

Key Contractual Issues

Public Private Partnership Guidance Note 13

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Contents

Section	Page
I. INTRODUCTION	1
PURPOSE AND SCOPE OF GUIDANCE	1
STRUCTURE OF GUIDANCE NOTE	2
PUBLIC PRIVATE PARTNERSHIP ROUTE MAP	3
II. CONTRACTUAL FRAMEWORK	5
OVERVIEW	5
CONTRACTING AUTHORITY DOCUMENTATION	5
CONTRACTOR DOCUMENTATION	6
III. LATE SERVICE DELIVERY	8
OVERVIEW	8
LIQUIDATED DAMAGES	8
PARENT COMPANY GUARANTEES	9
PAYMENT MECHANISM	9
PERFORMANCE BONDS	9
LONG STOP DATES	9
IV. DELAYS	11
COMPENSATION EVENTS	11
RELIEF EVENTS	12
V. CHANGE IN LAW	14
INTRODUCTION	14
SHARING CHANGE OF LAW RISK	14
VI. CHANGE PROCEDURE	16
INTRODUCTION	16
CONTRACTING AUTHORITY CHANGES	16
CONTRACTOR CHANGES	17
VII. CHANGE OF CONTROL	18
CONTRACTOR	18
SUBCONTRACTORS	18
VIII. DISPUTE RESOLUTION	20
INTRODUCTION	20
EXPERT DETERMINATION	20
CONCILIATION	20
ARBITRATION AND LITIGATION	21
IX. OWNERSHIP OF ASSETS AND RESIDUAL VALUE RISK	22
INTRODUCTION	22
ASSET REVERSION	22
ASSET OBSOLESCENCE	23
ALTERNATIVE USE	23
X. EARLY TERMINATION	24
INTRODUCTION	24
CONTRACTOR DEFAULT	24
CONTRACTING AUTHORITY DEFAULT	25
VOLUNTARY TERMINATION	25
FORCE MAJEURE	25

XI. STEP IN RIGHTS	26
CONTRACTING AUTHORITY	26
FUNDERS.....	26
XII. COMPENSATION ON TERMINATION.....	29
INTRODUCTION	29
CONTRACTING AUTHORITY DEFAULT.....	29
CONTRACTOR DEFAULT.....	30
FORCE MAJEURE	31
XIII. CONTRACTUAL PROTECTIONS.....	32
INTRODUCTION	32
INDEMNITIES.....	32
COLLATERAL WARRANTIES.....	32
CONTRACTUAL CLAIMS	33
XIV. PUBLIC SECTOR FINANCE.....	34
OVERVIEW	34
STEP IN RIGHTS.....	34
COMPENSATION.....	34
XV. ISSUES AND RECOMMENDATIONS.....	35
CONTRACTUAL FRAMEWORK	35
LATE SERVICE DELIVERY	35
DELAYS.....	35
CHANGE IN LAW.....	35
CHANGE PROCEDURE.....	36
CHANGE OF CONTROL	36
DISPUTE RESOLUTION	36
RESIDUAL VALUE RISK	36
EARLY TERMINATION	36
STEP IN RIGHTS	37
COMPENSATION ON TERMINATION	37
CONTRACTUAL PROTECTIONS	37
PUBLIC SECTOR FINANCE	37
APPENDICES	38
A. PUBLIC PRIVATE PARTNERSHIP GUIDANCE NOTES	38

I. Introduction

Purpose and Scope of Guidance Note

- 1.1 The purpose of this Guidance Note is to explain some of the key contractual issues that are likely to arise in Public Private Partnership projects in the roads, water and waste sectors. The Guidance Note also seeks to provide a summary of current market thinking in relation to these issues and to give advice as to how they are likely to be dealt with in the Project Agreement, the principal contract between the Contracting Authority and the Contractor.
- 1.2 The Guidance Note does not address all of the contractual terms that will be required in the Project Agreement for a Public Private Partnership project. Instead it focuses upon those issues that are likely to be regarded as central or key to the success of such a project. In addition, some significant contractual issues may not be susceptible to a standard or uniform treatment as all projects raise individual issues that cannot be addressed by general guidance. These issues will need to be identified and addressed at an early stage in the procurement process but they are not deemed to fall within the scope of this Guidance Note.
- 1.3 In using this Guidance Note it is important to be aware that a number of assumptions have been made with regard to the nature and form of the Public Private Partnership project being undertaken. In particular, this Guidance Note is predicated upon the following important assumptions:
 - **Legal form** - the Contractor or entity entering into the contractual relationship with the Contracting Authority is a special purpose vehicle, formed by a group or consortium of investors in order to isolate the liabilities of the Contractor from those of its shareholders, with responsibility for actual service delivery resting with a number of key subcontractors;
 - **Project nature** - the project involves a design and construction phase followed by an operational phase during which services are provided; and
 - **Financial structure** - the project is either wholly or partly financed by limited recourse debt (that is, the external funders to the project have access only to the assets of the Contractor and the limited amount invested in the Contractor by its shareholders).
- 1.4 In essence, this Guidance Note is most relevant where the Public Private Partnership project proposed is to take the form of a Design, Build, Operate and Finance contract or a Concession contract. Where a Public Private Partnership project does not involve private sector finance, different considerations will apply. In particular, the Section in this Guidance Note relating to the step in rights of funders will not be relevant and the Section on compensation on termination will need to be read and used in conjunction with the later Section on public sector finance.

- 1.5 This Guidance Note is one of a series of Guidance Notes which provide contextual information on Public Private Partnerships and procedural guidance for Central and Contracting Authorities covering each stage in the development and implementation of infrastructure projects using the Public Private Partnership approach. The titles of all of the Guidance Notes are set out in Appendix A to this Guidance Note.
- 1.6 The Guidance Notes are designed to be informative rather than prescriptive and the aim is to reflect good practice. They are generic in that they provide guidance on the use of Public Private Partnerships across a range of projects in the roads, water and waste sectors. However, different projects will give rise to different issues and the guidance provided will have to be reviewed in the context of each individual project. For this reason it is important that Central and Contracting Authorities obtain expert advice in order to help them to make best use of the Guidance Notes and to complete a successful Public Private Partnership procurement.

Structure of Guidance Note

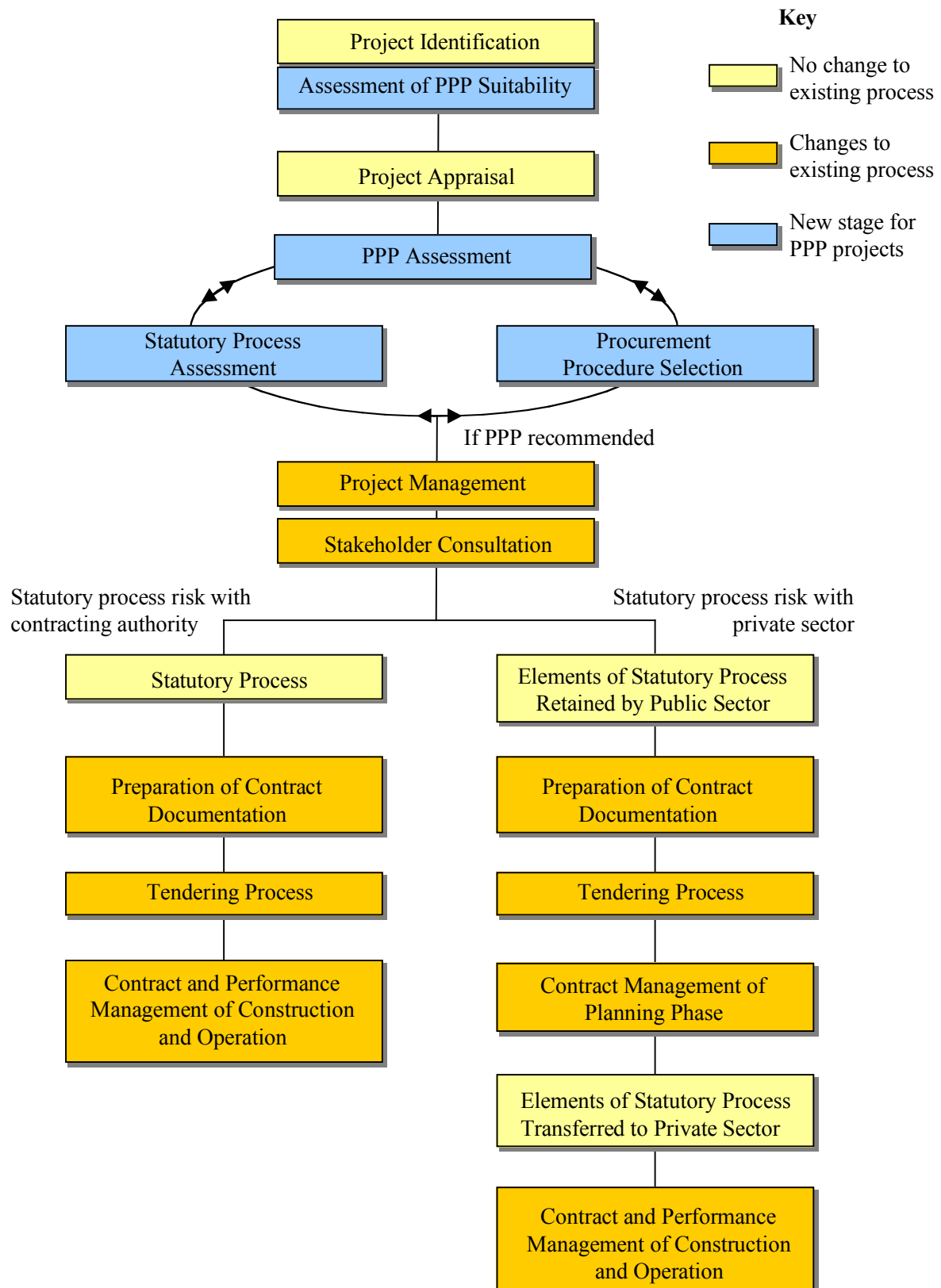
- 1.7 The key contractual issues addressed in this Guidance Note are as follows:
- **Section Two** - sets out the contractual framework surrounding a typical Public Private Partnership project and identifies the principal legal arrangements that will be put in place between the Contracting Authority, the Contractor and the funders and subcontractors to the Contractor;
 - **Section Three** - identifies the various methods that the Contracting Authority can use to ensure that it is protected against any delay in either construction or service commencement;
 - **Section Four** - sets out the circumstances in which certain types of project delay can give rise to compensation and relief;
 - **Section Five** - addresses changes in law and the respective responsibilities of the Contracting Authority and the Contractor where any such change occurs after the Project Agreement is signed;
 - **Section Six** - identifies the need for a change procedure or mechanism that will be capable of handling changes to be made to the provision of the services over the life of the project;
 - **Section Seven** - addresses the issues associated with a change of control in the Contractor or a change in the subcontract arrangements;
 - **Section Eight** - sets out the need for effective dispute resolution and identifies the principal methods of resolving disputes to be included within the Project Agreement;
 - **Section Nine** - addresses the risk to be borne by the Contracting Authority or the Contractor in relation to the value of an asset or facility upon expiry of the term of the Project Agreement;

- **Section Ten** - examines the circumstances in which the Project Agreement can be terminated prior to the expiry of its term;
 - **Section Eleven** - addresses the right of the Contracting Authority to step into the shoes of the Contractor in order to perform certain of the obligations of the Contractor under the Project Agreement; and sets out the right of the external funders to a Public Private Partnership project to step into the contract prior to early termination;
 - **Section Twelve** - addresses the compensation that may become payable to the Contractor in the event of the early termination of the Project Agreement;
 - **Section Thirteen** - addresses the main issues associated with various forms of contractual protections such as guarantees, indemnities and warranties; and
 - **Section Fourteen** - sets out some of the differences in contractual terms that will be required where private sector finance is not involved.
- 1.8 The final Section provides a summary of the main issues and recommendations that are identified and discussed within this Guidance Note.

Public Private Partnership Route Map

- 1.9 The process of project development and implementation changes significantly when a project is taken forward as a Public Private Partnership. For this reason a Public Private Partnership Route Map has been developed.
- 1.10 The Public Private Partnership Route Map sets out the main stages in the development and implementation of a Public Private Partnership project that must be undertaken by the Central Authority or the Contracting Authority. The Route Map is presented in the diagram shown overleaf.
- 1.11 The Public Private Partnership Route Map shows how the traditional processes of project development, procurement and implementation change for a Public Private Partnership project. A more detailed description of the Public Private Partnership Route Map is provided in the separate Guidance Note entitled *Introduction to Public Private Partnerships*.
- 1.12 The development of key contractual terms will first be considered during the Public Private Partnership Assessment and then again in detail during the preparation of the Contract Documentation. It is important to note that the development of the detailed contract cannot be undertaken in isolation. Accordingly, this Guidance Note should be read in conjunction with the Guidance Notes on *Output Specifications, Payment Mechanisms* and *Risk Assessment*.
- 1.13 In addition, it is important to note that this Guidance Note focuses on the key issues to be addressed in the contract between the Contracting Authority and the Contractor. It does not address any issues arising in relation to any other legal document.

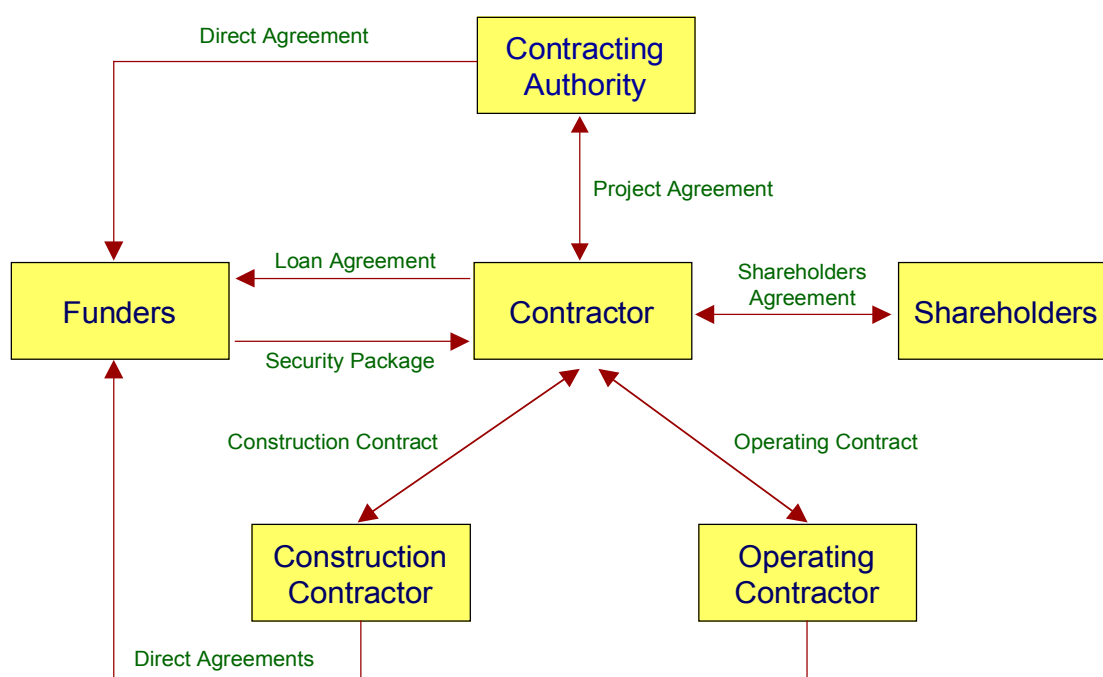
Figure 1: Public Private Partnership Route Map



II. Contractual Framework

Overview

2.1 The contractual framework that underpins a Public Private Partnership project being financed by the private sector is complex and typically involves a number of different arrangements involving the Contracting Authority, the Contractor and the funders and subcontractors to the Contractor. An overview of the key contractual relationships and documents which underpin a typical Public Private Partnership project involving private sector finance is set out in the diagram below.



Contracting Authority Documentation

2.2 The principal legal documents entered into by a Contracting Authority in relation to a typical Public Private Partnership project involving private sector finance are set out and described in the paragraphs below.

- **Project Agreement** - this is the core legal document that sets out in full the respective rights and obligations of both the Contracting Authority and the Contractor. It is not expected that a Contracting Authority will prepare a Project Agreement from first principles for each Public Private Partnership transaction. There are many model contracts in existence including those for design, build and turnkey contracts and an appropriate model will form the basis of the Project Agreement and will inform the development of model PPP contracts through the pilot projects process. Changes and amendments will also be necessary to suit Irish conditions and project specific requirements. However, any amendments to model documentation should be subject to legal review to ensure that the interests of the Contracting Authority are protected.

- ***Contracting Authority Requirements*** - these will include all of the technical and service requirements of the Contracting Authority and will be documented largely in the Output Specification. Ancillary detail in relation to planning issues, site information and any indicative drawings (including those drawings prepared for the Environmental Impact Statement) will also be included. It is expected that the majority if not all of these documents will either be separate documents to the Project Agreement or appended to it. Regardless of whether they exist as separate documents or as appendices to the Project Agreement, however, the Project Agreement must refer to, and incorporate properly, these documents as part of the Project Agreement and set out the obligations of the Contracting Authority and Contractor in relation to them.
- ***Collateral Warranties*** - these agreements provide for a direct contractual link between the Contracting Authority and the individual subcontractors or design teams appointed by the Contractor. The main purpose of these agreements is to give the Contracting Authority the benefit of an independent obligation in relation to the carrying out of the works or the provision of the services by the relevant subcontractor or professional adviser. They will also allow for step in rights so that the Contracting Authority may, subject to the rights granted to funders, step into the shoes of the Contractor in the event of default.
- ***Direct Agreement*** - this is an agreement between the Contracting Authority and the funders financing the Contractor. Typically, the Direct Agreement will provide that the Contracting Authority agrees to give the funders a period of advance notice of any intended termination of the Project Agreement and offers the funders the opportunity to step in to remedy the position and find a substitute entity acceptable to the Contracting Authority to take over the rights and obligations of the Contractor under the Project Agreement. In this context it should be noted that the rights of the Contracting Authority to step in under any collateral warranty agreements with subcontractors would be suspended until the funders make a decision regarding their position. Responsibility for drafting the Direct Agreement will rest in the first instance with the advisers to the funders and the document will then be subject to review by the Contracting Authority.

Contractor Documentation

2.3 In addition to the legal documentation entered into by the Contracting Authority, there will also be a number of legal agreements between the Contractor and its funders and subcontractors. The principal legal documents concerned are set out and described in the paragraphs below.

- ***Construction Contract*** - this agreement will be entered into by the Contractor and the subcontractor responsible for design and construction. The agreement will take the form of a fixed price contract and it will seek to transfer all of the design and construction risk associated with the Public Private Partnership project to the subcontractor. It will also impose liquidated damages on the subcontractor in relation to any delays in the construction of the project.

- ***Operating Contract*** - this agreement will be entered into by the Contractor and the subcontractor responsible for the ongoing operation and maintenance of the Public Private Partnership project. Again the agreement will usually take the form of a fixed price contract, at least in relation to routine or day to day operating activities. In addition, it is also likely to include a cap or limit on the ultimate liability of the subcontractor to the Contractor.
- ***Direct Agreements*** - these agreements will be entered into by the funders and key subcontractors such as the design and construction subcontractor and the operating subcontractor. The agreements provide that the key subcontractors may not exercise any rights of termination without first giving notice to the funders and then waiting for a defined period before terminating their contacts.
- ***Security Package*** - the principal component of the security package put in place for the funders will be the debenture granted by the Contractor which will include the assignment of all key project documents and ancillary rights such as insurance.

2.4 Whilst the Contracting Authority is not directly concerned with the subcontracts or funding documentation put in place by the Contractor, it will nevertheless wish to review that documentation in order to ensure that the interests of the Contracting Authority are not prejudiced in any way. For example, where compensation payable by the Contracting Authority on early termination is linked to amounts owing by the Contractor to its funders, the Contracting Authority will clearly wish to ensure that these amounts cannot be increased without its consent.

III. Late Service Delivery

Overview

- 3.1 There are various methods by which a Contracting Authority can seek to ensure that it is protected in circumstances where there is a delay in the construction phase and as a result the planned service commencement date is not met. These methods commonly include:
- **Liquidated damages** - an ascertained payment representing a genuine pre-estimate of the losses or damages the Contracting Authority will suffer in the event that the Contractor fails to commence service delivery on time;
 - **Parent company guarantees** - where the parent company of one (or more) of the shareholders in the Contractor will be liable for all of the costs incurred as the result of a delay;
 - **Payment mechanism** - where the payment mechanism contains provisions that enable the Contracting Authority or service user to withhold payments until the required standard and level of service is delivered by the Contractor;
 - **Performance bonds** - where a bank or an insurance company will guarantee payment of around 10 per cent of the total value of the design and construction contract in order to allow any cost overruns to be funded or a replacement subcontractor to be appointed; and
 - **Long stop dates** - where the Contracting Authority has the right to terminate the project if a predetermined long stop date for the commencement of service delivery is not achieved.

Liquidated Damages

- 3.2 As a general principle, liquidated damages should not be imposed on the Contractor in a Public Private Partnership project involving private finance. Where, however, the Contracting Authority stands to incur a loss if the date for service commencement is not met, it may be appropriate to consider requiring the Contractor to pay liquidated damages (which to be legally enforceable have to be a genuine pre-estimate of that loss). For example, in a waste treatment project late service commencement may result in the Contracting Authority having to make contingency arrangements that involve alternative treatment provision at its own cost. In these circumstances, the Contractor should be required to reimburse any such costs incurred by the Contracting Authority.
- 3.3 Liquidated damages may also be appropriate in circumstances where the Contracting Authority has contributed a valuable asset to the project that could otherwise have been utilised during the period prior to the services being commenced (in other words, an opportunity cost is incurred on the part of the Contracting Authority).

- 3.4 It is important to note though that tenderers will price the risk of incurring liquidated damages into their overall tender price. Accordingly, the level of liquidated damages (and any cap proposed) should be specified by the Contracting Authority in the tender documents in order to permit such pricing.

Parent Company Guarantees

- 3.5 It is not recommended that parent company guarantees be sought from the Contractor. The limited recourse structure used in Public Private Partnership projects to isolate the liabilities of the shareholders in the Contractor means that it is usually not appropriate for the Contracting Authority to require direct guarantees from the parent company of a subcontractor or the shareholders in the Contractor.
- 3.6 As long as the level of shareholder investment in the Contractor is sufficient to demonstrate a serious commitment to the project and the subcontractors have a proven track record and good financial standing, better value for money can be achieved if the Contracting Authority obtains any comfort needed by way of collateral warranties and indemnities. Collateral warranties and indemnities are discussed in greater detail in Section Thirteen of this Guidance Note.
- 3.7 Where private finance is involved, the Contracting Authority can also take comfort from the fact that the Contractor will have to perform its obligations under the Project Agreement in order to ensure the robust security package obtained by funders is never called.

Payment Mechanism

- 3.8 Typically, payment mechanisms should be structured in such a way that if services are not delivered, payment will be withheld. This approach means that it is generally not considered appropriate to demand other protections which may serve only to increase price, lengthen the expected construction phase and reduce value for money. Advice in relation to the development of effective payment mechanisms is presented in the separate Guidance Note entitled *Payment Mechanisms*.

Performance Bonds

- 3.9 It is not considered appropriate that the Contracting Authority obtain a performance bond as a method of contractual protection. Given the protection against late service delivery provided by the payment mechanism, if a performance bond is sought it will only serve to increase the price payable by the Contracting Authority or service users.

Long Stop Dates

- 3.10 The Contracting Authority will usually insert a long stop date for the planned service commencement. In other words, there will be a planned service commencement date as well as a long stop date for service commencement. The purpose of the long stop date is to give the Contracting Authority the right to terminate the Project Agreement.

- 3.11 The long stop date will be stipulated in the Project Agreement and it will incorporate an appropriate margin of time beyond the planned service commencement to allow for contingencies. The long stop date will also be capable of being pushed back in order to reflect the occurrence of compensation events, relief events and events of *force majeure*.
- 3.12 As part of the Project Agreement, it may be the case that the Contracting Authority will require the Contractor to obtain planning permission and all of the environmental and other consents needed to undertake a project in the roads, water and waste sectors. If this statutory process risk is passed either in whole or in part to the Contractor, the Project Agreement should provide a long stop date by which the Contractor shall be deemed to have complied with the obligations. If these obligations have not been complied with by that long stop date, then the Project Agreement should provide for the termination of the Project Agreement and contain appropriate provisions regarding compensation. More detailed advice in relation to the transfer of statutory process risk is set out in the separate Guidance Note entitled *Statutory Process Assessment*.
- 3.13 In conclusion it is important to note that it is generally accepted that a Contractor, whose operations are heavily financed by a funder with robust security arrangements giving it the ability to take over the project on the occurrence of certain defaults, has sufficient incentive to ensure target dates are met. Not only will the Contractor receive no income if services are not delivered on time but the period in which the Contractor can earn revenue will also be reduced, given the fact that the term of the Project Agreement usually runs from the planned service commencement date and not the date of actual service commencement.

IV. Delays

4.1 With regard to delays in service commencement under a Public Private Partnership, the Project Agreement will usually make specific provision for compensation events and relief events. Compensation events give the Contractor not only the right to an extension of time (relief) but also additional payment (compensation). On the other hand, relief events only give the Contractor a right to an extension of time.

Compensation Events

4.2 The Project Agreement will need to provide for circumstances where certain events caused by the Contracting Authority give rise to a delay and result in the planned service commencement date not being achieved. These events should include:

- A breach of the Project Agreement by the Contracting Authority;
- A change in the Output Specification requested by the Contracting Authority; and
- A change in law targeted at the Contractor or the project that gives rise to a requirement for further capital expenditure or increased operating costs. Such a change in law need not be limited to the specific project but rather can apply to all projects of the same type as the project being procured. For instance, if legislation is passed altering the law in relation to the standard to which motorways must be constructed and operated, then this will give rise to a compensation event.

4.3 Upon the occurrence of any of the above events, the planned service commencement date and the long stop date may, depending on the nature and severity of the relevant event, be postponed (usually by the length of the delay). In these circumstances, the Contractor is likely to incur additional funding costs and possibly liquidated damages. In addition, the commencement of the project revenue stream will also be delayed, as payments will not normally begin to be made until the service commencement date.

4.4 Accordingly, the Project Agreement will need to set out clearly the mechanism by which the Contractor is to be compensated for any delay arising from a compensation event. It is generally not considered appropriate to extend the term of the Project Agreement in these circumstances but instead to retain the original expiry date and compensate the Contractor for losses incurred. The retention of the original expiry date can avoid raising complicated issues in relation to the financial covenants in loan documentation where a Public Private Partnership project is privately financed. Any liability on the part of the Contractor in relation to liquidated damages should also be excused during the period of delay caused by the Contracting Authority.

4.5 However, it is important to note that the Contractor should be obliged under the terms of the Project Agreement to use all reasonable endeavours to mitigate any losses and increases in costs arising from such a delay. Such mitigation may result in the delay not affecting the planned service commencement date, although the Contractor will expect any costs incurred in this regard to be met by the Contracting Authority.

- 4.6 Some compensation events may give rise to a need for additional capital expenditure by the Contractor, especially in relation to variations requested by the Contracting Authority and discriminatory changes in law targeted at the project. Generally, it will be easier for the Contracting Authority to deal with this during the construction and the operational phases by way of lump sum or staged payments.
- 4.7 Where no additional capital expenditure is anticipated, the Contracting Authority can simply compensate the Contractor for costs properly and reasonably incurred as a result of the delay. This may occur, for example, where the Contracting Authority has breached a contractual obligation by delaying approval of a certain matter.

Relief Events

- 4.8 Whereas the concept of compensation events set out above should only apply during the construction phase of a Public Private Partnership project, a Contractor and its funders will invariably request the creation of a separate category of delay events which can affect the performance of the Contractor at any time. These events are commonly referred to as *relief events*.
- 4.9 Although some of the events typically regarded as relief events may not be insurable by the Contractor, it is generally considered appropriate for it to bear the financial risk associated with these events as it is better equipped than the Contracting Authority to mitigate and manage the consequences of such events.
- 4.10 The exact events to be included within the definition of relief events in the Project Agreement will depend on the nature of the Public Private Partnership project being procured. However, relief events typically include the following:
- failure by a statutory undertaking or other similar body to carry out works or provide services (for example, a state utility company);
 - discovery of fossils or antiquities;
 - any failure or shortage of power, fuel or transport;
 - any embargo or blockade not being an event of *force majeure*;
 - any accidental loss or damage to the development or roads leading to it;
 - fire, explosion, lightning, storm, tempest, flood, bursting or overflowing of water tanks, apparatus or pipes, ionising radiation (not being an event of *force majeure*), earthquakes, riot and civil commotion; and
 - any official or unofficial strike, lock-out, go-slow or other dispute generally affecting the industry relating to the project.

- 4.11 Upon the occurrence of any of the above events, assuming they have not been caused as a result of any wilful act or default on the part of the Contracting Authority, no compensation should be payable to the Contractor by the Contracting Authority. In addition, there should normally be no extension to the term of the Project Agreement as this may serve to reduce the incentive upon the Contractor to mitigate the impact of the relief event.
- 4.12 Instead, where a relief event occurs during the construction phase of a Public Private partnership project, then the planned service commencement date and long stop date should be pushed back by a period equal to the relevant delay to ensure a termination event does not arise. Where a relief event occurs during the operational phase of a project, the Contractor will only be given relief from termination.
- 4.13 In addition, value for money considerations will be used by the Contracting Authority to determine whether or not the Contractor should be excused from any liability to pay liquidated damages during the period of delay.

V. Change in Law

Introduction

- 5.1 The Contractor should be obliged under the Project Agreement and the financing documents to comply with all applicable law and legislation during the lifetime of the project and the cost of such compliance will be built into the original tender submitted by the Contractor. The issue then arises as to which party is responsible for any costs arising from changes in law or legislation that were not foreseen at contract award.
- 5.2 During the construction phase of a Public Private Partnership project, a change in law could require changes to be made to the design or specification of the construction works. A change in law may also affect the payments made by the Contractor to its subcontractors.
- 5.3 During the operational phase of a Public Private Partnership project, a change in law could have any number of possible effects which could serve to increase operational costs and prejudice the ability of the Contractor to cover its costs and service its debt. An example would be an amendment to minimum wage legislation.
- 5.4 In these circumstances, the main concern of the Contractor is that its income from the Contracting Authority has been defined on a long term basis. Unlike a conventional project, the Contractor will generally be unable to pass any increased costs resulting from a change in law onto its customers through an increased price, although in some projects where user charging is adopted this may prove to be possible.

Change in Law Risk

- 5.5 As a general rule in early Public Private Partnership projects in other jurisdictions the risks arising from any changes in law tended to be shared between the Contracting Authority and the Contractor.
- 5.6 The Contracting Authority would take the risk of changes in law that were project specific, for example, the introduction of more stringent water purity requirements or the imposition of additional health and safety requirements in relation to motorway lighting or crash barriers. In return, the Contractor would assume the risk of a general change in law likely to affect all private sector contractors equally, for example, an increase in the rate of corporation tax or changes in employment law. The Contractor would then in turn pass down these risks to each subcontractor.
- 5.7 In more recent years, it has been recognised that it is not always appropriate for the Contractor to assume all of the risk arising from general changes in law. Accordingly, an approach is emerging in Public Private Partnership projects in other jurisdictions whereby the costs of a general change in law that results in additional capital expenditure during the operational phase of a project and which was not reasonably foreseeable at contract award are shared between the Contracting Authority and the Contractor. Whether this approach is to be adopted in Ireland should be considered on a project specific basis.

- 5.8 If a sharing of this risk were adopted, the total liability of the Contractor in this regard could generally be capped at a percentage of the initial capital cost of the project. The level of this cap could then be determined by the availability of cash balances within the Financial Model prepared and submitted by the Contractor.
- 5.9 The financial advisers to the Contracting Authority need to be careful therefore, when requesting changes to the model, to ensure these changes leave sufficient balances to pay for capital expenditure at the level the Contracting Authority has requested. In addition, the Contracting Authority should note that the level of the capped liability (or the absence of such a cap) will have a direct impact on the level of user charges or unitary payment proposed by the Contractor.
- 5.10 Where a change in law involves a reduction in the capital expenditure forecast by the Contractor, with consequential savings in finance and operating costs, these savings should be reflected in a reduction in the level of user charges or unitary payment.

VI. Change Procedure

Introduction

- 6.1 It is likely that almost every Public Private Partnership project in the roads, water and waste sectors will involve a term of up to 25 years or longer. In these circumstances and given the long term nature of Public Private Partnership projects generally, there is a need for the Project Agreement to provide a mechanism for handling changes in the provision of the services.
- 6.2 Changes may be initiated at the behest of the Contracting Authority. For example, existing transport policies may change or changes in environmental health and safety standards may mean that the nature of service delivery at a water treatment or waste recycling plant may need to be modified. Alternatively, the Contractor may wish to propose changes to the service requirement or to the way it delivers the service.

Contracting Authority Changes

- 6.3 The Project Agreement should include a change procedure along the following lines:
- the Contracting Authority will send a notice to the Contractor specifying the nature of the change proposed;
 - the Contractor will be given the right to object to the change proposed on specified grounds. It is expected that the Contractor will attempt to limit the ability of the Contracting Authority to suggest changes which require the service to be performed in a way that infringes any law or is inconsistent with good industry practice, which would cause any consent held by the Contractor to be revoked or be unobtainable, which would result in a change in the nature of the project or in a reduction in size of the project or which would materially and adversely affect the service in a way that is not compensated for;
 - the Contractor will then make proposals in relation to the proposed change, the increased price of delivering that change, whether there are any additional capital expenditure implications and whether there are likely to be any other consequential changes that need to be made, for example, to the performance measurement system; and
 - there will then be a period of time during which the Contracting Authority and the Contractor will negotiate and seek to reach agreement, with disagreements normally being settled by an independent expert.
- 6.4 Broadly speaking if a change requested by the Contracting Authority requires capital expenditure or is to be incurred during the construction phase then the Contractor and its funder will normally expect these costs to be met by the payment of a lump sum or staged payments. Alternatively, the Contractor may be able to source the funding for capital expenditure itself and subsequently amortise these costs over the contract term by an increase in the level of user charges or unitary payment.

- 6.5 If a change requested by the Contracting Authority increases the operating costs of the Contractor, then this is usually dealt with by an increase in the level of user charges or unitary payment.
- 6.6 As part of the procurement process, the Contracting Authority should also attempt to agree a financial or monetary threshold beneath which the Contractor will absorb the cost of any changes requested by the Contracting Authority. If accepted at all by the Contractor, this is likely to be a small amount with the number of such changes being limited in each year. The cost of such an allowance will be reflected in the level of user charges or unitary payment.

Contractor Changes

- 6.7 The Contracting Authority should generally not object to any changes proposed by the Contractor unless fundamental aspects of the project are likely to be compromised. For example, where the Contractor believes it can deliver the service more cheaply (and therefore improve its return) the Contracting Authority should not agree to any such change if it fears that the service which the Contracting Authority requires will not be provided; or the change threatens the financial robustness of the Contractor; or the quality of the service will be diminished.
- 6.8 Generally a change proposed by the Contractor should not result in an increase in the level of user charges or unitary payment. If on the other hand the costs incurred by the Contractor are likely to be reduced by such a change, the Contracting Authority should seek to agree a reduction in the level of user charges or unitary payment.
- 6.9 In this context, however, it is important to note that the more a Contracting Authority tries to achieve a full pass through of any such cost reduction, the more unlikely it will be for the Contractor to introduce these changes. Clearly, the Contractor ought to be incentivised to make cost savings. It will then argue that it should be allowed to retain those benefits, but in the end some form of sharing arrangement can usually be agreed between the Contracting Authority and the Contractor.

VII. Change of Control

Contractor

- 7.1 A Contracting Authority may be concerned about transfers of shares and changes of ownership in the Contractor following contract award. Where this is the case, it may be tempted to impose restrictions on the ability of the shareholders in the Contractor to transfer their shares in the Contractor to third parties.
- 7.2 As a general rule, shareholders in the Contractor will not want their ability to transfer or sell their shares to be restricted unnecessarily. Such restrictions may, in certain instances, reduce the ability of the Contracting Authority to realise value for money gains that may emerge from changes in the financial structure of the project following service commencement. The Contracting Authority should not, therefore, attempt to restrict such transfers of shares in the Contractor indefinitely.
- 7.3 During the construction phase of a project, the Contracting Authority can reasonably restrict changes in the control of a Contractor by requiring the Contractor to seek its consent to such changes, with the Contracting Authority having absolute discretion as to whether or not such consent will be given.
- 7.4 During the operational phase of a project, the Contracting Authority should, where possible, attempt to set out in the Project Agreement a list of unacceptable holders of shares in the Contractor (for example, parties connected with a particular industry) rather than requiring the Contractor to seek its consent. However, given the real possibility of overlooking the identity of an unacceptable party or this arising over the term of the contract it is better for the Contractor to be obliged to seek the consent of the Contracting Authority. In these circumstances there should be an obligation on the Contracting Authority to act reasonably and in good faith in determining whether this consent will be given.

Subcontractors

- 7.5 The Contracting Authority should generally allow the Contractor freedom to manage its subcontractors and rely upon the payment mechanism for protection against poor service delivery rather than requiring the Contractor to seek its consent for any change in the nature of the subcontract arrangements underlying a project.
- 7.6 However, in certain circumstances, there may be a much greater concern about the identity of the subcontractor providing the services. For example, where a process such as sewage, sludge or thermal treatment is involved, the expertise and skill of the nominated subcontractors will be a significant factor in the evaluation of tenders and the selection of the preferred tenderer.
- 7.7 Accordingly, the Contracting Authority may be properly concerned that a change of subcontractor could have an adverse impact on the provision of the services and it may therefore wish to consider imposing a requirement on the Contractor to seek its consent to any proposed change in the subcontracting arrangements.

- 7.8 In return, the Contractor and subcontractor will be likely to require the Contracting Authority to identify the grounds on which it would wish to prohibit such a change. These grounds would typically relate to the technical ability and financial standing of the proposed replacement subcontractor.

VIII. Dispute Resolution

Introduction

- 8.1 The Project Agreement for a Public Private Partnership should include a method for resolving disputes and through experience abroad no single preferred method has emerged. Concerns commonly raised in relation to the issue of dispute resolution include:
- the need for a quick decision if it is anticipated that a delay in construction or delivery of the service will arise;
 - the need for confidentiality and sensitivity;
 - the need to deal with disputes involving many parties and complex issues; and
 - the need for certainty.
- 8.2 It may therefore be appropriate for the Project Agreement to provide for a hierarchy of dispute resolution processes or procedures and the most viable options are likely to involve independent expert determination or conciliation or arbitration.

Expert Determination

- 8.3 Independent expert determination is a popular method of resolving disputes within the private sector in Ireland and it is especially effective in relation to disputes involving the quality of work or materials. The procedure is inexpensive, straightforward and quick. The parties should set out in the Project Agreement the kinds of disputes in respect of which the determination of the independent expert is to be binding.
- 8.4 Where a Contracting Authority adopts this procedure, the Project Agreement should name the independent expert who will determine any disputes that arise or it should at least set out the process to be followed in the selection of an appropriate independent expert. Thereafter, any decisions made by the independent expert are generally only capable of being overturned for fraud, improper motive or where the independent expert has departed from his instructions in a material respect.
- 8.5 It is not considered practicable in the short term to set up a panel of experts having regard to the scope and diversity of disputes that are suitable for expert determination in the roads, water and waste sectors. Thus it will be for the Contracting Authority and the Contractor to identify the relevant professional to act as independent expert or to agree a procedure for the selection of such an expert. In the longer term, it may be considered practical to establish a panel of experts at a sectoral level.

Conciliation

- 8.6 As an alternative to independent expert determination, the Contracting Authority and the Contractor could agree to a conciliation process. Indeed, the parties could agree that certain categories of disputes would be referred to an independent expert and that the balance would be dealt with through conciliation, arbitration or litigation.

- 8.7 Conciliation is the method of dispute resolution that usually precedes arbitration or litigation and involves the assistance of an expert conciliator whose role is to facilitate settlement discussions between the parties in dispute. There are a number of different approaches to conciliation but in general terms the process involves the conciliator in a series of meetings with the parties both separately and together for the purpose of exploring the strengths and weaknesses of the case made by each party. Part of the role of the conciliator is to identify to one party the weaknesses of its own case and the strengths of the case made by the other party and vice versa. The procedure does not generally require lawyers to participate in the actual conciliation process itself. The process should have a defined time scale depending on its complexity and this should be agreed at the time of the appointment of the conciliator.
- 8.8 If the parties to a dispute cannot reach agreement themselves, then the conciliator can issue a recommendation as to the way in which he believes the dispute should be resolved. Once again, there are a number of approaches but a preferable approach is to regard the recommendation of the conciliator as final and binding on the parties unless within a specific period of time one or other of the parties formally rejects the recommendation. If rejected the parties then proceed either to arbitration or litigation depending on the dispute resolution method chosen.
- 8.9 Whilst bodies such as the Institution of Engineers in Ireland maintain a panel of conciliators, the scope and range of the disputes that may arise in a Public Private Partnership project are much wider than, for instance, in a civil engineering contract. Where provision is made for conciliation within the Project Agreement for a Public Private Partnership project, it is expected that in the short term the parties will appoint a conciliator based on their own knowledge of professionals practising in the relevant sphere. However, the parties may require assistance in identifying appropriate experts for conciliation. Therefore, consideration should be given to the establishment of a panel of conciliators relevant to Public Private Partnership projects in the roads, water and waste sectors, comprising experts in the various spheres of expertise required in a Public Private Partnership project.
- 8.10 The Contracting Authority should incorporate a conciliation procedure in the Project Agreement for each Public Private Partnership project such as that presented in the Institution of Engineers of Ireland Conciliation Procedure. There is no need to devise an entirely new conciliation procedure for Public Private Partnership projects.

Arbitration and Litigation

- 8.11 Independent expert determination or conciliation will not be appropriate for all situations, particularly catastrophic ones. Accordingly, where there has been a total breakdown in the relationship between the Contracting Authority and the Contractor, binding arbitration or, alternatively, litigation through the courts is likely to provide the most appropriate means of achieving a formal resolution of the dispute. In this regard, the relevant legislation in relation to arbitration is the Arbitration Acts, 1954 to 1998. Existing standard forms of building and engineering contracts contain typical arbitration clauses.

IX. Ownership of Assets and Residual Value Risk

Introduction

- 9.1 The Project Agreement should address the issue of asset ownership. The Guidance Note on *Legal Context* provides general guidance on some of the property issues that should be referred to when conducting the Public Private Partnership Assessment and in framing contract documentation.
- 9.2 The Project Agreement must also address the issue of where the ownership of any assets or facilities developed as part of a Public Private Partnership will reside once the project is at an end. The answer to this question is likely to be influenced by a wide range of factors including:
- whether the Contracting Authority requires the asset or facility to continue to operate once the Project Agreement has expired;
 - whether the asset or facility is likely to be obsolete by then; and
 - whether the asset or facility, whilst of no value to the Contracting Authority, may be put to alternative use by the Contractor.

Asset Reversion

- 9.3 In relation to most Public Private Partnership projects in the roads, water and waste sectors, the Contracting Authority will require any assets or facilities developed under the Project Agreement to continue in operation after the initial contract period. It is therefore essential that the Project Agreement provides for the return of the assets and for a mechanism to ensure that they are handed back in appropriate condition.
- 9.4 Where an asset or facility is to be handed back to the Contracting Authority at no cost at the end of a project, the Project Agreement should specify the condition the asset should be in at that time, assuming that the asset still has a useful economic life.
- 9.5 The issue as to whether or not the specified standards for asset transfer have been met will normally be assessed by an independent surveyor one to two years before the end of the term of the Project Agreement. Where this survey reveals that an asset will not be transferred in the required condition, the Contracting Authority should be entitled to recover the cost of any necessary remedial work from the Contractor and there are a number of different ways in which this can be achieved:
- the Contracting Authority may withhold a proportion of the user charges or unitary payment during the last few years of the Project Agreement and pay that amount into a separate bank account either in the name of the Contracting Authority or charged by way of security to it. Sufficient funds should then exist to cover the cost of any necessary works (where a security interest is created funders will invariably require the rights of the Contracting Authority to be subordinated to them if funding is still outstanding).

Either the Contracting Authority or the Contractor can then use these funds to carry out the works. If the funds are insufficient the Contractor should owe as a debt the relevant amount to the Contracting Authority and if there is a balance in the account after any works are completed, these funds (together with any accrued interest) should belong to the Contractor; or

- the Contractor may be obliged under the terms of the Project Agreement to arrange for a performance bond to cover the cost of any work required.

Asset Obsolescence

- 9.6 Some of the assets developed as part of a Public Private Partnership project may be likely to have reached the end of their useful economic lives by the time of the expiry of the Project Agreement. The Contracting Authority should ensure that appropriate provision is made within the Project Agreement for the subsequent disposition of any such assets, particularly where they may pose environmental problems as the assets will remain in the ownership of the Contractor.

Alternative Use

- 9.7 Where the assets developed as part of a Public Private Partnership project have no alternative use, a transfer of residual value risk to the Contractor at an acceptable price will generally not be possible. Accordingly, in the case of most projects in the roads, water and waste sectors residual value risk is likely to be of limited relevance.
- 9.8 Where the assets developed as part of a Public Private Partnership project can be put to an alternative use, there may be scope for transferring some residual value risk to the Contractor. Whether or not this is actually achieved, however, will usually be determined by whether or not the transfer of residual value risk represents good value for money.
- 9.9 Where value for money can be achieved, the Contracting Authority may pay the Contractor an amount over the term of the Project Agreement that is not sufficient to cover the complete cost of financing the project. Instead, the Contractor will have to try to recover the balance of that cost through any increase in the value of the asset at the end of the term. Given the inherent difficulty in estimating potential future values, however, the Contractor may simply decide to place a nominal value on the residual value of the asset.

X. Early Termination

Introduction

10.1 The Project Agreement for a Public Private Partnership must set out the circumstances in which the project can be terminated prior to its natural expiry. The events likely to give rise to early termination will comprise Contractor default, Contracting Authority default, voluntary termination by the Contracting Authority and *force majeure*.

Contractor Default

10.2 The Project Agreement will usually provide the Contracting Authority with a right to terminate in the following circumstances:

- ***Failure to achieve service commencement by the long stop date*** - the Project Agreement should permit the Contracting Authority to terminate the project where the final date for service commencement has not been achieved;
- ***Persistent breach of the Project Agreement*** - the Contracting Authority should be able to terminate the project where the Contractor is in persistent breach of its obligations. This will involve the Contracting Authority first giving notices to the Contractor to rectify certain breaches, then rectification or grace periods elapsing, further warning notices subsequently being given in relation to unrectified breaches and finally termination occurring as the result of persistent failure;
- ***Penalty points reaching a certain level*** - the Project Agreement should allow the Contracting Authority to terminate the project where the quality of the service being delivered by the Contractor as measured by the performance deduction mechanism or penalty points system is significantly and regularly below the standard required;
- ***Contractor insolvency*** - the Project Agreement should allow the Contracting Authority to terminate the project in the event of Contractor insolvency. The definition of the events constituting insolvency will include a resolution being passed by the Contractor for its winding up, a receiver being appointed under any financing agreement, an application being made to the High Court for the appointment of an examiner or a voluntary arrangement being entered into by the Contractor; and
- ***Breach of certain key contractual provisions*** - the Project Agreement should also allow the Contracting Authority to terminate the project in the event of a breach of certain key contractual provisions. Typically, the breaches relate to the provisions in respect of change of control, insurance, corruption and the replacement of subcontractors without consent, although other provisions may also be included. For example, the withdrawal or non-renewal of statutory consents or licences in the case of water and waste projects will usually be treated as giving the Contracting Authority a right to terminate.

Contracting Authority Default

10.3 The events that will entitle the Contractor to terminate the Public Private Partnership project will also need to be captured within the Project Agreement and these events commonly include:

- ***Failure to pay*** - the Contractor should be allowed to terminate the project where the Contracting Authority fails to make a payment of any amount of money exceeding a predetermined threshold after the expiry of the requisite grace period. Both the Contractor and its funders will expect prompt payment to avoid cash flow problems and will often seek payment of disputed amounts pending resolution of the relevant dispute. This approach is generally not recommended as payment should be withheld pending determination by an expert and interest paid to the Contractor where it is subsequently established that the Contracting Authority was at fault. In the preparation of the Project Agreement, regard should also be had to the effect of the Prompt Payment of Accounts Act, 1997.
- ***Breach of the Project Agreement*** - the Contractor should be permitted to terminate the project where the Contracting Authority commits a breach of the Project Agreement that in itself makes it substantially impossible for the Contractor to perform its obligations for an agreed period of time.

Voluntary Termination

10.4 Circumstances may arise in which the Contracting Authority is not able to continue with a Public Private Partnership project. For example, there may be a change in policy at a national or European level that renders the continued provision of a service redundant. In order to accommodate such circumstances, the Contracting Authority may wish to retain the right to terminate a Project Agreement voluntarily.

10.5 In addition, the Guidance Note on *Legal Context* identifies certain circumstances in which a third party (such as a Minister under the Public Health (Ireland) Act, 1896) has the power to appoint a person other than the Contractor to carry out necessary works to the project facilities. If the Minister proceeds to appoint a third party to carry out any such works, then the Contracting Authority will have to have the right to terminate the Project Agreement if termination is required. The consequences of such termination will depend on whether or not the Contractor was in default. This situation will have to be borne in mind when agreeing funder step in rights (where private sector finance is involved).

Force Majeure

10.6 Finally, the Project Agreement should allow early termination where a *force majeure* event lasts for around 6 months or more. A narrow definition of *force majeure* should be adopted with a view to limiting these events to those which are catastrophic, namely those relating to war or terrorism affecting the jurisdiction within which the project is being procured as well as nuclear war or contamination.

XI. Step In Rights

Contracting Authority

- 11.1 A Public Private Partnership project will include step in rights designed to allow the Contracting Authority to step into the shoes of the Contractor in order to undertake certain of the obligations of the Contractor under the Project Agreement.
- 11.2 These rights should, however, only be triggered where there is a serious short term problem which needs to be remedied as a matter of urgency, typically where there is a substantial health or safety risk or where the Contracting Authority has to take action to discharge a statutory duty. The concept behind Contracting Authority step in rights is that the Contracting Authority may be better equipped than the Contractor to deal with these types of situation.
- 11.3 Where the Contractor does not cause the problem leading to step in, the Contracting Authority should pay its own costs of stepping in and any payments to the Contractor should not be affected. Where the Contractor continues, however, to provide part of the service during the step in period, payment deductions should continue to be made if these services are not properly performed.
- 11.4 If the problem giving rise to step in is due to a breach of the Project Agreement by the Contractor and that breach has not been remedied within the agreed time, the costs of stepping in (including fees payable to advisers) should be set off against the user charges or unitary payment.

Funders

- 11.5 A Public Private Partnership project involving private sector finance will also include provisions granting step in rights to funders. It is important to note that funder step in rights are very different from the step in rights granted to the Contracting Authority and only come into play where there is a termination or threatened termination of the Project Agreement.
- 11.6 Funders are unable to take security over the capital assets provided by a Public Private Partnership project and instead security is taken over the revenue stream generated by the project. The step in rights given to funders in a default situation allow them to try to revive the project with a view to repaying their debt and the nature of these step in rights will be agreed by the funders, the Contracting Authority and the Contractor. If the funding provided to a Contractor is guaranteed by a robust parent company, then there may be no need for funder step in rights. However, this is usually the exception rather than the rule in Public Private Partnership transactions.
- 11.7 The approach normally taken with regard to step in is to allow the funder immediately to take over the decision making process without immediately accepting liability for reviving the project. The direct agreement between the Contracting Authority and the funder will therefore usually provide for a process along the lines set out below:

- the Contracting Authority will be asked to acknowledge that the benefit of the Project Agreement has been assigned to the funder as security for the payment obligations of the Contractor. Such an acknowledgement is required to legally effect the assignment to the funder;
- the Contracting Authority will be expected to notify the funder of any material breach of the Project Agreement and will be obliged to send it any notices it sends to the Contractor at the same time, for example, notices containing proposals for a variation to the service requirement or in connection with a deduction from the user charges or unitary payment;
- if the Contracting Authority intends to terminate the Project Agreement it will send notice of this fact to the funder. A period of time will then begin during which the funder will decide whether or not to exercise its right of step in. The Contracting Authority will, within approximately one month after that notice is given, notify the funder of the outstanding obligations and liabilities of the Contractor so that the funder knows exactly the liabilities it is accepting;
- at this point a funder will be wary of the accumulation of penalty points relating to poor service delivery which may well have led to termination. If these penalty points continue to accrue, a funder will be extremely unlikely to try to rescue the project and so penalty points should either be re-set to zero to allow a rectification program to be undertaken or their continued accrual should be suspended (but only for the purposes of termination being triggered and not in relation to accruing deductions from the user charges or unitary payment in respect of those services that continue to be provided);
- where a funder does step in, it will have to discharge the outstanding debts and liabilities of the Contractor to the Contracting Authority at the time of step in and undertake to remedy the breaches of the Project Agreement that led to the Contracting Authority serving notice of intention to terminate;
- a funder will need a degree of flexibility and a realistic time frame in which to implement a remedial program for the breaches of the Project Agreement that led to it stepping in. During the step in period the Contracting Authority will be unable to terminate the Project Agreement as a result of a breach arising prior to step in provided the funder has discharged all amounts owing to the Contracting Authority and is taking reasonable action to remedy that breach. A funder will need to ensure that no new breaches occur during step in as the Contracting Authority will be entitled to terminate the Project Agreement in these circumstances;
- the funder will be free to step out at any time during the step in period if it considers that it does not wish to take over the obligations of the Contractor, but it will usually have to give reasonable notice to the Contracting Authority. Alternatively, the funder can seek to transfer all of the rights and obligations of the Contractor under the Project Agreement to a third party approved by the Contracting Authority.

At that point the Contractor will be released from the Project Agreement and the project will continue, but not necessarily on the same basis. The parties may, for example, agree that the payment mechanism is not serving to incentivise the Contractor correctly and therefore amend it at the time a third party takes over;

- a funder will also expect the procedure outlined above to apply where no termination action has been taken by the Contracting Authority but where the Contractor has defaulted under the financing agreements and the funder is accelerating its debt repayment;
- a funder will also have direct agreements with the key subcontractors, again so as to ensure that it receives prior notice of termination action by them and is given a chance to step in; and
- upon early termination of a project, the funder will always insist that the rights of the Contracting Authority under any collateral warranties it has taken from the key subcontractors can only be exercised after the funder has exhausted its rights against those parties. Any monetary recoveries made by the funder will, however, normally reduce the compensation payable by the Contracting Authority upon early termination.

XII. Compensation on Termination

Introduction

- 12.1 The issues relating to compensation on termination will vary depending on whether a Public Private Partnership project is publicly or privately financed. Issues relating to projects financed by public capital are outlined in Section Fourteen while this Section addresses issues in relation to projects involving private sector finance.
- 12.2 In the United Kingdom, payments to be made on an early termination of a project are one of the most heavily debated issues in Public Private Partnership projects given the competing interests of the Contracting Authority, the shareholders in the Contractor and the funders. However, standard practice is now emerging in the United Kingdom and some of the basic principles are set out below:
- similar compensation provisions should apply both before and after the service commencement date;
 - cash balances held by the Contractor including amounts in debt service reserve and sinking fund accounts should be set off against any compensation payable by the Contracting Authority;
 - there should be no distinction between debt and equity as the source of finance which funded the project development and the working capital associated with the operation of the service; and
 - payments to the Contractor should be grossed up to reflect any tax deductions except where termination is as a result of Contractor default.

Contracting Authority Default

- 12.3 Where early termination is the result of Contracting Authority default or voluntary termination by the Contracting Authority, the Contractor and its funders will typically expect any compensation payments to be sufficient to restore the Contractor to the position it would have been in had the project successfully run its course.
- 12.4 The Contractor will therefore expect the full discharge of its funding obligations, the return of the equity invested by its shareholders, a recognition of loss of profit over the project term and compensation for any other costs incurred by the Contractor in terminating its contracts with its subcontractors.
- 12.5 If full compensation along these lines is made by the Contracting Authority, it will usually involve amounts similar to those recoverable through the courts in an action for breach of contract, namely:
- the repayment of debt funding including any break costs arising from the early repayment of debt; *plus*

- the repayment of equity and other types of project funding provided by the shareholders in the Contractor; *plus*
 - a notional return on the equity invested, as if future profits had been achieved but discounted to take account of the early payment of these amounts by the Contracting Authority; *plus*
 - a payment to meet the costs of terminating the involvement of subcontractors in the project.
- 12.6 A detailed review of the finance supporting the Contractor and the agreements entered into by the Contractor with other parties should be carried out by the advisers to the Contracting Authority in order to ensure that break costs cannot be artificially inflated upon early termination.

Contractor Default

- 12.7 It is likely that when a Contractor defaults, any assets associated with a Public Private Partnership project will already have been developed to provide a particular service. The Contracting Authority may have the ability to require the assets to be transferred to it on early termination without being required to pay any compensation in relation to the value of the asset.
- 12.8 However, it is more likely that the Contractor will seek to have a compensation arrangement included in the Project Agreement to cover such circumstances. The reason why, in a Public Private Partnership project, compensation is normally payable by a Contracting Authority to a Contractor that is in default is to ensure that a windfall benefit does not accrue to the Contracting Authority.
- 12.9 Historically in the United Kingdom, the level of compensation payable on Contractor default has been driven by the level of debt outstanding to the funders supporting the Contractor at the date of termination, less an amount equal to the costs incurred by the Contracting Authority in rectifying the breaches that led to early termination.
- 12.10 However, some public sector bodies in the United Kingdom are now endeavouring to base compensation for Contractor default on the market value of the unexpired term of the Project Agreement. It is argued that this method of compensation increases the incentive for funders to step in to revive a failing project rather than terminating with a view to simply securing debt repayment. In any event, this is an issue that should be resolved prior to the execution of the Project Agreement.
- 12.11 Whether there is a secondary market and whether Public Private Partnership projects prove to be bankable in these circumstances remains to be seen, although a schools project in Scotland has recently achieved financial close on this basis. The approach now emerging in the United Kingdom provides an incentive for funders to step in, but difficulties such as what will happen if there is no or inadequate competition to allow a proper retendering remain to be resolved. Nevertheless, Contracting Authorities should give consideration to this basis of determining compensation on termination in the roads, water and waste sectors.

Force Majeure

- 12.12 Negotiations as to the level of compensation payable where a project terminates as a result of a prolonged *force majeure* event are usually approached by the Contractor and the Contracting Authority on the basis that termination is the fault of neither party.
- 12.13 The shareholders in the Contractor will usually consider the loss of their investment in the project as unacceptable and the Contracting Authority will need to consider on a project specific basis whether equity and other types of project funding provided by shareholders should be repaid. The Contractor will also normally expect certain break costs to be discharged though these should be limited.
- 12.14 At the same time the Contracting Authority will normally require the Contractor to minimise its loss in these circumstances. A no fault compensation payment for termination arising from *force majeure* will usually include:
- the repayment of private sector debt funding including any break costs arising from the early repayment of debt; *plus*
 - the payment of certain break costs (for example, redundancy payments) but no payments in relation to any costs incurred in terminating subcontracts.

XIII. Contractual Protections

Introduction

- 13.1 In most Public Private Partnership projects, the entity contracting with the Contracting Authority will often be a thinly capitalised special purpose company with no track record of service delivery and whose main asset is the Project Agreement (and the revenue generated through the delivery of that agreement). The extensive comfort normally obtained by Contracting Authorities in a traditional procurement will not be appropriate in a Public Private Partnership project involving private finance. Certain types of comfort should, however, always be required.

Indemnities

- 13.2 The Contracting Authority should expect to receive an indemnity from the Contractor to make it responsible for (and indemnify the Contracting Authority against) any claims made against the Contracting Authority (for example, personal injury to staff or damage to property caused during the construction phase of the project).
- 13.3 The price tendered by the Contractor will make provision for a contingent liability in respect of such an indemnity and the liability of the Contractor under any indemnity will be passed to its subcontractors. Requiring an indemnity from the Contractor and its subcontractors that is unlimited in scope will, however, normally be unacceptable to those parties. Where it is acceptable, the tender price will always be increased to accommodate that risk.
- 13.4 It is generally appropriate, therefore, to allow the Contractor and its subcontractors to cap their liability under any indemnities in favour of the Contracting Authority. If a likely claim is covered by insurance, the level of the cap is often linked to the level of the agreed insurances. A monetary amount may be agreed for matters that are not likely to be covered by insurance.
- 13.5 The Contracting Authority should ensure it has sufficient other protections from the Contractor and its subcontractors such as collateral warranties before agreeing to cap their liability under any indemnities in the Project Agreement.

Collateral Warranties

- 13.6 The duties and obligations of subcontractors will be owed to the Contractor and not to the Contracting Authority. However, it is common in Public Private Partnership projects for subcontractors to give direct contractual undertakings to the Contracting Authority in the form of collateral warranties. These will, in certain circumstances, give the Contracting Authority direct claims against those parties.
- 13.7 If collateral warranties are obtained from subcontractors, the Contracting Authority will need to be satisfied as to the strength of covenant offered by that party. Where the subcontractor is thinly capitalised or has no proven track record, the Contracting Authority may need to seek a guarantee from the parent of the subcontractor to cover any amounts payable to the Contracting Authority under the warranty.

- 13.8 Where the project is privately financed, funders are likely to insist on the rights of the Contracting Authority under any such warranties being postponed until such time as the funders have exhausted their rights against those parties. Funders will usually obtain collateral warranties from the main subcontractors, normally contained in a direct agreement which will also require those parties to give the funders prior notice of any intended termination of the subcontract in order to allow them time to step into the shoes of the Contractor.
- 13.9 Such a postponement of the rights of the Contracting Authority is normally acceptable, as any amounts recovered by funders under collateral warranties from subcontractors will usually be deducted from any compensation the Contracting Authority is obliged to pay on an early termination of the Project Agreement.
- 13.10 Where a change in subcontractor is proposed then a replacement collateral warranty will typically be obtained from the replacement subcontractor, provided of course that the Contracting Authority is satisfied with the strength of the subcontractor and is content that the change should take place.

Contractual Claims

- 13.11 The ability of the Contracting Authority and the Contractor to make a claim against the other is normally limited by the terms of the Project Agreement. The reason for this approach is that deductions to the level of user charge or unitary payment for poor performance ought to reflect any loss to the Contracting Authority.
- 13.12 Where such deductions are insufficient to cover the loss incurred by the Contracting Authority, then liquidated damages may be appropriate, as long as the damages relate to costs properly incurred by the Contracting Authority as a result of a breach of the Project Agreement by the Contractor. Particular categories of claim requiring special treatment will normally be covered in the indemnity (for example, death or personal injury).

XIV. Public Sector Finance

Overview

- 14.1 Not all Public Private Partnership projects will involve private sector finance as a Contracting Authority may decide to finance a particular project using its own funds. The question as to whether better value for money is achieved through the use of public sector finance does not fall within the scope of this Guidance Note.

Step In Rights

- 14.2 Where the private sector is not involved in financing a Design and Build or a Design, Build and Operate project, then there will be no need for funder step in rights. As a result, the exercise of any rights obtained under collateral warranties or guarantees from shareholders in the Contractor or subcontractors will not need to be postponed until such time as the funders have exhausted their rights against those parties.

Compensation

- 14.3 The compensation payable on early termination will also be different where no private sector finance is involved and the principal differences are set out below.
- ***Contractor default*** - if the project terminates as a result of a default by the Contractor then, broadly speaking, the Contractor will only be compensated for the cost of work completed up to the date of termination. There would be no payment relating to funding or to the unexpired term of the contract;
 - ***Contracting Authority default*** - if the project terminates as a result of a default by the Contracting Authority, then compensation will be likely to be based on the loss of profit forecast by the Contractor over the remainder of the term of the project but without any payment relating to funding; and
 - ***Force majeure default*** - if the project terminates as a result of the occurrence of a prolonged *force majeure* event, then any compensation payable by the Contracting Authority will only relate to the limited amount of money already invested by the Contractor (but not loss of profit) and certain costs associated with termination (for example, redundancy payments).

XV. Issues and Recommendations

Contractual Framework

- 15.1 The Project Agreement is the key legal document between the Contracting Authority and the Contractor. It will have to be drafted, using model contract documents where appropriate, to ensure that the agreed risk allocation is properly recorded and, where risk is transferred by the Contracting Authority, that it does not revert unintentionally to the Contracting Authority.

Late Service Delivery

- 15.2 Better value for money is likely to be achieved where protections against late service delivery outside of the payment mechanism are limited. The Contracting Authority should only consider requiring the payment of liquidated damages by the Contractor in circumstances where either it stands to incur a loss if the service commencement date is not met or it has contributed a valuable asset that could otherwise have been used during the period. Performance bonds and parent company guarantees should not usually be the method of protection adopted.

Delays

- 15.3 Certain events arising in the construction phase of a Public Private Partnership project should be identified as compensation events within the Project Agreement and these events should entitle the Contractor to claim both compensation and relief from non performance.
- 15.4 Other events arising in the construction and operational phases of a Public Private Partnership project should be identified as relief events within the Project Agreement. These events should allow the Contractor relief from non-performance, but should not provide for compensation or an extension to the project term.

Change in Law

- 15.5 Liability for discriminatory changes in law targeted at a particular sector or Public Private Partnership project should generally be assumed by the Contracting Authority. Liability for more general changes in law that do not give rise to additional capital expenditure in the operational phase should generally be assumed by the Contractor. Experience from other jurisdictions shows that liability for any such general changes in law that require additional capital expenditure in the operational phase is often shared between the Contracting Authority and the Contractor in order to avoid risk pricing and to achieve value for money.

Change Procedure

- 15.6 The Project Agreement needs to include a mechanism for handling changes in service delivery requested by either the Contracting Authority or the Contractor. Changes requested by the Contracting Authority will often lead to an increase in user charges or the unitary payment while changes requested by the Contractor will usually not.
- 15.7 Where a change requested by the Contracting Authority increases project costs, the Contractor should use reasonable endeavours to secure external funding (the costs of which would then be amortised over the term of the Project Agreement through an increase in the level of user charges or unitary payment. Where external funding is not secured, the Contracting Authority should fund the change through an increase in the user charge or unitary payment (where the operating costs of the Contractor are affected) or by staged or lump sum payments (where the change requires additional capital expenditure).

Change of Control

- 15.8 The Contracting Authority should generally not try to preserve the comfort derived from the original consortium continuing to retain their economic stake in the Contractor by preventing a change of ownership in the Contractor. As a general rule, no change of control in the Contractor should be permitted during the construction phase (other than possibly within the consortium itself) and changes of control during the operational phase (other than within the consortium) should be permitted only with the consent of the Contracting Authority (such consent not to be unreasonably withheld or delayed).

Dispute Resolution

- 15.9 The agreed method of resolving disputes should involve negotiation in the first instance followed either by independent expert determination or conciliation. If either of these approaches does not prove successful, then the Contracting Authority and the Contractor can refer the matter to litigation or arbitration.

Residual Value Risk

- 15.10 This issue will be of limited relevance in the roads, water and waste sectors where the project assets are likely to revert to the Contracting Authority at the end of the term. Value for money considerations will determine whether residual value risk (the risk that the project assets will be worth anything at the end of the contract term) should be transferred to the Contractor. A transfer of this risk will generally only be appropriate where the project assets have an alternative use at the end of the contract term.

Early Termination

- 15.11 The Project Agreement should clearly set out the circumstances in which the Public Private Partnership project can be terminated prior to its natural expiry, along with the amount of compensation payable in these circumstances.

Step In Rights

- 15.12 The Contracting Authority should be entitled to step in to the shoes of the Contracting Authority and take over service delivery where there is a serious health or safety risk or where step in is necessary to enable it to discharge a statutory duty.
- 15.13 Funders should be entitled to exercise step in rights in order to allow a failing project to be rescued. However, where project debt is guaranteed by a well capitalised parent company of one of the shareholders in the Contractor, there may be no need for such step in rights.

Compensation on Termination

- 15.14 The level of compensation payable by a Contracting Authority under a Design, Build, Operate and Finance or concession contract as the result of an early termination of the Project Agreement will vary depending on the nature of the event giving rise to early termination. Generally in the event of Contracting Authority default or voluntary termination by the Contracting Authority, the compensation payable to the Contractor will usually involve amounts similar to those recoverable through the courts for breach of contract. These should cover the cost of the original investment made by the Contractor and forecast profit. In the event of Contractor default, the compensation payable to the Contractor will need careful consideration in the light of market developments.

Contractual Protections

- 15.15 In a Public Private Partnership project the Contracting Authority should generally not expect to receive the extensive comfort typically obtained in traditional procurement contracts in relation to the performance of the Contractor. Where the shareholders in the Contractor have demonstrated a strong financial commitment and a robust security package is agreed with funders, then the receipt of collateral warranties from the main subcontractors and indemnities from the Contractor within the terms of the Project Agreement ought generally to suffice.

Public Sector Finance

- 15.16 Where a Public Private Partnership project does not involve private sector finance, then there will be no need for funder step in rights nor any need to postpone the rights of the Contracting Authority to proceed against subcontractors under any collateral warranties provided in the event of a default. Compensation payable on termination will also differ where no private sector finance is involved.

Appendices

A. Public Private Partnership Guidance Notes

Public Private Partnership Guidance Notes

The Public Private Partnerships Policy Framework comprises a series of fifteen individual Guidance Notes, the titles of which are as follows:

- *Introduction to Public Private Partnerships*
- *Financial Context*
- *Legal Context*
- *Public Private Partnership Assessment*
- *Statutory Process Assessment*
- *Procurement Procedure Selection*
- *Project Management*
- *Stakeholder Consultation*
- *Procurement Management*
- *Output Specifications*
- *Risk Assessment*
- *Payment Mechanisms*
- *Key Contractual Issues*
- *Accounting Treatment*
- *Contract and Performance Management*