

Standardisation of PFI Contracts

Version 3

April 2004



HM TREASURY



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INTRODUCTION

I.1 BACKGROUND

I.1.1 In July 1999 the first edition of Standardisation of PFI Contracts (“SoPC”) was published. The aim was to provide guidance on the key issues that arise in PFI projects in order to promote the achievement of commercially balanced Contracts, and enable public sector procurers to meet their requirements and deliver best value for money. The second edition was published by the Office of Government Commerce (“OGC”) in September 2002. This third edition draws on the experience of the public and private sectors since 2002, and seeks to incorporate a number of improvements which have been identified over this period.

I.1.2 The guidance has been used by many different Authorities as the basis for delivering PFI contracts in a wide range of sectors. It has also provided the basis of sector specific guidance and contracts in the defence, health, prisons, education and local authority sectors. The IT guidance that formed part II of Version 2 is withdrawn and replaced by the “Decision Map Guidance For Procurement of IT-Enabled Projects” published for consultation by the Office of Government Commerce. The Guidance entitled “Standardisation of PFI Contracts for Local Authorities”, which formed part III of Version 2, is being updated and will be published separately on the HMT web site. The expected publication date is May.

The following documents are included as annexes to this document:

Annex 1 Guidance Note – Calculation of The Authority’s Share of a Refinancing Gain;

Annex 2 Guidance Note – The Use of Internal Rates of Return in PFI Contracts;

Annex 3 Guidance Note – Compensation on Termination for Corporate Finance Transactions;
and

Annex 4 Guidance Note – Permitted Borrowing.

I.1.3 Policy responsibility for PFI and for SoPC transferred from OGC to HM Treasury (“HMT”) on 1 April 2003. Partnerships UK plc (“PUK”) continues to assist HMT in the implementation of SoPC.

I.1.4 Practical experience with Version 2 of the guidance indicated the need for a small number of revisions and PUK was appointed by HMT to lead a review for a revised edition. A lengthy consultation exercise on certain issues has again been held within the private sector in an effort to address concerns that the private sector had with Version 2 of SoPC. The aim has been to achieve consensus where appropriate. In most cases this has been achieved.

I.2 PURPOSE

I.2.1 The three main objectives of the first edition remain unchanged. First, to promote a common understanding of the main risks which are encountered in a standard PFI project; secondly, to allow consistency of approach and pricing across a range of similar projects; and thirdly to reduce the time and costs of negotiation by enabling all parties concerned to agree a range of areas that can follow a standard approach without extended negotiations.

I.3 ASSUMPTIONS

I.3.1 In reviewing the guidance the working assumptions used for the first edition have been revisited, and confirmed as appropriate. Therefore, unless indicated otherwise, the following assumptions apply to the guidance:

- the party contracting with the public sector is a special purpose vehicle with sub-contractors providing the actual performance on its behalf;
- the project involves some development or a construction phase, followed by an operational phase during which the full Service is provided; and
- the project is wholly or partly financed by limited recourse debt.

I.3.2 These assumptions are relevant because: (a) that is how the majority of PFI transactions continue to be structured; and (b) such a contractual structure is inherently complicated and thus large parts of the guidance will be particularly helpful to users.

I.3.3 However, use of these assumptions does not mean that one financial structure is inherently preferable to another. The suitability of various structures, including trade-offs between cost, complexity and risk, should naturally form part of the public sector's overall appraisal of bidders' proposals. Accordingly, no conclusion may be drawn in advance of such appraisal as to which form of financial structure is most appropriate, including whether a special purpose vehicle will be required.

I.4 OUTLINE OF CHANGES

I.4.1 The major part of the guidance published in 1999 has stood the test of time, and has not required amendment. Version 2 contained updated material on the approach to be taken to the following areas: Service Commencement, Change in Service, Change in Law, Assignment, Early Termination and Early Termination Payments, Indemnities, Insurance and the Direct Agreement. This edition contains updated material in relation to the following primary areas: Replacement of Sub-Contractors; RPI, Re-tendering following Contractor Default; Third Party Insurance; Permitted Borrowing and Refinancing. Guidance Notes on the Calculating of the Authority's Share of a Refinancing Gain and on the use of Internal Rates of Return in PFI Projects have also been updated and attached as Annex 1 and Annex 2. New Guidance Notes on Compensation on Termination for Corporate Finance Transactions, and Permitted Borrowing have been added as Annex 3 and Annex 4.

I.4.2 A number of specific amendments have been made to a small number of other sections to clarify the text and to improve the guidance.

I.4.3 The principles used to develop the first edition of the guidance have been carried through to this edition. Therefore, the guidance is intended to be as user friendly as possible and written in "plain English". The guidance continues to use a range of approaches to issues from explanatory text to specific drafting.

I.4.4 Significant parts of the standard drafting are now sufficiently well established to be included in transaction documents without amendment. The clauses specified in the following sections should not now be amended (except as envisaged by its accompanying footnotes and guidance notes): 1.8, 2.2.4, 5.2.1.2, 5.2.3.9, 5.3.2.1, 5.3.3.5, 5.4.1.2, 6.3.3, 8.1.4, 8.5.2, 11.4.1, 11.4.2, 11.4.3, 12.4, 12.5, 12.6, 13.3, 13.6, 13.8.10, 16.3, 20.1.2.1, 20.1.3.9, 20.2.2.1, 20.2.3, 20.2.4, 20.2.7.6, 20.2.7.7, 20.2.8.9, 20.2.9.11, 20.3, 20.4.1.3, 20.4.2.3, 20.4.3.4, 20.5.3.3, 20.6.2.2, 21.3.8, 21.4.1, 21.5.3, 21.7.2, 22.5, 24.6, 24.7.4, 24.8.1, 24.8.5, 25.5.3, 27.5.3, 28.2, 28.3.3, 28.6.2, 30.5.1, 33.3, 35.8.

1.4.5 In certain circumstances (e.g. on large, complex or novel deals), Authorities will still need to consider making changes to standard drafting, in order to address project specific issues. In such circumstances, which should be limited, HMT and PUK can offer advice.

1.5 IMPLEMENTATION

1.5.1 The HM Treasury letter entitled “Implementation of Standardisation of PFI Contracts”, published on the HMT web site gives guidance on the implementation of this SoPC Version 3 and its use in the development of sector-specific contracts.

1.6 USE OF ADVISERS

1.6.1 Experience of delivering PFI Contracts continues to demonstrate that early appointment of suitably qualified advisers by the public sector is vital to success. These advisers should be required to work with this edition of SoPC as the basis for development of the Contract.

1.6.2 Authorities should continue to seek advice from relevant Private Finance Units, or the 4ps. Where Authorities need help in relation to this guidance they can also contact Partnerships UK. In particular, PUK operates a helpline service for the public and private sectors, free at the point of use. Parties with questions about this edition are encouraged to make use of this service, details of which can be found on PUK’s website at www.partnershipsuk.org.uk.

1.7 TERMINOLOGY

1.7.1 In this guidance, the public sector party buying the Service is referred to as the “Authority” and its counterpart as the “Contractor”, with the overall scheme referred to as the “Project”. The agreement entered into between the Authority and the Contractor is referred to as the “Contract”. When all those with a financial stake in the Project are referred to then the expression “financiers” is used. Accordingly, the term “financing” refers to all types of financial interest in the Project. There is a Section containing definitions at the start of this guidance (see Section 1.8 (Interpretation)). These definitions are used both in the text and the drafting. Definitions specific to a particular clause are set out with the Clause concerned.

1.7.2 Three different forms which the standard provisions can take are set out. First, the standard drafting of a whole subject with guidance notes. This approach is used in Sections 1, 2, 5, 11, 12, 13, 16, 17, 20, 21, 22, 24, 25, 27, 28, 29, 30, 33 and 35. Secondly, standard drafting of parts of a subject, with the rest of the subject being dealt with by explanatory notes. This approach is used in Sections 3, 6, 8, 19 and 23. Thirdly, a guidance note explaining how a subject should be dealt with in broad terms with a recommended approach to the issue. This approach is used in Sections 4, 7, 9, 10, 14, 15, 18, 26, 31, 32 and 34.

1.7.3 The following acronyms and abbreviations are used in this guidance:

IRR:	The internal rate of return on shareholders’ equity and subordinated debt
ISO:	International Standards Organisation
IP:	Intellectual Property
IPR:	Intellectual Property Rights
IT:	Information Technology

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- ITN: Invitation to Negotiate (i.e. the document referred to in Stage Ten of the Treasury Taskforce publication “Step by Step Guide to the PFI Procurement Process”)
- MOD: Ministry of Defence
- NHS: National Health Service
- NPV: Net Present Value

1.8 INTERPRETATION

1.8.1 Set out below is required wording for the following general definitions which are used at various stages in the guidance:

1.8.1 Definitions¹

In this Contract, unless the context otherwise requires:

“Additional Permitted Borrowing”

means on any date, the amount equal to any amount of principal outstanding under the Senior Financing Agreements in excess of the amount of principal scheduled under the Senior Financing Agreements at Financial Close to be outstanding at that date;

but only to the extent that:

- (a) this amount is less than or equal to the Additional Permitted Borrowings Limit; and
- (b) in respect of any Additional Permitted Borrowing the Agent is not in material breach of its obligations under Clause 10(d)(iii) of the Direct Agreement as it applies to such Additional Permitted Borrowing and provided further that any such excess amount of principal which is invested as part of any Qualifying Variation shall not be counted as Additional Permitted Borrowing;

“Additional Permitted Borrowings Limit”

means an amount equal to:

- (a) 10% of the Original Senior Commitment for any Additional Permitted Borrowing subsisting in the period from the date of Financial Close to the date on which the amount outstanding under the Senior Financing Agreements is reduced to 50% or less of the Original Senior Commitment; and thereafter;
- (b) the higher of:
 - (i) 5% of the Original Senior Commitment; and
 - (ii) the amount of any Additional Permitted Borrowing outstanding on the last day of the period referred to in (a);

“Affiliate”

means in relation to any person, any holding company or subsidiary of that person or any subsidiary of such holding company and “holding company” and “subsidiary” shall have the meaning given to them in Section 736 of the Companies Act 1985;

¹ Certain definitions exclusive to the direct agreement between the Authority and the Senior Lenders are contained in Section 30 (Direct Agreement).

“Agent”²

means [] in its capacity as agent for the Senior Lenders under the Senior Financing Agreements;

“APB Distribution”

means, for the period during which the Additional Permitted Borrowing subsists, an amount equal to the aggregate of all Distributions made during that period up to an amount equal to the principal of the Additional Permitted Borrowing on the first day of that period;

“Assets”³

means all assets and rights to enable the Authority or a successor contractor to own, operate and maintain the Project in accordance with this Contract, including:

- (a) any land or buildings;
- (b) any equipment;
- (c) any books and records (including operating and maintenance manuals, health and safety manuals and other know-how);
- (d) any spare parts, tools and other assets (together with any warranties in respect of assets being transferred);
- (e) any revenues and any other contractual rights; and
- (f) any intellectual property rights;

but excluding any assets and rights in respect of which the Authority is full legal and beneficial owner;

“Associated Company”

means in respect of a relevant company, a company which is a subsidiary, a Holding Company or a company that is a subsidiary of the ultimate Holding Company of that relevant company, and in the case of the Contractor shall include Holdco and each of the Shareholders;

“Authority Change”

means a change in Service by the Authority which the Contractor is obliged to implement under Clause 12.4 (Authority Changes);

“Base Case”

means the financial model agreed between the parties prior to the date of this Contract (as updated from time to time in accordance with the terms of this Contract⁴) for the purpose of calculating the Unitary Charge;

² In the context of a bond financing, this definition may be substituted by a definition of “Credit Provider”, the finance party that controls the rights of the financiers.

³ The precise nature of the assets involved and any exclusions will, of course, depend on the project concerned.

⁴ This should refer to those clauses in the Contract that allow a rebasing of the Unitary Payment (and by definition the base case financial model) on the occurrence of specific events, e.g. following a benchmarking or market testing exercise, a Qualifying Change in Law or an Authority Change.

“Base Senior Debt Termination Amount”

means:

- (a) all amounts outstanding at the Termination Date, including interest and Default Interest accrued as at that date, from the Contractor to the Senior Lenders under the Senior Financing Agreements⁵ and in respect of Permitted Borrowing; and
- (b) all amounts including costs of early termination of interest rate hedging arrangements and other breakage costs⁶, payable by the Contractor to the Senior Lenders⁷ as a result of a prepayment under the Senior Financing Agreements and in respect of Permitted Borrowings subject to the Contractor and the Senior Lenders mitigating all such costs to the extent reasonably possible;

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 balances⁸ on any bank accounts (but excluding the Joint Insurance Account)⁹ held by or on behalf of the Contractor¹⁰ 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 as a result of prepayment of amounts outstanding under the Senior Financing Agreements¹¹ and in respect of Permitted Borrowings;
- (iv) any Additional Permitted Borrowing and any interest and Default Interest on such Additional Permitted Borrowing; and
- (v) 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.

“Business Day”

means a day (other than a Saturday or Sunday) on which banks are open for domestic business in the city of London;

⁵ This assumes a check has been made by the Authority’s advisers that the provisions of such documents do not include unusual provisions that could artificially inflate amounts advanced beyond those provisions that are market standard (such as specific pre-payment fees). A judgment will have to be made, for example, on whether prepayment fees (in excess of market standard breakage costs) should be included. In most cases it is recommended that they should not be. See Section 34 (Due Diligence over Sub-Contracts and Financing Agreements).

⁶ This is intended to cover all net breakage costs if the compensation is not paid on an interest payment date.

⁷ 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. See also footnote 27 below.

⁸ Such references should also cover such credit balances whether they are held as cash (as with revenue accounts) or in the form of investments (as with reserve accounts).

⁹ Any proceeds standing to the credit of the Joint Insurance Account will continue to be used for reinstatement after the Termination Date. See Section 24.6.4 (Reinstatement and Change of Requirement after Insured Event).

¹⁰ This recognises that these balances will, in the ordinary course, be charged to the Senior Lenders as security and so on a termination can be set off by them against outstandings. It is sensible, therefore, not to pay such amounts, rather than to pay and subsequently recover such amounts. To the extent any accounts are not charged to Senior Lenders, they should be excluded from (i).

¹¹ See footnote 27.

“Capital Expenditure”

means any expenditure which falls to be treated as capital expenditure in accordance with generally accepted accounting principles in the United Kingdom from time to time;

“Consents”

means all permissions, consents, approvals, certificates, permits, licenses and authorisations of a Relevant Authority required for the performance of any of the Contractor’s obligations under this Contract¹²;

“Construction Sub-contractor”

means the [person performing the construction or development obligations¹³];

“Contingent Funding Liabilities”

means []¹⁴;

“Default Interest”

means any increased margin that is payable to the Senior Lenders or which accrues as a result of any payment due to the Senior Lenders not being made on the date on which it is due;

“Direct Agreement”¹⁵

means the direct agreement dated on or about the date of this Contract and made between the Authority, the Contractor and the Agent;

“Effective Date”

means [the date on which any conditions precedent have been satisfied¹⁶];

“Estimated Change in Project Costs”

means in relation to Clause 5.2 (Delays in Service Commencement Due to a Compensation Event), Clause 12 (Change in Service) and Clause 13 (Change in Law), the aggregate of any estimated increased construction costs, operating costs and financing costs less the aggregate of any reduced construction costs, operating costs and financing costs;

¹² These will include, for example, planning consents.

¹³ In transactions that do not involve construction work (for example, some defence contracts) other terminology will be required.

¹⁴ These will be any contingent liabilities of the shareholders in respect of financial obligations owed to the Contractor and/or lenders under the Financing Agreements in relation to the Project which are triggered as a result of or in relation to the termination of the Contract (see Section 34.2 in relation to due diligence). For example, guarantees or letters of credit in respect of deferred equity, subordinated debt or obligations to fund reserve accounts. This will not include any guarantees or letters of credit issued in support of the sub-contractors’ obligations under the relevant sub-contracts.

¹⁵ The form of direct agreement that should be used is set out in Section 30 (Direct Agreement).

¹⁶ Conditions precedent will often not be necessary in a Contract. They can be used as a checklist of what needs to be delivered on or prior to signing (e.g. the Senior Financing Agreements). Such issues can be dealt with in separate ways, for example, by having a checklist of tasks that must be completed or documents signed prior to the Contract being signed. Conditions precedent are strictly only needed for items which are necessarily to be done after signing. One example would be planning consents in projects in which it is necessary to have a signed document prior to a planning application being made (this is the case in certain waste treatment projects). See also Clause 2(a).

“Expiry Date”

means the [xth] anniversary of [the Effective Date] [the date of this Contract]¹⁷;

“Financial Close”

has the meaning given to it in the Senior Financing Agreements;

“Financing Agreements”¹⁸

means all or any of the agreements or instruments entered into or to be entered into by the Contractor or any of its Associated Companies relating to the financing of the Project (including the Initial Financing Agreements and any agreements or instruments to be entered into by the Contractor or any of its Associated Companies relating to the rescheduling of their indebtedness or any Refinancing);

“Guidance”

means any applicable guidance or directions with which the Contractor is bound to comply¹⁹;

“Holding Company”

has the meaning given to it in Section 736 of the Companies Act 1985, as amended by Section 144 of the Companies Act 1989;

“Holdco”

means [insert details of the Contractor’s holding company] if any;

“Initial Financing Agreements”

means the Financing Agreements put in place upon signature of this Agreement as follows: []

“Joint Insurance Account”

means the joint bank account in the names of the Authority and the Contractor, having account number [] and held with [];

“Junior Debt”

means all amounts outstanding at the Termination Date under the Subordinated Financing Agreements;

“Operating Sub-contractor”

means [the person performing obligations to provide the Service during the Service Period²⁰];

¹⁷ An alternative approach is to define the Expiry Date by reference to the Planned Service Commencement Date, although the drafting will need to avoid extending the term of the Contract in the event of a Relief Event, i.e. by ensuring that the postponement of the Planned Service Commencement Date as a result of a Relief Event does not lead to a similar postponement of the Expiry Date (see Section 5.3.3.2).

¹⁸ This definition assumes that the project is being financed using Senior Debt and equity (i.e. subordinated debt provided by the shareholders). The guidance does not deal specifically with the provision of mezzanine debt to a project and its treatment (e.g. in terms of the compensation payable on termination for Authority Default, refinancing and force majeure), although this has been used in some PFI projects (most notably roads and light rail projects). How mezzanine financing is treated is an issue for specific projects, although this will naturally depend upon the particular funding structure, the rate of return on the mezzanine and the nature of the project concerned.

¹⁹ Whether this definition is needed will depend on the sector (i.e. whether the introduction of Guidance can have the same effect as a change in law (see Section 13 (Change in Law)).

²⁰ In the absence of a single service provider assuming all such obligations, this definition should be amended to refer to persons contracting directly with the Contractor to provide the constituent elements of the Service.

“Original Senior Commitment”

means the amount committed under the Senior Financing Agreements as at Financial Close (as adjusted to take into account any Qualifying Variation)²¹;

“Permitted Borrowing”

means, without double counting, any:

- (a) advance to the Contractor under the Senior Financing Agreements²² [, provided that such advance is not made under any Committed Standby Facility];
- (b) Additional Permitted Borrowing;
- (c) [advance to the Contractor under the Committed Stand-by Facility which is made solely for the purpose of funding any cost overruns, increased expenses or loss of revenue which the Contractor incurs, provided that such funds are not used in substitution for other sources of committed funding designated for those purposes.]²³; [and]
- (d) interest and, in respect of the Initial Financing Agreements only (prior to any subsequent amendment), other amounts accrued or payable under the terms of the Senior Financing Agreements;

except where the amount referred to in paragraphs (a) to (d) above is or is being used to fund a payment of Default Interest on any Additional Permitted Borrowing;

“PFI”

means the Government’s Private Finance Initiative or any similar or replacement initiative;

“PFI Contractor”

means a person that has contracted with the Government, a local authority or other public or statutory body to provide services under the PFI;

“Planned Service Commencement Date”²⁴

means [fixed date by [on] which Service Commencement is planned to occur] or such other date as the parties may agree;

“Project”

means [²⁵];

²¹ Adjust for a bond transaction.

²² If the Senior Lenders are not committing a Committed Stand-by Facility at financial close, the Authority should conduct due diligence over the sizing of the facilities that are committed, so as to ensure that they have not been inflated in such a way that the effect is to create a facility which by its very nature, also acts as a “Committed Stand-by Facility.”

²³ This will be any standby facility that is committed by the Senior Lenders at financial close for the purposes of funding any unforeseen cost overruns, increased expenses or loss of revenues incurred by the Contractor, and the Authority should conduct due diligence over the size and terms of the facility prior to Financial Close to evaluate its potential liability under this Clause 21.3. The protection given to the Contractor under Clause 21.3 (Changes to Financing Agreements) should only take effect if the purpose of the advance under the Committed Standby Facility is to fund genuine unforeseen costs and not, for example, to prepay amounts owned by the Contractor under the Subordinated Financing Agreements.

²⁴ Whether this concept (and definition) is required will depend on:

- (a) the attitude taken to early Service Commencement (See Sections 3.7 (Existing Services) and 4.6 (Bonus Payments for Early Service Commencement)); and
- (b) whether any dates need to refer to the date on which the Service is due to commence (for example, a default long-stop date or liquidated damages for failure to complete on time).

See also footnote 34 below.

²⁵ This term should be defined on a project-specific basis.

“Project Documents”

means the agreements entered into by the Contractor for the performance of the obligations under this Contract which are listed in [²⁶];

“Relevant Authority”

means any court with the relevant jurisdiction and any local, national or supra-national agency, inspectorate, minister, ministry, official or public or statutory person of the government of the United Kingdom or of the European Union;

“Revised Senior Debt Termination Amount”

means, subject to Clause 21.3 (Changes to Financing Agreements)

- (a) all amounts outstanding at the Termination Date, including interest and Default Interest accrued as at that date, from the Contractor to the Senior Lenders under the Senior Financing Agreements including in respect of Permitted Borrowing other than any such amounts that are in respect of Additional Permitted Borrowings;
- (b) all amounts of Additional Permitted Borrowings including interest but excluding Default Interest outstanding at the Termination Date, including such Additional Permitted Borrowings accrued at that date; and
- (c) all amounts including costs of early termination of interest rate hedging arrangements and other breakage costs, payable by the Contractor to the Senior Lenders as a result of a prepayment under the Senior Financing Agreements including in respect of Permitted Borrowing, subject to the Contractor and the Senior Lenders mitigating all such costs to the extent reasonably possible,

less, to the extent it is a positive amount, the aggregate of (without doubt 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) 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 as a result of prepayment of amounts outstanding under the Senior Financing Agreements including in respect of Permitted Borrowing;
- (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;

²⁶ These will usually be listed in a schedule and include contracts the Contractor has with its main Sub-Contractors, usually:

- (a) the Construction Sub-Contractor; and
- (b) the Operating Sub-Contractor.

The definition should not, however, be extended to include contracts between the main Sub-Contractors and their sub-contractors (i.e. those without a direct contractual relationship with the Contractor).

“Senior Debt”

means the financing provided by the Senior Lenders under the Senior Financing Agreements;

“Senior Financing Agreements”

means []²⁷ as at the date of this Contract or as amended with the prior written approval of the Authority²⁸;

“Senior Lender”

means a person providing finance to the Contractor under the Senior Financing Agreements²⁹;

“Service”

means [the operating obligations of the Contractor];

“Service Commencement”

means the commencement of the Service;

“Service Commencement Date”

means the date³⁰ on which Service Commencement occurs in accordance with [Section 3 (Service Commencement)];

“Service Period”

means the period specified in Clause 2(b)³¹;

“Shareholders”

means any person from time to time holding share capital in the Contractor or its Holding Company;

²⁷ These are all documents relating to the Senior Debt and may include:

- (a) a credit agreement;
- (b) interest rate hedging agreements; and
- (c) security documents.

Alternatively, bond documentation may be included, in which case the definition will include the bond trust deed, the terms and conditions of the bond, as well as security documents. A monoline insured deal will also include reference to the monoline’s Policy and Endorsement and its Insurance and Indemnity Agreement (each of which will be defined in the Contract). Other financing structures will mean referring to other documents.

The Authority should place limits on hedging agreements to allow only those agreements that comply with an agreed hedging policy and details of which have been notified to and acknowledged by the Authority to be included in the definition of Senior Debt (Base Senior Debt Termination Amount or Revised Senior Debt Termination Amount, as appropriate). The hedging policy may, of course, change over time, which the parties should agree to as necessary.

²⁸ Where referred to in the Contract, Senior Financing Agreements should mean those agreements as at the date of the Contract as may be amended with the approval of the Authority. This is particularly important if Senior Debt is paid on early termination of the Contract. On signature of the Contract, the Authority has an assumed profile of its termination liabilities (based on the financing structure in place at financial close); the Authority should therefore generally have the right to approve any amendments to the financing agreements that would have the effect of changing the Authority’s liability profile (see Section 21.3 (Certainty of Compensation Payments)).

²⁹ This and related definitions will need to be carefully reviewed for projects whose financial structures include a mixture of Senior Debt and mezzanine debt as well as subordinated debt and equity.

³⁰ This assumes a single Service Commencement Date. To the extent a project has more than one Service Commencement Date (see Section 3.6 (Acceptance and Service Commencement)), then this will need amendment to recognise that partial provision of the Service may commence prior to the main Service Commencement Date. See Section 3 (Service Commencement).

³¹ That is the period from the Service Commencement Date to the Expiry Date, unless the Contract is terminated early (see Sections 2 (Duration of Contract) and 20 (Early Termination)).

“Sub-Contractors”

means the counterparties of the Contractor to the Project Documents;

“Sub-Contracts”

means the contracts entered into by the Contractor and the contracts entered into by Sub-Contractors;

“Subordinated Financing Agreements”

means []³² as at the date of this Contract or as amended with the prior written approval of the Authority;

“Subordinated Lender”

means a person providing finance under a Subordinated Financing Agreement;

“Suitable Substitute Contractor”

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

- (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;

“Tax”

means any kind of tax, duty, levy or other charge (other than VAT) whether or not similar to any in force at the date of the Contract and whether imposed by a local, governmental or other Relevant Authority in the United Kingdom or elsewhere;

“Termination Date”

means any date of early termination of this Contract in accordance with [Section 20 (Early Termination)];

“Unitary Charge”

means the payment calculated in accordance with [Section 10 (Price and Payment Mechanism)];

“VAT”

means any value added taxes.

1.8.2 Along with the definitions, a clause dealing with interpretation of the drafting and definitions should be included, as follows:

³² These are the debt financing documents signed at Financial Close, through which the equity investors will often invest ‘equity’ in the Project in the form of subordinated debt.

1.8.2 Interpretation

- (a) In this Contract, except where the context otherwise requires³³:
- (i) the masculine includes the feminine and vice-versa;
 - (ii) the singular includes the plural and vice-versa;
 - (iii) a reference in this Contract to any clause, sub-clause, paragraph, schedule or annex is, except where it is expressly stated to the contrary, a reference to such clause, sub-clause, paragraph, schedule or annex of this Contract;
 - (iv) any reference to this Contract or to any other document shall include any permitted variation, amendment, or supplement to such document³⁴;
 - (v) any reference to any enactment, order, regulation or other similar instrument shall be construed as a reference to the enactment, order, regulation or instrument (including any EU instrument) as amended, replaced, consolidated or re-enacted;
 - (vi) references to any documents being “in the agreed form” means such documents have been initialled by or on behalf of each of the parties for the purpose of identification;
 - (vii) a reference to a person includes firms, partnerships and corporations and their successors and permitted assignees or transferees; and
 - (viii) headings are for convenience of reference only.
- (b) This Contract is entered into under the PFI³⁵. This Contract is excluded from Part II of the Housing Grants, Construction and Regeneration Act 1996 by operation of Paragraph 4 of the Construction Contracts (England and Wales) Exclusion Order 1998. The Contractor acknowledges that the operation of the Housing Grants, Construction and Regeneration Act 1996 upon any Project Document shall not affect the parties’ rights or obligations under this Contract³⁶.
- (c) References to amounts expressed to be “indexed” are references to such amounts multiplied by

Index_1 ³⁷

Index_2

where Index_1 is the value of [index/indices selected] most recently published prior to the relevant calculation date. Index_2 is the value of [index/indices selected] on []³⁸.

³³ This clause may be extended as appropriate (e.g. to deal with the meaning of “day” and “month”).

³⁴ It may be necessary to limit the ability of the Contractor to amend other documents to which it is a party. See Sections 21.3 (Certainty of Compensation Payment Amounts) and 35 (Refinancing) in respect of changes to the Senior Financing Agreements.

³⁵ See paragraph 4 of the Construction Contracts (England and Wales) Exclusion Order 1998, SI No. 648.

³⁶ The underlying justification for this Clause is outlined in Section 27.4.2. The Clause should be omitted from Contracts for projects without a construction phase (i.e. those outside the scope of the Housing Grants, Construction and Regeneration Act 1996).

³⁷ If RPI is the index used (see Section 14.2 (Indexation)), then this can be defined as the index published in Table 5 (excluding mortgage interest payments) of Business Monitor (MM 23) published by the Office of National Statistics or failing such publication or in the event of a fundamental change to the index, such other index as the parties may agree, or such adjustments to the index as the parties may agree (in each case with the intention of putting the parties in no better nor worse position than they would have been had the index not ceased to be published or the relevant fundamental change not been made) or, in the event that no such agreement is reached, as may be determined in accordance with Schedule [] [Dispute Resolution Procedure]. See Section 14 (Price Variations) as other indices may be relevant.

³⁸ This is the date by reference to which the prices expressed in this Contract to be indexed are fixed, often the bid date.

2

DURATION OF CONTRACT

2.1 INTRODUCTION

2.1.1 The Contract must specify its duration. It will usually also specify a Service Commencement Date to distinguish the time (if any) from the signing of the Contract and before the Service Period from the Service Period itself¹. The choice of duration should be considered in the light of the issues set out in Section 2.2 (Factors to Consider).

2.2 FACTORS TO CONSIDER

2.2.1 The Authority will wish to specify a duration which is expected to result in the best value for money solution for the Project. Factors to be taken into account when deciding on the duration of the Contract will include:

- the service requirements of the Authority (see Section 7 (Service Requirements and Unavailability));
- the possibility of alternative uses of assets for the Authority which might result in a significant residual value (see Sections 2.2.2 and 19 (Termination on Expiry of Service Period));
- the affordability of the Service for the Authority, taking into account the expected useful economic life of the underlying assets (a longer duration may be preferable, from an affordability perspective, if assets involved in delivering the Project have a longer economic life);
- the need for and timing of major refurbishment or asset refreshment programmes during the Contract (see Section 8 (Maintenance));
- the likely term of the Senior Debt and the possibility of refinancing the Project (see Section 35 (Refinancing)) a longer debt service period could allow a longer duration; and
- the possibility of an option to extend the term of the Contract by entering into a further contract period with the initial Contractor (this can equally be structured as a no cost early termination option – see Sections 19.2.5 and 19.6.3) even if there is no alternative use.

2.2.2 Some assets (e.g. vehicles or property) may have an alternative use which means that they can generate revenue for the Contractor after the Contract expires (see Section 19 (Termination on Expiry of Service Period)). If this is the case, the Contractor may not expect to recover the full cost of financing its investment (i.e. debt and equity return) over the life of the Contract, as it will be able to recover the balance by putting the assets to such alternative use after the Contract expires (e.g. selling them). The price the Contractor charges to the Authority can therefore be lower and the Contract duration shorter than would be the case if the Contractor needed to recover all its costs over the life of the Contract (see Section 19.2 (Assets with No Alternative Use)).

¹ The Highways Agency approach for certain new contracts to be let is no longer to have a requirement for a long-stop date for Service Commencement leading to default termination, relying instead in such cases on the commercial incentives for the Contractor to commence the Service. This is because any non-payment of the Unitary Charge when debt outstandings are at their highest can have significant adverse financial consequences for the Contractor. This has implications for the approach taken in Section 5.3 (Relief Events).

2.2.3 Given the rapid pace both of technological change and Authority functions (particularly in projects such as hospitals), the Authority should ensure that the Contract is sufficiently flexible to allow changes to the Service over time (see Section 12 (Change in Service)). If, however, the Authority is concerned that changes will be so radical that the Service in its present form may become redundant it may wish to retain some flexibility by having shorter Contract periods, consistent with an affordable financing plan.

2.2.4 The impact of certain events on the duration of a Contract is dealt with in the Sections on Compensation Events (see Section 5.2 (Compensation Events)), Relief Events (see Section 5.3 (Relief Events)) and Force Majeure (see Section 20.3 (Termination on Force Majeure)). A delay in the Service Commencement Date should not lead to an extension of the Contract (see Section 5 (Delays)).

Required drafting is as follows:

2 Duration of Contract²

- (a) This Contract and the rights and obligations of the parties to this Contract shall take effect³ on the [date of this Contract][Effective Date].
- (b) The Service Period will commence on the Service Commencement Date⁴ and terminate on the earlier of:
 - (i) the Expiry Date; and
 - (ii) the Termination Date.

² This approach assumes a fixed term for the Contract. Another way of dealing with this is to have a maximum length, but have the Contract terminate when a specified level of return has been achieved or some other agreed event has occurred. This is not generally recommended, but may be appropriate, for example, where a significant proportion of project revenues are generated from third parties (e.g. toll payers) and the Authority has a legitimate interest in capturing surplus revenues for the public benefit.

³ It is often possible for contract signature and financial close to be simultaneous. If there are project specific reasons for conditions precedent being required (i.e. a condition such as planning must be satisfied), then the concept of conditions precedent and “Effective Date” will be needed (and the effect of pricing of interest rate fluctuations, between the date of contract signature and financial close, will need to be addressed). If conditions precedent do exist, the obligation to use reasonable endeavours to satisfy these (to the extent this is needed) should take effect prior to the conditions precedent being met. Other obligations (such as those of confidentiality) may also come into effect prior to the satisfaction of any condition precedent.

⁴ See footnote 1 above.

3

SERVICE COMMENCEMENT

3.1 INTRODUCTION

3.1.1 After the Contract is signed and in force, there is usually a construction or development phase during which the Contractor carries out its construction or development obligations and puts in place the operational procedures which it believes will meet the service requirement.

3.1.2 During this period, the Authority naturally wants to know if the Contractor is going to deliver the Service on time and in a way which meets all the Authority's contracted requirements. The Contractor will not wish to be unnecessarily hampered by the Authority, but it will also want to be reassured that what it is developing will meet the Authority's requirements.

3.1.3 The key issue here is the extent to which the Authority should be involved during this phase and what rights, if any, the Authority should have to approve or monitor the Contractor's progress prior to and on Service Commencement.

3.1.4 There must be a clear limit to the extent of Authority participation as involvement to a greater extent than is appropriate may lead to the Authority taking back both a risk it is paying the Contractor to accept and a management role it is paying the Contractor to deliver. It will not be appropriate for the Authority to adopt the type of overseeing role it might traditionally expect to have when procuring stand-alone construction or development services.

3.2 AUTHORITY'S ROLE – GENERAL

3.2.1 The design, construction, integration, installation, testing, commissioning, operation, maintenance and ultimate performance of any asset procured or developed for the purposes of meeting the requirements of the output specification are all the Contractor's responsibility and the Authority should not (save in exceptional circumstances) take any responsibility for this risk. Correspondingly, the Contractor should be afforded the freedom to manage its activities without interference from the Authority. It is the Contractor's risk whether the design and development it has carried out and the operational procedures it has put in place are capable of satisfying the Authority's service requirements. The Authority should not, save in exceptional circumstances (for example, those giving rise to Authority step-in – see Section 28 (Authority Step-In)), agree to any role before or following Service Commencement which involves the Authority taking back any part of the Contractor's risk. In this context, the issues referred to in Section 3.3.2 are important.

3.2.2 The Authority's role prior to signature of the Contract includes:

- defining the output requirements and any constraints within which the output requirements must be achieved;
- reviewing the Contractor's proposals (submitted at final bid stage) for achieving the outputs in terms of approach, methods, resources, timetable, management and organisation (including design, maintenance and operational procedures); and

-
- negotiating and agreeing with the Contractor all contractual terms, including the procedure for either party proposing and implementing a change in Service (see Section 12 (Change in Service)), the consequences of a failure to meet the Service Commencement Date (see Section 4 (Protections Against Late Service Commencement)), and the procedure for accepting Service Commencement (see Section 3.6 (Acceptance and Service Commencement)).

In accordance with the principle outlined in Section 3.2.1, the Authority should not confirm to the Contractor that the Contractor's proposals will meet the service requirement. In practice, however, the Authority should be confident before signing the Contract that the Contractor's proposals will be capable of delivering the Service once fully developed and implemented¹. The Authority should also ensure that the Contractor's basic design proposal is incorporated into the Contract (see Section 3.4 (Submission of Designs and Information to the Authority)).

3.2.3 The Authority's role after signature of the Contract and prior to Service Commencement will normally include:

- reviewing and commenting upon the Contractor's designs, maintenance and operational procedures as they are developed (see Section 3.4 (Submission of Designs and Information to the Authority));
- viewing and observing tests of any equipment being developed;
- administering the agreed process for either the Contractor or itself to propose and implement changes to the output requirements, constraints on inputs or the Contractor's proposals (see Sections 3.5 (Quality Management Systems) and 12 (Change in Service));
- following the agreed procedure by which the Contractor demonstrates to the Authority that Service Commencement can be accepted (see Section 3.6 (Acceptance and Service Commencement));
- following the agreed procedure in relation to a failure to meet the Service Commencement Date and agreeing with the Contractor the measures to be taken and the financial consequences (see Sections 4 (Protections against Late Service Commencement) and 5 (Delays)); and
- auditing the Contractor's activities in accordance with an acceptable Quality Management Systems regime (see Section 3.5 (Quality Management Systems)).

3.2.4 The Authority should require only enough management information to be reassured that the delivery timetable is on track and any overriding safety issues are being satisfactorily addressed. This will involve having access to the site.

¹ The Department of Health has issued guidance on how NHS Trusts should deal with design sign-off on PFI Projects (see The Design Development Protocol for PFI Schemes – Jan 2001).

3.2.5 The principle outlined in Section 3.2.1 must be upheld to ensure the appropriate risk transfer during the pre-Service Commencement period. The Authority should not, for example, retain any rights to approve or accept interim stages such as practical completion of construction or detailed design prior to acceptance of Service Commencement, as this may dilute any risk transfer (unless, of course, the Authority takes the risk of commissioning as the NHS does for clinical services in relation to the technical interface in hospital projects). This is different to the point made in Section 3.6.4 in relation to accepting Service Commencement before all construction requirements are completed. In the case of certain defence projects involving very specialised or necessarily subjective requirements there may be a case for the Authority to accept some aspects of the design by agreeing a methodology for meeting such requirements in the Contract (see Section 3.6.2). This should only be contemplated where transfer of all aspects of the design risk would clearly not offer the best value for money.

3.3 CRITICAL DATES

3.3.1 In many projects the effects of late Service Commencement can be handled through the payment mechanism (see Section 10 (Price and Payment Mechanism)). In some cases, however, there will be a critical date beyond which the adverse consequences of non-provision of the Service are greatly magnified (see Section 4 (Protections Against Late Service Commencement)). Where failure to provide the Service by a critical date would be unacceptable, the Authority must develop a contingency plan.

3.3.2 As a last resort, the Authority would usually expect to have the ability to terminate the Contract (subject to the step-in rights of the Senior Lenders) so that it can use another Contractor (see Section 20 (Early Termination))². In Section 20.2.2.1 (Termination on Contractor Default), paragraphs (j) and (k) of the definition of Contractor Default give the Authority the right to terminate during the construction or development phase. Section 20.2 (Termination on Contractor Default) makes it clear that termination for failure to achieve a milestone during that period is not recommended.

3.4 SUBMISSION OF DESIGNS AND INFORMATION TO THE AUTHORITY

3.4.1 The key aspects of the Contractor's tender should be incorporated into the Contract schedules so as to ensure that the Contractor is bound to deliver the Project in accordance with its tender submission. However, the incorporation of the Contractor's tender submission in the Contract (as updated by the Contractor to enable it to meet changes in the Output Specification which are agreed with the Authority before signature) should not be interpreted as representing any form of approval by the Authority that the plan will satisfy the requirements of the output specification³.

² See however footnote 1 to Section 2 (Duration of Contract).

³ This can be achieved by setting out in the Contract that the output specification takes priority over the technical solution being provided by the Contractor. Under no circumstances should the output specification be amended to reflect the Contractor's solution.

3.4.2 The basic design proposal must be set out in the Contract and will be developed further by the Contractor after signature⁴. The procedure for developing the design must also be specified in the Contract so that changes beyond the permitted parameters of further design development can be distinguished from permitted design developments. The Contract should also specify the extent (if at all) to which other minor changes⁵ may be made without triggering the change in Service mechanism (see Section 12 (Change in Service)).

3.4.3 Although the Contractor is responsible for the design development, the Authority knows its own service requirement and the means by which it has been delivered in the past and this should not be lost to the development process⁶. Consultation with the Authority and subsequent adoption of any comment made by the Authority must, however, remain firmly at the Contractor's risk. The Contractor and its financiers should accept that it is not in the Authority's interests to watch without comment as a design is developed and implemented which it knows will not be able to deliver the Service. The procedure for submitting and commenting on design issues should be capable of giving all parties the reassurance they need.

3.4.4 The Contract should therefore set out a mechanism for:

- the Contractor to submit designs and information to the Authority and its representatives. Such designs should be in a package and format and submitted to a timetable to be agreed between the parties;
- the Contractor to submit minor design changes which do not have any impact on cost or the Service and which the Authority can accept without the change in Service mechanism having to be implemented (see Section 12 (Change in Service));
- the Authority to comment (if it wishes) on such submissions within an agreed time period⁷ (see Section 5.2 (Compensation Events)); and
- the discussion of and, if appropriate, adoption by the Contractor of any comments by the Authority.

3.5 QUALITY MANAGEMENT SYSTEMS

3.5.1 One central source of comfort for the Authority that assets and services are being provided in accordance with good industry practice should be the Contractor's quality management system (such as ISO 9000 or an equivalent standard).

⁴ Depending on the nature of the Contract, the Authority may also wish to include (amongst other things) the Contractor's operational procedures, key asset proposals or manpower and spares policies in the Contract.

⁵ Such changes will include, for example, changes which have no financial impact or which do not affect the pre-agreed risk allocation.

⁶ It may be acceptable for an Authority to accept a limited degree of design responsibility insofar as it relates solely to the ability of the Authority to carry out its functions in the project building.

⁷ Irrespective of the Authority's comments (if any) on the minor design changes submitted by the Contractor which do not have any impact on cost, level of fit out, quality of scheme or the Service, the Contractor may choose to adopt such changes, albeit at its own risk, to ensure that it satisfies the Authority's service requirement.

3.5.2 The Authority should retain the right to audit the Contractor's quality management system which should include the right to examine or inspect works or activities on or off-site to establish the adequacy and accuracy of the system documentation. The Contract should provide for the Contractor and Sub-contractors to provide such assistance and access as the Authority requires and include provisions setting out the obligations upon the Contractor and Sub-contractors to respond to any recommendations which result from an audit. No other rights or remedies (e.g. rights to terminate for default) should arise from such an audit since deficiencies in the quality management system will manifest themselves through poor performance (see Section 9.11 (Consequences of Poor Performance)). The audit is essentially a due diligence tool available to the Authority.

3.6 ACCEPTANCE AND SERVICE COMMENCEMENT

3.6.1 Before Service Commencement and at points in the Contract where the Service changes significantly (for example on the introduction of a new asset or new operational procedures), the Contractor should be under an obligation to demonstrate that the arrangements put in place will meet the output specification in the Contract. The method of demonstration by the Contractor will be dependent on each situation but may take the form of:

- a completion inspection of any asset built or developed with demonstration of principal facilities and services;
- completion of acceptance trials for new services; and
- other performance tests or inspections.

3.6.2 The Contract should set out in detail:

- the form of the tests, inspections or demonstrations ("Tests") to be carried out by the Contractor;
- the timetable for the Tests – it may be appropriate to undertake partial Tests over a period rather than a single Test;
- the consequences of a failure to pass a Test;
- the notice of the Tests to be given by the Contractor to the Authority – this is particularly important if the Authority has to roster staff and resources to participate. If it is essential for the Authority to attend the Tests, the Contract should specify a time period for the Authority to respond to the notice and, to the extent that the Authority does not respond in time, a Compensation Event will have occurred (see Section 5.2 (Compensation Events)) although the Authority can still attend once it has responded;
- the responsibility for the cost and organisation of resources for the Tests. Again this is particularly important if the Authority's staff and resources are to be involved (also the responsibility for costs if Tests have to be repeated should be considered);
- the access for the Authority to witness the Tests (if the Authority does not control the site);
- the documentation required by the Authority as evidence of the results of the Tests;

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- who is responsible for assessing satisfaction of the Tests – this should, in most cases, be done by joint assessment by the Authority and the Contractor or by an independent third party, although there will be cases where both parties accept that the Authority is the best judge (e.g. with defence equipment projects the best judge of whether the equipment behaves like it should are its users). The Authority should in no circumstances rely on any technical or other adviser appointed solely on behalf of the Senior Lenders, but may accept an adviser that has been jointly appointed and owes duties to all sets of interested parties; and
 - the timing and procedure for acceptance of Service Commencement if the results of the Tests are satisfactory. Acceptance may be confirmed by the third party tester or by the Authority, in which case again the Compensation Event consequence of being late should be borne in mind if the Service cannot commence before any such confirmation is issued.

3.6.3 At the time of acceptance of the Service, there must be no “approval” of the means of delivery of the Service, as this may involve the Authority in taking back part of the Contractor’s risk. Rather, acceptance should be based as far as possible on satisfaction by the Contractor of objective Service Commencement based tests.

3.6.4 As stated in Section 3.2.5, the Authority should not generally accept stages of work (e.g. by signing off milestones) prior to the Service Commencement Date and delivery of the full Service as this dilutes risk transfer⁸. In certain projects, however, it may be appropriate for the Authority to commence payment before a complete service is available. The principal examples of these are as follows:

- in roads projects, where the Highways Agency issues a permit allowing traffic to use the road once certain safety standards have been achieved, although construction may not be fully completed. Final acceptance of the road takes place once the Contractor has completed the outstanding construction works and the payment mechanism is structured to ensure that the Contractor is incentivised to do so;
- in accommodation projects, the Authority may accept Service Commencement where certain minor aspects of the construction works are incomplete but which are not integral to the Contractor’s ability to provide the main Service – this may be done by specifying particular areas (e.g. landscaping works) or through more generic descriptions (e.g. “de minimis defects, shrinkages or faults”). Whether this is agreed prior to or after signature of the Contract, the Authority must ensure that the Contractor remains incentivised through the payment mechanism to complete the outstanding works. The Authority’s technical adviser should advise on what aspects of the works can be completed after Service Commencement;
- in light rail projects where milestones trigger payments of grant, or where a portion of the repayments are derived from fare box revenues;
- in certain projects there may be aspects of the project for which the Authority retains a part of the risk deliberately, as it will ultimately retain responsibility for a part of the overall Service; and

⁸ Neither should the Authority seek to impose any milestones during the construction phase.

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- in projects in which Service Commencement is phased (i.e. different buildings or pieces of equipment are brought into service at different times), then an appropriate phasing in the introduction of payments (again with built-in incentives) may be appropriate.

3.6.5 In projects where Service Commencement is phased, there are two clear alternatives available to the Authority:

- to stipulate that full Service Commencement will only be accepted when all phases in the scheme reach the required output specification level, which would incentivise the Contractor to bring them all up to the output specification standard as quickly as possible. This would mean, however, that the Authority would receive the full output specification level of service for some phases without paying for it; or
- to accept full Service Commencement as each phase reaches the output specification standard, so that payments reflect the service received. A slight variant to this that may be adopted in very large grouped schemes, where it would be administratively cumbersome to have phase by phase Service Commencement, would be to accept Service Commencement in batches as full service availability is confirmed. If this approach is adopted, some of the incentive effect of the first alternative above can still be achieved if payment is not increased pro rata as phases reach the output specification, so that there is in effect an amount retained or abated until the last phase reaches Service Commencement.

3.6.6 The overall time period until the planned completion and service commencement of the last phase is likely to have a significant impact on the relative value for money of these two alternatives – the longer the period, the more reluctant the Contractor is likely to be to accept the delayed payment involved in the first alternative above.

3.6.7 For example, an educational establishment may want to move to actually start using the new facilities outside full term times, and preferably in the long summer break. The Authority should make clear its requirements in this respect in the ITN.

3.7 EXISTING SERVICES

3.7.1 The approval/acceptance procedure raises other issues if the Contractor is taking over existing services as well as undertaking additional services. The Authority should structure the payment mechanism and any termination compensation so as to incentivise the Contractor to commence delivery of the new service on time, so that it cannot simply choose to provide the existing service only. This is the case even where provision of the existing service is more important to the Authority from an operational perspective than provision of the new service.

3.7.2 The first question to address is, when does the Contractor take over full or partial responsibility for service delivery? Authorities should recognise that any TUPE transfers of staff that may arise out of the Contract are likely to take effect from the time at which the Contractor takes over provision of the relevant service. There are therefore three options open to the Authority:

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- responsibility for all sites in the Contract is taken over by the Contractor following financial close, commonly after a brief mobilisation period. This provides a clean start and minimises ambiguity about responsibilities between the Authority and the Contractor, and is therefore the recommended approach. However, in some cases, for example where there are particular concerns or uncertainty about the condition of the buildings, this approach may require the Contractor to take on risks that are unacceptable to it at a realistic price, and so not provide value for money;
 - phase the handover so that the Contractor takes over responsibility for the sites when it has planned to start works on them to bring them up to the full output specification standard. This would leave the Authority responsible for some sites between financial close and the programmed start date of the Contractor's work on site. For a large grouped scheme this may well create some greater complexity in the management arrangements throughout the transitional phase from financial close to the point at which all of the sites have reached full Service Commencement, but is recommended where the first approach above does not provide value for money; and
 - only hand the sites over to the Contractor once they have been brought up to the full output specification standard. This would cause an additional complexity as the pre-contract arrangements, involving in-house provision or a separate contractor, would continue in relation to facilities management (if relevant) and operation of the accommodation, whilst the Contractor was carrying out works to bring the sites up to the output specification standard. Scope for disputes over responsibility for problems that arise suggest that this would not be an attractive option, and it is therefore not recommended.

In some cases, the existing condition of buildings may be such that there is a risk (however remote) of criminal prosecution, for example under Health and Safety legislation. The output specification will generally require the buildings to be in a condition that complies with all applicable law. In some schemes prospective shareholders of a Contractor will be understandably nervous about taking on such a risk for the period before Service Commencement. In such circumstances, Authorities should consider retaining legal responsibility for the buildings until planned Service Commencement, and so any Existing Services provided by the Contractor may be in the form of a maintenance and/or FM contract.

3.7.3 In relation to the first two options, a specification will be needed for the service level that is expected for the period while the Contractor is responsible for each site, but has not yet reached full Service Commencement. The specification should include requirements in relation to individual FM services that the Contractor will be required to provide (if relevant), and a reactive and responsive maintenance and repair service that at least keeps the sites open to the standard they are when the Contract starts. It is important for all parties that there is a common understanding of the service required during this period. This will assist in minimising dispute if under performance occurs. There are generally two options available to the Authority:

- use the output specification that will apply from Service Commencement for the transitional period as well, albeit with a relaxed payment and performance regime (including default termination thresholds). However, this may lead to regular performance failures due to the pre-existing condition of the buildings and cause disputes between the parties; or

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- tailor a bespoke specification for the transitional period which sets out the Authority's requirements and is realistic in terms of delivery. In relation to some individual service requirements however, the Contract output specification may be relevant and sufficient for the transitional period (e.g. response and rectification periods, or if it is reasonable to expect individual "soft" FM services to be provided to the output specification standard from the award of the Contract). However, where the output specification for the Service Period cannot be met by the Contractor during the transitional period, bespoke outputs will need to be tailored.

3.7.4 In PFI projects, no payment should be made until the services are available and being delivered. This fundamental principle of "no service, no payment" is not compromised in instances where the Contractor takes over the delivery of existing services and is paid accordingly. There are two approaches that the Authority can take in relation to payment for delivery of services during the transitional period and the Authority should assess which of these approaches to adopt depending on the value for money they provide:

- many Authorities have based payments before full Service Commencement on their current expenditure, pre-contract, and then applied a performance regime so that, in accordance with the principles of the full payment mechanism, there would be no payment if, for example, a building was unavailable and could not be used, and deductions from the payments if there was poor performance, for example a failure to meet response or rectification periods that did not lead to non-availability. Payment for those parts of the services being delivered will not diminish the significance of full Service Commencement provided the Unitary Charge is structured to incentivise the Contractor to achieve this standard; or
- an alternative to the approach described above would be for the Authority to make no payment in relation to the services received during the transitional period. This would maximise the incentive on the Contractor to bring the facilities up to the Service Commencement level as quickly as possible, but the Authority may lose some influence over the standard of service during the transitional period. As the two approaches will lead to different funding requirements and cash flows for the Contractor, it may well have a significant impact on price.

4

PROTECTIONS AGAINST LATE SERVICE COMMENCEMENT

4.1 INTRODUCTION

4.1.1 The Contract must ensure that the Authority is protected against late Service Commencement by the Contractor in a way which gives the Authority value for money, taking into account the type of loss the Authority may suffer and the need for (and cost of) any contingency plans that are put in place (see Section 3.3.2). This Section deals with the level, types and combinations of protections appropriate in relation to a particular project.

4.1.2 In considering the issue of late Service Commencement, the Authority should acknowledge that the Contractor is likely to be at least as concerned as the Authority to commence Service delivery on time due to significant financial pressures. The Contractor's financing will often be structured with limited contingency to deal with a delay in Service Commencement (particularly where Senior Debt is involved), and the Contractor risks suffering a cash flow drain because its Senior Debt obligations are not being met by payments of the Unitary Charge by the Authority. For every day the Contractor is late in commencing Service delivery, not only does it lose revenue, but its revenue earning period is also reduced. The longer the construction phase is relative to the Service Period, the greater the concern for the Contractor.

4.1.3 If the Authority will not suffer any significant loss as a result of late Service Commencement, then it is unlikely to need specific protections. In exceptional cases, however, the Authority may need protections from the Contractor (in addition to the non-payment of the Unitary Charge) such as liquidated damages, performance bonds and/or parent company guarantees¹. These types of protections are, however, likely to increase the price and affect the project timetable, so the Authority must consider carefully their effect on value for money (see Sections 4.2 (Liquidated Damages), 4.3 (Performance Bonds), 4.4 (Parent Company Guarantees) and 23.5 (Financiers' Security)).

4.1.4 The Authority may also want to protect itself against prolonged uncertainties arising from late Service Commencement by having a cut-off date after which it may terminate the Contract if the Contractor has not commenced Service delivery by such a date (see Section 4.5 (Long-stop Date))². As stated in Section 3.3.3 and elsewhere throughout this guidance, termination should be a last resort.

4.1.5 The Authority should also consider the issue of early Service Commencement and whether the Authority should accept and reward early delivery (see Section 4.6 (Bonus Payments for Early Service Commencement)).

4.2 LIQUIDATED DAMAGES

4.2.1 Liquidated damages for delayed Service Commencement are an ascertained payment representing a genuine pre-estimate of the losses or damages the Authority will suffer if the Contractor fails to fulfil its obligation to commence Service delivery on time. If the Authority will not suffer any losses in excess of the payment of the Unitary Charge (taking into account the cost of procuring the Service itself), liquidated damages are not appropriate or recoverable. If the Authority will suffer such losses, liquidated damages may be appropriate but only where they offer the Authority value for money, taking into account the effect of any other protections being required by the Authority, the Contractor or its financiers.

¹ This may be the case if, for example, Authority assets are being used by the Contractor.

² See also footnote 1 to Section 2 (Duration of Contract).

4.2.2 To protect against late Service Commencement, Senior Lenders will usually require the Sub-contractors to cover debt service for any period of delay through liquidated damages paid to the Contractor (secured to the Senior Lenders) as the finance plan will assume Service Commencement and so finance costs being recovered in accordance with a particular timetable. The Construction Sub-contractor will price this requirement into the price it charges the Contractor (for example, by increasing its construction costs to ensure completion will be achieved on time) and may also require a longer build period to allow itself more contingency time. This cost is then likely to be passed on to the Authority through the Unitary Charge and the project timetable is likely to be longer. If the Authority requires liquidated damages to be paid by the Contractor to itself in addition to those already required by the Senior Lenders, this is likely to further increase the Unitary Charge and the build period. Liquidated damages payable to the Authority may therefore prove bad value for money unless circumstances such as those outlined in Section 4.2.3 exist.

4.2.3 Liquidated damages may prove value for money in situations where the costs the Authority incurs as a result of the delay are so great as to justify the increased expense (e.g. a higher Unitary Charge) to which such liquidated damages give rise. This could be the case where there are critical dates (see Section 3.3 (Critical Dates)) and the Authority's contingency plan to cope with such dates has a significant quantifiable expense associated with it³. Liquidated damages may also be justified where:

- the Authority has contributed a valuable asset to the Project which could otherwise have been used by the Authority during the period prior to Service Commencement, so an "opportunity cost" is incurred; or
- there are no prior claims on liquidated damages paid by a Sub-contractor (for example, from Senior Lenders) and liquidated damages give value for money.

4.2.4 If liquidated damages are considered worthwhile and value for money, the Authority should specify the level of liquidated damages, and any cap⁴, early on in the bidding process (i.e. in the ITN) to enable the bidders to price the risk of incurring liquidated damages⁵. Bidders could also be invited to submit alternative bids without liquidated damages and/or using higher or lower caps. The Authority's technical or financial adviser should advise on an appropriate level.

4.2.5 The Authority should note that any assessment of the appropriate rate of liquidated damages must be a genuine pre-estimate of the losses the Authority is likely to incur as a result of the delay in Service Commencement. If this is not the case, the rate may be judged to be a penalty and the liquidated damages provision will not be legally enforceable against the Contractor.

4.2.6 If the Contractor is not going to be able to deliver the Service on time, but is able to find some form of alternative which is acceptable to the Authority and which can commence on the Planned Service Commencement Date (or will reduce the delay in Service Commencement), the Authority may agree that this alternative service may be provided for a certain period for a reduced Unitary Charge. Any liquidated damages liability will be deferred for the period in question and the Contractor's revenue stream will commence. The Unitary Charge will be reduced appropriately to reflect the fact that the Service is not being provided as contracted. This is not an issue which needs to (or necessarily can) be agreed prior to signature of the Contract, so it may need to be negotiated at the time.

³ For example, in school projects, the Authority may have to purchase temporary classrooms to replace school accommodation that is not available; in prison projects, the Authority may have to pay to house prisoners in police cells because a prison is not ready on time; and in training projects involving flight simulators, the Authority may incur costs in providing training by alternative means if the simulator-based training is not available on time.

⁴ A cap will be a key issue for financiers.

⁵ It will assist the evaluation of any bids submitted if the cost of providing liquidated damages could be identified separately within such bids.

4.3 PERFORMANCE BONDS

4.3.1 In the construction industry, performance bonds are generally given by construction contractors as a form of guarantee of completion (the amount guaranteed is usually a percentage of the construction price). They can be called by the recipient when, for example, the Planned Service Commencement Date is missed. Accordingly, the Contractor and its financiers may well require a performance bond from the Construction Sub-contractor. The Construction Sub-contractor will pass through the cost and timing effects of providing such a bond to its customer (i.e. the Contractor), who will in turn pass them on to the Authority. As with liquidated damages, the consequences of the Authority itself requiring a performance bond - in addition to any bond required by the Contractor and its financiers - is likely to be an increased Unitary Charge and longer build period. Again, this may not give the Authority value for money⁶.

4.4 PARENT COMPANY GUARANTEES

4.4.1 In traditional procurement, the Authority may expect to obtain parent company guarantees from the parent companies to the Contractor and/or the Sub-contractors (in particular, the Construction Sub-contractor) to support the obligation to deliver the Service on time. This is not, however, normally appropriate in PFI contracts and should not be a pre-condition to acceptance of a tenderer's bid.

4.4.2 Rather, the necessary comfort and protection for the Authority can be provided through the Project Documents, the use of collateral warranties and or direct agreements between the Sub-contractors and the Authority (see Sections 23.5 (Financiers' Security) and 28 (Authority Step-In)). Further discussion of this issue takes place in Section 23 (Indemnities, Guarantees and Contractual Claims).

4.5 LONG-STOP DATE

4.5.1 Service Commencement should not generally be allowed to be delayed indefinitely due to Contractor default. The Authority may impose a long-stop date after which the Contract may be terminated by the Authority if the Service has not yet been commenced (see Section 20.2.2 (Events Leading to Termination)).

4.5.2 The long-stop date is often fixed by reference to the Planned Service Commencement Date. The date chosen should be reasonable, taking into account the nature of the Project and the length of time the Contractor and its Senior Lenders should reasonably be allowed to remedy the situation. The Planned Service Commencement Date and, therefore, the long-stop date should be extended to the extent of any delay caused by any Compensation Event, Relief Event or Force Majeure Event (see Sections 5 (Delays) and 20.3 (Termination on Force Majeure)).

4.5.3 The Authority may not always require the rights that a long-stop date gives. For example, the Highways Agency's approach for road schemes is no longer to require a long-stop date for Service Commencement for the same reason that it does not require a fixed Service Commencement Date (see Section 2 (Duration of Contract), footnote 1), relying instead on the economic incentive for the Contractor to complete and on remedies available to the Senior Lenders to achieve Service Commencement.

⁶ The reasons for not requiring parent company guarantees (see Section 4.4.2) are equally relevant when considering Authority demands for performance bonds.

4.6 BONUS PAYMENTS FOR EARLY SERVICE COMMENCEMENT

4.6.1 It is sometimes proposed that “bonus payments” should be paid for early Service Commencement, particularly where the Authority has required protections of the types described above against late Service Commencement. The term “bonus payment” can be misleading, however, so it is important to understand what is envisaged and how it ties in with the implications of early Service Commencement.

4.6.2 The key point for the Authority is that it should not be under an obligation to accept early Service Commencement (unless it has agreed to be). It should only accept early Service Commencement and payment of any relevant bonus if it offers value for money. Early Service Commencement may clearly prove good value for money if there is a critical demand for the Service or if it would benefit the Authority financially. This might be the case, for example, if the early start date meant the Project generated additional third party revenue, or the Contractor made savings, in which the Authority shared. Any benefit to the Authority should be assessed on a case by case basis.

4.6.3 There may be budgetary problems for some Authorities (such as local authorities) in accepting and paying for early Service Commencement. These should generally be surmountable, however, if sufficient warning is given by the Contractor of early commencement, particularly as the Authority would in many cases be sharing in extra revenue or savings⁷.

4.6.4 If the Authority decides to accept early Service Commencement, the Contractor's revenue stream will commence earlier than originally planned. The Authority will have the choice between bringing the Expiry Date of the Contract forward to retain the length of the original Service Period or retaining the original Expiry Date, thereby extending the original Service Period. This is where the “bonus payment” concept is relevant since:

- if the Authority retains the original Expiry Date, the Contractor will receive a “bonus” amount of revenue through the Unitary Charge payable in respect of the extra Service Period;
- if the Authority brings the Expiry Date forward, the Authority may either simply pay the Unitary Charge for the same length of Service Period (i.e. essentially what it would have paid originally), which involves a “bonus” element (as payment is being received earlier) or it may pay the Contractor a “bonus payment” equivalent to the additional amount the Contractor would have received if the original Expiry Date had instead been retained. The difference between this approach and the alternative outlined in the first bullet point is that this bonus would not be subject to deductions as a result of unavailability or poor performance. It would also be likely to be paid as a lump sum;
- the Authority may alternatively simply opt to make a “bonus payment” which is unrelated to the length of the Service Period or any additional amounts of revenue which the Contractor may expect to receive due to its early Service Commencement. Such a bonus would typically be an agreed fixed amount⁸.

⁷ See also Section 7.5 (When Does Availability Commence?).

⁸ If “bonus payments” are to be made for early Service Commencement then the parties will need to consider what, if any, further compensation should be paid to the Contractor in circumstances where the occurrence of a Compensation Event prevents early Service Commencement (see Section 5.2 (Delays Due to a Compensation Event)).

5

SUPERVENING EVENTS

5.1 INTRODUCTION

5.1.1 The Contractor undertakes to ensure Service Commencement usually by a particular fixed date¹ and to continue to provide the Service for the duration of the Contract. There may, however, be circumstances in which the Contractor should fairly be relieved from liability for failure to commence or provide the Service. A balance must be struck between encouraging the Contractor to manage the risk and protecting the Authority from non-performance.

5.1.2 Supervening events for which some relief is appropriate should be divided into three categories:

- Compensation Events – i.e. events which are clearly at the Authority's risk and in respect of which the Contractor should be compensated (see Section 5.2 (Compensation Events));
- Relief Events – i.e. events which are best managed by the Contractor (although not necessarily in its control) and for which the Contractor bears the financial risk, but in respect of which no rights of termination should arise (see Section 5.3 (Delays Due to a Relief Event)); and
- Force Majeure Events – a limited set of events which arise through no fault of either party, which are best managed by the Contractor (although not in its control) and in respect of which rights of termination can arise (see Section 5.4 (Force Majeure Events)).

5.1.3 The distinction between Compensation Events and Relief Events is sometimes expressed as being the difference between the Contractor being given 'time and money' and 'time' only.

5.1.4 Certain events may be dealt with differently in specific projects, depending on the nature of the Project, the likelihood of the event occurring and the value for money obtainable if the Contractor prices the risk of such event occurring into its price. Given the effect on the Authority of adding risks to Compensation Events, this should only be done after careful consideration in specific cases. For example, in a project in which Government use means that delays during the construction phase are a high risk, the Authority may accept that the event leading to such increased risk should be a Compensation Event. In a project where such risks do not exist, the parties may agree that a Relief Event is the way to deal with that risk. An alternative way of dealing with the risk of discovery of fossils or antiquities during the construction phase, which lies somewhere between the Compensation Event and Relief Event approach, is for the Contractor to bear a pre-determined initial level of loss (both financial and in terms of delays to the construction timetable), as defined in the Contract, with further losses above that prescribed level being shared by the parties in accordance with an agreed formula².

¹ The typical structure will require the Contractor to ensure Service Commencement either by a scheduled date for completion of construction (i.e. the Planned Service Commencement Date) or at any time from the date of the Contract or the Effective Date (depending upon the presence of conditions precedent) but by a pre-agreed long-stop date (see Section 4.5 (Long-Stop Date)).

² This alternative approach may be applied in a wide range of projects, but should only be used ordinarily when dealing with the risk of discovery of fossils or antiquities and not other risks. A different approach is justified here because of:
(a) the potential impact of such risk being greater than is the case with other possible Relief Events;
(b) the public benefit that is derived from the discovery of fossils and antiquities.

5.1.5 Similarly, the risk of planning delays may require different treatment in different projects. For example, the Authority may accept some planning delay risk in order to obtain value for money if it wants the Contract to be signed before full detailed planning consent is obtained or challenge periods in respect of such consents have expired³. As far as the discovery of adverse ground conditions and historic contamination is concerned, this should not usually be at the Authority's risk as the Contractor should have carried out appropriate surveys in relation to such matters prior to signing the Contract and can often assess and accept such risks more economically than the Authority. The situation may be different in specific circumstances such as where the Contractor has been prevented from carrying out appropriate surveys or it is not reasonable or good value for money for surveys to be undertaken (e.g. because of the number of sites involved in the project)⁴.

5.2 COMPENSATION EVENTS

5.2.1 Purpose and Scope

5.2.1.1 Compensation Events are designed to cater for events which arise before the Service Commencement Date which are at the Authority's risk and which result in a delay to Service Commencement and/or increased costs to the Contractor, although the concept can be extended to the Service Period (see Section 5.2.1.4). Such events are more appropriately dealt with by compensation methods than by being an Authority Default (see Section 20.1.2.1 (Contractor's Right to Terminate for Authority Default)) as termination should in all circumstances be a last resort (although if an event renders the parties' contractual relationship untenable the Authority may choose to exercise its voluntary termination rights). In fact, even a delay is not strictly necessary for the occurrence of a Compensation Event (see Clause 5.2(a)) as cost increases can arise without any timetable changes.

5.2.1.2 Events which can arise before the Service Commencement Date and which are at the Authority's risk (i.e. for which compensation should be paid to the Contractor) are:

- Authority breach of an obligation⁵ (which includes a breach occasioned by third parties for whom the Authority is responsible⁶, such as teachers or doctors);
- Authority Changes (see Section 12.3 (Authority Changes)); and
- discriminatory or specific changes in law (see Section 13.6 (Discriminatory, Specific and General Changes in Law)).

The Authority should bear the effects of Authority Changes and Qualifying Changes in Law in accordance with the principles set out in Section 12 (Change in Service) and Section 13 (Change in Law) respectively. The only significant difference in relation to how the approaches are dealt with during the Service Period is referred to in Section 5.2.3 (Calculation of Compensation).

³ In these circumstances the Authority should consider very carefully how its liabilities in the event of planning failure can be mitigated.

⁴ See Section 6 (Information Warranties).

⁵ Authorities should ensure that their obligations under the Contract are both limited and specific.

⁶ Compensation claims should be very much the exception. Particularly where the Works are to be carried out on buildings that remain in use, the Contract should require the Contractor to co-operate with and work around other third party contractors wherever possible, and the effects should be anticipated and factored into the programme up front.

As mentioned in Section 5.1.5, it may, after careful consideration in certain projects, be appropriate to add other (or sector) specific events. As Authority Changes and Qualifying Changes in Law are dealt with in Sections 12 and 13 respectively, the required definition of Compensation Event is as follows:

“Compensation Event”

means a breach⁷ by the Authority of any of its obligations under this Contract⁸.

5.2.1.3 It is of course possible that Authority Changes and changes in law will occur during the Service Period. The Authority should bear the risk of these events in accordance with the principles set out in Section 12 (Change in Service) and Section 13 (Change in Law).

5.2.1.4 The Authority may be faced with a request by the Contractor and its financiers to give compensation for Authority breaches which occur during the Service Period. This will not always be appropriate and the Authority should consider carefully the nature of its obligations during the Service Period⁹. If its sole obligation is to make payment, then there is no need to give compensation as non-payment in the Service Period is addressed through the provisions dealing with interest on late payment (see Section 10.2.5 and Clause 29.8 (Interest on Late Payments)) and, in extreme cases, through termination for Authority Default (see Section 20.1 (Termination on Authority Default)). During an insurance reinstatement, however, the concept of Compensation Events would apply irrespective of the position for the treatment of Compensation Events in the Service Period, as the construction phase will effectively be starting again until reinstatement is completed. The issues relating to reinstatement are dealt with in depth in Section 24.6 (Reinstatement and Change of Requirement After Insured Event). Compensation is relevant if the Authority fails to release surplus land at the required date.

5.2.1.5 If, however, the Authority has significant ongoing obligations and breach of such obligations would seriously adversely affect the Contractor’s ability to perform (e.g. if the Authority failed to carry out procedures for certifying operating matters) or materially affect the cost of performance, then it may be appropriate to give compensation if such breach occurs. This can most easily be address by extending the scope of the Compensation Event concept.

5.2.2 Consequences

5.2.2.1 A practical consequence of a Compensation Event occurring is that the Planned Service Commencement Date may have to be postponed, usually by the length of any delay caused (any long-stop date will be similarly put back)¹⁰. This means that the start date of the Contractor’s revenue stream is also delayed and/or additional costs are incurred (see Section 5.2.2.6). As a result, the Contractor may incur finance charges and additional costs which could involve the Contractor in significant expense¹¹.

⁷ This is a breach that will not normally lead to an Authority Default (which can lead to termination – see Section 20.1 (Termination on Authority Default)), but which will nevertheless cause delay and put the Contractor to material expense, including, for example, a failure to allow the Contractor appropriate access to an Authority provided site.

⁸ To the extent that the Authority is contracting on behalf of others (such as school governing bodies in school projects), then these should be included. Other persons responsible to the Authority can, by failing to act, also trigger Compensation Events.

⁹ If it is appropriate for the Authority to give the Contractor compensation for Authority breaches arising during the Service Period, the Contract will need to incorporate an appropriate compensation mechanism.

¹⁰ A Compensation Event may not affect the Contractor’s ability to achieve the Planned Service Commencement Date but increase the Contractor’s costs.

¹¹ If “bonus payments” are to be made for early Service Commencement (see Section 4.6 (Bonus Payments for Early Service Commencement)) the parties will need to consider what, if any, further compensation should be paid to the Contractor where early Service Commencement has been prevented by the occurrence of a Compensation Event.

5.2.2.2 A decision has to be made prior to contract signature as to how to compensate the Contractor for any delay to Service Commencement resulting directly from a Compensation Event. The recommended approach is to retain the original Expiry Date and compensate the Contractor for its loss. This does not mean that payment of the Unitary Charge is made for a month in which no Service has been provided although the monetary value of the compensation may be the same as the Unitary Charge.

5.2.2.3 If the Contract contains liquidated damages provisions (see Section 4 (Protections Against Late Service Commencement)), then the Contractor's liability for liquidated damages will also be relieved for the period of delay caused by the Compensation Event. The Contractor should, of course, also be relieved of any other liability for the Authority's losses in respect of the Compensation Event. This should be taken into account in determining the consequences for the Authority of a Compensation Event.

5.2.2.4 The main advantages of the recommended approach are first, simplicity and second, it will be preferable to financiers, since the senior debt loan life cover ratio and equity return can be preserved. This approach also means that the Authority has an incentive to manage its rights and obligations in the construction phase in a way that does not result in delay. The detail of how this approach should work in practice can be seen by reference to Section 5.2.3 (Calculation of Compensation).

5.2.2.5 Some projects have sought to compensate the Contractor by paying up-front for its additional Sub-contractor's costs, but dealt with financing costs by extending the Expiry Date. This is unlikely to be financeable and so is not recommended. If the Contractor is fully compensated for the delay, there is no need to extend the Expiry Date and a danger exists of unnecessary complication by doing this. Provided compensation has been paid as set out below, extension of the Expiry Date is not appropriate.

5.2.2.6 The Contractor should be obliged to use reasonable endeavours to mitigate its losses and costs (for example, by rescheduling its works timetable or by redeploying staff). Such mitigation may result in there being no delay in the Planned Service Commencement Date (although extra costs may result from steps taken to mitigate).

5.2.3 Calculation of Compensation

5.2.3.1 The Unitary Charge may need to be adjusted if the Compensation Event concerned involves an additional cost or a time delay which has cost or loss of revenue implications. It is important that the Contract contains an appropriate method for dealing with any changes that arise as a result of a Compensation Event. The approach set out in the drafting is referred to in Section 5.2.3.3 below. The treatment of issues here is equally applicable to costs arising as a result of an Authority Change (see Clause 12.4) or Qualifying Change in Law (see Section 13.8 (General Change in Law as a Shared Risk)).

5.2.3.2 One common way of dealing with such events is to rely on the financial model to deal with the issue and for both parties to use this to calculate how and when compensation should be paid. Typically this would require the Authority to agree that the senior debt loan life cover ratio¹² and equity return are to remain unchanged. Whilst there is no objection in principle to the parties referring to a financial model (provided both parties fully understand all of its various aspects), there are three principal problems that can arise in using a financial model to calculate compensation payable for Compensation Events (and for that matter the effects of an Authority Change (see Clause 12.4) and Qualifying Changes in Law (see Section 13.8 (General Change in Law as a Shared Risk)):

- the financial model may obscure the process being followed in reaching the answer, unless there is clarity on all sides on how the relevant formulae used in the model work. For example, if something has happened which was not originally modelled for and audited, there could be conflict arising on how to model it, which could impact on the calculation concerned;
- if the Authority has access to a financial model in sufficient detail and to all of the internal costs, returns and other assumptions (to the level of detail required), then more information than is relevant simply to value the consequences of the event may have to be provided by the Contractor, which may not be acceptable to it (and, in addition, certain of the assumptions may need to be updated); and
- the result of preserving the ratios and equity return can be achieved in a number of different ways (these are referred to in Section 5.2.3.4).

The guidance recommends that as simple an approach as possible is followed as the only concern of this Section is to ensure fair compensation for a limited number of events which can be calculated in a straightforward manner. If the Unitary Charge is to change, then financial advice is likely to be needed.

5.2.3.3 The approach taken in the drafting to the various events that may lead to a change in the Unitary Charge is as follows:

- if the event concerned requires Capital Expenditure (whether before or during the Service Period), then in most cases, it will be more practicable to deal with this by a lump sum reimbursement (subject of course to the possibility of staged payments¹³) (see Clause 5.2(c)(ii)); and
- if the event concerned requires a change in operating costs, then an alteration in the Unitary Charge is the appropriate means of payment (see Clause 5.2(c)(iii)).

¹² If this is being calculated during the Service Period and no further drawings are possible, then this is arrived at by dividing:

- (a) forecast net revenues until the final maturity date of the loan (including any payments from the Authority, any business interruption insurance receipts, as well as other similar payments (such as additional shareholder contributions) that any person is obliged to pay to the Contractor), discounting back future revenues to the date of calculation (at the interest rate payable under the Senior Debt (including hedging)).
- (b) the Senior Debt outstanding (having deducted credit balances on bank accounts) on the date of calculation. If further drawings are possible, then the above calculation will have to take into account the forecast level of Senior Debt up to the maximum committed debt.

¹³ Significant Authority changes are likely to be acceptable to the Contractor only if compensation is paid by the authority, so as to match the timing of the agreed costs of the change.

Although the issue is dealt with in this way in the drafting, it is important to stress that for Authority breach it is also perfectly acceptable for the Authority simply to reimburse the Contractor on the basis of costs incurred (for example, as a result of any delay in giving an approval).

5.2.3.4 The approach referred to in the drafting and Section 5.2.3.3 ensures that a minimum of additional financing costs are incurred. Other reasons, including affordability constraints may, however, mean that an Authority wishes to reserve the right to ask the Contractor to use reasonable endeavours to finance the event where Capital Expenditure is required. If this is done¹⁴ then careful scrutiny of the value for money implications should be undertaken.

5.2.3.5 Where the compensation involves an increased obligation to incur Capital Expenditure, other possibilities¹⁵ to that referred to in the drafting and Section 5.2.3.3 include:

- a lump sum payment from the Authority paid immediately on Service Commencement, the amount payable to exceed the amount of the relevant increase in Capital Expenditure by any incremental increase in financing costs consequent on a more rapid drawdown of Senior Debt and/or Junior Debt than originally anticipated and the agreed costs incurred in arranging any such financing;
- an adjustment to the Unitary Charge to take account of the Contractor's additional funding outstanding for the event concerned. This adjustment would reflect the actual terms and conditions of the funding, which would have been agreed between the parties at the outset, and be applied on the basis that the financiers are no worse and no better off, from the perspective of risk and return, than they would have been had the increase in Capital Expenditure not arisen. As stated above, in practice this generally means that an increase is made to the Unitary Charge (over the term of amortisation of the additional dedicated funding) to restore the senior debt loan life cover ratio and equity return to their values had the additional funding not been required. This calculation can only be made by using the financial model (as to which see Section 5.2.3.2 above). The Authority should not seek a grace period on paying higher Unitary Charge even if this would satisfy the senior debt loan life cover ratio and equity return (as this could cause inappropriate distortion to the cash flow profile); or
- particularly if the Authority cannot afford to pay compensation in the form of a lump sum but wishes to avoid having to use a financial model, it may offer to pay a supplementary Unitary Charge over a period of its choosing as an annuity equivalent of the Capital Expenditure. If this approach is adopted, the discussion can be reduced to a single issue, namely the annuity rate to be applied. In this case, the Authority need not be concerned with how and at what cost the Contractor has arranged additional dedicated funding, if any¹⁶.

¹⁴ As stated in Section 5.2.3.3 this approach should not be used for Authority breach, but will be a common option to include, for example, for Authority Changes and Qualifying Changes in Law (see Sections 12 (Change in Service) and 13 (Change in Law)).

¹⁵ Particularly to avoid the time and expense of engaging advisers for what may be minor compensation sums (if this approach is used), it is recommended that the parties agree and record in the Contract the incremental impact on Unitary Charge of minor capital expenditure and operational expenditure changes.

¹⁶ If the original Unitary Charge over the chosen annuity payment period is profiled, then the supplementary Unitary Charge should similarly be profiled. Annuities being based upon nominal discount rates would be excluded from any indexation provisions of the Unitary Charge.

5.2.3.6 If the event concerned involves a Capital Expenditure reduction (e.g. cancellation of a wing of a building), this would involve:

- a reduction in Unitary Charge. The size of reduction will depend upon not only savings in Capital Expenditure but also consequent savings in finance and operating costs. The decision on whether or not to cancel any excess committed finance prior to project completion (if this is possible with the financing structure concerned) will be taken jointly with the Contractor and its financiers. The concept of lump sum payment (or refund), whether single or by instalment, does not arise as a possibility in this context.
- there are two alternative approaches to determining the appropriate reduction in Unitary Charge: either to use the financial model (see Section 5.2.3.2 above); or to determine the annuity equivalent reduction. With an annuity equivalent reduction the term of the annuity should be the term of the Contract, unless the parties otherwise agree.

5.2.3.7 If the compensation arises only because of a change in operating costs then appropriate changes in the Unitary Charge should be by negotiation and may be possible without reference to the financial model, even where the impact on operating costs is periodic or irregular over time. The change in Unitary Charge should be made at the time of the Compensation Event to reflect forecast operating costs changes, as to amount and timing. The use of lump sum compensation payments or annuity equivalents are also inappropriate for changes in operating costs.

As many of the above issues have complicated financial consequences, financial advisers should be consulted as to the most appropriate approach for a particular project.

5.2.3.8 In any event, (even if this approach is taken in relation to Authority Changes and Qualifying Changes in Law) it is not appropriate in any circumstances for breach by the Authority of its obligations to give rise to an obligation on the Contractor to finance any Capital Expenditure consequences¹⁷.

5.2.3.9 In assessing the consequences of a Compensation Event, other causes of delays to the Service Commencement Date will be relevant as to whether the Contractor will receive relief from its obligations and/or compensation. The Contractor's losses should be calculated as accurately as possible at the time and payment made as appropriate.

¹⁷ See Clauses 12.4 (Authority Changes) and 13.8 (Qualifying Change in Law) which provides for the approach set out in the second bullet point to Section 5.2.3.5.

Required drafting is as follows:

5.2 Delays in Service Commencement Due to a Compensation Event

(a) If, on or before the Service Commencement Date¹⁸, as a direct¹⁹ result of the occurrence of a Compensation Event²⁰:

- (i) the Contractor is unable to achieve Service Commencement on or before the Planned Service Commencement Date;
- (ii) the Contractor is unable to comply with its obligations under this Contract; and/or
- (iii) the Contractor incurs costs or loses revenue²¹,

then the Contractor is entitled to apply for relief from its obligations and/or claim compensation under this Contract.

(b) To obtain relief and/or claim compensation the Contractor must:

- (i) as soon as practicable, and in any event within [21] days after it became aware that the Compensation Event has caused or is likely to cause delay, breach of an obligation under this Contract and/or the Contractor to incur costs or lose revenue, give to the Authority a notice of its claim for an extension of time for Service Commencement, payment of compensation and/or relief from its obligations under the Contract;
- (ii) within [14] days of receipt by the Authority of the notice referred to in paragraph (b)(i) above, give full details²² of the Compensation Event and the extension of time and/or any Estimated Change in Project Costs claimed²³; and
- (iii) demonstrate to the reasonable satisfaction of the Authority that:
 - (A) the Compensation Event was the direct cause of the Estimated Change in Project Costs and/or any delay in the achievement of the Planned Service Commencement Date; and
 - (B) the Estimated Change in Project Costs, time lost, and/or relief from the obligations under the Contract claimed, could not reasonably be expected to be mitigated or recovered by the Contractor acting in accordance with good industry practice²⁴.

¹⁸ This provision will also apply during the work of a construction nature (such as on an insurance reinstatement following total or partial destruction of an asset) (see Section 5.2.1.4). The concept can also be extended in respect of an Authority obligation to be performed during the Service Period, particularly if there are non-payment obligations on the Authority (again see Section 5.3.1.4). Subject to the reinstatement point, however, the principal obligations in the Service Period will be payment related and can often be dealt with through provisions dealing with interest on late payment (see Clause 29.8 (Interest on Late Payments)).

¹⁹ Some contracts provide for the event concerned to be the "sole cause". The approach taken here is to refer to the "direct" cause.

²⁰ In the event of a delay to the Planned Service Commencement Date the construction costs will most likely increase, due to a longer financing period. The Contractor is under a duty to mitigate its other costs associated with any delay (for example, by delaying recruitment, if this can be done) (see Clause 5.2(b)(iii)).

²¹ This loss means not only out of pocket costs but also a claim for loss of profits (including a lost completion bonus) caused directly by the Compensation Event.

²² The Authority and the Contractor may wish to specify in the Contract precisely what details are required.

²³ This figure will not calculate the compensation payable, but it gives an indication of the seriousness of the breach and so what steps should be taken by way of mitigation.

²⁴ This will depend on the industry concerned.

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- (c) In the event that the Contractor has complied with its obligations under paragraph (b) above, then:
- (i) the Planned Service Commencement Date shall be postponed by such time as shall be reasonable for such a Compensation Event, taking into account the likely effect of delay²⁵;
 - (ii) in the case of an additional cost being incurred by the Contractor:
 - (A) on or before the Service Commencement Date; or
 - (B) as a result of Capital Expenditure being incurred by the Contractor at any time,

the Authority shall compensate the Contractor for the actual Estimated Change in Project Costs as adjusted to reflect the actual costs reasonably incurred within [30] days of its receipt of a written demand by the Contractor supported by all relevant information²⁶;
 - (iii) in the case of a payment of compensation for the Estimated Change in Project Costs that does not result in Capital Expenditure being incurred by the Contractor referred to in paragraph (b) above but which reflects a change in the costs being incurred by the Contractor after the Service Commencement Date, the Authority shall compensate the Contractor in accordance with paragraph (f) below by an adjustment to the Unitary Charge; and/or
 - (iv) the Authority shall give the Contractor such relief from its obligations under the Contract, as is reasonable for such a Compensation Event.
- (d) In the event that information is provided after the dates referred to in paragraph (b) above, then the Contractor shall not be entitled to any extension of time, compensation, or relief from its obligations under the Contract in respect of the period for which the information is delayed²⁷.
- (e) If the parties cannot agree the extent of any compensation, delay incurred, relief from the Contractor's obligations under the Contract, or the Authority disagrees that a Compensation Event has occurred (or as to its consequences), or that the Contractor is entitled to any relief under this Clause, the parties shall resolve the matter in accordance with Clause 27 (Dispute Resolution).
- (f) Any payment of compensation referred to in paragraph (c)(iii) above shall be calculated in accordance with [Section 5.2.3 (Calculation of Compensation) above]²⁸.

²⁵ This is only necessary to the extent there is a long-stop default date termination (see Section 2 (Duration of Contract)). Other consequential dates would also have to be postponed (for example, the long-stop default termination date). If the Contractor is required to pay the Authority liquidated damages for failure to achieve Service Commencement by the Planned Service Commencement Date, the Authority and its advisers should consider how the Contractor's obligation to pay will be relieved if a Compensation Event occurs after the Planned Service Commencement Date but prior to actual Service Commencement.

²⁶ This payment can be in the form of a monthly payment as expenditure is incurred (or staged payments against milestones) and invoiced if the delay is for a significant period of time. In the event that the Authority wishes the Contractor to increase its financing to pay for the consequences of a Compensation Event (other than an Authority breach), then Section 5.2.3 (Calculation of Compensation) should be reflected.

²⁷ Some Contracts provide that to the extent procedures are not followed here that no extension of time, payment or relief is given. This is not recommended as an approach.

²⁸ It is not recommended that the Authority enter into an arrangement whereby after the relevant effects of the Compensation Event have been calculated there is a consolidation if the costs are greater or lesser than those agreed or estimated.

5.3 RELIEF EVENTS

5.3.1 Purpose

5.3.1.1 Relief Events are events which prevent performance by the Contractor of its obligations at any time, in respect of which the Contractor bears the financial risk in terms of increased costs and reduced revenue but for which it is given relief from termination for failure to provide the full Service. The events listed in Section 5.3.2 (Scope of Relief Events) may be outside the Contractor's control, but that is not the appropriate measure of whether an event should appear on the list, as many events beyond a person's control at the time they occur could in fact have been prevented by proper precautions (e.g. fire). In fact, the list of events has been arrived at because the risk of the events concerned occurring is better borne by the Contractor as it is in a better position than the Authority to mitigate and manage the consequences. In some cases this will be with insurance, in others with a combination of insurance and proper planning and in others still, by risk management and planning (i.e. the events can be worked around for the period they exist).

5.3.1.2 It is clear in most cases that termination should not follow a Relief Event. This is because any replacement Contractor would be similarly affected and so the Authority's position would not be improved by termination. Relief Events do not, however, require the same treatment as Force Majeure Events (see Section 5.4 (Force Majeure Events)) as their consequences are not likely to be as severe and will usually only last for a finite period.

5.3.1.3 In the past it has been argued that a right to terminate should exist for the prolonged occurrence of a Relief Event. Other than in certain defence projects²⁹, this is not appropriate for two reasons. First there is a risk of there being no proper incentive on the Contractor to manage the risk (depending on any compensation payable on termination) and secondly the occurrence of such an event is likely either to be short-lived (e.g. strikes by a supplier) and/or lead to an alternative sourcing of the supply concerned by the Contractor (e.g. any shortage of fuel). In any event, the appropriate measure for a termination payment in such circumstances (i.e. Contractor Default – see Section 20.2.5 (Compensation on Termination for Contractor Default)) would be unlikely to be agreed to by Contractors.

5.3.2 Scope of Relief Events

5.3.2.1 The definition of Relief Events should be drafted as follows:

“Relief Event”

means³⁰:

- (a) fire, explosion, lightning, storm, tempest, flood, bursting or overflowing of water tanks, apparatus or pipes, ionising radiation (to the extent it does not constitute a Force Majeure Event³¹), earthquakes, riot and civil commotion;

²⁹ In the interests of certainty in particular defence projects, for example where the Service is needed by the MOD for military or operational reasons, a right to terminate should exist for both parties in the event of prolonged occurrence of a Relief Event. A discussion of when it may be appropriate to consider the inclusion of such a provision is set out in the Standardisation of MOD PFI Contracts.

³⁰ This list can be extended or tailored for specific sectors (e.g. the unintentional introduction of a virus in an IT project) provided that the commercial risk of the occurrence of such events clearly still lies with the Contractor. Authorities should be aware that the issues relating to termination rectification should restrict the list to events (other than those set out above) over which the Contractor has no control. If the approach set out in footnote 1 of Section 2 (Duration of Contract) is taken, then the result is (effectively) that the concept of Relief Events becomes redundant during the construction phase. There will also be circumstances in which the uninsurability of particular risks may constitute a Relief Event and prevent either party from terminating the Contract (see Section 24.8 (Risks that Become Uninsurable)).

³¹ Force Majeure Events are defined in Section 5.4.

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- (b) failure by any statutory undertaker, utility company, local authority³² or other like body to carry out works or provide services;
 - (c) any accidental loss or damage [to the development³³ or any roads servicing it]³⁴;
 - (d) any failure or shortage of power, fuel or transport;
 - (e) any blockade or embargo which does not constitute a Force Majeure Event³⁵; and
 - (f) any:
 - (i) official or unofficial strike;
 - (ii) lockout;
 - (iii) go-slow; or
 - (iv) other dispute,

generally affecting the [] industry³⁶ or a significant sector of it, unless any of the events listed in paragraphs (a) to (f) inclusive arises (directly or indirectly) as a result of any wilful default or wilful act of the Contractor³⁷ or any of its sub-contractors.

5.3.2.2 The Contract will have similar provisions during both the construction/development phase and the Service Period. In addition, as mentioned in Section 5.1.5, the above list of events may be extended to include other similar events if the circumstances warrant. This approach is accepted during the construction phase in certain Highways Agency projects (see Section 2 (Duration of Contract), footnote 1). Force majeure delays should be excluded (see Section 5.4 (Force Majeure Events)) as they are treated separately. In addition, in circumstances where the Contract imposes a long-stop date for Service Commencement (see Section 4.5 (Long-Stop Date)) the scope of Relief Events may be extended to cover further events (e.g. extreme adverse weather conditions and/or unforeseen ground conditions) given that the financial risks associated with such events will remain with the Contractor.

5.3.3 Consequences

5.3.3.1 The financial effects of delays caused by Relief Events are borne by the Contractor, so no compensation should be paid by the Authority on the occurrence of such delays. If a Relief Event occurs prior to Service Commencement any long-stop termination date will be put back by a period equal to the relevant delay. In most cases the only relief given will be relief from termination (i.e. Relief Events are separate and distinct from Compensation Events and Force Majeure Events).

³² In the context of a local authority project this will need to exclude the Authority as purchaser so as not to undermine the Relief Event concept.

³³ Development means, during the construction phase, certain items used for the development. This would cover, for example, the scenario where during the construction phase an integral piece of equipment with a lengthy procurement and/or manufacturing period is lost or damaged in transit or is damaged at a late stage in its manufacture.

³⁴ This may apply if, for example, a building is being built under a construction contract. In other cases other descriptions may be needed.

³⁵ See footnote 31 above.

³⁶ This will be the principal industry relating to the project concerned. For example, in an accommodation project this will include the building maintenance or facilities management industries.

³⁷ See also Section 20.2.4.3 in relation to Relief Events occurring during rectification periods for Contractor Default.

5.3.3.2 There should be no extension to the Contract owing to a Relief Event. The Authority should not regard an extension of the Contract as a concession without significant cost. This is because if an extension is given, then although the Contractor does not receive the Unitary Charge during a Relief Event (save to the extent the Service is delivered), the Contractor's revenue period would be kept whole. If this occurs, then there is a reduced incentive on the Contractor to manage the effects of the Relief Event and restore the Service as soon as possible. In addition, the Authority's exposure to any risks it bears under the Contract is extended indefinitely as the Expiry Date may be continually extended. By extending the Contract, therefore, the Authority can be taking a large element of the risk of the occurrence of Relief Events (as the economic effects of an extension can be substantial).

5.3.3.3 The parties should consider, on a project specific basis, whether or not the Contractor should be relieved of any liability for liquidated damages, although availability and performance deductions should continue to be made where necessary in respect of the period of delay caused by the Relief Event (see Sections 4 (Protections Against Late Service Commencement), 7 (Service Requirements and Availability), 9 (Performance Monitoring) and 10 (Price and Payment Mechanism)). Liquidated damages prior to Service Commencement (to the extent they exist) are designed to compensate the Authority for specific losses due to late Service delivery so that if the Contractor fails to commence provision of the Service due to a Relief Event, the Authority will still suffer this loss. Depending on the nature of the Project, however, the Authority may feel that it will obtain better value for money if it allows any liability of the Contractor for liquidated damages to be postponed by the period of the delay.

5.3.3.4 When a Relief Event has occurred and the Authority has been informed, the parties should consult to discuss relevant issues, such as the likely duration of the Relief Event and the action to be taken to mitigate its effects.

5.3.3.5 The Authority should not normally expect to exercise any step-in rights it has during a Relief Event (see Section 28 (Authority Step-In)). If the Contractor is not using reasonable endeavours to rectify matters and mitigate the consequences, it will not obtain the relief afforded by Relief Events and will be at risk of termination for default (see Clause 5.3(b) (Delays due to a Relief Event)). This should provide a sufficient spur for the Contractor to perform (depending, in part, on the approach taken to relief from other obligations under the Contract).

Required drafting to deal with Relief Events is as follows:

5.3 Consequences of a Relief Event

(a) If and to the extent that a Relief Event:

- (i) is the direct cause of a delay in Service Commencement; and/or
- (ii) adversely affects the ability of the Contractor to perform any of its obligations under this Contract,

then the Contractor is entitled to apply for relief from any rights of the Authority arising under Clause 20.2 (Termination on Contractor Default) [and its obligations³⁸ under this Contract].

³⁸ In most contracts Relief Events should give only relief from the risk of termination for failure to complete or failure to perform (see Section 5.3.3.1). In cases in which liquidated damages are payable to the Authority there will be an issue of the extent to which relief can be given from claims for damages or liquidated damages (see Sections 5.3.3.3 and 23 (Indemnities, Guarantees and Claims for Damages)). The performance regime should still apply and this should be made clear, to the extent there is potential for relief from liquidated and other damages.

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- (b) To obtain relief, the Contractor must:³⁹
- (i) as soon as practicable, and in any event within [14] days after it became aware that the Relief Event has caused or is likely to cause delay and/or adversely affect the ability of the Contractor to perform its other obligations give to the Authority a notice of its claim for relief from its obligations under the Contract, including full details of the nature of the Relief Event, the date of occurrence and its likely duration;
 - (ii) within [7] days of receipt by the Authority of the notice referred to in paragraph (b)(i) above, give full details of the relief claimed; and
 - (iii) demonstrate to the reasonable satisfaction of the Authority that:
 - (A) the Contractor and its Sub-contractors could not have avoided such occurrence or consequences by steps which they might reasonably be expected to have taken, without incurring material expenditure;
 - (B) the Relief Event directly caused the delay to the Planned Service Commencement Date [or the need for relief from other obligations under the Contract]⁴⁰;
 - (C) the time lost and/or relief from the obligations under the Contract claimed could not reasonably be expected to be mitigated or recovered by the Contractor acting in accordance with good industry practice⁴¹, without incurring material expenditure; and
 - (D) the Contractor is using reasonable endeavours to perform its obligations under the Contract.
- (c) In the event that the Contractor has complied with its obligations under paragraph (b) above, then:
- (i) the Planned Service Commencement Date shall be postponed by such time as shall be reasonable for such a Relief Event, taking into account the likely effect of delay; and/or
 - (ii) the Authority shall not be entitled to exercise its rights to terminate the Contract under Clause 20.2 (Termination on Contractor Default)⁴² [and, subject to paragraph (d) below, shall give such other relief as has been requested by the Contractor].⁴³
- (d) [Nothing in paragraph (c) above shall affect any entitlement to make deductions⁴⁴ or any deductions made as a result of [Section 9 (Payment and Performance Mechanism)] during the period in which the Relief Event is subsisting].⁴⁵

³⁹ The approach here is to set out a quick procedure so that relief can be given or refused on a sensible timescale without additional delays.

⁴⁰ See footnote 38 above.

⁴¹ This will depend on the industry concerned.

⁴² See Section 20.2 (Termination on Contractor Default).

⁴³ See footnote 38 above.

⁴⁴ If the termination levels under the Contract for non-performance are connected to the deductions made under the Contract or the award of performance points, the Contract should ensure that deductions or points arising due to non-performance caused by Relief Events are not taken into account in the termination provisions of the Contract.

⁴⁵ See footnote 38 above.

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- (e) In the event that information required by paragraph (b) above is provided after the dates referred to in that paragraph, then the Contractor shall not be entitled to any relief during the period for which the information is delayed.
 - (f) The Contractor shall notify the Authority if at any time it receives or becomes aware of any further information relating to the Relief Event, giving details of that information to the extent that such information is new or renders information previously submitted materially inaccurate or misleading.
 - (g) If the parties cannot agree the extent of the relief required, or the Authority disagrees that a Relief Event has occurred or that the Contractor is entitled to any [extension of the Planned Service Commencement Date and/or relief from other obligations under this Contract], the parties shall resolve the matter in accordance with Clause 27 (Dispute Resolution).

5.4 FORCE MAJEURE EVENTS

5.4.1 Scope of Force Majeure

5.4.1.1 The purpose of force majeure provisions is to give the Affected Party relief from liability and, if the event continues for a certain period, to give the parties an opportunity to terminate the Contract. The definition of Force Majeure Events (see Section 5.4.1.2) should only include events which, unlike Relief Events, are likely to have a catastrophic effect on either party's (although usually the Contractor's) ability to fulfil its obligations under the Contract. In practice, such events are highly unlikely to occur. As neither party is likely to be in a better position than the other to manage either the occurrence or the effects of force majeure, and the events may continue for a long period of time, such events are given a different treatment from Relief Events and the financial consequences shared.

5.4.1.2 The following is the required definition of Force Majeure Events:

“Force Majeure Event”⁴⁶

means the occurrence after the date of Contract of:

- (a) war, civil war, armed conflict or terrorism; or
- (b) nuclear, chemical or biological contamination unless the source or cause of the contamination is [the result of actions of the Contractor];⁴⁷ or
- (c) pressure waves caused by devices travelling at supersonic speeds,

which directly causes either party (the **“Affected Party”**) to be unable to comply with all or a material part of its obligations under this Contract.

⁴⁶ This definition should not be expanded without a very careful consideration of the specific issues on the Project concerned, as the effect can be to dilute or undermine agreed areas of risk transfer. It is recognised, however, that there are some obvious sector specific changes that may be needed (for example, certain MOD projects might exclude some of paragraph (a) if it is intended to operate during times of war). The definition may also be narrowed to cope with the fact that paragraph (b) may be inapplicable to environmental projects or projects involving chemical treatment which may be designed to deal with a certain degree of chemical contamination.

⁴⁷ In the case of a single site project, such as one involving a building, the wording in square brackets can be expressed as “the source or cause of the contamination is brought to or near the site”. This is the approach taken by the NHS Standard Form Project Agreement.

5.4.1.3 Relief for Force Majeure Events applies only to the extent that the Contractor or the Authority is unable to comply with all or a material part of its obligations under the Contract and the parties cannot agree within a limited period (say 6 months) how to restart the Project.

5.4.1.4 The Authority should not automatically be obliged to pay the Contractor any amount simply to service the Contractors' debt obligations in whole or in part, but the parties should recognise that the Contractor may wish to include certain tolerances into its Contract to allow for this. If termination occurs, the Authority will in any event compensate the Contractor for outstanding Senior Debt⁴⁸. If termination does not occur, then the parties will be discussing continuation of the Contract against a back drop of such a compensation payment.

5.4.2 Consequences of Force Majeure

5.4.2.1 On the occurrence of a Force Majeure Event, the parties should consult to attempt to find a way to continue the Project, such as agreeing how it can be reinstated if destroyed (although neither party will be obliged to do this). The solution will depend on the nature of the event and its effects, but may involve altering the service requirement, amending the payment mechanism or even extending the term of the Contract. The required drafting for dealing with the effects of Force Majeure Events is set out in Section 20.3 (Termination on Force Majeure).

5.4.3 Relief Events, Force Majeure Events and Insurance

5.4.3.1 Contractors may take out advance loss of profit or business interruption insurance against certain of the Relief Events (see Section 24 (Insurance)) to provide a replacement revenue stream for financiers and others reliant on the revenue of the Project for the duration of the event and/or the duration of a rebuild. Such insurances will often be subject to an excess for a number of days and so the occurrence of any such event may still involve the Contractor in substantial cost. Such insurance may not be available in respect of all types of Relief Event and, generally, will only pay out where there is physical damage to the Project.

5.4.3.2 The issue of allocating the risk of Relief Events and Force Majeure Events should be treated separately from the issue of whether or not insurance is available. The primary factor in allocating risk is who is best placed to manage the risk and its consequences and, in the case of Relief Events, this is the Contractor. Whether it can insure against such risk is a matter for the Contractor as it is essentially the Contractor's decision to manage the risk (to the extent the insurances are not required) in a satisfactory manner. Authorities should therefore not accept the argument that uninsurable events should inevitably fall within the definition of force majeure or an equivalent. This would significantly extend the definition of Force Majeure Events (see Sections 24 (Insurance) and 20.3 (Termination on Force Majeure)). Force Majeure is specifically given a different treatment in this guidance as the occurrence of the events listed in Section 20.3.2.2 are judged to be risks which the Contractor is not necessarily best placed to manage, and so should be shared by the Authority.

⁴⁸ Section 20.3.4 (Compensation on Termination for Force Majeure).

