority should be prepared to give its reasons to the Contractor for not consenting in a transparent manner. The Authority should also not unduly delay its response to any proposal.

34.3.4 A refusal to consent might arise, for example, where the Contractor proposes a new financing structure that the Authority perceives to be inherently much less flexible than the structure it replaces and the Authority places a high value on flexibility.

34.3.5 Generally, refinancings which increase the risks borne by the Authority (for instance, by replacing equity with debt) will also result in greater gains for sharing. The Authority's consent to a refinancing should be forthcoming if its 50% share of the gain arising from the refinancing is reasonable compensation for the increased risks it is being asked to bear as a result of the new financing structure, for example through contracting with a more highly geared counter-party.

34.3.6 Where a proposed refinancing involves an increase in termination liabilities, Contractors will need to secure the Authority's consent both to the refinancing itself and to the change in termination liabilities as these rights are separate and distinct.¹ In practice, many Authorities are likely to consider the Contractor's proposals on both a refinancing and any changes in termination liabilities concurrently. An Authority should not use its separate approval rights over increases in termination liabilities to agree a greater than 50% share of the refinancing gain. In consequence, an Authority will be unlikely to agree to a refinancing that increases its termination liabilities unless the additional refinancing gain available to be shared, relative to a refinancing which does not involve such increase in termination liabilities, is judged to represent better value. See generally HMT's application note dated 9 February 2005 entitled "*Value for Money in Refinancing*" on the HMT website.

34.3.7 Increases in Senior Debt arranged for a PFI project, whether through the Contractor or otherwise having security (or other rights) over and/or recourse to the assets, contracts or cash-flow of the Contractor, beyond the original capital value of the Project should not be approved by the Authority without it first seeking appropriate professional advice.

34.4 EXEMPTIONS

The following transactions should not be subject to Authority consent or gain sharing:

34.4.1 Junior Capital

34.4.1.1 Disposals of investments or commitments of junior capital in the Contractor which are equity or equivalent, such as shareholder subordinated debt, which in terms of rights is equity in all but name.² Similarly exempt, are transactions involving dividends paid on equity and debt service on shareholder subordinated debt, once such dividends and payments have left the security net of all creditors having rights in relation to the cash-flow, assets or contracts of the Contractor.

¹ See Section 22.3 (Certainty of Compensation Payment Amounts and Changes to Financing Agreements).

² It is common practice, however, that the Authority will have some degree of approval rights over changes in ownership of the Contractor, particularly during the construction phase of a project. These are important where the shareholder has expertise which is relevant to that phase of the project (for example, a construction company which is also associated with construction being undertaken through the Contractor). The Authority should also consider the credit worthiness of providers of shareholder subordinated debt and equity in relation to restrictions on transfers before this capital is fully paid.

34.4.2 Base Case Refinancings

34.4.2.1 Authorities should, as always, be seeking to generate strong competition in their procurements. Since successful PFI projects are more likely to generate refinancing opportunities, the effect of this competition should be to encourage the Contractor to anticipate the gain from some refinancings within its original bid price. Such refinancings which are clearly and fully included within the original Financial Close Base Case financial model and taken into account in the calculation of the Unitary Charge should therefore be exempt from Authority consent and gain sharing up to the amount included in the Financial Close Base Case.

34.4.2.2 To guard against the Contractor seeking to use this exemption to bypass the Refinancing Gain sharing provisions, the Authority and its advisers should conduct due diligence over the Base Case prior to Financial Close so as to clarify and agree any refinancing assumptions that have been demonstrably taken into account in the Unitary Charge bid at the time of final bids, i.e. that a reasonable return on equity will only be achieved if and to the extent that these refinancings take place.³ If an Authority receives a bid that claims to take into account future refinancings, the Authority should consult with its Department, relevant Private Finance Unit and/or HMT before selecting a winning bidder.

34.4.3 Corporate Finance

34.4.3.1 Transactions originally undertaken on a strictly corporate finance basis should not be subject to the Refinancing provisions contained within this Section. The Authority (and its advisers) will need to conduct due diligence over the structure and nature of a bid being put forward on a “corporate finance” basis to satisfy itself that the funding solution being proposed is a corporate financing and not a structure designed to bypass the Refinancing provisions. Bids should be reviewed on a case by case basis against the criteria set out in Section 37.2.5.

34.4.3.2 This exemption from Refinancing Gain sharing applies only to the extent that such corporate finance arrangements are implemented at Financial Close (see Section 37 (Corporate Finance)).

34.4.4 Interest Rate Hedging

34.4.4.1 Gains derived from fixing of interest rates for part or all of the Contract period at a lower rate than had been assumed at Financial Close, and hence used to calculate the Unitary Charge, should be exempt from Authority consent or gain sharing, subject to three conditions:

- if the Contractor wishes any interest rate hedging contracts to qualify as part of Senior Debt for the purposes of termination compensation under the Contract, these must be approved by the Authority;
- it is clear within the Contract that the Contractor bears all interest rate risks after Financial Close; and
- the Unitary Charge has been determined by reference to market interest rates for the full term of the Contract at Financial Close. If a Contractor elects not to hedge the interest rate on its Senior Debt over its full term from Financial Close, the interest rate at which it does partially hedge its Senior Debt will not necessarily be appropriate for determining the Unitary Charge, and Authorities must seek suitable financial advice on this matter at the time.

34.4.5 Taxation and Accounting Policies

34.4.5.1 Changes in taxation or in the Contractor’s accounting policies, such as depreciation are not considered to be Refinancings.⁴ However, Authorities and their advisers must take care to

³ In practical terms, a bid that includes a Unitary Charge that takes into account future refinancings may produce a higher Threshold Equity IRR than one that does not.

⁴ See Section 14.9 (Changes in Tax Law) for a discussion of how changes in taxation should be addressed in the Contract.

ensure that the tax and accounting assumptions within bids are not unduly conservative or likely to change, for example under codes of practice already announced by the professional accounting authorities, but not yet implemented or by reference to precedents already agreed with HMRC which may be applicable to the Contractor.

34.4.5.2 Whilst they are not regarded as refinancings, changes in taxation or in the Contractor's accounting policies which involve amendments to Project Documents to which the Authority is a party, or otherwise require its consent under separate provisions of the Contract, will quite clearly be subject to the Authority's approval in their own right at the time and subject to the usual critical examination as to their likely impact on risk, incentives and value for money. If the Authority is in any doubt about the implications of such proposed changes, they should consult their respective Departmental Private Finance Unit or HMT.

34.4.6 Qualifying Bank Transactions

34.4.6.1 In recognition of Senior Lenders' concerns, provision has been included within the definition of Exempt Refinancing for bank to bank transactions, and similar, which are undertaken by Senior Lenders in the normal course of their business. The common purpose of all these transactions is to permit such Senior Lenders to manage their assets (in this case a loan to the Contractor). Hence transfers, syndications and sub-participations of loans may qualify as bank transactions which are exempt from refinancing gain sharing. This may include securitisation of loans.

34.4.6.2 However any transaction involving Senior Debt (including securitisation) which has the intended effect of giving a direct or indirect economic gain to a party in its capacity as an equity holder (including any Shareholder, Subordinated Lender, guarantor, beneficial interest holder or equivalent) in the Contractor (or its Associated Companies) is clearly not a bank to bank or equivalent transaction. Accordingly it should not fall within the definition of Qualifying Bank Transaction, and thus not benefit from that exemption from the Refinancing Gain sharing provisions.

34.5 METHOD OF CALCULATING, SHARING AND PAYING BENEFITS

34.5.1 The Contract should include the provisions in Section 34.8 below which specify how the benefits of any refinancing will be determined and shared between the Authority and investors in the Contractor. These provisions do not set out the detailed basis and method of calculating the gains, as these will vary from project to project and so need to be agreed between the parties at the time of the refinancing.

34.5.2 The high level principles for calculating, sharing and paying gains are set out below. It is mandatory that investors submit a bid which reflects these principles, however it may be appropriate in certain limited circumstances for the Authority to consider alternative bids as offering better value for money - for example where there is a substantial residual value or demand risk, or where there is substantial third party income. In these situations the Authority should consider inviting bids on an alternative basis but should always ensure that a bid is also received on the basis of the provisions set out in this guidance. In such cases the Authority should always ensure that it evaluates both bids.

34.5.1 Calculation

34.5.1.1 The Refinancing Gain is derived from the changes in Distributions projected to take place after the refinancing, by comparison with the position immediately before the refinancing.

34.5.1.2 These changes can be both positive and negative. If, for example, the Contractor raises additional amounts of debt, the additional debt will probably be paid out as an immediate Distribution (e.g. to prepay amounts outstanding under Subordinated Financing Agreements), and hence will be an increase compared to the pre-refinancing position. Thereafter, however, as the amount of debt has increased, debt service payments will also be greater and hence future Distributions will be lower than the pre-refinancing position.

34.5.1.3 These positive and negative changes in the Distributions should be discounted to their net present value at the refinancing date: the result of this calculation is the Refinancing Gain.

34.5.1.4 Thus the Refinancing Gain is not necessarily an actual cash sum as at the refinancing date, and the payment of the Authority's share has to take this into account.

34.5.1.5 Insofar as payment of the Authority's share of the Refinancing Gain is tax-deductible, the benefit of this to the Contractor should be taken into account in the calculation.

34.5.2 Discount Rate

34.5.2.1 The discount rate to be used in the calculation set out in Section 34.5.1 is the original base case equity internal rate of return (IRR),⁵ since:

- this is the Threshold Equity IRR used for sharing the Refinancing Gain (see Section 34.5.3);
- if the investors did not undertake the Refinancing, this is the rate they would be earning from capital invested in the project, so the benefit of refinancing should be evaluated against that benchmark; and
- it is the effect of the Refinancing on equity returns which is being measured.

34.5.2.2 It is not appropriate to use alternative discount rates such as:

- the Equity IRR expected by investors in the project at the time of refinancing;
- the Project IRR; or
- Senior Debt interest rate.

34.5.2.3 The equity IRR which an investor in the project at the time of the refinancing would expect (i.e. the then current market for investment returns) should not be used because it is not feasible to find an objective way of determining this rate in advance, and would provide opportunities to construct a rate at the time which is unduly favourable to one party or the other.

34.5.2.4 The project IRR should not be used because the purpose of the discount calculation is to look at the effect of changes in the debt structure or terms, which were not considered in the original project IRR calculation.

34.5.2.5 Similarly, using the debt interest rate as a discount rate is also inappropriate, because in many cases this would lead to an artificial reduction of the Refinancing Gain to zero.⁶

34.5.3 Sharing

34.5.3.1 The Refinancing Gain should be shared 50:50 between the Authority and the Contractor. However the sharing of the Refinancing Gain with the Authority should only apply if the projected performance of the Project, at the time of refinancing, is above that included in the original Financial Close Base Case financial model.

34.5.3.2 In consequence, the original Base Case investor rate of return (i.e. the Threshold Equity IRR) is of key significance to the Authority which, during the course of its due diligence, must satisfy itself of the reasonableness of this figure as the key threshold above which Refinancing Gain sharing applies. This may be a critical issue if competition has been weak, such that either the Base Case return is higher than can be justified or, conversely, the return is artificially

⁵ This should be the "blended" equity IRR – i.e. including both share capital and shareholder subordinated debt. If projects are calculated on a nominal basis then the IRR used should also be a nominal rate. The IRR used should be on the post-tax basis i.e. post tax of Contractor, but pre tax of Shareholders or Senior Lenders (see HMT's "Guidance Note in the Use of IRRs in PFI Contracts, at www.hm-treasury.gov.uk).

⁶ Because the NPV of a series of future debt interest and principal payments, discounted at the debt interest rate, and deducting the original debt amount, is zero.

depressed by the use of overly conservative assumptions (for example in relation to accounting policies, changes to which are exempt from gain sharing (see Section 35.4.5 above)).

34.5.4 Payment

34.5.4.1 The Authority's share should be taken as:

- (i) a cash sum at the time of Refinancing; and/or
- (ii) by a reduced Unitary Charge.

34.5.4.2 In determining the appropriate form of Refinancing Gain sharing, the Authority should consider the value for money implications of taking it in a lump sum or over time (see further Guidance Note "*Calculation of the Authority's share of a Refinancing Gain*").

34.5.4.3 Often, Refinancing Gains will be both immediate (e.g. by release of a reserve which can then be paid out as a Distribution) and long-term (e.g. by increasing the debt repayment period or reducing interest margins). In these cases, a mixture of cash lump sum and reduced Unitary Charge may be appropriate.

34.5.4.4 An Authority may elect (having discussed with its sponsoring Department or Private Finance Unit) to receive its share of a Refinancing Gain through increased scope of services, subject to suitable value for money tests and the application of any relevant procurement procedures.

34.5.4.5 Where the Authority's share of Refinancing Gains is to be paid by way of a reduced Unitary Charge, the reduction in Unitary Charge should not be at risk to Project performance even though the investors' share, which may well be projected to come through future dividend distributions, will be at risk.

34.6 AUDIT RIGHTS AND TRANSACTION COSTS

34.6.1 The Authority will need to ensure it has the right of access at any time (either before or after the Refinancing) to audit the financial model used by the private sector for the Refinancing and calculation of the Refinancing Gain, the underlying assumptions for the data and projections used in the model and to review documentation resulting from the refinancing, whether or not a refinancing appears to be subject to Authority consent and gain sharing.

34.6.2 These rights are important to enable the Authority to confirm whether the Refinancing is subject to its consent, to verify any calculations in respect of the sharing of Refinancing Gains, and to assess the impact (if any) of the refinancing on the Authority's termination liabilities and other considerations highlighted above, including any adverse impact on the private sector's incentive to sustain service standards throughout the term of the Contract, particularly in later years.

34.6.3 The Authority should be reimbursed by the Contractor for its reasonable costs of engaging suitable advisers to review refinancing proposals and to support the Authority in connection with implementing an agreed refinancing. The Refinancing Gain available for sharing will be calculated after deducting the reasonable third party costs incurred by the Contractor and the Authority in connection with the transaction.

34.7 JOINT VENTURE PFI PROJECTS

34.7.1 In some PFI projects, the Authority may elect to take equity in the Contractor by way of a shareholding and/or as a provider of subordinated debt. In the context of refinancing, the Authority has interests in the Project both as an investor in the Contractor and as counterparty to the Contract. Accordingly, the Authority will potentially take the benefit of any Refinancing Gain in both capacities, through a payment to it as Authority under the Contract and by way of an increase in Distributions to investors.

34.8 MODEL REFINANCING PROVISIONS

34.8.1 Required drafting (including definitions) is as follows:

34 Refinancing

- 34.1 The Contractor shall obtain the Authority's prior written consent to any Qualifying Refinancing and both the Authority and the Contractor shall at all times act in good faith with respect to any Refinancing.⁷
- 34.2 The Authority shall be entitled to receive a 50 per cent share of any Refinancing Gain arising from a Qualifying Refinancing.
- 34.3 The Authority shall not withhold or delay its consent to a Qualifying Refinancing to obtain a greater than 50 per cent share of the Refinancing Gain.⁸
- 34.4 The Contractor shall promptly provide the Authority with full details of any proposed Qualifying Refinancing, including a copy of the proposed financial model relating to it (if any) and the basis for the assumptions used in the proposed financial model. The Authority shall (before, during and at any time after any Refinancing) have unrestricted rights of audit over any financial model and documentation (including any aspect of the calculation of the Refinancing Gain) used in connection with that Refinancing (whether that Refinancing is a Qualifying Refinancing or not).
- 34.5 The Authority shall have the right to elect to receive its share of any Refinancing Gain as:
- (a) a single payment in an amount less than or equal to any Distribution⁹ made on or about the date of the Refinancing;
 - (b) a reduction in the Unitary Charge over the remaining term of the Contract; or
 - (c) a combination of any of the above.
- 34.6 The Authority and the Contractor will negotiate in good faith to agree the basis and method of calculation of the Refinancing Gain and payment of the Authority's share of the Refinancing Gain (taking into account how the Authority has elected to receive its share of the Refinancing Gain under Clause 34.5 above). If the parties fail to agree the basis and method of calculation of the Refinancing Gain or the payment of the Authority's share, the dispute shall be determined in accordance with Clause 28 (Dispute Resolution).¹⁰
- 34.7 The Refinancing Gain shall be calculated after taking into account the reasonable and proper professional costs that each party directly incurs in relation to the Qualifying Refinancing and on the basis that all reasonable and proper professional costs incurred by the Authority will be paid to the Authority by the Contractor within 28 days of any Qualifying Refinancing.
- 34.8 Without prejudice to the other provisions of this Clause 34, the Contractor shall (a) notify the Authority of all Notifiable Financings on becoming aware of the same and again when they are entered into and provide full details of the same and (b) include a provision in the Financing Agreements whereby it is entitled to be informed of any

⁷ The Authority may terminate the Contract for a wilful breach of this clause. In such circumstances, the amount of compensation payable to the Contractor shall be the same as that paid to the Contractor if the Contract is terminated under Clause 21.5 (Termination on Corrupt Gifts or Fraud). See Section 21.6 (Termination for Breach of the Refinancing Provisions).

⁸ Please see Section 22.3 (Changes to Financing Agreements and Project Documents) in relation to requests made to the Authority for increases in its termination liabilities.

⁹ Any Distributions projected to be made after the Refinancing will be net of any payment to be made to the Authority on or about the date of the Refinancing. If a Distribution is made on or about the date of the Refinancing which would have been made if the Refinancing had not occurred, the amount of that Distribution will not be taken into account for the purposes of paragraph (a).

¹⁰ Any dispute should be determined under the dispute resolution process (see Section 28.3).

proposals which the Senior Lenders may have to refinance the Financing Agreements.

“Distribution”

means:

- (a) whether in cash or in kind, any:
 - (i) dividend or other distribution in respect of share capital;
 - (ii) reduction of capital, redemption or purchase of shares or any other reorganisation or variation to share capital;
 - (iii) payments under the Subordinated Financing Agreements (whether of principal, interest, breakage costs or otherwise);
 - (iv) payment, loan, contractual arrangement or transfer of assets or rights to the extent (in each case) it was put in place after Financial Close and was neither in the ordinary course of business nor on reasonable commercial terms; or
 - (v) the receipt of any other benefit which is not received in the ordinary course of business and on reasonable commercial terms; or
- (b) the early release of any Contingent Funding Liabilities, the amount of such release being deemed to be a gain for the purposes of any calculation of Refinancing Gain;

“EEA”

means from time to time the European Economic Area as created by The Agreement on the European Economic Area 1992 or any successor or replacement body, association, entity or organisation which has assumed either or both the function and responsibilities of the European Economic Area;

“Equity IRR”

means the projected blended rate of return to the Relevant Persons over the full term of the Contract, having regard to Distributions made and projected to be made;

“Exempt Refinancing”¹¹

means:

- (a) any Refinancing that was fully taken into account in the calculation of the Unitary Charge¹²;
- (b) a change in taxation or change in accounting treatment;
- (c) the exercise of rights, waivers, consents and similar actions which relate to day to day administrative and supervisory matters, and which are in respect of:
 - (i) breach of representations and warranties or undertakings;
 - (ii) movement of monies between the Project Accounts in accordance with the terms of the Senior Financing Agreements as at Financial Close;
 - (iii) late or non-provision of information, consents or licences;
 - (iv) amendments to Sub-Contracts;

¹¹ To the extent a Holdco is used, an equivalent exemption will need to be reflected in the drafting.

¹² See Section 34.4.2 above.

- (v) approval of revised technical and economic assumptions for financial model runs (to the extent required for forecasts under the Financing Agreements);
 - (vi) restrictions imposed by the Senior Lenders on the dates at which the Senior Debt can be advanced to the Contractor under the Senior Financing Agreements and/or amounts released from the [Escrow Account] during the [Initial Availability Period], each as defined in the Senior Financing Agreements¹³ and which are given as a result of any failure by the Contractor to ensure that the construction work is performed in accordance with the agreed construction programme and which are notified in writing by the Contractor or the Senior Lenders to the Authority prior to being given;
 - (vii) changes to milestones for drawdown and/or amounts released from the [Escrow Account] during the [Initial Availability Period] set out in the Senior Financing Agreements and which are given as a result of any failure by the Contractor to ensure that construction work is performed in accordance with the agreed construction programme and which are notified in writing by the Contractor or the Senior Lenders to the Authority prior to being given;
 - (viii) failure by the Contractor to obtain any consent by statutory bodies required by the Senior Financing Agreements; or
 - (ix) voting by the Senior Lenders and the voting arrangements between the Senior Lenders in respect of the levels of approval required by them under the Senior Financing Agreements;
- (d) any amendment, variation or supplement of any agreement approved by the Authority as part of any Qualifying Variation under this Agreement;
 - (e) any sale of shares in the Contractor [or Holdco] by the shareholders or securitisation of the existing rights and/or interests attaching to shares in the Contractor [or Holdco] provided that this paragraph (e) shall, in respect of shares in Holdco, only apply for so long as Holdco holds 100% of the issued share capital of the Contractor];¹⁴
 - (f) any sale or transfer of the Subordinated Lenders' existing rights and/or interests under the Subordinated Financing Agreements or securitisation of the Subordinated Lenders' existing rights and/or interests under the Subordinated Financing Agreements; or¹⁵
 - (g) any Qualifying Bank Transaction;

“Financial Close”

shall have the meaning given to it in the Senior Financing Agreements;

“Insurance Undertaking”

has the meaning given in the rules from time to time of the Financial Services Authority;

“Net Present Value”

¹³ These definitions should follow those contained in the Senior Financing Agreements – the Initial Availability Period being the construction phase drawdown period. These will need to be checked.

¹⁴ This Clause therefore means that any grant of new rights over the Contractor's assets, cashflows or contracts in conjunction with this transfer would not be exempt.

¹⁵ See footnote 14.

means the aggregate of the discounted values, calculated as of the estimated date of the Refinancing, of each of the relevant projected Distributions, in each case discounted using the Threshold Equity IRR;

“Notifiable Financings”

means any Refinancing described in paragraph (a) or (c) of the definition of Refinancing and any other arrangement which has or would have a similar effect or which has or would have the effect of limiting the Contractor’s or any Associated Company’s ability to carry out any such arrangement;

“Pre-Refinancing Equity IRR”

means the nominal post-tax (i.e. post-tax with respect to the Contractor, pre-tax with respect to Shareholders) Equity IRR calculated immediately prior to the Refinancing;

“Project Accounts”

means accounts referred to in and required to be established under the Senior Financing Agreements;

“Qualifying Bank Transaction”¹⁶

means:

- a) the syndication by a Senior Lender, in the ordinary course of its business, of any of its rights or interests in the Senior Financing Agreements;
- b) the grant by a Senior Lender of any rights of participation, or the disposition by a Senior Lender of any of its rights or interests (other than as specified in paragraph (a) above), in respect of the Senior Financing Agreements in favour of (i) any other Senior Lender (ii) any institution which is recognised or permitted under the law of any member state of the EEA to carry on the business of a credit institution pursuant to Council Directive 2001/12/EC relating to the taking up and pursuit of the business of credit institutions or which is otherwise permitted to accept deposits in the United Kingdom or any other EEA member state (iii) a local authority or public authority (iv) a trustee of a charitable trust which has (or has had at any time during the previous two years) assets of at least £10 million (or its equivalent in any other currency at the relevant time) (v) a trustee of an occupational pension scheme or stakeholder pension scheme where the trust has (or has had at any time during the previous two years) at least 50 members and assets under management of at least £10 million (or its equivalent in any other currency at the relevant time) (vi) an EEA or Swiss Insurance Undertaking (vii) a Regulated Collective Investment Scheme (viii) any Qualifying Institution or (ix) any other institution in respect of which the prior written consent of the Authority has been given; and/or
- c) the grant by a Senior Lender of any other form of benefit or interest in either the Senior Financing Agreements or the revenues or assets of the Contractor [or Holdco], whether by way of security or otherwise, in favour of (i) any other Senior Lender (ii) any institution specified in paragraphs (b)(ii) to (vii) above (iii) any Qualifying Institution or (iv) any other institution in respect of which the prior written consent of the Authority has been given;

“Qualifying Institution”

means:

[];¹⁷

¹⁶ A broad purposive approach shall be taken to the interpretation of this Clause 34. Any attempt by banks to attempt to conceal refinancings behind elaborate avoidance structures will be regarded as a serious breach of these provisions and dealt with accordingly.

¹⁷ If there are particular institutions which for particular reasons do not come within the other heads of Qualifying Bank Transaction, bidders may propose to the Authority that such institutions be included as Qualifying Institutions. In the light of the broad drafting of the other

“Qualifying Refinancing”

means any Refinancing that will give rise to a Refinancing Gain greater than zero that is not an Exempt Refinancing;

“Refinancing”

means:

- (a) any amendment, variation, novation, supplement or replacement of any Financing Agreement (other than any Subordinated Financing Agreement);
- (b) the exercise of any right, or the grant of any waiver or consent, under any Financing Agreement (other than any Subordinated Financing Agreement);
- (c) the disposition of any rights or interests in, or the creation of any rights of participation in respect of, the Financing Agreements (other than the Subordinated Financing Agreements) or the creation or granting of any other form of benefit or interest in either the Financing Agreements (other than the Subordinated Financing Agreements) or the contracts, revenues or assets of the Contractor whether by way of security or otherwise; or
- (d) any other arrangement put in place by the Contractor or another person which has an effect which is similar to any of (a)-(c) above or which has the effect of limiting the Contractor’s or any Associated Company’s ability to carry out any of (a)–(c) above;

“Refinancing Gain”

means an amount equal to the greater of zero and $[(A - B) - C]$, where:

- A = the Net Present Value of the Distributions projected immediately prior to the Refinancing (taking into account the effect of the Refinancing and using the Base Case as updated (including as to the performance of the Project) so as to be current immediately prior to the Refinancing) to be made to each Relevant Person over the remaining term of the Contract following the Refinancing;
- B = the Net Present Value of the Distributions projected immediately prior to the Refinancing (but without taking into account the effect of the Refinancing and using the Base Case as updated (including as to the performance of the Project) so as to be current immediately prior to the Refinancing) to be made to each Relevant Person over the remaining term of the Contract following the Refinancing; and
- C = any adjustment required to raise the Pre-Refinancing Equity IRR to the Threshold Equity IRR;

provisions in the definition of Qualifying Bank Transaction, any such proposal must be specific and limited. Broad group definitions will not be entertained. For a listed bond transaction, however, the following may be inserted:

- “(a) any holder in due course of any security arising under or constituted by the Senior Financing Agreements in respect of which an application has been made for such security to be admitted to listing, either:
 - (i) on the Official List of the Financial Services Authority in its capacity as competent authority for the purposes of Part IV of the Financial Services and Markets Act 2000 (and to trading on the London Stock Exchange); or
 - (ii) to the competent authority in any other EEA state; or
- (b) in a situation where any security arising under or constituted by the Senior Financing Agreements is no longer admitted to listing as described in paragraph (a) above, any person whose ordinary activities involve them in acquiring, holding or disposing of investments (as principal or agent) for the purposes of their business where the acquisition of the rights of a Senior Lender in the Senior Financing Agreements takes place in accordance with all applicable securities legislation other than where such acquisition, grant or disposition is made in concert with the Shareholders and/or the Subordinated Lenders for the purpose of giving rise to a Refinancing Gain; or
- (c) a trustee for any other entity listed in paragraph (b)(ii) to (viii) or (c)(ii) or (iii) of the definition of Qualifying Bank Transaction other than a trustee whose acquisition, grant or disposition is made in concert with the Shareholders and/or the Subordinated Lenders for the purpose of giving rise to a Refinancing Gain.”

“Regulated Collective Investment Scheme”

has the meaning given in the rules from time to time of the Financial Services Authority;

“Relevant Person”

means a Shareholder and any of its Affiliates;

“Shareholder”

means any person from time to time holding share capital in the Contractor or [Holdco¹⁸];

“Threshold Equity IRR”

means [•]%;¹⁹

¹⁸ This definition should include any intermediate special purpose company between the Contractor and the investors in the Project. If the Contractor is a partnership or other legal entity, the definition should be revised so as to include all equity investors such as the General Partner and Limited Partner in the case of a Limited Liability Partnership.

¹⁹ This is the nominal post-tax (i.e. post tax with respect to the Contractor, pre-tax with respect to the shareholders in the Contractor). Equity IRR set out in the Base Case, which excludes the effects of any anticipated refinancing.

35 FINANCIAL ROBUSTNESS: CONTRACTOR DISTRESS

35.1 STRUCTURAL PROTECTION FROM THE CONSEQUENCES OF CONTRACTOR DISTRESS

35.1.1 PFI Contracts are structured so that the private sector is responsible for the delivery of services on time, on budget and according to specification. Such structuring helps to insulate Authorities from the consequences of a Contractor's financial difficulties. The key elements of such structuring are:

- **Fixed Price Contracts** - the Unitary Charge is fixed at Financial Close and thereafter changes only for agreed indexation, value testing, Change of Law, Service Change or upon the occurrence of a Compensation Event. It does not increase for Contractor delay or failure or for Contractor under-estimation of the actual outturn cost of delivery of the Services.
- **Multiple Stakeholders** - both Shareholders and Senior Lenders are financially incentivised to manage and resolve difficulties, which may arise within projects, since their returns are dependent on the successful delivery of the Project (rather than the balance sheet of the Contractor).¹
- **Fixed Term Contracts** – the length of the Contract is fixed, so that the private sector investors have a finite period over which to make a return on their investment (in the case of the Shareholders) and to achieve repayment of debt (in the case of Senior Lenders). The private sector is therefore incentivised to ensure that Services commence on time and remain available for the required period. Given this risk allocation the private sector will take responsibility for managing financial difficulties of the Contractor or its Sub-Contractors to the extent they impact on delivery of the project.
- **No Service No Payment** – this principle means that no payment of Unitary Charge is made until the Works have been constructed in accordance with the Authority's requirements and are available for use. The principle of "no service no payment" allocates to the private sector the risk of late delivery or non-completion, or delivery of an asset outside the pre-agreed contractual specification, and thus helps insulate the Authority from problems in the construction period. During the operational period, if full Services are not provided, the Authority will not make full payments (or potentially any payment) and is therefore not at risk of providing financial support to the Contractor.
- **Senior Lenders' Due Diligence** - Senior Lenders (assuming the funding is provided on a project finance basis) will undertake substantial due diligence in order to ensure, amongst other things, the financial robustness of the project structure, that the Contractor's obligations have been contractually passed to the Sub-Contractors or otherwise suitably insured, and that the Sub-Contractors are able to meet their obligations under the Sub-Contracts. Characteristically this would involve testing the financial model against various distress scenarios.

35.1.2 The structure of PFI contracts will help ensure that the risk of delays and increases in costs are allocated to the private sector. There are however a number of structuring and

¹ This guidance assumes the Project is being financed on a project finance basis. If this is not the case, different principles may apply (see Section 37 (Corporate Finance)).

management measures that Authorities should implement to ensure that their PFI project operates effectively in circumstances of Contractor distress.

35.2 FINANCIAL AND STRUCTURING ROBUSTNESS

35.2.1 Any bid should be examined from the perspective of how resilient the proposed project structure is to the Contractor or the Sub-Contractor experiencing financial distress. Relevant issues to consider include:

- **Overall Project Structure** - Different project structures have an impact on financial robustness. For example, projects structured on a limited recourse basis (as for standard project finance) will necessitate careful structuring as the ability of the Contractor to absorb the cost of crystallised Project risks is limited.

In corporate-financed deals where the Contract is entered into with a corporate entity with a significant balance sheet, the long-term financial standing of the Contractor will be of relevance and as such credit enhancement in the form of guarantees, bonds or letters of credit will normally be required. Such credit enhancement may be required at Contract signature or post-Contract signature on the occurrence of certain events e.g. downgrading in the Contractor's credit standing (see also Financial Robustness of Equity Providers and Sub-Contractors below).

- **Financial Robustness of the SPV or Other Proposed Contractor Company** - An Authority should analyse bidder sources and terms of funding including whether contingent equity and/or standby facilities are in place, reserve account levels, gearing,² cover ratios (which are essentially measures of available cash within a project, whether on an annual basis or over the full length of the Contract) and liquidity.
- **Sub-Contractors and Sub-Contractor Interfaces** - As well as the pass down of obligations from the Contractor to its Sub-Contractors, Authorities should also seek to ensure that the allocation of risks as between the key Sub-Contracts (i.e. construction and FM contracts) is largely market standard (taking professional advice as appropriate). For example, an arrangement whereby the FM Sub-Contractor takes defects liability risk for construction work would be regarded as unusual. Non-market standard Sub-Contracts do cause additional difficulties, where the Contractor or the Sub-Contractor experiences financial difficulties, as any replacement Sub-Contractor would be likely to contract only on the basis of different contractual terms. Accordingly the Contractor itself may assume risks previously borne by the Sub-Contractor that is being replaced, with consequential destabilising effects on the Project.³
- **Strong Contractor Management** - the Contractor should manage its Sub-Contractors robustly to ensure delivery of the Contract. Authorities should consider whether the Contractor is appropriately staffed to perform such functions and whether it has management services provided to it or will be actively supported by its shareholders.
- **Financial Robustness of Equity Providers and Sub-Contractors** - Authorities should assess the robustness of equity providers (where they have ongoing funding obligations) and Sub-Contractors, considering issues such as that party's importance to the Project, ease of replacement, credit ratings, length of time and level of overall exposure to that party, and whether parent company guarantees or some other form of performance or financial support is being or should be proposed. Where credit enhancement is considered appropriate, Authorities will need to:
 - balance the cost of providing the enhancement against the risk of a substantial deterioration in the financial standing of the relevant party;

² For example a high gearing could mean that the Contractor has little ability to absorb the costs of the crystallisation of project risks unless the Contractor has access to other sources of funding.

³ The issue of non-standard risk allocation between key Sub-Contractors is of perhaps of particular relevance where the bidder is proposing an integrated approach to a project (i.e. where it will be contributing equity, constructing the asset and providing facilities management services to the Contractor).

- consider the form of the enhancement (e.g. on-demand bonds will be more costly although payment of the full amount of the claim is more certain when compared to other instruments);
 - consider the identity of the issuer of such credit enhancement, bearing in mind that the credit standing of a corporate may be susceptible to greater fluctuations than banks or other financial entities;
 - consider the timing for the issue of the credit enhancement – if credit enhancement is only required once the party is in difficulties, it may at that stage be unable to procure its issue; and
 - consider the application of the proceeds of any credit enhancement.
- **Appropriate pricing of Works and Services** - Authorities should ensure bidders have reasonable cost assumptions in their financial models (e.g. underestimating costs may lead the Contractor to compromise full service delivery or result in financial difficulty).
 - **Third Party Income** - Authorities should be cautious of over-optimistic assumptions of third party income in the financial model; if such income does not materialise this may destabilise the economic basis of the Project. Unrealistic third party income assumptions can also raise transferability issues. For example, where the economics of a project are dependent on levels of third party income guaranteed under a Sub-Contract, any replacement Sub-Contractor would need to be comfortable with generating the same levels of third party income or the risk will revert to the Contractor.
 - **Capital Contributions:-** Capital contributions by the Authority towards project costs should not ordinarily be included as part of the structure of a project, to ensure the normal PFI incentives are not distorted. Section 3.9 sets out further details concerning Authority capital contributions and the impact this has on projects.

35.2.2 A bid does of course need to be looked at in the context of a number of evaluation criteria other than financial robustness, for example quality and price. It is possible for one bid to be cheaper in terms of the Unitary Charge but also more prone to failure and consequentially worse value for money. Authorities must consider financial and structural robustness as part of their evaluation, and a project with a high risk of failure should be regarded as unacceptable.⁴

35.3 CONTRACTUAL PROTECTION

35.3.1 In addition to the structural protection as set out in Section 35.1 above afforded by PFI contracts, a number of key contractual provisions provide Authorities with protection in circumstances of Contractor distress. Such key Contract provisions are:

- **Change of Ownership provisions** - These provisions would usually provide, subject to certain exceptions, that the ownership of the Contractor (and Holdco, if relevant) is fixed throughout the Construction Period and the defects liability period (usually one year post-construction completion). By fixing the ownership of the Sub-Contractor, the Authority ensures that the bidding consortium which it selects to deliver the Project is maintained, and that key shareholders (one of whom may be the Construction Sub-Contractor) are incentivised to ensure that the Project is delivered in accordance with requirements of the Contract. Section 18 provides further details on Change of Ownership together with drafting for such provisions.

⁴ See further HMT "*Value for Money Assessment Guidance*" November 2006 from section 5.35 onwards, published on HMT website at www.hm-treasury.gov.uk.

- **Additional Permitted Borrowings** - the Additional Permitted Borrowing regime affords Senior Lenders the ability to provide limited additional funding to the Contractor where the Project is in difficulty (whether in the construction or operational period) without the consent of the Authority. Such additional loans do not affect the Unitary Charge but are taken into account as part of the Authority's liabilities if the Project is terminated for Authority Default, Voluntary Termination, Force Majeure or Corrupt Gifts or at an Authority Break Point Date.
- **Defaults and Termination** - On termination, the Contractor will commonly, broadly, be paid the market value of the Contract. There is no guarantee that this will be sufficient to pay out the Senior Lenders, therefore they are incentivised to also ensure that the project does not fail and that its market value is maintained. Authorities should ensure that the payment mechanism is calibrated so that the accumulation of points, deductions and default triggers appropriately incentivise performance.
- **Construction Period** - During the construction period, where, in projects without any early service provision, the payment mechanism may not be relevant, the Authority's contractual remedies are its termination rights under the Contract. They may arise following failure to start Works by a certain date, abandonment of the Contract or failure to meet the acceptance criteria applicable to the Works by the long-stop date, among other circumstances. Contracts do not generally include termination triggers relating to Sub-Contractors, since the Contractor assumes the risk of managing Sub-Contractor performance. However the Authority may insert provisions requiring the Contractor to replace a defaulting building Sub-Contractor (breach of which could lead to a Contractor Default).
- **Information Rights** - Section 26 (Information and Confidentiality) contains information rights for the Authority, including rights to receive:
 - the annual reports and accounts of the Contractor;
 - a notification requirement where a Financing Default has occurred under the Senior Financing Agreements and, following such default, a right to request the production of an Interim Project Report and meetings with the Contractor and the Senior Lenders to discuss such report; and
 - other information relating to the Project which it may reasonably request.

This information may provide early warning of Contractor distress to the Authority.

- **Step-in Rights** - Contracts allow Senior Lenders to step-in (giving them the opportunity to resolve difficulties in order to preserve the value of their investment) and replace the Contractor with a new Contractor. The Authority also has step-in rights which allow it, in certain circumstances, to substitute performance of the Contractor's obligations under the Contract or (subject to prior rights of the Senior Lenders) to take over management of key Sub-Contractors.⁵

35.4 RECOGNISING CONTRACTOR DISTRESS

35.4.1 A robustly-structured project will help to minimise the impact of Contractor distress on users and on the Authority's own finances. It is nevertheless important that Authorities recognise signs of Contractor distress as early as possible.

35.4.2 At a general level indicators of Contractor distress include:

⁵ See Section 29 (Authority Step-in) and Section 31 (Direct Agreement and Senior Lenders) for further details on Authority step-in rights.

- reports in the media concerning the deterioration of a company's financial health;
- annual accounts showing deteriorating finances;
- profit warnings issued by, or erratic share price movements relating to, corporate entities involved in the Project such as shareholders, Sub-Contractors or their related companies; and
- a downgrade in the crediting rating of a shareholder, Sub-Contractor or related company's credit rating.

35.4.3 At project level, indicators of Contractor distress include:

- **Delay in works** - Reduced or minimal site activity resulting in the programme of works being delayed (for example a failure to meet interim or final construction milestones).
- **Late payment/failure to pay** - Late payment or failure to pay sub-contractors of the Sub-Contractor whether during the construction or operation phase. There may of course be other reasons for non-payment, such as a genuine dispute regarding payment. In such circumstances the Authority should check whether there has been a history of late or non-payment. The Authority should seek to corroborate whether the issues arising within its project are arising on other projects being developed by the same Contractor.
- **Performance issues within the Contract** - Regular Service underperformance, particularly where the performance relates to matters that require a potentially large amount of capital expenditure such as obligations relating to lifecycle maintenance or rectification of snagging issues.
- **Increase in disputes** - Financial distress may cause the Contractor to take a more formal contractual approach to its relationship with the Authority; this may manifest itself in established working methods between the Contract and the Authority being changed so that, for example, additional payments are required for Services which were historically regarded as being within the agreed Services specification. Authorities may also see an increase in referrals to dispute resolution procedures or litigation.
- **Staff changes** - Unexpected staff changes (particularly senior management), especially where this is also occurring on other projects where the Contractor is involved. Further indicators of distress may include where staff are replaced by workers who are on short term contracts (such as consultants) or headcount of staff is reduced.
- **Breaches under Financing Agreements** - failure to pay amounts due under the Senior Financing Agreements or the financial agreements entered into by a shareholder or a Sub-Contractor. The extent and frequency of the non-payment will need to be considered so as to get a clearer indication of the degree of financial difficulties.
- **Restructuring proposals** - proposals to restructure/refinance the Project (although such proposals might be inspired by a range of financial or operational drivers). This is particularly apparent where the transaction is presented as a 'rescue refinancing', in which case the Authority may not have the same consent rights which it would have for a non-rescue refinancing – see Section 34 (Refinancing). More generally, whilst financial restructuring can be complex, the Authority should be aware of restructuring motivated by a lack of resources (evidenced for example by a request from the Contractor for additional resources or a relaxation of the payment mechanism).

35.4.5 Where review against the above, and any other indicators identified by an Authority, indicates that there is Contractor distress, the Authority should consider: how significant the distress, how it is being approached by the Contractor, and what further information the Authority might seek from the Contractor or elsewhere.

35.5 MANAGING CONTRACTOR DISTRESS

35.5.1 If a project is experiencing Contractor distress there are a number of practical measures that Authorities may adopt to help manage and resolve issues. Such measures include:

- **Advice** - It is important that Authorities promptly contact their departments' Private Finance Unit and HMT's Operational Taskforce, which has direct experience of dealing with issues arising from Contractor distress. Authorities should also obtain appropriately experienced technical, legal and/or financial advice at an early stage.
- **Information Flows** - It is important to establish clear lines of communication with Shareholders, the Contractor, the Senior Lenders and the users of the Service.
- **Records of Project Documentation** - Contract distress scenarios may involve dispute resolution and litigation. To assist in these procedures it is important at all times and in particular throughout a Contractor distress situation to keep up-to-date records of all contractual documentation, records of agreements amending the Contract and records of works undertaken.
- **Scenario Planning** - The Authority together with the Contractor, Shareholders and the Senior Lenders should set out clear plans for the resolution of difficulties arising from Contractor distress. Such plans should also cover scenarios where the Contractor or the relevant Sub-Contractor enters into a formal insolvency procedure.
- **Joined-up Approach** - A contractual counterparty that is experiencing Contractor distress may be involved in a number of PFI projects and in such instances it will be beneficial for the different Authorities to adopt a joined-up approach. A collective position on common issues will further strengthen the public sector negotiating position. Departmental Private Finance Units should be ready to help facilitate a joined-up public sector approach.

35.5.2 Furthermore, specific contractual issues may arise in circumstances of Contractor distress, including:

- **Consideration of Waivers** - The private sector may request the Authority to waive its rights under the Contract – for example where a termination right has arisen. Such a request may arise in the context of a standstill arrangement (which is an arrangement whereby parties, such as the Senior Lenders, who may exercise rights arising from an event of default occurring under the Financing Agreements, agree to a conditional suspension of those rights while a plan for resolving difficulties in the Project is implemented). An Authority should consider carefully whether the waiver of any of its rights would be appropriate, and whether this would have any legal effect on the Contract (obtaining legal advice where necessary). In circumstances where it does consider it appropriate, any waiver granted should be specific and time limited. The Authority should also consider whether it is appropriate to place other conditions on the grant of the waiver, which may relate to more general issues concerning the Project.
- **Termination Rights** - Where an Authority is considering exercising termination rights, it should consider the consequences of exercising such rights and the plans that will need to be implemented in order to ensure that works/services are continued. It should consider whether the Senior Lenders are preparing, pursuant to their rights under the Direct Agreement, to step-in following the termination notice. The Direct Agreement will also provide for a period of time during which the Senior Lenders may consider stepping-in. The Authority should ensure that the Senior Lenders have in place plans to protect the site during such period; the financial incentive will be on the Senior Lenders to do so. Senior Lenders will generally seek to avoid a termination notice being issued under the

Contract, because of the reduced recoveries that actual termination might bring as compared to rescuing the Project outside the formal termination process.

36 BOND FINANCE

36.1 INTRODUCTION

36.1.1 A bond is a negotiable debt instrument that pays the bondholder a rate of interest on the face value of the bond. The bond markets offer a source of long-dated debt and, accordingly, it is now commonplace for bidders on larger PFI projects to consider raising money in this market as an alternative to (or in addition to) the banking sector.

36.1.2 Bonds can be issued on various different terms. The principal amount of the bond can be repaid either in full on final maturity (a “bullet bond”) or, more commonly for PFI projects, in instalments according to an agreed amortisation schedule. Interest may be fixed rate (the interest rate is set on issuance and does not vary) or floating rate (the interest rate varies with a money market reference rate, such as LIBOR, and is reset at the beginning of each interest period). In addition, bonds (usually only fixed rate bonds) may be index-linked, so that payments of principal and interest escalate according to movements in a selected index, commonly the United Kingdom Retail Price Index (all items).

36.1.3 Bond issues may be public, meaning they are listed on a stock exchange (and therefore are more widely available). Alternatively, they may be distributed by way of a private placement. This will involve an offer to a very limited number of (occasionally sole) investors.¹ Private placements are often unlisted, and if so need not comply with listing authority’s disclosure rules, therefore requiring less disclosure than a public offering.

36.1.4 Almost all public PFI bond issues are rated by one or more rating agencies. This provides a transparent assessment of the underlying credit quality of the issuer, and when combined with the relative standardisation of bond terms and conditions it assists in the tradeability of bonds. The underlying credit rating of PFI projects is usually at the lower end of “investment grade”, in the range of BBB-/Baa3 to BBB+/Baa1.

36.1.5 In order to reduce the cost of raising debt, most PFI bonds to date have been “wrapped”: scheduled payments of principal and interest are guaranteed (in return for a fee) by a monoline insurer.² As a result of the guarantee (or “credit wrap”) the bonds are themselves rated according to the rating of the monoline, typically AAA/Aaa. This has tended to offer a more affordable financing solution to the Contractor even once the cost of the credit wrap is considered.

36.1.6 Bond transactions require specific documentation. The primary selling document is the Prospectus, which sets out all the information that the issuer of the bonds believes is material to any potential bondholders’ decision to invest. It contains the terms and conditions of the bond, together with a description of the issuer and the project. If the bond issue is listed, the Prospectus must comply with the relevant listing authority’s rules. There will also be a bond trust deed, setting out the rights of the bondholders, and a subscription agreement, obliging the bond managers to subscribe for the bonds at the issue price.

36.1.7 In addition, as bond proceeds are usually received in a lump sum at Financial Close, but the expenditure profile may vary, the proceeds are often deposited with a highly rated bank until required, through a fixed-rate deposit known as a “Guaranteed Investment Contract”.³

¹ It is of course important to ensure that a transparent, competitive process is adopted to price the bonds.

² A monoline insurer is a specialist insurer whose only line of business is financial guarantees.

³ As regards hedging more generally, see HMT Guidance “*Interest rate and inflation risks on PFI transactions*” of April 2006. HMT website at www.hm-treasury.gov.uk.

36.2 PRINCIPAL CHANGES TO THE CONTRACT FOR BOND FINANCE

36.2.1 This Section provides an explanation of the principal changes to the Contract required where bond finance is used. Where permissible amendments to provisions are outlined, no derogation approval is needed if these are made.

36.2.2 A definition for Bonds should be included.

“Bonds”

means the [] bonds due [] of the Issuer, issued at Financial Close, in the aggregate principal amount of [];

Issuer

36.2.3 It is common for bonds to be issued by a special purpose public limited company (the “Issuer”), separate from the Contractor. Commonly, both the Issuer and the Contractor have the same 100% holding company, Holdco. It may be simpler in these cases to include a definition of “Obligors”, to include the Contractor, the Issuer and Holdco, and to use this definition as appropriate. If the Issuer is a separate entity to the Contractor, this requires various changes to Contract drafting, as set out below.

36.2.4 A definition for Issuer should be included.

36.2.5 The Issuer must also, as a required drafting matter, be referenced alongside the Contractor in all appropriate provisions of the Contract, including:

- the definition of Associated Company (Section 1.7.1);
- the definition of Financing Agreements (Section 1.7.1);
- the definition of Permitted Borrowing (Section 1.7.1);
- the definition of Senior Lender (Section 1.7.1);
- the definition of Shareholders (Section 1.7.1);
- in all definitions relating to the calculation of the compensation sums, where the cash balances and assets of the Contractor are taken into account (including in the definition of “Adjusted Estimated Fair Value of the Contract” (paragraphs (i) and (ii)), in the definition of “Adjusted Highest Compliant Tender Price” (paragraphs (i) and (ii)), and in the definitions of “Base Senior Debt Termination Amount” and “Revised Senior Debt Termination Amount” (see below)) (Section 1.7.1);
- the change of ownership provisions (Section 17);
- the insolvency defaults (Section 20.2.2.1(c) to (f));
- the information and confidentiality provisions (Section 26);
- paragraphs (c) and (d) of the definition of Refinancing (Section 34.7); and
- the definition of Relevant Person (Section 34.8.1).

Financing Agreements

36.2.6 As noted above, the definition of “Financing Agreements” should be amended to include reference to the Issuer and its Associated Companies alongside existing references to the Contractor.

36.2.7 The definition of Senior Financing Agreements must include the relevant bond documentation, alongside any other finance agreements. These may include the Bonds, the bond trust deed, the subscription agreement and any guaranteed investment contract, alongside the security documents, the collateral deed, intercreditor agreements, and any hedging documents. Where the bonds are “wrapped”, the financial guarantee(s) and related guarantee and indemnity agreement should also be included. Each such document should be defined in the Contract.

36.2.8 The Prospectus is not usually included as it is not a contractual document. In addition the on-loan documents, under which the bond and other finance proceeds are passed from the Issuer to the Contractor, should generally not be included. If they are, care must be taken to ensure that no payments in respect of them are included in any termination payment.

36.2.9 Careful due diligence should be done by the Authority’s financial and legal advisers to ensure that any fees or break costs are appropriate to be covered in the various (non-Contractor default) termination scenarios (and, if not, are carved out) and that there is no double counting between the various instruments (or coverage of costs other than those to the external finance market).

36.2.10 If preferred, the definition of “Senior Lender” could be extended specifically to include the relevant parties to the Senior Financing Agreements.

Agent

36.2.11 The standard definition of “Agent” may be substituted by a definition of Credit Provider or Bond Trustee or similar, being the finance party that controls the rights of the Senior Lenders. It may be in some circumstances that more than one entity will wish to have the rights normally afforded to the Agent. For example, both the Credit Provider and the Security Trustee would normally receive all notifications usually provided to an Agent.

Permitted Borrowing

36.2.12 Bonds that are issued and sold at Financial Close should be deemed Permitted Borrowing. Variation bonds (to finance future variations to the Contract) may form part of the bond arrangements. If these are effectively committed facilities (and sold at Financial Close, thus raising actual funding) then they would be treated as any other part of the Senior Debt and should fall within the Permitted Borrowing definition. Often however variation bonds are not “committed”, and are not sold at Financial Close. Instead they are issued under the main bond documentation, and thus can be sold without a new Prospectus or trust deed being required, but are held by the Issuer and therefore do not accrue interest until additional funds are needed and they are sold to the market. Listing authorities impose limitations on the amount of variation bonds that can be dealt with in this way. These uncommitted variation bonds should not be treated as Permitted Borrowings. If they are subsequently sold as part of an agreed variation, they can at such time be re-categorised as Permitted Borrowing.

36.2.13 If rescue bonds are proposed from the outset, a similar analysis would apply (but these could qualify as Additional Permitted Borrowing).

36.2.14 The definition of Original Senior Commitment (from which Additional Permitted Borrowing Limit is calculated) should only include amounts in respect of bonds which have been issued and sold.

“Original Senior Commitment”

means the [amount of principal issued and outstanding in respect of the Bonds]/[gross proceeds of the issue of the Bonds] as at Financial Close, [other than the [principal

issued and outstanding in respect of the Variation Bonds]/[proceeds of the issue of the Variation Bonds]];⁴

36.2.15 The amount referred to in limb (b)(ii) of the definition of Additional Permitted Borrowing Limit should not be indexed, even where the bonds are index-linked, and this definition should be amended as necessary.

36.2.16 These changes assume that any bonds will be issued at par (not at a discount or a premium). If an issue is not at par, financial advice should be taken as to further changes that might be needed.

Termination payments and the Spens Clause

36.2.17 Terms and conditions in the long-term sterling market for most borrowers (corporate as well as project-related) typically contain break-cost provisions, applicable in the event of early repayment or acceleration of the bonds (known as the “Spens” or “Make-whole” formula). In the long-term sterling market, the Spens formula has historically operated such that on an early redemption of the bonds, the bondholders are broadly paid an amount equal to the higher of the outstanding principal on the bond and the foregone coupon (interest and principal) on the bonds, discounted at a rate equal to the gross redemption yield on a Treasury Gilt of comparable weighted average life to the bond. This level of compensation is set to allow the bondholder to attain the same return by reinvesting in risk free gilts.

36.2.18 In the PFI context HMT’s April 2006 “*Guidance on the Application of Spens clauses in PFI transactions*” must be followed, according to which the Authority may pay the full amount due under a Spens formula as above on an Authority Default, a modified Spens formula on an Authority Voluntary Termination (including termination on an Authority Break Point Date), and no Spens formula payment on any other termination. These are required drafting provisions for bond-financed projects. Drafting is set out below:

“Make-Whole Payment”

means:

- (a) in relation to termination of the Contract under Clause [] (Termination on Authority Default), the Make-Whole payment to be made pursuant to and in accordance with Condition [] of the Bonds;
- (b) in relation to termination of the Contract under Clause [] (Voluntary Termination by the Authority) [or Clause [] (Termination on an Authority Break Point Date)], the modified Make-Whole payment to be made pursuant to and in accordance with Condition [] of the Bonds; and
- (c) in relation to termination of the Contract in any other circumstances, zero.

36.2.19 The Authority’s financial and legal advisers must do a due diligence review of the bond arrangements and, in particular, their Spens provisions and the discount rate used⁵. The contingent liabilities inherent in the Spens clause should be taken into account in the Authority’s overall assessment of value for money.

36.2.20 Where a monoline guarantee is in place, Authorities should note that the full guarantee fee will usually be due to the monoline in the event of early termination of the project for whatever reason. If the Contractor has already paid the full fee to the monoline, it will not be repayable. Further, if the full fee was to be paid in instalments over the life of the bonds, on early termination the compensation payable by the Authority may include any fee unpaid to the monoline insurer.

⁴ Proceeds of uncommitted variation bonds should be excluded. Where committed variation bonds are issued, the face value of these bonds should be included in this definition.

⁵ HMT’s April 2006 “*Guidance on the Application of Spens clauses in PFI transactions*” and May 2006 “*Interest-rate and inflation risks in PFI Contracts*” should be followed. For both see HMT web site at www.hm-treasury.gov.uk.

This is an important difference of practice between bond and bank markets, as bank borrowers are generally not expected to pay future risk margins foregone to banks whose loans are repaid early.

36.2.21 The definitions of “Base Senior Debt Termination Amount” and “Revised Senior Debt Termination Amount” should be revised specifically to refer to the Make-Whole Payment. Suggested changes are outlined below, with additions underlined.

"Base Senior Debt Termination Amount"

means, subject to Clause 22.3 (Certainty of Compensation Payment Amounts and Changes to Financing Agreements):

- (a) all amounts outstanding at the Termination Date, including interest and Default Interest accrued⁶ as at that date, from the [Contractor and/or the Issuer⁷ to the Senior Lenders in respect of Permitted Borrowing⁸ (other than in respect of Additional Permitted Borrowing) and
- (b) all amounts including costs of early termination of interest rate hedging arrangements and other breakage costs⁹ (including for the avoidance of doubt any Make-Whole Payment), payable by the [Contractor and/or the Issuer to the Senior Lenders¹⁰ as a result of a prepayment in respect of Permitted Borrowing (other than in respect of Additional Permitted Borrowing), or, in the case of early termination of interest rate hedging arrangements only, as a result of termination of this Contract, subject to the [Contractor, the Issuer and the Senior Lenders mitigating all such costs to the extent reasonably possible [(unless the amount, or the formula for determining the amount, of such costs is fixed in advance under the terms of the relevant Senior Financing Agreements)],¹¹

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

- (i) all credit balances on any bank accounts (but excluding the Joint Insurance Account) held by or on behalf of the Contractor and/or the Issuer [and/or Holdco]¹² on the Termination Date;
- (ii) any amounts claimable on or after the Termination Date in respect of Contingent Funding Liabilities;
- (iii) all amounts, including costs of early termination of interest rate hedging arrangements and other breakage costs, payable by the Senior Lenders

⁶ Consideration may be given as to whether some specific reference to an indexation amount/ bond condition is appropriate here for an indexed bond.

⁷ Inclusion of the Contractor will depend on whether the Contractor is a party to any Senior Financing Agreements but see Section 36.2.8.

⁸ This assumes a check has been made by the Authority's advisers that the provisions of the Senior Financing Agreements do not include unusual provisions that could artificially inflate amounts advances beyond those provisions that are market standard. See Section 33 (Due Diligence over Sub-Contracts and Financing Agreements).

⁹ This is intended to cover net breakage costs if the compensation is not paid on an interest payment date. Authorities may consider whether they should exclude any future profit element from the calculation of costs of early termination of interest hedging arrangements where the termination is for force majeure, breach of refinancing, corrupt gifts and uninsurability. See footnote 8 below.

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

¹¹ Authorities should consider whether it would be appropriate in the context of the Project to include this language. Advisers should check any such terms in the Senior Finance Agreements carefully.

¹² If the Senior Lenders have security over bank accounts in Holdco (or any other company), then Holdco (or such other company) needs to be referenced here.

to the [Contractor and/or the] Issuer as a result of prepayment of amounts outstanding in respect of Permitted Borrowing (other than in respect of Additional Permitted Borrowing), or, in the case of early termination of interest rate hedging arrangements only, as a result of termination of this Contract; and

- (iv) all other amounts received by the Senior Lenders on or after the Termination Date and before the date on which any compensation is payable by the Authority to the Contractor as a result of enforcing any other rights they may have;

“Revised Senior Debt Termination Amount”

means, subject to Clause 22.3 (Certainty of Compensation Payment Amounts and Changes to Financing Agreements)

- (a) all amounts outstanding at the Termination Date, including interest and (other than in respect of Additional Permitted Borrowing) Default Interest accrued¹³ as at that date, from the [Contractor and/or the] Issuer¹⁴ to the Senior Lenders in respect of Permitted Borrowing; and
- (b) all amounts including costs of early termination of interest rate hedging arrangements and other breakage costs (including for the avoidance of doubt any Make-Whole Payment), payable by the [Contractor and/or the] Issuer to the Senior Lenders as a result of a prepayment in respect of Permitted Borrowing, or, in the case of early termination of interest rate hedging arrangements only, as a result of termination of this Contract, subject to the [Contractor, the] Issuer and the Senior Lenders mitigating all such costs to the extent reasonably possible [(unless the amount, or the formula for determining the amount, of such costs is fixed in advance under the terms of the relevant Senior Financing Agreements)]¹⁵,

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

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

¹³ Consideration may be given as to whether some specific reference to an indexation amount/or related bond condition is appropriate here for an indexed bond.

¹⁴ Inclusion of the Contractor will depend on whether the Contractor is a party to any Senior Financing Agreements, but see Section 36.2.8.

¹⁵ Authorities should consider whether it would be appropriate in the context of the project to include this language. Advisers should check any such term in the Senior Finance Agreements carefully.

Direct Agreement

36.2.22 In the Direct Agreement (see Section 31.5), Clause 10 (d) (iv) may be amended to reflect the different reporting arrangements for a bond financing, as follows:

10 (d)(iv) [The Contractor shall promptly notify the Authority] on each [Payment Date]¹⁶ on which any Additional Permitted Borrowing is, or may be, subsisting, the Amount outstanding under the Senior Financing Agreements and to the extent it is aware (having made reasonable and proper enquiry):

(a) on each [Payment Date] and the first Business Day of each calendar month following a Distribution, the amount of any Distribution made by the Contractor; and

(b) on each [Payment Date] and on the first Business Day of each calendar month following 5 Business Days written notice from the Authority, the amount of any credit balance on any account of the Contractor.

36.2.23 Authority legal advisers will need to check the relevant bond documentation to ensure that the obligations of the representative of the Senior Lenders (which may be a trustee) under the Direct Agreement (for instance, any covenants to act reasonably) flow through to the party or parties which will direct such representative (for example, a monoline insurer or the bondholders).

Refinancing

36.2.24 In the refinancing provisions, the definition of Qualifying Institution from footnote 19 of Section 34.8 (Model Refinancing Provisions) should be used, to reflect the transferable nature of bonds in the market. This allows for ordinary market dealings in the bonds to be classed as an Exempt Refinancing, outside the refinancing gain provisions.

¹⁶ To correspond with Bond payment dates.

37 CORPORATE FINANCE

37.1 INTRODUCTION

37.1.1 As discussed in Section 1.3 (Assumptions), the general assumptions behind this guidance are that a SPV contracts with the public sector, with Sub-Contractors providing the actual performance on its behalf, and makes use of a significant level of limited-recourse debt to finance the Project. This structure is known as 'project finance', meaning that the debt financing (provided by banks or the bond market) is raised on a project-specific basis, relies primarily on the PFI Contract and the various Sub-Contracts for security, and on the specific project cash flows for repayment.

37.1.2 However, "corporate finance", where the funding is raised based on the credit strength of the Contractor's or its parent company's general (non project-specific) business and balance sheet, also plays a role in some PFI transactions.

37.1.3 The differences between project and corporate finance (discussed in Section 37.2 below) mean that some aspects of this guidance will not be fully applicable to corporate-financed transactions. A number of issues follow from this:

- procurement implications, where some or all bidders may choose to use corporate finance (see Section 37.3 below);
- evaluation of corporate-financed bids (see Section 37.4 below);
- required amendments to standard drafting, especially as to Unitary Charge adjustments, insurances, refinancing and termination provisions, where a bidder wishes to use corporate finance (see Section 37.5 below);
- situations where a Contractor proposes to change from corporate to project finance, or *vice-versa*, at some time after Financial Close (see Section 37.6 below); and
- 'variant' structures which fall between corporate and project finance (see Section 37.7 below).

37.2 PROJECT AND CORPORATE FINANCE

37.2.1 The majority of PFI projects involving an initial capital investment of more than £10 million have been based on a project-finance structure. This is due principally to the following factors:

- the amount of finance required to meet the investment needs of many PFI projects is beyond the balance-sheet capacity of many of the individual companies bidding for these projects. Typically therefore consortiums of financial and industry investors bid for PFI projects through SPVs (whose financing will normally be off the investors' balance sheets);
- low average cost of capital with project finance, as a high proportion of the funding (typically 90% or more) is derived from debt rather than higher-cost equity;¹
- the project finance markets can provide long-term finance to match the long-term service delivery requirements of many Contracts, whereas few individual companies bidding for

¹ Notwithstanding that there is a theoretical position that gearing might not affect the overall cost of funding.

PFI projects can support such long-term finance; and

- PFI payment mechanisms are based on Unitary Charges which are payable over the full period of service delivery and are linked to standards of service performance. Such long-term predictable revenues are a common characteristic of project finance transactions and the project finance market is thus familiar with and able to fund such arrangements.

37.2.2 However transactions are also financed using the balance-sheet resources of the contractors, *i.e.* using corporate finance, which is not project-specific but relies on the overall financial strength of the contractor.

37.2.3 Corporate finance may be used by a bidder:

- where there is a single bidder instead of a bidding consortium;
- where the bidder has a strong balance sheet, and uses corporate finance for new projects as part of its normal business model;
- where it is cost-effective, such as for smaller transactions where the reduced transaction costs make it more cost-effective than project finance (which has relatively high fixed transaction costs); or
- where it gives greater flexibility for the investor or the Authority compared to project finance.

37.2.4 Although used in the past mainly for smaller (below £10 million) transactions, more recently corporate finance has also been used in some sectors for large transactions. It should be noted however that transactions below £20 million capital value should not be pursued through a PFI route.

37.2.5 Defining characteristics of corporate finance are:

- the entity with which the Authority signs the Contract is a prime contractor with credible financial standing or is supported by equivalent guarantees from a member of its group which impart financial strength to the entity;
- no references to third-party finance, or associated features such as interest-rate hedging (whether equity, debt or other forms of finance), appear within the Contract or other documents or letters entered into by the Authority;
- there is no third-party creditor due-diligence process;
- no assignments, acknowledgements or other documentation are given by the Authority in favour of or for the benefit of the Contractor's funders;
- there is no direct agreement between the Authority and the Contractor's funders; and
- there is no movement in the bid price once the bid has been submitted because of changes in market rates.

37.2.6 Where all the characteristics set out in Section 37.2.5 are present the funding can qualify as Corporate Finance, and the Contract amendments set out in Section 37.5, and the procurement changes set out in Section 37.4 should be applied. Where some but not all such characteristics are present, the Project has a "variant" structure (see Section 37.7) and amendments and procurement changes should be applied as appropriate to deal with corporate finance aspects of the funding. Authorities should seek advice in this regard.

37.2.7 Corporate finance, if chosen by bidders, may provide equally good performance incentives and value-for-money drivers as project finance, so long as the principles underlying this guidance are followed. The key principle is that private-sector capital must be at risk during

the long-term delivery of outputs specified by the public sector in the Contract. The form of private-sector capital is, in this sense, secondary so long as risks are transferred cost-effectively.

37.3 CORPORATE FINANCE – PROCUREMENT IMPLICATIONS

37.3.1 If some bidders propose to use project finance and some corporate finance, the latter will have to bid against a Contract that takes account of the changes set out in Section 37.5.

37.3.2 It may not be necessary for bidders using corporate finance to provide bank commitment letters (see Section 32 (Competitive Dialogue and Commitment Letters)), although comfort around availability of funding will still be required.

37.3.3 To the extent that no project-specific external debt is being provided, a formal funding competition is not relevant.²

37.3.4 The Authority should not automatically be assumed to be responsible for interest-rate movements between bid and Financial Close (see Section 37.4.3).

37.4 CORPORATE FINANCE – EVALUATION IMPLICATIONS

37.4.1 Project finance can bring a number of benefits for an Authority such as:

- systematic and rigorous techniques for credit analysis are central to project finance, and play an important role in achieving value-for-money risk transfer to the private sector;
- the SPV is bankruptcy-remote, and hence the project can survive the insolvency of the Shareholders. Often SPVs have a higher long-term credit rating than that of many individual construction or facilities-management contractors in the UK market; and
- the cash flows of the SPV can be predominantly based on actual contracts with suppliers and lenders. These figures are then used to model and calculate the Unitary Charge, and this process is subject to due diligence from the Senior Lenders and the Authority. This degree of challenge leads to improved transparency in PFI contract pricing, costs and returns, as central corporate overhead costs (which cannot easily be challenged) are not part-allocated to an individual PFI project.

37.4.2 It is therefore important for the Authority to ensure that the use of corporate finance:

- does not preclude sufficient analysis of the Project, i.e. given the absence of third-party lenders the Authority will have to pay special attention to the due-diligence process;
- does not reduce the financial robustness of the private-sector counterparty to the Contract (i.e. this is no worse than a project finance SPV), which means that the Contractor under the Contract must be highly creditworthy (perhaps demonstrated by a good credit rating) or be guaranteed by a creditworthy group company; and
- does not result in the Authority being inadequately informed about the costs, cash flows and returns of the transaction.

37.4.3 Evaluation of corporate-financed proposals should also take into account:

- the greater simplicity, speed and lower transaction costs of using corporate finance;

² HMT, *Preferred Bidder Debt Funding Competitions – Draft outline guidance for feedback* (August 2006).

- the fixed-price nature of bids, e.g. with no adjustment for interest-rate movements between bid and Financial Close;³
- the relative flexibility of the funding arrangements, especially as to major changes and Authority Voluntary Termination;
- the loss of share in any Refinancing Gains, if an exemption from sharing applies;
- the potential loss of transparency of Sub-Contracting arrangements. However, it should be noted that the Authority should always satisfy itself about the suitability of the proposed Sub-Contracting arrangements regardless of whether project or corporate finance is used;
- any project-specific provisions to protect the Authority's position, such as a requirement for the Contractor or its guarantor to maintain a certain credit rating, the use of escrow accounts to ensure Sub-Contractors are paid, or additional credit enhancement such as performance bonds or standby letters of credit;⁴
- the process by which poor performance can be remedied, by replacing Sub-Contractors or otherwise;
- the absence of lenders who may step in and rescue the project should it get into difficulty, so ensuring continued Service provision; and
- the absence of specific liability for the Authority to repay senior debt (or associated breakage costs) on termination (see 37.5.5).

37.5 AMENDMENTS TO STANDARD DRAFTING

37.5.1 Various sections of this guidance, and consequent standard drafting, require amendment to deal with a corporate finance structure:

- Unitary Charge adjustment (see Section 37.5.2):
- insurance (see Section 37.5.3):
- refinancing (see Section 37.5.4);
- early termination (see Section 37.5.5);
- Direct Agreement (see Section 37.5.7); and
- various definitions which are not required where corporate finance is used (see Section 37.5.7).

37.5.2 Unitary Charge Adjustment

37.5.2.1 Section 5.2.3 (Calculation of Compensation) sets out the basis for adjusting the Unitary Charge to take account of Compensation Events, Authority changes in Service, or Qualifying Changes in Law.

37.5.2.2 Where this would have involved returning the senior debt loan-life cover ratio and Equity IRR to their original values, this approach will not work for corporate finance as there is no identifiable senior debt.

³ See HMT, *Application Note: Interest-rate & Inflation Risks in PFI Contracts*, May 2006, especially section 2.3, for further discussion of movements in bid prices before financial close.

⁴ See Section 35 (Financial Robustness: Contractor Distress) and, for further background, Schedule 7.4 of the Office of Government Commerce's "ICT Services Agreement", version 2.0 issued in September 2006, which also includes provisions designed to improve the position of the Authority should the Contractor encounter financial distress.

37.5.2.3 The alternative methods set out in Section 5.2.3 (Calculation of Compensation), namely a lump-sum payment, or payment on an annuity basis, can be adopted. Otherwise, the calculation can be performed by returning the Project IRR to its original value.

37.5.3 Insurance

37.5.3.1 Corporate finance may result in insurances required under the Contract being covered by a corporate policy (i.e. a policy covering the activities of a company or group of companies, or covering a group of projects, but not specific to the Project), which may produce a cost saving which can be reflected in the Unitary Charge. However, the Contract will still need to have a Required Insurances Schedule as if the project were being insured on a project basis (see Section 25.2 (Authority's Requirements)).

37.5.3.2 Although it is important that the bidder is able to demonstrate transparency in terms and pricing, it is unlikely to be practical to apply the Insurance Premium Risk Sharing principles used within project-financed Contracts (see Section 25.8) to a corporate-financed Contract, as it is unlikely to be possible to determine the change in premium attributable to the relevant project.

37.5.3.3 If the Project is corporate-financed and it is proposed that the corporate insurance programme is used to provide insurance, the Authority may not be afforded certain protections available when insurance is placed on a project basis. If this is the case, it will be necessary for appropriate alternative arrangements to be agreed between the parties in order to ensure that the Authority is adequately protected. The most material issues are likely to be as follows:

- the concept of uninsurability (see Section 25.9) relates only to causes which affect the insurance market as a whole. Accordingly, where corporate insurance policies are used any uninsurability protection afforded should relate to the unavailability of insurance for the Project as a consequence of market-wide events;
- if the Project is project financed, should the Contractor fail to renew insurances it is possible for the Authority to make the payment and recover the cost from the Contractor. This is unlikely to be practicable where insurance is placed on a corporate basis. However, to the extent that the Authority has an insurable interest in the project, it could itself take out a new substitute project-specific insurance policy if the corporate insurance is not renewed. In such circumstances, the Authority must have the right under the Contract to recover the costs of the substitute insurance from the Contractor;
- corporate insurance programmes generally carry significantly higher insurance deductibles (see Section 25.11.5) than project-specific policies. The Authority will need to ensure that the deductibles are appropriately limited in the Required Insurance Schedule so it is not excessively exposed;
- the Authority will need to ensure that the maximum indemnity cover under a corporate insurance programme is adequate for the Project, particularly where cover limits are on an aggregated basis across all of the Contractor's activities;
- a number of the endorsements typically agreed with insurers to protect the Authority may no longer be available, including the Authority being named as a co-insured. However, the Authority should always be named as a co-insured under the material damage insurance, so it can claim directly should the Contractor elect not to do so. For other Required Insurances, if the Authority cannot be named, the Authority and its insurance adviser should consider other measures. In particular, the third-party liability policies must include (i) an appropriately-worded 'indemnity to principals' clause, and (ii) a waiver of subrogation for the benefit of the Authority;
- a notification of cancellation endorsement is unlikely to be available. Instead the Contract must require the Contractor to provide immediate notification to the Authority of any cancellation or material change in the terms and conditions of the policy. There should be a similar obligation on the Contractor's broker within the Broker's Letter of Undertaking;

- with the exception of the third-party liability policy (for which claims will be paid by insurers directly to the aggrieved party), corporate insurance policies are likely to name the Contractor as the sole loss payee. For material damage insurance, the insurance proceeds should be paid directly into the Joint Insurance Account (see Section 25.6). In this case, insurers must confirm their acceptance of the reinstatement provisions. If insurers are unwilling to pay other insurances into the Joint Insurance Account, the Contract should specify that they are paid into the Joint Insurance Account upon receipt by the Contractor, with such proceeds being held on trust for the benefit of the Authority prior to any such transfer; and
- the corporate insurance policies are unlikely to be available for scrutiny by the Authority. If specific policy information is required by the Authority which is not contained in the cover notes (for example, premium information), this will need to be made available by the Contractor and specific provisions for this incorporated in the drafting.

37.5.4.4 As there is no Senior Debt, the Economic Test drafting in Clause 25.6 (Economic Test) will not be required, and reference to this Economic Test in Clause 25.5 (Reinstatement) can be deleted.

37.5.4 Refinancing

37.5.4.1 As there is no project-specific debt arranged within a corporate-financed project, the standard drafting relating to Authority consent for Refinancings and sharing in Refinancing Gains, as set out in Section 34 (Refinancing), could, in principle, be deleted in its entirety. However, in practice very few projects meet the full requirements of a corporate finance classification (see 37.2.5). Considerable care must be exercised by Authorities, particularly having regard for the variants to corporate finance which may be proposed (see 37.7). If there is any doubt concerning whether the corporate finance classification applies to a project then generally the prudent approach will be to include the standard refinancing drafting, although amendments to such drafting may be necessary (any such amendments will be derogations from required drafting and will need to be approved by HMT).

37.5.5 Early Termination

37.5.5.1 The effect of corporate finance on each of the scenarios set out in Section 21 (Early Termination), where the Authority is required to pay compensation on termination, is considered below.

(a) *Compensation on Termination for Authority Default (Section 21.1.3) or Voluntary Termination (Section 21.5.3)*

37.5.5.2 The provisions of Section 21.1.3 need to be adapted for corporate finance in two respects:

- deletion of references to debt repayments (Section 37.5.5.3); and
- adjustment of the equity compensation provisions (37.5.5.4-37.5.5.5).

References to redundancy payments and Sub-Contractor Breakage Costs are not affected.

37.5.5.3 References to payment of senior debt, whether the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount (i.e. including Additional Permitted Borrowings), should be deleted.

37.5.5.4 None of the options for payment of equity, namely: (i) Base Case Equity IRR to the Termination Date; (ii) market value of the Contractor's share capital; and (iii) present value of the Base Case equity return over the remainder of the Contract term (see Section 21.1.3.6), is directly applicable in the case of corporate finance, where the business of the Contractor may not

be limited to the project, and its results can be distorted by internal group transfers.

37.5.5.5 The appropriate approach is therefore to use the value of the Contract as a basis for compensation. This can be calculated in one of two ways:

- open market value of the Contract. This parallels option (ii) above as applied to project-financed cases; or
- the net present value (discounted at the pre-tax Base Case project IRR) of future Unitary Charges⁵ as shown in the Base Case less future operating costs (including the provision for corporate overhead costs) and future capital expenditures as shown in the Base Case. This parallels payment option (iii) above as applied to project-financed cases. The pre-tax IRR should be used here as there is no allowance for tax in the calculation, and a nominal rate should be used on the assumption that the Base Case shows nominal cash flows.

As with project finance, bidders should bid which of the two approaches they prefer.

37.5.5.6 Required drafting is as follows:

[21.1.3] Compensation on Termination for Authority Default

On termination of the Contract under Clause [21.1.2] (Termination on Authority Default) the Authority shall pay the Contractor the “Authority Default Termination Sum” in accordance with [Section 22 (Calculation and Payment of Early Termination Payment)] on the Termination Date. The Authority Default Termination Sum shall be an amount equal to the aggregate of:

- (i) redundancy payments for employees of the Contractor that have been or will be reasonably incurred by the Contractor as a direct result of termination of this Contract and any Sub-Contractor Breakage Costs; and

either

- (ii) [the amount for which the Contract could have been sold on an open market basis assuming [that there is no default by the Authority but otherwise that the actual state of affairs of the Contractor and the Project is taken into account]]

or

- (ii) [(A) all amounts of Unitary Charge shown in the Base Case as payable by the Authority⁶ from the Termination Date, each amount discounted back at the nominal pre-tax Project IRR from the date on which it is shown to be payable in the Base Case to the Termination Date *less*
- (B) the aggregate of all capital expenditure and operating costs shown in the Base Case to be incurred from the Termination Date discounted back at the nominal pre-tax Project IRR from the date on which such expenditure is shown to be incurred in the Base Case to the Termination Date.]

⁵ See also Section 7.4.7 regarding the implications of income sources other than the Unitary Charge for termination arrangements (and for other areas of the Contract).

⁶ Third party income as shown in the Base Case may also be referenced here.

“nominal pre-tax Project IRR”

means [●] %.

37.5.5.7 Where provisions set out in Clauses 21.5.4 (Termination on an Authority Break Point Date) and 21.5.5 (Compensation on Termination on an Authority Break Point Date) are included, the reference to Clause 21.1.3 (a) (iii) should be amended to Clause 21.1.3 (ii).

(b) Compensation on Termination for Contractor Default (Sections [21.2.5-21.2.9])

37.5.5.8 The provisions relating to Contractor default do not require substantial amendment, because these are already based on the value of the Contract.

37.5.5.9 However where the Contract is being retendered, as set out in Sections 21.2.7 (Retendering Election and Liquid Market) and 21.2.8 (Retendering Procedure), it may be disadvantageous for both the Authority and the Contractor for this to be done on the basis of a corporate-financed Contract if bidders wish to use project finance. This may discourage bidders from bidding and so produce a lower winning bid price, or leave the Authority with a less beneficial Contract than it might have been had a project-finance structure been used.

37.5.5.10 The following amendment may be made to the definition of “New Contract” set out in 20.2.8.9 to deal with this:

Insert new paragraph (d), as follows (and change) the current (d) to (e):

“(d) any amendments which parties interested in entering into a New Contract propose as required in order for the arrangements to deliver the New Contract to be financed on a project finance basis, any such amendments to be considered at the Authority’s discretion; and”

37.5.5.11 The standard definition of “Liquid Market” includes a reference to a vehicle controlled and established by the Senior Lenders specifically for the purposes of the project being excluded for the purposes of determining the existence of a “Liquid Market”. Such a reference is redundant for a corporately-financed projects and should be deleted.

(c) Compensation on Termination for Force Majeure (Section 21.3.2)

37.5.5.12 Again references to debt repayment are not required, and compensation is thus calculated as:

Capital expenditure and operating expenditure (in nominal cash terms), to the Termination Date,, to be no greater than the amounts for such expenditure shown in the Base Case

minus

total Unitary Charge paid to the Termination Date

plus

redundancy and Sub-Contractor breakage costs.

37.5.5.13 Required drafting is as follows:

21.3.2 Compensation on Termination for Force Majeure

(a) On termination of the Contract under Clause 21.3 (Termination on Force Majeure) the Authority shall pay to the Contractor the "Force Majeure Termination Sum" in accordance with [Section 22 (Calculation and Payment of Early Termination Payments)].

(b) The Force Majeure Termination Sum shall be the amount equal to:

- (i) the aggregate of capital expenditure and operating costs incurred as at the Termination Date, such expenditure in each case being no greater than the amounts shown for such expenditure in the Base Case *less*
- (ii) total Unitary Charges paid to the Termination Date; *plus*
- (iii) redundancy payments for employees of the Contractor that have been or will be reasonably incurred by the Contractor as a direct result of termination of the Contract and any Sub-Contractor Breakage Costs.

(c) If (i) less (ii) is less than zero then for the purposes of the calculation in paragraph (b) it shall be deemed to be zero.

(d) Such amount shall be determined and paid in accordance with [Section 22 (Calculation and Payment of Early Termination Payments)].

(d) Compensation on Termination for Corrupt Gifts and Fraud (Section 21.4.3)

37.5.5.14 No compensation is payable.

37.5.5.15 Required drafting is as follows:

21.4.4 Compensation on Termination for Corrupt Gifts and Fraud

On termination of the Contract in accordance with Clause 21.4.3 (Termination for Corrupt Gifts and Fraud), the Authority shall not be obliged to pay a Termination Sum to the Contractor.

(e) Termination for Breach of the Refinancing Provisions (Section 21.6)

37.5.5.16 If the Refinancing provisions do not apply, due to full satisfaction of the relevant corporate finance criteria (see Sections 37.2.5, 37.2.6 and 37.5.4), it follows that termination for breach of these provisions does not apply.

37.5.5.17 In such cases, Clauses 21.6.1 and 21.6.2 (Termination for Breach of the Refinancing Provisions) and 21.6.2 (Compensation on Termination for Breach of the Refinancing Provisions) can be deleted.

(f) Consequential changes

37.5.5.18 In addition to the changes to the calculation of compensation on termination discussed above, where corporate finance is used the required drafting contained in Section 22 (Calculation and Payment of Early Termination Payments) requires modification. Clause 22.3 (Changes to Financing Agreements and Project Documents) is not required where there are no Financing Agreements (but should be retained insofar as it applies to Project Documents), Clause 22.4 (Set-off on Termination) is not required as it serves only to protect Senior Lenders, and the drafting in Clause 22.5 (Method of Payment) will require an alternative source for an appropriate 'Senior Debt Rate' and references to Base Senior Debt Termination Amount, Revised Senior Debt Termination Amount, Outstanding Principal and Senior Credit Agreement should be

removed.

37.5.6 Direct Agreement

37.5.6.1 There will be no Direct Agreement (see Section 37.2.3) – therefore the provisions set out in Section 31 (Direct Agreement and Senior Lenders) are not relevant.

37.5.7 Definitions not required when Corporate Finance is used

37.5.7.1 There are a number of definitions not required when corporate finance is used, as follows. These, together with all references thereto, can be removed:

- Additional Permitted Borrowing;
- Additional Permitted Borrowings Limit;
- Agent;
- APB Distribution;
- Base Senior Debt Termination Amount;
- Default Interest;
- Direct Agreement;
- Financing Agreements;
- Initial Financing Agreements;
- Junior Debt;
- Original Senior Commitment;
- Permitted Borrowing;
- Revised Senior Debt Termination Amount;
- Senior Debt;
- Senior Financing Agreements;
- Senior Lender;
- Subordinated Financing Agreements; and
- Subordinated Lender.

37.5.7.2 The reference in the definition of Financial Close to Senior Financing Agreements should be deleted. It may be appropriate to refer to the date of the Contract.

37.6 CHANGES BETWEEN PROJECT AND CORPORATE FINANCE

37.6.1 Change from Project to Corporate Finance

37.6.1.1 A change from project to corporate finance may occur for a number of reasons, including: (i) the owner of the Contractor wishes to deploy its balance sheet in this way; (ii) a new investor acquiring the Contractor may prefer to use its own balance sheet to finance the project; or (iii) because several separate projects are being combined together for financing purposes to create a “synthetic corporate”. This change is not something that can be provided for in advance in the Contract in any greater detail than that of the standard Refinancing provisions, and would have to be considered based on the detailed proposals at the time.

37.6.1.2 Such a change when it does occur will constitute a Refinancing, for which Authority consent will be required. In evaluating whether to give its consent, the Authority should consider the issues set out in Section 37.4 above and, if consent is given, the Contract should be amended as set out in Section 37.5.

37.6.1.3 The Authority should also expect to receive a share of the Refinancing Gain which would result from the change to corporate finance. Calculation of this is likely to be more complex than that set out in Section 34.5 (Method of Calculating, Sharing and Paying Benefits), and the Authority should take appropriate financial advice before proceeding.

37.6.1.4 It should be noted that these principles apply both to an explicit change from project to corporate finance and to a 'synthetic' change where, for example, the original project finance loan is left in place, but the cash flows (and relevant security) from it are passed to new lenders at a corporate level for the benefit, whether direct or indirect, of equity in the project (see Section 34 (Refinancing)).

37.6.2 Change from Corporate to Project Finance

37.6.2.1 This is a scenario which may arise because the bidder is prepared to finance construction of the Project using its own balance sheet, but may then wish to have the option to switch to more cost-effective project finance once the Project is completed and operating successfully, perhaps also selling a share of the equity at that time in order to take the project off its balance sheet as well. If not envisaged as part of the documentation at Financial Close, the introduction of limited recourse (*i.e.* project-specific) funding is likely to require Authority consent, as the new lenders may require a direct agreement and changes to the Contract, such as in relation to termination. In any event, a change from corporate finance to project finance is *de facto* a refinancing albeit not one addressed specifically by the standard drafting of Section 34 (Refinancing) and so will be subject to negotiation as to Contract amendments and the sharing of the benefits between Authority and Contractor at the time. In order to help ensure that a project financing may not be effected without Authority consent, Authorities might consider including arrangements such as an absolute prohibition on charging the Contract or any of the Project Assets or project revenues.

37.6.2.2 If the Contractor builds-in a post-completion refinancing on a project finance basis (on reasonable market terms) as part of the Base Case (in accordance with 34.4.2 (Base Case Refinancings)), the financing package may offer the Authority good value for money (for example because the Contractor takes the Refinancing risk, while offering the full benefit of the Refinancing to the Authority rather than 50%). However, the Authority should compare such proposals with the alternative of using a standard project-finance structure from Financial Close.

37.6.2.3 If a specific project-finance Refinancing is not built into the Base Case, the Authority should not agree in advance to such a Refinancing.

37.6.2.4 If a Base Case project-finance Refinancing is agreed as part of the Contract structure, the original Contract should reflect the amendments to standard drafting set out in Section 37.5, and a 'Conversion Schedule' should be added to the Contract, reflecting the changes which will be needed when the switch to project finance takes place. This Conversion Schedule should:

- restore the standard Contract Clauses in lieu of the provisions set out in Section 37.5;
- require the Authority to sign a Direct Agreement as set out in Section 31 (Direct Agreement and Senior Lenders);
- require Authority consent to be obtained for any project finance refinancing which is on terms different to agreed minimum / maximum parameters, e.g. as to debt:equity ratio, lenders' cover ratios and reserve accounts, and credit margin;

- require that the maximum Compensation on Termination at any time shall not exceed amounts in a schedule agreed at Financial Close, i.e. based on the original Base Case (unless the Authority agrees otherwise at the time of the Refinancing);
- ensure that other than as set out in the Conversion Schedule, the Authority shall have no additional liabilities other than those set out in the original Contract; and
- provide the Authority with a 50% share of any net Refinancing Gain resulting from the terms of the project-finance Refinancing being better than the Base Case.

The normal refinancing provisions should apply to any subsequent refinancing.

37.7 VARIANT STRUCTURES

37.7.1 A variant structure is one which either: (i) has some of the features of project finance and some of corporate finance; or (ii) follows the standard approach to corporate finance (see 37.2.5) except on a few points which may be sector-specific. The question is not in which category – project or corporate – to place the structure as a matter of principle, but rather which treatments of the various evaluation and contractual issues are most appropriate to the structure in question, and consistent with the Authority obtaining the best value for money.

37.7.2 Variant structures will fail to meet one or all of the requirements of Section 37.2.5.

37.7.3 Some examples of issues which can arise with the use of such structures are given below. These are given by way of illustration of variant structures and do not necessarily reflect best practice, nor are they complete case studies on sector-specific issues.

- The Contractor may arrange leases, hire purchase agreements or similar for equipment forming part of the Project scope with the support of its balance sheet, in apparent compliance with corporate finance principles. However, the lessors or other finance counter-party may seek an acknowledgement of assignment from the Authority of payments it makes to the Contractor, or seek a security interest in the equipment, which breaches the corporate finance criteria (see Section 37.2.5).
- The Contractor may be a project-specific SPV, wholly owned by a company of substance, which has no capital resources of its own and relies on guarantees or on lending from its parent. In certain circumstances, the Authority may wish to have the right to require the parent to inject capital into the Contractor rather than rely solely on guarantees, under the terms of a direct agreement between Authority and parent.
- A loan arranged by the Contractor for a Project on a corporate-finance basis may be ring-fenced on its balance sheet, so that hedging instruments arranged for the loan will be project-specific despite their being supported by the Contractor's balance sheet.

37.7.4 Authorities should ensure that bidders using variant structures do not 'cherry-pick' between the benefits and drawbacks for Contractors and lenders of the provisions set out in this Section 37. Evaluation of variant structures should therefore always consider the issues set out in Section 37.4 (Corporate Finance – Evaluation Implications).