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## **4ps Guidance**

### **Protections – Local Authority PFI Procurement and Contracts**



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## Protections - Local Authority PFI Procurement and Contracts

There have been instances recently where service providers involved in local government PFI and PPP schemes have faced uncertainties about their future, with much press coverage of the potential options, and the implications on local authority PFI and PPP schemes in procurement or operation.

Part One of this note reiterates the guidance in the *4ps Procurement Packs* regarding the financial assessment necessary at each stage of the procurement process. Part Two highlights the standard clauses for protecting the long-term deliverability of services, which are contained in HM Treasury *Standardisation of PFI Contracts* (SoPC). Where PFI contracts have followed SoPC drafting (as should be the case in the majority of existing operational schemes), this drafting will be included in PFI contracts as standard.

### Part One – Financial Assessment in Procurement

#### Pre-Qualification

The pre-qualification stage allows a local authority to obtain information that will establish whether potential bidders, or bidding consortia, have the technical capacity and ability, and have the economic and financial standing to deliver the advertised project, and also to enable a Local authority to determine whether there are any grounds pursuant to which a bidder may be rejected under the procurement regulations.

The extent of the information that can be requested from each bidder at the pre-qualification stage is limited by the procurement regulations, which describe the categories of information that it is legitimate to request at this stage, namely information as to economic and financial standing, ability and technical capacity.

The local authority should identify the tests and criteria that will be used to assess the general technical and financial strength of the bidders. A local authority has discretion to decide upon the precise details of how it conducts the pre-qualification evaluation and has the right to set minimum standards of financial and economic standing/technical capacity and ability. 4ps recommends that local authorities seek legal advice on developing the pre-qualification evaluation framework.

Financial and economic standing is typically assessed by looking at the solvency and financial strength of the bidder or bidding consortia: through analysis of financial accounts, other information requested as part of the pre-qualification questionnaire, textline search information, and an assessment of the bidders credit rating. Local authorities should also assess the fund-raising capability of the members of the bidding consortium and for the bidder as a whole. If internal skills and expertise are not available in-house to undertake this work, local authorities will need to appoint external financial advisors with the skills and expertise to undertake the pre-qualification evaluation.

It is important that a detailed report is prepared from the pre-qualification evaluation, for agreement of the list of the pre-qualified bidders with the project board, and importantly the chief financial officer.

To maintain the integrity of the process, once these pre-qualification tests have been passed they should generally not be revisited. The local authority should not need to re-evaluate competence unless new information emerges which gives reason to doubt the original assessment (for example, the financial position of the bidder changes subsequent to the original evaluation).

#### Short-Listing

The short-listing stage, which typically involves the use of an *Invitation to Submit Outline Proposals* and/or interviews with pre-qualified bidders, provides a further opportunity for a local authority to ask specific questions regarding the bidders financial and commercial proposals, albeit at an 'outline' level.

Again, it is important that a detailed assessment is made of the outline proposals or points raised at interview; by financial advisors with the skills and expertise to critically assess the proposals put forward by the bidder, or bidding consortia. Any concerns with the bidders' financial or commercial proposals at the short-listing stage must be discussed with project board and chief financial officer.

The short-listing stage also provides the opportunity for the local authority to seek assurance from bidders, or bidding consortia, that they are prepared to follow SoPC, along with any agreed service specific derogations, such as those set out in HM Treasury approved **4ps Procurement Packs**.

## ITN Bids and BaFO Evaluation

The Invitation to Negotiate (ITN) *Instructions and Guidance to Bidders* will set out the service delivery and technical, financial and commercial, and legal and contractual information required from each bidder as part of the bidding process. In preparing the Instructions, it is important that local authorities ensure that financial advisors with the appropriate skills and expertise are used in the preparation of the Instructions to ensure that the relevant information is sought, and that the Instructions are clear as to exactly what information is needed.

For PFI and PPP schemes, bids are typically evaluated on the basis of the most economically advantageous bid, having regard to a range of criteria set out in the Instructions. The local authority will usually allocate a maximum score for each area that reflects the relative importance attributed by the local authority to that area. The financial and commercial evaluation will normally award scores to reflect the extent to which bids meet the local authority's expectations in the following areas:

- Overall costs, affordability and value for money of the bid
- The financial and economic standing of the bidding consortia
- Financial robustness of the bid
- Deliverability of the funding package

It is important that financial advisors with the skills and experience to critically assess and evaluate the financial and commercial proposals from bidders at the ITN stage, including:

- The financial robustness of the organisations involved in the bidding consortia
- The strength of the funding proposals
- The robustness of the assumptions used in the bidder's financial model, including the credibility of the financial assumptions used, the completeness, quality, and integrity of financial information provided, the level of cash throughout the contract period, the level of distributable reserves throughout the contract period, interest cover ratios, and debt service ratios.
- The level of commitment of funders to the funding package proposed; any pre-conditions in the funding arrangements should be assessed
- The proposed financing structures, including an assessment of the proposed contract delivery vehicle, the debt/equity split, the terms and conditions of financing and degree of conditionality attached, the terms and conditions relating to any guarantees and other security required to realise financing, the level of third party income assumed, and the project/equity rates of return.

To enable these conditions to be met, the local authority should, as part of the response to the ITN (or BaFO), seek from bidders preliminary term sheets for the facilities required as part of the financing plan. The deliverability of the financing plan should be an explicit part of the criteria for evaluating bidders proposals, and a matter on which the local authority should seek the advice of their financial advisors in order to test the proposals received from the bidders.

The aim of the financial and commercial evaluation at the ITN stage is to ensure that the local authority only enters into a contract with a financially robust and secure bidder or bidding consortia.

Any issues not adequately addressed to the satisfaction of the financial advisors and chief financial officer at the ITN bid stage should be addressed through clarification and negotiation with the bidders, or if necessary subsequently through a Best and Final Offer (BaFO) stage.

The legal and contractual evaluation at the ITN stage will award scores to reflect the extent to which Bids meet the local authority's expectations, and the local authority is unlikely to expect significant qualifications to the model contract as part of a standard bid.

If bidders have fundamental concerns in relation to the model contract, which would significantly affect their proposed pricing, they should be requested to identify these during the bid preparation period. The model contract should have followed SoPC in relation to termination and the consequences of termination (i.e. the basis of assessment of compensation for contract default by either party or due to Force Majeure events).

## Selection of Preferred Bidder

As set out in 4ps Procurement Packs, an important element of the decision to select a preferred bidder is that there must be confirmed access to finance. A bid cannot be credible without satisfactory assurances of the adequacy of funding. Prior to the selection of a preferred bidder the local authority should seek assurances from the funding institutions behind the proposed preferred bidder that they would be willing to finance the proposed project. As part of the local authority's assessment and evaluation of bids, as much information as possible should be gleaned as to the 'quality' of the funding institutions, the financing plan and the preliminary term sheet for the financing facilities to deliver that plan, the security they are likely to seek, their experience of financing PFI/PPP projects, and the proposed method of funding.

Before the appointment of a preferred bidder, the local authority should require confirmation from the debt providers to the bidder the following:

- That the debt providers have reviewed the results of the financial model runs reflecting the results of the commercial proposals agreed between the local authority and the bidder as a basis of the bidder's selection as preferred bidder, and are satisfied, subject only to final credit approval, that those results are capable of supporting the debt facilities envisaged by the project's financing plan.
- That all key aspects of the debt providers' due diligence process capable of affecting their willingness to enter into the financing have been completed to the debt providers' satisfaction. It will be necessary to identify which aspects of the due diligence process have this degree of significance. To sign-off certain issues, debt providers may require to engage specialist consultants. In deciding how far the due diligence process should have been completed before a preferred bidder is selected, the local authority will need to pay attention to the cost of the due diligence process.
- That the debt providers have reviewed and signed off the model contract, and/or have put forward proposed changes as part of the variant bid process (it is unlikely that any departures from SoPC on termination or the consequences of early termination will be acceptable unless HM Treasury has previously agreed service specific derogation).
- That debt providers have been asked to confirm that, subject to any outstanding aspects of their due diligence programme, they have received 'in principle' approval from their credit committees or other internal sanctioning authorities to enter into the financing on the basis contemplated by the financing plan.
- That a timetable to financial close has been submitted, and agreed with the debt providers. Confirmation should also be sought from the debt providers regarding the extent of their due diligence programme still remaining to be completed.

An important part of the above is that the likely preferred bidder accepts the key contractual terms that form the basis of the agreement between the parties and that the bidder and its lenders sign a commitment letter in the form recommended by SoPC (see section 33) committing to contractual terms or including an exhaustive list of any amendments it is seeking. It is also important that the Local Authority's assessment and evaluation of the Bids is robust to ensure that:

- The financing packages proposed by the likely preferred bidder are deliverable
- The bidder has involved the debt and equity providers in a review of the contractual terms and proposed risk allocations, and they have accepted those contractual terms
- The debt providers have undertaken preliminary due diligence of the contractual documentation and that this is evidenced in the Bid (or BaFO) submitted by the likely preferred bidder.

For clarification, the local authority should not require all debt providers' due diligence checks to have been completed prior to the selection of a Preferred Bidder. In most cases, it will be more cost effective if parts of the due diligence work is carried out after the selection of preferred bidder. Bidders are understandably reluctant to commit to the expense of full debt providers' due diligence until they enjoy the security of preferred bidder status, and the local authority should not expose bidders to unnecessary expense before this point.

## Contract Signature

Management of the period between the appointment of a preferred bidder and financial close is critical to the success of the procurement. Key to its success is the development of a proper, effective partnership between the local authority and the preferred bidder, whereby there is a mutual interest in achieving financial close, while still accommodating each party's requirements.

An important aspect of this stage in the procurement process for the local authority is that it must not depart from the positions agreed at the selection of the preferred bidder, and importantly that that contractual positions on termination and the consequences of termination do not depart from the drafting set out in SoPC, unless a specific derogation is sought from the service specific position with HM Treasury.

Bidders are customarily required in their submissions to notify the local authority of changes in their technical or financial standing post pre-qualification. Rather than rely solely on this obligation, the local authority may, as an additional due diligence measure, seek specific confirmation from the bidder, or bidding consortia, and otherwise verify that there have been no material changes affecting the bidder's technical and financial standing in the period since pre-qualification.

## Part Two – Standard Protections in Construction and Operation

### Risk allocation in PFI

The fundamental premise of PFI is that risk should lie with the party best able to manage it. Therefore, since the private sector service provider is employed to design, build and operate a facility, or series of facilities, typically for a 25 to 30 year period, the majority of risks including design, construction, operational services and cost/time overruns are borne by the service provider. The special purpose vehicle (SPV) or service provider in turn passes down most of the risks it has accepted in the contract through its supply chain down to its respective subcontractors, retaining some risks within the SPV.

Accordingly, the risk that the facilities cannot be delivered, or that the operational services cannot be provided from the contractually agreed date, lie with the SPV and its supply chain. In practical terms this means local authorities are entitled to receive the completed facilities and the operational services on the due dates, and do not pay any monies out to the service provider until the facilities have been delivered and the services (which are the essence of a PFI contract) start to come on stream. SoPC contains standard clauses which provide the local authority with protection in circumstances where service providers default on their obligations under the contract. In some circumstances, project specifics might also require additional protections for the local authority, such as liquidated damages.

In these circumstances, the service provider will need to look to the party that agreed to manage the risk in question. For example, construction cost overruns or late completion will be risks that lie with the construction subcontractor.

In the past, however, where concerns have arisen in relation to certain PFI service providers a commercial solution has generally been found which has not involved the local authority in exercising any contractual remedies. The banks, equity providers and other partners to the PFI contract will all have a common interest in seeking to ensure the contract continues, especially where the contract (as will be the case in all local authority PFI contracts) is at a relatively early stage (either in the build period or early on in the operational period).

There are several options that need to be explored before the decision to terminate a contract is taken. Termination of a PFI contract should always be a last resort. SoPC contains the following provisions that seek to ensure continuity of the contract:

#### 1. Replacement Service Provider

Where an existing service provider is in default, finding a replacement service provider may well be the best option for the bank since this would enable the new service provider to finish the build stage, commence the operational stage, and start the flow of funds from the local authority, thus enabling the bank's debt to be repaid. This may also be a preferable option for the local authority since it will then receive its facilities and operational services without undue disruption. The local authority, in consultation with its legal advisors, needs to:

- Approve the replacement service provider put forward by the bank;
- Ensure replacement warranties were delivered to the local authority by the replacement service provider;
- Agree any consequential amendments to the contract; and
- Approve the novation of the operating agreement to the replacement service provider.

By virtue of the standard 'step-in' rights contained in SoPC and exercisable by the bank under the Direct Agreement, the bank and the new service provider can put the project back on track. The local authority need not incur any additional expenditure or undue delay. The 4ps have recently produced a project information briefing based on precisely this scenario

involving a PFI schools scheme and joint service centre procured by Bolton MBC. See the 4ps/Bolton MBC Project Information Briefing on Castle Hill Primary School and Joint Service Centre available from the 4ps web site [www.4ps.gov.uk](http://www.4ps.gov.uk)

## 2. Step-In Rights

As part of a normal PFI transaction the bank or senior funder will enter into a direct agreement with the local authority and the service provider. Broadly speaking, funders' direct agreements enable the funders to procure the continued provision of services to the local authority while at the same time looking for a permanent replacement service provider.

SoPC specifically highlights that the funders direct agreement is a particular benefit to the public sector since it gives banks an opportunity to 'revive' a project and avoid the invariable disruption and consequences of a termination. Specifically, the agreement deals with:

- When and how senior lenders are permitted to step-in (obtain rights under the contract);
- The extent to which senior lenders are obliged to assume any liabilities that have been or are being incurred by the service provider; and
- The extent of their opportunity to rectify a breach by the service provider.

The local authority is also protected under the terms of the funders' direct agreement, since the bank is required to notify the local authority that the service provider may not be in a position to honour its obligations under the contract. In these circumstances the local authority must give the bank an opportunity to step in and rectify the breach. SoPC also stipulates that banks should pay any amounts owed by the service provider to the local authority at the time of step-in, before the bank is allowed to take any action.

Upon step-in the bank is, amongst other things, required to procure the continued performance of the provisions of the PFI contract. The local authority still retains a right to terminate the contract if during the period which the bank has stepped-in a termination right arises under the contract. Step-in comes to an end if the bank steps-out, or if it finds a new service provider willing to take on the project. If the project is financially viable, as most local authority PFI projects should be, there are grounds for optimism that a new service provider will take on the business opportunity. Some consequential amendment of the PFI contract may be needed at this point.

However, if no new service provider can be found, and the bank steps out, it is likely that termination will occur. On such termination for contractor default the local authority has the right to elect to re-tender the PFI contract and in such circumstances the amount received, after deducting the authority's costs, is paid over to the Contractor and its creditors by way of compensation. Theoretically, if the market has no interest in the contract, no compensation would be payable to the Contractor or their funders. Only in circumstances where there is no 'liquid market' (a term which is narrowly defined in *SoPC*) or where the authority decides for policy reasons not to retender the contract, will such compensation be determined and assessed by an independent expert in accordance with the provisions of the contract. The flow chart below illustrates how these provisions work in practice.

## PFI versus Traditional Procurement

The PFI position in relation to service provider default risk offers considerable protections for the public sector. Under a traditional procurement, the local authority retains the majority of the project risks since projects are designed in-house; and the local authority directly employs construction and facilities management service providers. Any time or cost overruns must be managed and borne by the local authority. In the event that a service provider were to go into receivership, the local authority would be required to devote resources to finding and appointing a new service provider, as well as any appropriate subcontractors. This may cause difficulties in relation to ensuring the standard and quality of work remained consistent and compliant with all necessary regulations, not to mention how to deal with any resultant programme delays and necessary interim measures.

In PFI, such risks are transferred to a private sector service provider and the local authority has recourse against the service provider if adequate action is not taken and the service provider's obligations remain unfulfilled.

# Process for determining Compensation for Contractor Default

