



MOD Private Finance Unit Guidance Note MOD Standard Project Agreement

Version 2
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Issue No	Details Of Amendments Made	Amended By	Date
1	First formal issue.	MOD PFU	8 Aug 06
1	Re-issue of original version in new format with no amendments.	MOD PFU	Sep 09
2	Revised issue incorporating some additional guidance notes.	MOD PFU	21 Oct 11

MOD PFI Project Agreement Guidance Notes

Constraints

1. The purpose of these guidance notes is to explain the background to MOD PFI PAV2, the reasons for some of its provisions, and to provide guidance on how to use the provisions set out in MOD PFI PAV2, but these guidance notes are not a contract document.

Authoritative Guidance

2. The MOD Private Finance Initiative (PFI) Project Agreement Version 1.0 (MOD PFI PAV1) was approved by HM Treasury (HMT) on 31 July 2006. It was delivered in full consultation with HMT, industry and the advisory community. MOD PFI PAV1, which incorporated MOD's standard position on HMT's drafting and guidance as set out in Standardisation of PFI Contracts version 3 (SoPCv3), superseded MOD's Guidance on the Standardisation of PFI Contracts version 2 issued in 2003.
3. MOD PAV2 has subsequently been developed, incorporating Addendums 1, 2 and 3 to MOD PAV1, reflecting revisions to HMT guidance and MOD's experience of using MOD PAV1 as the base document for PFI procurements since 2006.

Objectives of MOD PFI PAV2

4. In common with SoPCv4, the MOD PFI PAV2 shares three main objectives:
 - to promote a common understanding of the main risks encountered in a MOD PFI project;
 - to allow a consistency of approach and pricing across the range of MOD PFI projects;
 - to reduce the time and costs of negotiation for both MOD and industry.
5. While MOD PFI PAV1 was designed to cover the 60-70% of any project agreement that should be common to all MOD PFI projects, MOD PAV2 goes further by providing templates for the Output Based Specification and the Performance and Payment Mechanism. The remaining areas to be developed on a project by project basis, will include:
 - Contractor's Asset Provision and Service Provision Proposals and programmes;
 - performance monitoring regimes;

- provisions to cover specific land issues, and, if relevant, development of any leases;
- completion of the blank Schedules,

as well as any other area that is genuinely peculiar to a specific project or group of projects. Completing these areas in MOD PFI PAv2 should not extend to acquisition teams seeking to change the risk balance in the contract, unless a derogation is requested on project-specific grounds from the MOD Private Finance Unit (PFU).

Flexibility

6. MOD PFI PAv2 is designed to be as flexible as possible. Some text has been colour shaded to enable customisation as follows:
 - **green** shading – for projects involving construction. Delete these provisions for projects which do not involve construction operations.
 - **blue** shading – for projects involving specialised equipment provision. Delete these provisions for projects which do not involve specialised equipment provision.
 - **yellow** shading – retain or delete text (including optional clauses) to reflect the specifics of the project.
 - **tan** shading – amend stated time periods or enter project specific details.
 - **grey** shading – for projects involving training. Delete these provisions for projects which do not involve training.
7. In order to achieve commonality across MOD's wide range of PFI projects, some terminology which is appropriate to a specific type of project has been replaced by more generic wording. For example, references to "works" or "construction" have been replaced by the term "**Asset Provision**". The use of this term is not intended to change the overriding concept of a PFI project that what the MOD procures is output-based services, not assets. In addition, and in order to provide flexibility, no pre-defined project phases have been set, such as a construction phase, followed by interim services, followed by full service provision. Instead the concept of "**Service Levels**" has been introduced. Service Levels are groups of services to be provided at or using the assets specified at the times stated, and full details (together with an example of how Service Levels may be set up on a project) are given in the Core Table in Schedule 1.

Clarity and Simplicity

8. Although it is a complex legal document, where possible expressions in "legal Latin" such as "mutatis mutandis" or other legalese such as "for

the avoidance of doubt" have not been used in MOD PFI PAV2 (although where these expressions are SoPCv4 mandated language they have had to be retained). This makes the contract easier for those involved in the procurement and operation of the project, who may have no legal background, to understand and manage the project throughout its life. In addition, MOD PFI PAV2 has been structured in a non-linear manner, grouping provisions which deal with related subjects in "Parts", which may be compulsory "**Core Clauses**" or, if shaded in line with the general colour-coding scheme, "**Optional Clauses**" and can be deleted if inappropriate to a particular project.

9. Capitalised terms in these guidance notes refer to the definitions in the MOD PFI PAV2. Definitions which apply only to one Optional Part are included in that Part. This allows easy removal of redundant definitions if a Part is removed but should be moved to Clause 2 (Definitions) if they are to be retained in the draft Contract to be issued at Invitation to Tender (ITT)/Invitation to Negotiate (ITN). These Parts are designed to assist both acquisition teams and bidders in easily identifying contract provisions dealing with issues which may arise during their project, both before and after financial close.

Project Management

10. To reflect the key driver of clarity and simplicity, project management is at the heart of the contract. By their nature, PFIs are long-term, relationship driven projects and MOD PFI PAV2 supports these principles within the constraints imposed by SoPCv4. To this end, references to the MOD taking action have, where possible, been replaced by references to the Authority's Representative, with a general obligation on MOD to procure that the Authority's Representative acts in accordance with the contract.

Derogations from MOD PFI PAV2

11. The usage of and derogations from SoPCv4 in MOD PFI PAV2 have been approved by HMT. All proposed amendments to the Core Clauses must be submitted to the MOD PFU for approval. If an Optional Clause is relevant in the context of a particular project it must be used unamended unless the amendment is approved by the MOD PFU.
12. Once MOD PFI PAV2 has been issued as part of an ITT/ITN, acquisition teams should not look to vary the draft contract during the bid process except where it allows customisation or where the ITT/ITN expressly invites bidders to submit variant positions. Any proposal to invite variant bids or any amendments proposed to the Core Clauses, or any Optional Clauses which are used, requires the prior approval of the MOD PFU. Any proposed project specific derogations must be submitted through the MOD PFU in the first instance with those that relate to SOPC, if approved by the MOD PFU, submitted to HMT. The MOD PFU will ensure that MOD

has a consistent approach, enable the appropriateness of the MOD PFI PAv2 provisions to be maintained, and address any common concerns.

Further Information

13. This guidance should also be read in conjunction with the guidance contained in SoPCv4 and the MOD PFU's general guidance to acquisition teams on the PFI process for MOD projects.

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MOD PFI PA EXPLANATORY NOTES

The concepts explained in this document, and their legal effects, are necessarily summarised and simplified in order to make the guidance more comprehensible to readers with little prior experience of a PFI procurement.

STARTING OUT

Specified Services and Service Levels

Once acquisition teams have created their list of output-based services ("**Services**"), it may be a useful first step for the acquisition team to set up the Core Table in Schedule 1 to group their Services into Service Levels. "**Service Levels**" are one or more groups of Specified Services to be provided using one or more Specified Assets and it is the grouping of Specified Services into Service Levels that determines the phasing of the project. If a Service does not form part of a Service Level, such as the provision of a helpdesk facility, it will be a Service but not a "**Specified Service**", which are the sub-set of the Services which go to make up a Service Level. In determining whether a given Service should be a Specified Service and therefore part of a Service Level, acquisition teams should generally include all

Services which have corresponding Deductions as Specified Services and attach them to a Service Level. If acquisition teams need assistance on this aspect, the MOD PFU can provide guidance.

The advantage of the Core Table is that it allows acquisition teams complete flexibility in the phasing of the Specified Services for their project, without any need to change the drafting in the body of the MOD PFI PAV2.

In a project where all Specified Services are to start at the same time at or using each Specified Asset, but where there are multiple Specified Assets, each of which will commence service on a rolling basis, the Core Table could look like this:

KEY:

- SAR = Service Available Requirements
- SPR = Service Provision Requirements
- SPP = Service Provision Proposals
- PSDC = Planned Services Commencement Date
- LSD = Long Stop Date

A	B	C	D	E	F
Services	SAR's	Parts of SPR	Parts of SPP	PSDC	LSD
All. At Specified Asset X only	All	All	All	1 Jan 2012	1 Jun 2012
All. At Specified Assets X and Y only	All	All	All	1 Mar 2012	1 Sep 2012
All. At Specified Assets X Y and Z	All	All	All	1 Jun 2012	1 Dec 2012

Alternatively, a more complex phasing structure where each Specified Asset has mobilisation Services, interim Services and full Services, each of which commence sequentially for that Service Level but run in parallel with Specified Services for other Service Levels might have the following Core Table:

A	B	C	D	E	F
Services	SAR's	Parts of SPR	Parts of SPP	PSDC	LSD

Mobilise at Specified Asset X only	Schedule 7 Part 2 Paras 1 to 10 Asset X	Schedule 1 Part 4 Paras 1 to 10 Asset X	Schedule 2 Part 2 Paras 1 to 10 Asset X	1 Jan 2012	1 Jun 2012
Interim services at Specified Asset X and mobilise at Specified Asset Y	Schedule 7 Part 2 Paras 11 to 20 Asset X, Paras 1 to 10 Asset Y	Schedule 1 Part 4 Paras 11 to 20 Asset X, Paras 1 to 10 Asset Y	Schedule 2 Part 2 Paras 11 to 20 Asset X, Paras 1 to 10 Asset Y	1 Mar 2012	1 Sep 2012
Full services at Specified Asset X, interim services at Specified Asset Y and mobilise at Specified Asset Z	Schedule 7 Part 2 Paras 21 to 50 Asset X, Paras 11 to 20 Asset Y, Paras 1 to 10 Asset Z	Schedule 1 Part 4 Paras 21 to 50 Asset X, Paras 11 to 20 Asset Y, Paras 1 to 10 Asset Z	Schedule 2 Part 2 Paras 21 to 50 Asset X, Paras 11 to 20 Asset Y, Paras 1 to 10 Asset Z	1 Jun 2012	1 Dec 2012
Full services at Specified Assets X, Y and Z	Schedule 7 Part 2 Paras 21 to 50 Assets X, Y and Z	Schedule 1 Part 4 Paras 21 to 50 Assets X, Y and Z	Schedule 2 Part 2 Paras 21 to 50 Assets X, Y and Z	1 Sep 2012	1 Mar 2013

And, the Core Table for an incremental build up of Specified Services for a simulator training project might look like this:

A	B	C	D	E	F
Services	SAR's	Parts of SPR	Parts of SPP	PSCD	LSD
Subject 1 at building X only	Schedule 7 Part 2 Paras 1 to 10 Asset X	Schedule 1 Part 4 Paras 1 to 10 Asset X	Schedule 2 Part 2 Paras 1 to 10 Asset X	1 Jan 2012	1 Jun 2012
Subjects 1 and 2 at building X and subject 1 at building Y	Schedule 7 Part 2 Paras 1 to 20 Asset X, Paras 1 to 10 Asset Y	Schedule 1 Part 4 Paras 1 to 20 Asset X, Paras 1 to 10 Asset Y	Schedule 2 Part 2 Paras 1 to 20 Asset X, Paras 1 to 10 Asset Y	1 Mar 2012	1 Sep 2012

Subjects 1, 2 and 3 at building X, subjects 1 and 2 at building Y and subject 1 at building Z	Schedule 7 Part 2 Paras 1 to 50 Asset X, Paras 1 to 20 Asset Y, Paras 1 to 10 Asset Z	Schedule 1 Part 4 Paras 1 to 50 Asset X, Paras 1 to 20 Asset Y, Paras 1 to 10 Asset Z	Schedule 2 Part 2 Paras 1 to 50 Asset X, Paras 1 to 20 Asset Y, Paras 1 to 10 Asset Z	1 Jun 2012	1 Dec 2022
Subjects 1, 2 and 3 at buildings X, Y and Z	Schedule 7 Part 2 Paras 1 to 50 Assets X, Y and Z	Schedule 1 Part 4 Paras 1 to 50 Assets X, Y and Z	Schedule 2 Part 2 Paras 1 to 50 Assets X, Y and Z	1 Sep 2012	1 Mar 2013

Although these examples of the Core Table keep the same paragraph numbering across the Services Availability Requirements, Service Provision Requirements and Service Provision Proposals for each Service Level, this may not be required. For example, one paragraph in the Services Availability Requirements could correspond to six paragraphs in the Service Provision Requirements and twenty paragraphs in the Service Provision Proposals, in which case the cross referencing can be customised to show this.

Given the need to cross reference paragraphs of the Services Availability Requirements, Service Provision Requirements and Service Provision Proposals in the Core Table, acquisition teams should draft the Services Availability Requirements and Service Provision Requirements so that this cross referencing is possible. When responding to the Invitations to Tender (ITT)/Invitation to Negotiate (ITN), bidders should be asked to follow this structure so that the appropriate cross references from their Service Provision Proposals can be inserted into the Core Table.

The Core Table is (as its name suggests) one of the most important parts of the Contract. When completed, it governs not only how the Specified Services will be grouped into phases, but also the planned commencement and long stop dates for each phase. Of course, if there are no phases for a particular project, acquisition teams can use only one row in the Core Table as follows:

A	B	C	D	E	F
Services	SAR's	Parts of SPR	Parts of SPP	PSDC	LSD
All	All	All	All	1 Jan 2012	1 Jun 2012

Specified Assets

Having set up the Core Table, it becomes easier for acquisition teams to see which "**Specified Assets**" will be used for each

Service Level. Of course, the exact nature of the Specified Assets will not be known until bidders return their bids, but generic references can be included in the list of Specified Assets at ITT/ITN stage or it can be left blank until a preferred bidder is appointed.

Specified Assets should be listed in Part 2 of Schedule 1 and are a sub-set of Assets. "**Assets**" are very loosely defined in the MOD PFI PAV2 as "all assets and rights to enable the MOD or a successor contractor to own, operate and maintain the project". Because this definition includes both tangible and intangible assets, most of the Contractor's obligations relating to assets reference the Specified Assets rather than the Assets. It is therefore important that acquisition teams cover the significant project Assets in their list of Specified Assets. One way to determine whether an Asset should be included in the list of Specified Assets is if the answer to any of the questions below is "yes":

1. should the Contractor be obliged to maintain this Asset?
2. does MOD want to inspect or survey the condition of this Asset?
3. does this Asset need to be repaired or reinstated if it is damaged?
4. is this Asset critical to the provision of a Service Level?
5. should Unavailability Deductions be imposed if this Asset is unavailable?

Some Assets will almost always be Specified Assets, such as land and buildings, major pieces of equipment, management information or communications systems etc. However, Assets such as furniture may not need to be Specified Assets. If acquisition teams need assistance in determining whether an Asset should be included as a Specified Asset, the PFU can provide guidance.

Government Furnished Assets and/or Existing Assets should be included in the list of Specified Assets if they meet the tests above.

Service Provision Requirements

The Service Provision Requirements cover the MOD's requirements (output specification) for the Specified Services.

In complex projects, there could be multiple parts to the Service Provision Requirements covering areas such as: estates and buildings, grounds and gardens, utilities management, equipment, and communications and management information systems. Each of these can then be broken down, so that a building specification could include minimum and maximum room temperatures and heating controls, lighting requirements, acoustics, ventilation, power outlets, water, installations, communications capacity, finishes, fixtures.

If Government Furnished Assets and/or Existing Assets (including buildings or equipment) form part of the Specified Assets, consideration should also be given to how these are to be refurbished or maintained. See the guidance on Part 8 (Government Furnished Assets, Existing Assets and Existing Contracts) for further details.

**THE CONTRACT
INITIAL
CUSTOMISATION**

Having prepared preliminary drafts of the above documents, acquisition teams should be ready to begin customising the body of MOD PFI PAV2 for their project.

The first step is to delete the blue, green and grey shaded Parts and text within Parts if the project does not involve the provision of major equipment, accommodation or training respectively. Having done this, the yellow shaded text needs to be customised or deleted if it is not relevant in the context of the project, and the tan shaded text completed. The guidance below explains the various provisions of MOD PFI PAV2 to assist with this customisation.

Before the Contract is issued as part of the ITT/ITN, the words "(Core Clauses)" or "(Optional Clauses)" in the heading of each part of MOD PFI PAV2 should be removed as these are there to give guidance to acquisition teams only.

APPOINTMENT 1

The standard position is that the Contractor is not given the exclusive right to perform the Services. If exclusivity is required on value for money grounds, acquisition teams should consider carefully the scope of the exclusivity (both geographically and the extent of the Services to be covered), and can seek further guidance on this issue from the MOD's Central Legal Services – Commercial Law .

PART 1 – PRELIMINARY PROVISIONS

DEFINITIONS 2 AND INTERPRETATION

Definitions 2.1 The main definitions used in MOD PFI PAV2 are given in this Clause. Other definitions which apply only to one Optional Part are given at the head of the relevant Part, allowing easy removal of redundant definitions if an Optional Part is not used for a particular project. If the Optional Part is to be retained in the draft Contract to be issued at ITT/ITN, then these definitions should be moved to Clause 2 (Definitions).

Within these guidance notes, defined terms are discussed in relation to the Clauses in which they are predominately used.

Interpretation 2.2.1

**SoPCv4
Para 1.7.2 (h)** The effect of this Clause is that where a provision is defined as "including" certain things, the definition is not exhaustive and anything which falls within the ordinary meaning of the provision within the context of MOD PFI PAV2 will be included. For example, the definition of "Assets" contains a list of nine categories of asset that may fall within the definition, but the important parts of the definition are the first and last paragraphs, namely "all assets and rights to enable the Authority or a successor contractor to own, operate and maintain the project in accordance with this Contract...excluding any assets and rights in respect of which the Authority is full legal and beneficial owner". If a particular asset does not fall into one of the nine categories, but is nevertheless necessary to enable MOD or a successor contractor to operate the project and is not already owned by MOD, it will be an Asset for the purposes of MOD PFI PAV2.

**SoPCv4
Para 1.7.2 (c) 2.2.3** There are two types of indexation within the MOD PFI PAV2. The Payment Mechanism in Schedule 13 may have its own specific indices (which should be set by acquisition teams on a value for money basis, and not be left to bidders). This Clause relates to indexation of other amounts stated in the body of MOD PFI PAV2, such as the values of a Minor Change or Major Change, which are indexed in line with RPIX.

When completing the (tan shaded) text for the pricing reference date, acquisition teams should normally insert the date of the Contractor's bid.

No Better and No Worse 2.3 MOD PFI PAV2 contains many references to the Contractor being left in a "**no better and no worse position**", for example in the Change procedure in Part 18 (Changes and Change in Law).

The effect of the definition in Clause 2.3 is that to ascertain "no better and no worse", the Parties should have regard to:

1. the financial aspects (Clause (b)(i)) so that the

Contractor's internal rate of return (see below) and the key ratios shown in the Base Case are preserved; and

2. the Contractor's ability to perform its obligations under MOD PFI PAV2 (Clause (b)(ii)).

MOD PFI PAV2 refers to the state of both of these immediately before the relevant event (following which the Contractor is to be left in a no better and no worse position). The intention of references to "no better and no worse" is that the Contractor's position should be preserved in all respects irrespective of the relevant event. To achieve this, adjustments may need to be made to parts of MOD PFI PAV2 or direct payments may need to be made to the Contractor, e.g. by variation of the Unitary Charge, as stated in the relevant Clause.

For example, on a Change, the Contractor is allowed to price so that it will be left in a no better and no worse position. This might include not only claiming the costs of the Change by way of an increase to the Unitary Charge or as a lump sum capital payment from MOD, but also claiming a risk premium if the Change increases the Contractor's risk that it will be liable for Deductions or breach MOD PFI PAV2 in any other way.

"Internal rate of return" refers in this case to the post tax internal rate of return calculated in respect of actual outturn cash flows associated with the provision of funding, properly incurred in connection with the project, by its sponsors from the Contract Commencement Date up to the relevant date for the period for which return is being measured, and is explained in HMT's *"Guidance Note on the Use of IRRs in PFI Contracts"*. Briefly, it is a measure of the rate of return the private sector sponsors can expect to earn on their investment in the project either from subscription to equity in the project company or by provision of shareholder loans to the project company. Acquisition teams should seek guidance from their financial advisers on completing the tan shaded text in the square brackets.

PRECEDENCE OF DOCUMENTATION 3

- 3.1 This is the order of priority in which the Contract documents should be read in order to resolve any ambiguities or inconsistencies between the documents.
- 3.2 This Clause is intended to ensure that action is taken as soon as possible under the Project Management procedures (Schedule 19) to resolve any ambiguities or inconsistencies in the Contract documents forming part of MOD PFI PAV2. If the Project Management procedures (Schedule 19) cannot resolve the ambiguity or inconsistency, either Party may refer to the Dispute Resolution Procedure (Part 27) if it considers the ambiguity or inconsistency to be material.

Ambiguities and inconsistencies may be easily resolved if two or more documents are discrepant. However, if there is an

ambiguity or inconsistency within any one document or between two or more Schedules (not being the Authority's Requirements or Contractor's Proposals), it may be difficult to decide which interpretation prevails. In these circumstances, the Project Management Group or person appointed to resolve any dispute referred under Part 27 (Dispute Resolution) should have regard to the common law rules on interpretation of contracts, which differ depending on whether there is an ambiguity or inconsistency. If this issue arises during a project, acquisition teams may wish to consult the MOD's Central Legal Services - Commercial Law.

EXCLUSION OF LEGISLATION

4

4.1 The Contracts (Rights of Third Parties) Act 1999 gives third parties, identified either by name or as members of a class, rights to enforce terms of contracts. Because of the number and scope of third parties who may potentially be given rights by this Act, it is not considered appropriate for the Act to be used in conjunction with PFI contracts, including MOD PFI PAV2, and its operation is therefore excluded by this Clause. Those third parties who are given rights to enforce terms of MOD PFI PAV2, such as the Senior Lenders, are given those rights by way of a Direct Agreement (Schedule 18) between themselves and the MOD and the Contractor.

SoPCv4 Para 1.7.2 (b)

4.2

In projects involving construction operations, the Housing Grants, Construction and Regeneration Act 1996 gives the Parties certain rights in respect of statutory adjudication and payment. PFI projects involving construction operations are, however, excluded from this Act by the Construction Contracts (England and Wales) Exclusion Order 1998. This Clause reflects the Order and excludes the Act from operating in relation to MOD PFI PAV2.

Acquisition teams should, however, note that if the project involves construction operations, the Contractor's construction sub-contracts will be governed by the Act. The main area in which this may impact upon MOD PFI PAV2 is in the Dispute Resolution Procedure (Part 27) where, when this is flowed down by the Contractor to its sub-contractors, time periods and other requirements of statutory adjudication will be automatically imposed on the Contractor by the Act. This is why the time periods for the non-statutory adjudication procedure in MOD PFI PAV2 are customisable to fit with the requirements of the statutory adjudication procedure the Contractor must include in its construction sub-contracts by virtue of the Act.

COMMENCEMENT AND DURATION

5

Contract Period

5.1

This Clause defines the Contract Period as starting on the "**Commencement Date**" (the date MOD PFI PAV2 is executed) and ending on the earlier of the "**Expiry Date**" or "**Termination Date**". If MOD PFI PAV2 is not to commence on

SoPCv4 Chapters

2 and 3

the date it is executed, because conditions precedent need to be satisfied, Clause 5.2 (shaded yellow) needs to be included (see para 5.2 below) and the Contract will become effective on the "**Effective Date**".

The duration of the project (the period from the Commencement Date to the Expiry Date) should be decided by the acquisition team, having regard to HMT's Value for Money Guidance, MOD's acquisition guidance and affordability. Paragraphs 2.2.1 to 2.2.4 of SoPCv4 also give guidance on the factors acquisition teams should consider in setting the duration of their project. Acquisition teams may wish to allow variant bids in this respect so that bidders can employ different funding structures requiring varying contract lengths.

The Contract Period should be treated as a whole from the Effective Date to the Expiry Date and not split into phases. These are dealt with by customising the Core Table in Schedule 1 as described above.

There is no definition of a "**Service Period**" because it is assumed that Service Level 1 commences at the start of the Contract Period. If there is to be period in which no Services will be performed whilst the Contractor is performing Asset Provision or otherwise, a Clause will need to be drafted to include a Service Period, using the wording in SoPCv4 paragraph 2(b).

SoPCv4 section 1 footnote 20 and section 2.2.4 footnote 2

5.2

This optional Clause is appropriate if the full Contract is not to commence on the Commencement Date because conditions precedent need to be satisfied. A condition precedent is a condition which must be fulfilled before any binding contract is concluded at all. The expression is also used to describe a condition which does not prevent the existence of a binding contract, but which suspends performance of it until fulfilment of the condition. Failure to fulfil the condition will go to the root of the Contract, such that it can be rescinded (cancelled) by the offended Party. Parts of MOD PFI PAV2 must, however, be made binding as from the Commencement Date, and a suggestion of these Parts is given in Clause 5.2.1.

The Conditions Precedent should be specified in Schedule 3. Where a Condition Precedent is to be satisfied after the Commencement Date, the relevant Party must use reasonable endeavours to ensure it is satisfied as soon as reasonably possible after the Commencement Date, and has an absolute obligation to ensure it is satisfied by the relevant Long Stop Date, otherwise Clause 5.2.5 provides that MOD PFI PAV2 will terminate automatically.

Conditions Precedent may be waived by the Party not responsible for their satisfaction by that Party giving a written waiver in accordance with Clause 155. If a Condition Precedent is waived, it is treated in the same way as if it has been satisfied.

If the Conditions Precedent are satisfied or waived, Clause

In some projects, Collateral Warranties may be required from key Sub-contractors who are not top tier Sub-contractors (i.e. who are not in a direct contractual relationship with the Contractor and caught within the definition of "**Sub-contractor**"). The MOD PFI PAv2 can be amended to include other Sub-contractors in Clause 6.1, but acquisition teams should be aware that asking for further Collateral Warranties can have value for money implications, and should consult the MOD's Central Legal Services – Commercial Law if they are unsure as to whether to extend the persons caught by Clause 6.1.

Compliance with and Changes to Project Documents or Ancillary Documents

6.2 The distinction between Project Documents and Ancillary Documents is that "**Project Documents**" are those documents to which MOD is a party, whereas "**Ancillary Documents**" are other documents required as part of the Contract, to which the MOD is not a party (such as the Contractor's shareholders' agreement).

In accordance with SoPCv4 paragraph 33.1.2, acquisition teams should conduct due diligence¹ over the Project Documents, Ancillary Documents and Financing Agreements before financial close. However, the Contractor is given flexibility to manage its own affairs and therefore the restrictions in Clause 6 (and, in the case of Sub-contracts, Part 19) are MOD's sole involvement in Project Documents and Ancillary Documents.

The Contractor is obliged to comply with both the Project Documents and Ancillary Documents and is restricted by Clause 6.2 from actions which may affect MOD's rights or change the risk MOD has assessed during its due diligence activities.

Changes to the Financing Agreements

SoPCv4 Para 22.3.8. (22.3)

6.3 In common with PFIs generally, there is less control in MOD PFI PAv2 over how the Contractor deals with its "**Financing Agreements**" than there is over how it deals with the Project Documents and Ancillary Documents. If the change to the Financing Agreements amounts to a refinancing, Part 15 (Refinancing) applies. Otherwise, the Contractor is free to deal with the Financing Agreements as it sees fit, subject only to its obligation to provide MOD with a copy of any new, amended or waived Financing Agreement and provided that the change does not materially and adversely affect the ability of the Contractor to perform its obligations. MOD can take comfort from Clause 6.3.2 which provides that its liabilities on termination are unaffected by a change to the Financing Agreements unless MOD's consent has been obtained before the change or the Contractor has made a Permitted Borrowing.

A "**Permitted Borrowing**" is:

- a borrowing made by the Contractor under the Senior

¹ Due diligence is the process of ensuring that the MOD understands how the Contractor is seeking to deliver the Services (both in terms of sub-contractual arrangements and financing) and be comfortable that those arrangements are sufficient to allow the Contractor to deliver the Services....

Financing Agreements;

- an Additional Permitted Borrowing (see below)
- an advance to the Contractor under **any** Committed Standby Facility which is made solely for the purpose of funding any cost overruns, increased expenses, or loss of revenue which the Contractor incurs (provided that such funds are not used in substitution for other sources of committed funding designated for those purposes);
- interest; and
- amounts accrued or payable under the original Senior Financing Agreements.

An "**Additional Permitted Borrowing**" is an amount over the amount of principal to be repaid under the Senior Financing Agreements up to a maximum cap, being the "**Additional Permitted Borrowings Limit**".

The effect of this Clause, and of the definitions of Permitted Borrowing, Additional Permitted Borrowing and Additional Permitted Borrowings Limit, is that the Contractor may freely reschedule and deal with its debt. MOD will know in advance the maximum amount it will need to pay on termination (other than Contractor Default termination) to cover debt owed by the Contractor, because this is fixed by the debt position as at financial close. Further guidance for acquisition teams on conducting due diligence over financing documents prior to financial close is given in Section 33 of SoPCv4 and the PFU can also assist with this aspect.

CONTRACTOR RELATED PARTIES **7**

- 7.1** The defined term "**Contractor Related Parties**" provides a convenient reference to people or organisations who are not the Contractor, but who are involved in the Contractor's provision of the project or for whom the Contractor is expected to take responsibility. This Clause provides that the Contractor is responsible for the failure of a Contractor Related Party as if it had done the act or made the omission itself.

It is common in MOD's PFI projects that the same entities may be both a Contractor Related Party, because they are undertaking work for the Contractor in connection with the project, and also working for MOD under a separate contract on another project. In these circumstances, the entity will be a Contractor Related Party insofar as it is acting in connection with the project, but not otherwise. For example, there is an indemnity from the Contractor to MOD in Clause 119.2 which covers Contractor Related Parties causing damage to MOD's property. If such an entity causes damage whilst it is working in connection with the project, it will be caught by this

indemnity and the Contractor will be liable, but not otherwise.

- 7.2** Under this Clause the Contractor is assumed to have the knowledge that each of the Contractor Related Parties has, or ought reasonably to have had, in relation to the project. However, acquisition teams should note that communications or decisions to be given to the Contractor must be given to the person named in Clause 146.4 and not to any other Contractor Related Party.

**AUTHORITY
RELATED
PARTIES**

8

- 8.1** This is the equivalent of Clause 7.1 in relating to Authority Related Parties. The MOD is responsible for the acts and omissions of its own employees and Service Personnel as well as anyone visiting a Specified Asset at the MOD's invitation, such as another contractor (who is not the Contractor or a Contractor Related Party) and, in the case of Defence Housing projects, Permitted Occupiers.

**APPROVAL BY
THE AUTHORITY**

9

- 9.1** The MOD PFI PAV2 contains a number of provisions requiring MOD's approval or consent to be obtained, and a number of provisions where MOD is entitled to review the Contractor's documents or procedures. The effect of this Clause is that, irrespective of the granting of approval or consent, or the conducting of any review, the Contractor's obligations and MOD's rights are unchanged. The only exception to this is the confirmation of a Change by MOD's Commercial Officer which expressly changes the Contractor's obligations or liabilities under MOD PFI PAV2.

- 9.2** There are a number of occasions when MOD might conduct reviews, make comments or suggest its approval or consent to the Contractor, either to reflect its views on the Contractor's provision of the project or to check the project's interface with MOD's operational requirements. Irrespective of anything MOD says or does, however, the effect of this Clause is that the Contractor's obligations remain unchanged from those set out in MOD PFI PAV2.

**CONTRACTOR'S
WARRANTIES
AND
UNDERTAKINGS**

10

**Contractor
Warranties**

**10.1
and
10.2**

Contractor Warranties are used to express statements of fact which are true at the Commencement Date and Contractor Undertakings are used to express obligations with which the Contractor must comply during the Contract Period. Acquisition teams should consider the extent to which they require these warranties and undertakings to be extended to the Asset Provider and Service Provider and other key Sub-

contractors, or to Holdco and any guarantors of the Sub-contractors, always bearing in mind any value for money implications of such extension.

Change of Ownership

SoPCv4 Chapter 18

10.3 This Clause restricts the way in which the Contractor can deal with its shares, and the shares of its holding company ("**Holdco**") and its Sub-contractors. If the project involves Secret Matters (protectively marked material classified confidential and above), MOD PFI PAV2 is structured so that this Clause applies to sub-contractors of all tiers, and the yellow text at the end of the definition of "**Change of Ownership**" should be included. If there are no Secret Matters it should be deleted. Acquisition teams should, however, always consider whether these provisions fit the security and other requirements of their project in including either too much or too little control.

The MOD PFI PAV2 also contains the concept of a "**Lock in Period**" which is one year after a date referenced to the commencement of a Service Level. It is suggested that this is the final Service Level, but acquisition teams can customise this period having regard to the specifics of their project. During the Lock in Period there is a total freeze on the Contractor, Holdco or Sub-contractors transferring their shares with the exception of shares listed on a stock exchange or shares transferred to the Contractor's Senior Lenders by way of security for the Contractor's loan.

After the Lock in Period, shares (not counting those listed on a stock exchange or transferred to the Contractor's Senior Lenders) can be transferred to any "**Suitable Third Party**", which is a person:

1. whose activities do not pose a security threat (if acquisition teams invoke a refusal for share transfer on this basis, it should be confirmed by a Senior Civil Servant at 2* level or above);
2. whose activities are not incompatible with MOD's operations in connection with the project or otherwise;
3. who is not considered unsuitable on the basis of specific information from the Crown Prosecution Service or the Serious Fraud Office.

If the project involves Secret Matters, the final (yellow shaded) bullet point in the definition of "**Unsuitable Third Party**" should be included, restricting share transfers to entities who are not List X organisations.

If there is a proposed Change of Ownership of the Contractor's, Holdco's or a Sub-contractors shares (other than shares listed on a stock exchange or shares transferred to the Contractor's Senior Lenders by way of security for the Contractor's loan) the Contractor will inform MOD's Representative under Clause 10.3.1 (a) and once the transfer has taken place the Contractor notifies MOD's Representative

of the details of the new owner of the shares. MOD has a right to terminate the Contract for Contractor Default if there is a Change of Ownership to an Unsuitable Third Party.

Status of Contractor's Warranties and Undertakings **10.4** This Clause makes it clear that each of the Contractor's warranties, undertakings, indemnities and obligations in MOD PFI PAV2 should be read separately and that their meaning is not narrowed by any other provision of the Contract.

AUTHORITY DISCLOSED DATA AND UNDERTAKINGS

11

Authority Disclosed Data

11.1

As is usual in PFI contracting, MOD will disclose a considerable amount of data to the Contractor both as part of the bidding and negotiation process and during the project. However, in PFI projects across all sectors, SoPCv4 stipulates that the Contractor cannot rely on this information being either accurate or complete, and that it is up to the Contractor to make any investigations it considers necessary to properly perform the project. This Clause therefore makes it clear that MOD is not responsible or liable for any errors or omission in the information it discloses to the Contractor and neither is it responsible for failing to disclose information relating to the project.

SoPCv4 Para 6.3

Although MOD will not normally warrant data or information (i.e. assume contractual liability if it is incorrect) in exceptional circumstances, where the data or information is believed to be accurate and complete, provisions for warranted data may be included with the approval of the PFU on a value for money basis. Any matter warranted should only be warranted as "reasonably believed to be true accurate and complete".

The only data for which MOD should take full responsibility is data relating to employees who will transfer under the TUPE Regulations. This data must not be included in Disclosed Data and should instead be inserted in Part 1 of Schedule 15.

Contractor's Due Diligence

11.2

This Clause reiterates that the Contractor should investigate or survey anything it considers necessary to properly perform the project.

SoPCv4 Paras 6.2 and 6.4

However, in a number of areas it may prove better value for money for MOD to provide the Contractor with surveys which have already been undertaken prior to ITT/ITN stage (such as surveys of MOD's sites, asbestos surveys and surveys of Existing Assets or Government Furnished Assets), thereby enabling the Contractor to properly price its risk. If surveys are to be provided, acquisition teams should ideally commission an independent surveyor who can give a direct warranty to the Contractor, so that this Clause can remain as drafted and the Contractor's assumption of risk for the project is not undermined. If a direct warranty from the surveyor to the Contractor is not possible, for example because MOD itself has undertaken the survey, acquisition teams must seek

advice from the PFU on their course of action as any amendments to this Clause may prejudice the project's accounting treatment and its ability to be cleared through HMT.

If the project does not involve any construction or land operations the green shaded text can be deleted.

Fraudulent Statements

11.4 Under common law, a party is not allowed to exclude or limit its liability for statements which are made fraudulently. This Clause reiterates that position.

CO-OPERATION

12

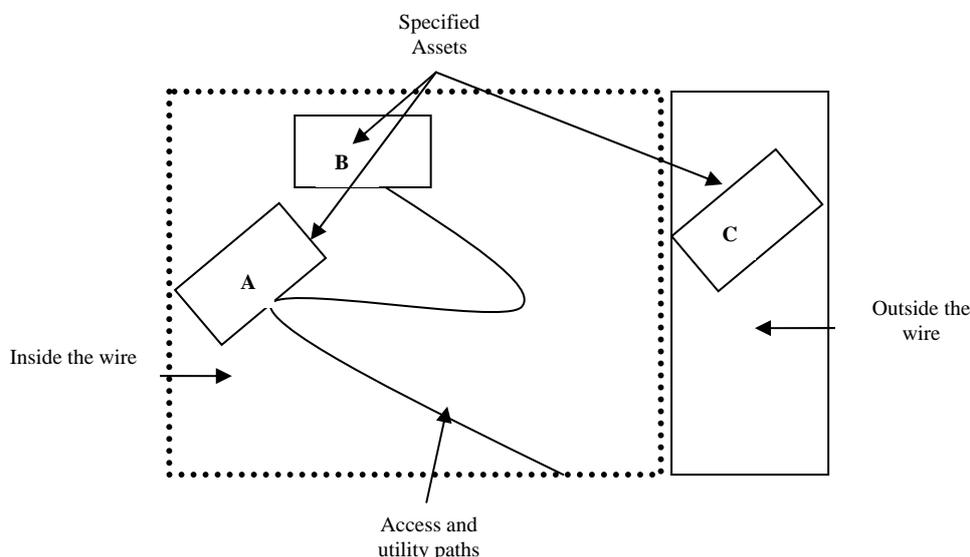
12.1 In general, English law implies a term into a contract that neither party will prevent the other from performing the contract. Clause 12.1 goes much further, in that it imposes a positive duty on both Parties to co-operate with each other to fulfil the purpose and intent of MOD PFI PAv2, subject to the limitations in Clause 12.1. Both Parties should have regard to this Clause when performing and administering the project.

PART 2 – SITE ISSUES

All of the provisions in Part 2 (Site Issues) are drafted on the basis that both the Contractor's Sites and the Authority Sites are in England or Wales. If other sites will be used, acquisition teams should consult the MOD's Central Legal Services - Commercial Law.

MOD PFI PAV2 is structured so that the sites provisions are as flexible as possible, to cater for the different risk profile which may be accepted by the Contractor if it selects the site on which the Specified Assets will be located, if the Contractor is required to use a MOD owned (or previously MOD owned) site, if the project is primarily accommodation based or if it is predominately an equipment project, with just a small element of accommodation provision.

The way MOD PFI PAV2 deals with site issues is by dividing sites into Authority Sites and Contractor Sites as follows:



Land inside the wire will always be, and Specified Assets A and B will always be on, an Authority Site for the purposes of MOD PFI PAV2. This is because it will be owned by MOD or will have been previously owned by MOD prior to the Commencement Date (if, for example it is transferred to the Contractor by way of lease).

Land outside the wire may be, and Specified Asset C may be on, an Authority Site if the land outside the wire was previously owned by MOD prior to the Commencement Date. However, this land may be a Contractor Site if MOD did not own the land or Specified Asset C prior to the Commencement Date.

As the selection of a Contractor Site is the Contractor's choice, whereas the use of an Authority Site is dictated by the requirements of the project, the risk assumed by the Contractor and the control over site issues retained by MOD differs between Authority and Contractor Sites.

The MOD PFI PAV2 does not impose a standardised structure for dealing with land issues as this should be decided by acquisition teams having regard to HMT's Guidance on Value for Money. The provisions in Part 2 (Site Issues) are suitable for the Contractor to take advantage of composite trade tax (see below) but acquisition teams should seek guidance from financial advisers on this aspect (particularly in relation to accommodation projects). If a leasing structure is decided upon, provisions for the lease or leases will need to be inserted in Part 9 (Transfer of Title) and a form of lease developed. The MOD PFI PAV2 does, however, contain provisions for the Contractor to be granted a licence over Authority Sites (Clause 14.1). This is because, using the diagram above, even if Specified Assets A and B are leased to the Contractor, a licence to use the access and utility paths may still be required and Clause 14.1 will govern the Contractor's rights to use such paths. If Specified Assets A and B are licensed rather than leased to the Contractor, the provisions of this Clause will govern the Contractor's use of those Specified Assets as well as the other parts of the Authority Site.

Composite Trade Tax

SoPCv4 Para 19.5

Composite trade tax is particularly relevant in accommodation projects. It allows a Contractor to take advantage of a favourable tax treatment, which can then be passed on to MOD by a reduction in the Unitary Charge proposed at the bidding stage.

Generally, a construction contractor cannot claim its design and construction costs as allowable expenses in order to reduce its taxable trading profit. Accordingly, a significant proportion of the Contractor's expenditure in a construction project may be subject to tax. However, if the Contractor provides design and construction services as well as ancillary support services as part of the project, it may qualify as a composite trader under the Inland Revenue's definition, in which case it may be able to claim tax relief on its design and construction costs. Because such relief will be passed on to MOD, this should reduce the Unitary Charge in comparison with bidders who are not composite traders and to whom such relief is not available.

For the Contractor to be classed as a composite trader it should satisfy the following tests:

1. it receives no rental income in relation to the project i.e. no element of the Unitary Charge can be treated as rent paid by MOD for use of the land on which the services are provided;
2. it receives a licence rather than a lease of the land from MOD. MOD PFI PAV2 contains such a licence in Part 2 (Site Issues);
3. it does not control essentially all of the activities within a building or on the land, and MOD retains some control. For example, construction of training accommodation

might allow the Contractor to qualify as a composite trader if it did not provide the training services, but not if it was the sole training provider from the building;

4. its memorandum states its principal objectives in a manner compatible with it being a composite trader.

Further detail on composite trade tax can be found in the Inland Revenue Tax Bulletin Issue 60, "PFI projects: Scope of trade". If there is any likelihood that a project can be structured so that the Contractor can qualify as a composite trader, acquisition teams should seek specific guidance on this issue from their financial advisers.

CONTRACTOR'S SITES 13

Authority's Monitoring and Inspection Rights 13.1 and 13.2

It is important that MOD's Representative and any other Authority Related Party have the right to visit places where work is carried out for the project, even if these places are not Authority Sites. This Clause gives MOD and any Authority Related Party the right to visit both Contractor Sites (Clause 13.1(a)), and other places which are not Authority or Contractor Sites such as suppliers' and Sub-contractors' premises (Clause 13.1(b)) and permit the MOD to inspect work intended for use in the project. Clause (b) also gives MOD the right to witness tests and investigations of work intended for use in the project.

The yellow shaded wording in Clause (a) may be useful where construction works are taking place on the Contractor's Sites such as in defence housing projects. "Emergency" as used in this Clause is intended to cover project-related emergencies and not Measures in a Crisis (see guidance on Clause 71).

The Contractor must, and must procure that Sub-contractors will, provide reasonable access to the properties covered by (a) and (b), subject to the MOD's access not interfering with the work being carried out so as to adversely affect the project.

Authority's Conduct on Contractor Sites 13.2

If MOD exercises its rights under Clause 13.1, MOD's Representative or other Authority Related Party visitor must comply with the reasonable instructions and health and safety rules of the site owner.

If any person exercising rights under Clause 13.1 causes material damage to the Contractor's Site, the Contractor can claim a Compensation Event.

AUTHORITY SITES 14

Contractor's Rights Over Authority Sites 14.1

These provisions are suitable for use if the Contractor will be granted a licence over any part of the Authority Site. They give the Contractor rights to enter and conduct activities on the Authority Sites (Clauses 14.1.1(a) and (b)) and to use

utilities already serving the Authority's Sites and, if necessary, to connect into the Conduits for such utilities or construct new Conduits into such utilities (Clauses 14.1.1(c) and (d)).

These rights are subject to the restrictions set out at the end of this Clause. If the Contractor infringes these restrictions, MOD may be able to limit or withdraw the Contractor's licence, but should seek guidance from the MOD's Central Legal Services – Commercial Law before doing so.

Acquisition teams should be aware that Clause 14.1.1(e) at the end of this Clause is incompatible with the Contractor being granted a lease (exclusive possession) of any part of the Authority Sites. If a lease is planned at the commencement of the project, or arises as a result of a Change under Part 18 (Changes and Change in Law), acquisition teams should amend this Clause to exclude leased areas, having first consulted the MOD's Central Legal Services – Commercial Law .

The yellow shaded text in Clause 14.1.1(h) should be deleted if the project will not involve Existing Assets.

14.1.2 The original limits of the Authority Sites are defined in Schedule 4. As its plans develop, the Contractor may find it needs additional areas to carry out the project, or greater rights than those given by Clause 14.1. In this case, the Contractor takes full responsibility for securing those additional areas or additional rights. MOD is not bound to grant these but should have regard to Clause 12 (Co-operation) in deciding whether to do so.

**Contractor's
Conduct on
Authority Sites**

14.2 As well as the restrictions set out in Clause 14.1.1(e) to (h), this Clause restricts what the Contractor can do and how it can behave on the Authority Sites.

The green shaded text can be deleted if the project does not involve construction operations.

Acquisition teams should also consider whether their project requires any provisions of DEFCON 76, which are not already covered either in this Clause or in Clause 102, to be inserted here.

**Utilities on
Authority Sites**

14.3 This Clause is structured on the basis that the Contractor is connecting into utilities on the Authority Site, and not providing utilities from scratch. If the project involves the Contractor providing completely new utility routes on Authority Sites, appropriate amendments will need to be made here.

**Condition of
Authority Sites**

14.4.2 (d) MOD expects the Contractor to take the risk of restrictions on access to and use of the assets and the site when MOD prevents or restricts access by the Contractor's or any of the Sub-contractor's personnel on grounds that they do not have the requisite security clearance, or imposes conditions on the

use of the assets to comply with security procedures which are in place at the Commencement Date (see guidance on Parts 19 and 20).

Finds, Ground Conditions and Contamination at Authority Sites

SoPCv4 Para 5.1.4

14.4.4 The provisions in this Clause deal solely with matters found within the ground. Asbestos is dealt with within the provisions for defects in Part 8 (Contractor's Equipment, Government Furnished Assets, Existing Assets and Existing Contracts and Mess Property).

For all of Finds, ground conditions and Contamination, the starting point for assessing liability is Clause (f), which allows the acquisition team or the Contractor to carve out areas of the Authority Sites for which the MOD will retain all ground risk.

If an area is listed in (f), and a Find or unforeseen ground conditions are discovered in such an area, the Contractor will be compensated for both cleaning up and/or dealing with the Find or ground conditions and any effect on Asset Provision or Service Provision as a Compensation Event. In the case of Contamination, there is a further question to be asked – namely where did the Contamination arise from? If the area is listed in (f) and:

1. the Contamination arose from the Authority Site, the Contractor will be able to claim a Compensation Event;
2. the Contamination arose from a neighbouring site (not being a Contractor Site), the Contractor will be able to claim a Relief Event and relief from Deductions for affected Service Levels (if relevant), but must meet the cost of cleaning up or dealing with the Contamination itself. This risk sharing is considered appropriate here, as the Contamination has not arisen through "fault" of either Party;
3. the Contamination arose from a Contractor Site, the Contractor will receive no compensation or relief.

If the area is not listed in (f), the Contractor takes the risk of a Find, ground conditions or Contamination in such area and will receive no compensation or relief unless the Find is ordnance, for which MOD always takes the risk.

(g) In addition, and in relation to Contamination only, if the Contractor does not receive a Compensation Event for the cost of cleaning up or dealing with the Contamination (i.e. if the Contamination arose from a neighbouring site or a Contractor Site), the Contractor is made the responsible person for cleaning up the Contamination on the Authority Site for the purposes of the Environmental Protection Act 1990. It provides an indemnity to the MOD for any losses suffered by the MOD as a result of the Contamination on the Authority Site.

Latent Defects	14.5	Latent defects in an Existing Facility at the Commencement Date are the responsibility of the MOD and are to be dealt with through the change procedure. This Clause provides detail on the process to follow in such an event.
PROVISIONS COMMON TO THE SITES	15	
Site Meetings	15.1	For both Authority Sites and Contractor Sites, MOD and its representatives or advisers are given the right to attend any site meetings. If MOD's representatives or advisers are visiting a Contractor's Site, Clause 15.1.2 requires the Contractor to provide any information which they reasonably request. This is not intended to cover provision of detailed designs (which are covered by Part 4 (Design Obligations)) or documents (which are covered by Clause 111) but is more in the nature of requiring the Contractor to answer reasonable questions and provide ad hoc information.
Hazardous Substances	15.2	This Clause governs the Contractor's responsibilities in relation to hazardous substances. MOD PFI PAV2 does not define a hazardous substance because Clause 15.2.2 refers to the COSHH Register. There is an approved code of practice and guidance issued by the Health and Safety Executive which gives further guidance on how to comply with COSHH.
Environmental Management System	15.3	This Clause requires the Contractor to develop, implement, maintain and comply with an appropriate environmental management system, certified as appropriate, and to provide and maintain an environmental management plan. The Contractor is also required to procure that its sub-contractors develop, implement, maintain and comply with an appropriate environmental management system and plan. Sustainable procurement policy and guidance on the Acquisition Operating System (including the Sustainable Procurement Commercial Policy Statement) should be consulted to determine the appropriate environmental management requirements on a project specific basis.

PART 3 – QUALITY AND PERFORMANCE STANDARDS
CORE 16
OBLIGATIONS

16.1 This Clause together with Clause 17 contains the Contractor's basic obligations in respect of the project. Essentially these are: to comply with the requirements in Clause 16.1.1, to ensure that the Specified Assets comply with the Asset Provision Requirements (and to comply with the Asset Provision Proposals) and, from the relevant Service Level commencement date in the Core Table in Schedule 1, to ensure that the Specified Services comply with the Service Provision Requirements (and to comply with the Service Delivery Proposals).

The Contractor is responsible for complying with all of the requirements referred to in Clause 16.1.1 equally. There is no hierarchy of requirements in this Clause. If the Contractor subsequently discovers a conflict between these requirements, it must resolve this at its own risk and cost. However, if the documents or Legislation referred to in Clauses 16.1.1(b), (e) or (f) change during the currency of the project, this will be a Change and Part 18 (Changes and Change in Law) should be followed.

A PFI contract is a contract for services, and is therefore governed by the Supply of Goods and Services Act 1982 which requires the Contractor to provide the services with reasonable skill and care. However, this statutory standard is increased in PFI contracts, including MOD PFI PAV2, where there is an absolute requirement for the Contractor to ensure the Specified Services meet the Service Provision Requirements and Service Provision Proposals both as referenced in the Core Table in Schedule 1. The Act also requires any goods supplied in the course of the service to be fit for their purpose. This is reflected by the Contractor's obligation in this Clause to ensure that the Specified Assets meet the Asset Provision Requirements.

(b) The distinction between "**Guidance**" and "**Authority**
and **Policies**" is that Guidance should cover all relevant non MOD-
(e) specific guidance or MOD-specific guidance if MOD acts as regulator for such guidance. All other MOD specific guidance and standards (eg JSPs, DEFSTANS etc) should be included in Authority's Policies. The insertion of a particular standard in Guidance as opposed to Authority's Policies should be considered by acquisition teams having regard to value for money issues (commercial standards may be less stringent and therefore more affordable than military standards) and Part 2 of the Public Services Contracts Regulations 1993.

A change in Guidance will be a Change in Law for the purposes of Part 18 (Changes and Change in Law), whereas a change in the Authority's Policies will be a Change only. This affects the amount payable by the MOD (termed "compensation") to the Contractor if the relevant document is

changed. That is if MOD changes an Authority Policy, the Contractor receives full compensation in accordance with Part 18 (Changes and Change in Law), whereas if Guidance is changed, there may be a sharing of compensation depending on whether the change amounts to a Qualifying Change in Law or a General Change in Law (for further details, see the guidance notes below on Part 18)

- 16.1.2** Although the Contractor is only required by Clause 16.1.3 to supply goods and materials to be used in the Specified Assets which are of satisfactory quality, Clause 16.1.2 requires the Specified Assets themselves to be fit for the purpose described in the Asset Provision Requirements and as described in the Asset Provision Proposals.
- and**
- 16.1.3**

There is therefore a distinction between the quality of goods and materials which go to make up a Specified Asset and the Specified Asset itself. For example, if the Specified Asset is a building, the Asset Provision Requirements may require that it has a certain thermal emission value. This would dictate the Contractor's choice of structural materials (which have to be both capable of meeting this thermal emission value and of satisfactory quality) but would give the Contractor freedom to specify in the Asset Provision Proposals its choice of floor covering (which only has to be of satisfactory quality). If the selection of flooring is critical to MOD (for example because it has to withstand a certain wear), the floor covering output specification should be made part of the Asset Provision Requirements for the Specified Asset that is the relevant building. This may help acquisition teams decide whether an Asset should be included in the list of Specified Assets (see "Starting Out" above).

Acquisition teams should note that Part 3 is not looking at the design of the Specified Assets, which is covered by Part 4 (Design Obligations), merely their performance in practice as part of the project.

- 16.1.4** This Clause requires the Contractor to commence Service Provision for each Service Level on the Planned Service Commencement Date specified in the Core Table in Schedule 1 and to ensure that from such date the relevant Specified Services are available and comply with the relevant parts of the Service Provision Requirements and Service Provision Proposals as specified in the Core Table.

If the Contractor does not begin a Service Level by the relevant Planned Service Commencement Date, it will receive no payment of the part of the Unitary Charge attributable to this Service Level (and, if is so late in Services commencement that it does not begin a Service Level by the Long Stop Date, MOD will have the right to terminate the Contract for Contractor Default). This is considered sufficient incentive for most projects to achieve timely Service commencement, but if appropriate on a value for money basis, optional provisions for the Contractor to pay the MOD a pre-ascertained amount for lateness are included in the MOD

PFI PAV2 (see the guidance notes on Clause 31 for further details).

MOD is not required to accept commencement of a Service Level before the relevant Planned Service Commencement Date. However, if acquisition teams consider that MOD should have the option of accepting early Services Commencement, additional provisions will need to be included to cover this (see guidance on Clause 36).

**CONDITION OF
THE ASSETS AND
DELIVERY OF THE
SERVICES** **17**

**SoPCv4 Chapter
20** **17.1**

Clause 17 is another key clause within MOD PFI PAV2 and is the equivalent of Clause 16 for the Service Provision phase of the project. It requires the Contractor to maintain and operate the Specified Assets (i.e. as part of its performance of the Services) so that they meet the requirements of this Clause.

17.1.6 Because the Contractor generally has to return the Assets to MOD on expiry or termination of the Contract (see guidance on Clauses 42 and 43), without this Clause and the Handback Standard the Contractor might be tempted to minimise its maintenance costs in the latter part of the project so that the Assets are effectively run down by the time the Contract Period expires.

The "**Handback Standard**" included in Schedule 5 Part 1 should therefore cover, as a minimum, the condition the Specified Assets are expected to be in at the Expiry Date and any design life requirement for the Specified Assets after the Expiry Date. For further details on MOD's rights if the Specified Assets do not meet the Handback Standard, see the guidance on Clause 129.

Acquisition teams should note that the Handback Standard only covers the sub-set of Assets that is the Specified Assets. If an Asset is required to be handed back in a certain condition, this may assist the acquisition team in deciding whether to include it in the list of Specified Assets.

If the Specified Assets are Government Furnished Assets or Existing Assets, the Handback Standard for these should interface with Schedule 9 Part 1 or 2 respectively, which contains the terms on which Government Furnished Assets or Existing Assets are made available to the Contractor.

**CONTRACTOR'S
PROPOSALS** **18**

**18.1
and**

Although acquisition teams should review the Contractor's Proposals (which are made up of the Asset Provision and the

- 18.2** Service Provision Proposals) during the bid stage to assure themselves that the proposals are capable of meeting MOD's requirements once implemented, it is a fundamental principle of PFI contracts, including MOD PFI PAV2, that there should be no acceptance by MOD that these proposals will, in fact, meet its requirements.

Both this Clause, and the precedence of documentation in Clause 3, make it clear that the Contractor's Proposals are subservient to the Authority's Requirements. If it transpires that any element of the Contractor's Proposals needs to be amended so that the Contractor can comply with the Contractor's Proposals and MOD's Requirements (Clauses 16.1 and 17.1), the Contractor must make such amendment and alter any part of a Specified Asset that has already been constructed or manufactured on the basis of the erroneous proposals, without claiming any compensation or extension of time from MOD.

NECESSARY CONSENTS

19

- 19.1** "**Necessary Consents**" are defined as all statutory and non statutory permissions, approvals etc. to perform the project. In an accommodation project this might include planning permissions and section 106 agreements, whereas in an equipment project Necessary Consents might be export and import licences. It is deliberate that Necessary Consents are not listed in the MOD PFI PAV2, because it remains the Contractor's responsibility to ascertain which consents are required and to obtain and comply with these (both under Clause 19.1.5 and Clause 16.1).

The only exception is Necessary Consents which (as a matter of law) only MOD may give or obtain. In this case, the Contractor must provide reasonable assistance to the MOD, but MOD must use its reasonable endeavours to obtain the Necessary Consent. Because there is no absolute obligation on MOD to obtain the consent, it will not breach its obligation if the consent is not, in fact, obtained providing it has used reasonable endeavours to do so. In these circumstances, the Contractor will not be entitled to a Compensation Event or other relief to cover the failure to obtain the Necessary Consent, and either Party should use the Change procedure (Part 18) to deal with the failure to obtain the consent. However, if a Necessary Consent which only MOD can obtain is fundamental to the project, the Parties may wish to make its grant a Condition Precedent, thereby allowing the Contract to be terminated if it is not obtained.

The Contractor is required to provide copies of Necessary Consents and associated documents applied for and obtained to the MOD's Representative under Clause 19.1.5.

The Contractor also gives an (optional) indemnity to the MOD if it breaches the requirements of this Clause. At the date of publication of MOD PFI PAV2, MOD was exempt from Local

Authorities' right to serve enforcement notices on it without its consent. During 2006, this exemption is expected to be removed, and this indemnity might then become appropriate. In deciding whether to include it, however, acquisition teams should have regard to HMT's Value for Money Assessment Guidance as well as the nature of their project.

With specific regard to planning consents, it is left to acquisition teams to decide (on a value for money basis) whether to apply for outline planning permission before issue of their ITT/ITN. As far as planning and surplus land is concerned, acquisition teams may wish to prepare a planning brief rather than apply for outline planning permission, as this will give the Contractor greater flexibility to prepare innovative land use proposals as part of its bid.

**CONTRACTOR'S 20
QUALITY
ASSURANCE AND
PERFORMANCE
MONITORING**

SoPCv4 Chapter 9

Monitoring of performance in the Contract is principally undertaken by the Contractor, with MOD having rights to audit or check the Contractor's compliance with the Contract if it has legitimate concerns regarding the Contractor's own monitoring or at periodic intervals.

**Contractor's 20.1
Quality
Assurance**

Because the Contractor acts as its own auditor, one source of comfort for MOD that the Contractor is properly performing its obligations, is that the Contractor is required by Clause 16.1.1(d) to comply with an approved quality assurance system. This Clause requires the Contractor to develop, implement, maintain and comply with an appropriate quality assurance system, certified as appropriate, and to provide and maintain a quality plan. The Contractor is also required to procure that its sub-contractors obtain and maintain an appropriate quality assurance system and quality plan. Defence quality assurance policy and guidance on the Acquisition Operating Framework (AOF) should be consulted to determine the appropriate quality assurance requirements on a project specific basis.

**Contractor's 20.2
Performance
Monitoring**

This Clause is key to the self-monitoring which will undertaken by the Contractor to show its performance of the Services, and any Deductions which apply to poor performance ("**Service Performance Deductions**") or unavailable Assets ("**Unavailability Deductions**").

**AUTHORITY'S
PERFORMANCE
MONITORING** 21

SoPCv4 Chapter 9

Audit of Contractor's Quality Assurance Systems 21.1 MOD retains the right to audit the Contractor's quality assurance system to check the adequacy of the system documentation. The Contractor must cooperate, and must procure that its Sub-contractors (of all tiers) cooperate, with MOD's audit.

Monitoring and Inspection during Asset Provision 21.2 MOD has a right to open up or inspect any part of a Specified Asset before the commencement of a Service Level using that Specified Asset. A defect in the Specified Asset is defined in this Clause as an "**SA Defect**", and includes any matter which would, or which MOD's Representative reasonably believes would, not comply with the Asset Provision Proposals, the Asset Provision Requirements or any other requirement of MOD PFI PAv2. This includes both defects in construction or manufacture of a Specified Asset, and design defects.

If, on opening up or inspection, a SA Defect is found (even if it is not the original defect which prompted the opening up or inspection), the Contractor must rectify such SA Defect at its own risk and cost. If no SA Defect is found, the Contractor can claim a Compensation Event for any delay caused to Service Provision.

Monitoring during Service Provision 21.3 and 21.4 This Clause looks at the monitoring reports submitted by the Contractor whereas Clause 21.6 relates to monitoring and inspection of the Specified Assets themselves.

MOD is most likely to come across failures in the Contractor's own performance monitoring during the Service Provision phase, because it does not agree with the Contractor's assessment of the level of its own failures. Under Clause 21.1, MOD can undertake its own monitoring of the Contractor's performance at any time. This will be at MOD's cost unless Clause 21.3.2 applies and MOD increases its level of monitoring because the Contractor has either submitted a fraudulent report, or more than one erroneous report within the given period, in which case Clause 21.3.4 allows MOD to recover its costs of such increased monitoring from the Contractor.

If MOD's monitoring shows that Deductions should have been imposed for service failures or unavailability which were not reported by the Contractor, Clause 21.4 allows MOD to make these Deductions from future payments to the Contractor.

Authority's Periodic Survey Rights during Service Provision 21.6 Unlike Clause 21.3, which examines the Contractor's monitoring reports, Clause 21.6 allows MOD to survey the condition of the Specified Assets. Because this is more invasive than merely looking at reports, MOD cannot exercise this right more than once in any period (to be set on a project-specific basis) from the time its survey shows the

SoPCv4 Para 11.5

Contractor has complied with its obligations in Clause 17.A worked example assuming a two year period is as follows:

Time the survey can be undertaken after commencement of the Service Level using the relevant Specified Asset	Does survey show failure by the Contractor?
1 year	Yes
15 months	Yes
2 years	No
4 years	

Results of Authority's Periodic Survey

21.7 If the survey shows the Contractor has failed to maintain the Specified Assets in accordance with Clause 17, MOD's Representative should notify the Contractor of the required standard for the Specified Assets and give the Contractor a reasonable period to bring the Specified Assets up to this condition. In addition, MOD can deduct from any monies due to the Contractor (including any instalments of the Unitary Charge) either the full cost of the survey and any associated administrative changes (if more than the threshold percentage of the Specified Assets are shown to have failed) or a pro rata proportion of the cost of the survey and any associated administrative changes (if less than or equal to the threshold percentage of the Specified Assets are shown to have failed). The percentages inserted in (i) and to (ii) should be the same.

Clauses (i) and (ii) are particularly useful in equipment projects, where there may be multiple Specified Assets to be surveyed and it does not represent value for money for MOD to charge the full cost of the survey to the Contractor if only one Specified Asset is shown to have failed. This is particularly so if some of the Specified Assets to be surveyed are not in the UK. If there is only one, or a small number of Specified Assets, acquisition teams may delete the threshold percentages and use Clause (ii) only.

If the Contractor fails to rectify the Specified Assets within the reasonable period specified by MOD's Representative under (b), MOD can employ another contractor to carry out the required work and deduct the costs paid to this contractor from any monies due to the Contractor.

Annual Compliance Testing

21.8 This optional Clause is designed to ensure the Contractor confirms that the Services continue to comply with the requirements of the Contract by carrying out an annual programme of compliance testing.

PART 4 – DESIGN OBLIGATIONS

This Part is yellow shaded as some MOD PFI projects do not involve the Contractor in undertaking any design, i.e. it provides the Services using "off-the-shelf" equipment. It should be included if the Contractor undertakes any design work, whether of management information systems, equipment or buildings.

If the Contractor has not completed its design by the Commencement Date, any subsequent completion of a design that proves more expensive than anticipated will not entitle the Contractor to any change in Unitary Charge or to a reallocation of risks. The Contractor is also made responsible for agreeing the design provided by the Asset Provider with the Service Provider and any other Sub-contractors. Because the Contractor takes the risk for any failure of the design to meet the Authority's Requirements or failure to complete to the agreed design, MOD PFI PAV2 distinguishes design development from changes to the original design. Further guidance on this issue is given in the guidance notes on Schedule 6 (Design Review Procedure).

DESIGN REVIEW PROGRAMME 22

SoPCv4 Para 3.4 22.1

This Clause requires the Contractor to prepare a Design Review Programme not later than 10 Business Days from the Commencement Date. It forms part of the Asset Provision Programme (Clause 27.1). Clause 23.1.1 and Schedule 6 (Design Review Procedure) require the Contractor to comply absolutely with the dates for design submission as shown on the Design Review Programme in respect of "**Reviewable Design Data**".

Although the provisions in Part 4 (Design Obligations) and Schedule 6 (Design Review Procedure) refer to design, there is no requirement for Reviewable Design Data to comprise designs only. For example, in a training project Reviewable Design Data could include course manuals and lesson plans, in an equipment project it could include technical specifications, and in an accommodation project it could include operating and maintenance manuals for plant as well as building designs.

DEVELOPMENT OF DESIGN 23

23.1

The Contractor must carry out, develop and submit its design to MOD's Representative in accordance with all of the requirements of DEFSTAN 05-10/4 and Schedule 6 (Design Review Procedure).

PART 5 – CONSTRUCTION OBLIGATIONS

CDM 25 REGULATIONS

Duties under CDM Regulations 25.2 and 25.3 In projects involving construction operations, the CDM Regulations require the project to adopt a regime of health and safety management. The Regulations allocate specific duties to categories of people known as a Client, a Principal Contractor, a Planning Supervisor and Designers, to: register with the Health and Safety Executive, ensure safety, design for safety, draw up a health and safety plan before construction works commence and report to the Health and Safety Executive. In MOD PFI PAV2 the Contractor assumes the duties required by the Regulations for all of these types of people.

MOD must co-operate with the Contractor and provide documents which it has, or which it can reasonably obtain, so that the Contractor can fulfil its duties under the CDM Regulations.

PART 6 – ASSET & SERVICE PROVISION, TIME AND PROGRAMMES
CORE OBLIGATIONS 26

Compliance with Programmes 26.3 The Asset Provision Programme and Planned Maintenance Programme are key documents within MOD PFI PAV2.

The **Asset Provision Programme** is not binding on the Contractor, but it must work to the Asset Provision Programme insofar as Asset Provision affects MOD's operations or activities at Authority Sites. Conversely, MOD must ensure that its activities and operations at the Authority Sites are compatible with the Contractor carrying out Asset Provision within the times shown on the Asset Provision Programme. In effect, both Parties will agree the Asset Provision Programme to their mutual benefit before financial close (and any amendments to it under Clause 27.2) and then comply with it so as not to interfere with each other's operations.

The **Planned Maintenance Programme** is binding on both Parties. The Contractor must carry out its planned maintenance in accordance with the Planned Maintenance Programme, and the MOD can only prevent it doing so if it interrupts planned maintenance under Clause 28.4.1 (which entitles the Contractor to a Compensation Event) or if it invokes Measures in a Crisis.

ASSET PROVISION PROGRAMME 27

Information to be shown on the Asset Provision Programme 27.1 This Clause lists the information that the Contractor is required to show on the Asset Provision Programme in Schedule 7 and on each new Asset Provision Programme prepared when required by Clause 27.2. The Contractor is not required to separately identify any periods of float or time risk allowances which it has built into the Asset Provision Programme. These periods and allowances are "owned" by the Contractor.

Time for Submission of Asset Provision Programme 27.2 It is in both Parties' interests that the Asset Provision Programme is updated on the occurrence of certain events, so that they can agree their operations so as not to interfere with each other. This Clause provides for this by requiring the Contractor to submit a revised Asset Provision Programme under the Project Management Procedure (Schedule 19) on the occurrence of events, such as supervening events (Part 15) or a Major Change (Part 18), which may significantly affect Asset Provision.

PLANNED MAINTENANCE PROGRAMME 28

Information to be Shown on Planned Maintenance Programme 28.1 to 28.2
SoPCv4 Chapter 11

Unlike the Asset Provision Programme, the Planned Maintenance Programme is binding on the Contractor so that MOD can ensure that the Contractor's planned maintenance does not interfere with MOD's use of the Specified Assets and Services. On Equipment projects it is often the case that the Planned Maintenance Programme forms part of the bidder's response to the ITT/ITN and is agreed prior to contract placement. Where this is the case sub clauses 28.2.1 (a) and (b), shaded green, should be deleted.

A new Planned Maintenance Programme must be submitted by the Contractor:

1. at least two months before the Planned Service Commencement Date for a Service Level using the Specified Asset;
2. at least two months before each subsequent year;
3. on the occurrence of an interruption by MOD to the Contractor's planned maintenance under Clause 28.4;
4. following any damage to a Specified Asset.

These Clauses set out the minimum detail MOD needs to see in order to be able to agree that the Planned Maintenance Programme will not interfere with its operations or activities, and the regime for agreeing the Planned Maintenance Programme with the Contractor.

Generally in PFI projects, the Contractor is given some relief from Deductions for the period when it is carrying out planned maintenance in accordance with the Planned Maintenance Programme. When drafting the Payment Mechanism (Schedule 13), acquisition teams should discuss with their financial advisers how this should best be structured.

This Clause also contains optional (yellow shaded) provisions requiring the Contractor to prepare a 5 year maintenance plan, showing its planned maintenance over a 5 year period. However, this plan is not contractually binding, and is provided for the purposes of MOD's long term or strategic planning only.

Agreement of Planned Maintenance Programme 28.3

On receipt of the Contractor's proposed Planned Maintenance Programme, MOD has a defined period to notify the Contractor that it does not agree with the proposed programme because it will interfere with MOD's operations or activities (for example, planned maintenance of an officer's mess can be refused if it will take place at the time of a mess supper). If MOD does not notify its disagreement with the proposed programme within this period, the Planned Maintenance Programme is deemed accepted.

If there is a disagreement as to when the Contractor should schedule its planned maintenance, the Parties should resolve this using the Project Management Procedure in Schedule 19.

**Interruption of
Planned
Maintenance**

28.4 Although Clause 28.3 allows MOD to instruct the Contractor to schedule its planned maintenance around MOD's operations and activities, as MOD may have operational requirements that are unforeseeable at Contract signature, it needs to be able to disrupt the Contractor's planned maintenance works in order to meet these requirements. It is therefore preferable for the Planned Maintenance Programme to be as flexible as is technically possible without resulting in equipment degradation and for maintenance to be planned by reference to intervals rather than specific dates.

If such an interruption is necessary, this Clause can be used both where the event necessitating the interruption does or does not amount to Measures in a Crisis (see guidance on Part 16 (Supervening Events and Measures In A Crisis)). If it is used as part of MOD's rights on Measures in a Crisis, Clause 77 governs the compensation payable to the Contractor. This may be greater than the compensation payable if Measures in a Crisis are not invoked, because Clause 77 includes indemnities from MOD to the Contractor whereas Clause 28.4.2 merely allows the Contractor to claim a Compensation Event (which does not include compensation on an indemnity basis from MOD).

**Unplanned
Maintenance**

28.5 Of course, in every PFI project there will be times at which the Contractor needs to carry out emergency reactive or unplanned maintenance. To satisfy operational sensitivities, the Contractor must obtain MOD consent before carrying out unplanned maintenance. However, because these works may be urgent, a provision may be included here that MOD's Representative can consent by telephone (followed up by written consent) or that, for the purposes of Clause 28.5 only, the relevant Authority Site's commanding officer or his representative can give consent to unplanned maintenance under this Clause.

Unlike planned maintenance, the Contractor should not be given relief from Deductions in the payment mechanism for the period during which it carries out unplanned maintenance.

**EARLY WARNING
OF DELAYS IN
SERVICES
COMMENCEMENT**

29

29.1 The purpose of this Clause is to make binding the obligation on the Contractor to warn MOD of anything which may delay Service commencement, including the Contractor's own defaults, Compensation Events and Relief Events. There is no sanction for the Contractor failing to give an early warning of delay due to its own default, but delaying notification of a Compensation Event or Relief Event beyond the times for notification required by Part 16 (Supervening Events and Measures In A Crisis) has a sanction in that the Contractor will not be entitled to any compensation or relief as appropriate for the period in which notification is delayed.

However, the Contractor should notify MOD's Representative as soon as possible under this Clause so that the Contractor can provide a revised Asset Provision Programme. It is in both Parties' interests that the Asset Provision Programme reflects as closely as possible the Contractor's plans for Asset Provision.

29.2 Regardless of the cause of the delay to Asset Provision, this Clause requires the Contractor to take reasonable steps to mitigate the delay. It is in both Parties' interests for this to be done: the Contractor because it may reduce and/or avoid delay to Service commencement and its receipt of the Unitary Charge for the Service Levels affected; and MOD because it will receive Service commencement on or closer to the planned commencement date for the relevant Service Level.

**EXTENSIONS OF
TIME FOR ASSET
PROVISION 30**

30.1 This Clause lists the various sections of MOD PFI PAV2 in which the Contractor may receive an extension of time for actual or anticipated delay which means the Contractor is not able to achieve the Planned Services Commencement Date or Long Stop Date for a Service Level, or the knock-on delay caused to other Service Levels.

Acquisition teams should note that the five causes of delay set out here are a definitive list and no other delaying causes may be included unless a project-specific derogation is obtained from the PFU.

**COMPENSATION
TO THE
AUTHORITY FOR
DELAY IN
SERVICE
PROVISION 31**

SoPCv4 Para 4.2 31.1 In accordance with the principles expressed in SoPCv4, the general position in MOD PFI PAV2 is that MOD does not levy a predetermined financial charge (liquidated damages) on the Contractor for delay in commencement of a Service Level beyond the Planned Service Commencement Date, as the lack of Unitary Charge corresponding to those Service Levels coupled with the Contractor's funding arrangements is considered sufficient incentive for the Contractor to commence Service Provision on time. However, the optional provisions for liquidated damages contained in this Clause may be used if there is a value for money reason for doing so.

An example of when it might represent value for money for MOD to include this Clause would be if MOD is contributing surplus land to the project which has a material value. In these circumstances it might be acceptable to use this liquidated damages Clause to reflect the Contractor's benefit in having the land before it has commenced the relevant

Service Level.

In order to be enforceable, English law requires any liquidated damages to be a genuine pre-estimate of loss. Accordingly, when completing the weekly rates of liquidated damages payable for late commencement of a Service Level in Schedule 7, acquisition teams should set these having regard to MOD's loss in, for example, having neither the benefit of the surplus land nor the benefit of provision of the relevant Service Level. However, specific advice should be taken from the MOD's Central Legal Services – Commercial Law as to the enforceability of the rates included in Schedule 7.

PART 7 – TESTING, COMMISSIONING AND SERVICE AVAILABILITY
INDEPENDENT CERTIFIER 32

32.1 The usual position in MOD's PFI projects will be to use an Independent Certifier, who under his Deed of Appointment (Schedule 8) owes his duties to both MOD and the Contractor. However, for certain projects, no independent certification will be possible. For example security considerations may mean that it is not desirable to appoint an independent person to certify Service commencement. In training projects, where the MOD's acceptance of course materials and proposed tutors is critical to Service commencement, it also might not be possible to subject this to an independent certification process. Accordingly, acquisition teams may remove the references to "Independent" and Schedule 8 in Part 7, leaving a MOD-appointed certifier to act in relation to the project. In these circumstances, however, acquisition teams should be aware of the need to provide the Contractor and its funders with comfort that the issue of the Acceptance Certificate will not be unreasonably withheld or delayed and should consult with the PFU for advice on how this might be achieved.

INSPECTION 33

Clause 33 does not apply to tests and inspections done by the Contractor at his own discretion and for his own purposes (but the MOD may witness these tests and inspections in accordance with Clause 13.1). This Clause deals with the procedure for the Contractor notifying MOD's Representative and the Certifier of when testing is to be done or inspection is to be allowed as a preliminary to the Certifier certifying Service commencement, and gives MOD's Representative and the Certifier the right to witness such testing or inspection.

COMMISSIONING TESTS AND JOINT COMMISSIONING 34

SoPCv4 Para 3.6 34.1

If relevant in the context of a given project, the dates for Commissioning Tests and Joint Commissioning should be shown on the Asset Provision Programme (Clause 27.1). Commissioning Tests and Joint Commissioning is intended to take place prior to Service commencement of a Service Level using the relevant Specified Asset. Whilst it is usual in some non-PFI projects involving complex equipment to provide for testing after take over (for example the performance of process plant), in PFI projects and in MOD PFI PAV2, poor performance after Service commencement is dealt with by MOD imposing Availability and Service Performance Deductions.

The objectives, procedures and the standards to be satisfied by the Commissioning Tests or Joint Commissioning and the location of the tests (if not on the Authority Site) and the Party responsible for providing materials, facilities and

samples can form part of either the Asset Provision Requirements or the Asset Provision Proposals (or both) but must also be provided in a Commissioning Test Schedule within a defined period following the Commencement Date. Other items which may be included are:

1. details of testing apparatus, test loads, measuring instruments etc. and whether these will be provided by the Contractor or the MOD
2. testing facilities such as a site laboratory on an Authority Site or off-site laboratories;
3. provision of utilities and fuel for the tests and, for tests on the Authority Site, whether these will be provided by the MOD or the Contractor;
4. provision and disposal of production materials.

Because an Acceptance Certificate is issued on completion of the relevant Services Availability Requirements, it is recommended that a requirement for satisfactory completion of any Commissioning Tests is included within the Services Availability Requirements.

Joint Commissioning is only likely to be relevant in complex equipment projects and the blue shaded text can be deleted by acquisition teams if not required.

**34.2
and
34.4** This Clause deals with the requirement for the Contractor to carry out Commissioning Tests within the times shown in the Asset Provision Programme. If a Commissioning Test has to be repeated because the Specified Asset has failed the test, this is at the Contractor's risk and cost. The procedure for testing set out in Clause 33 (Inspection) will apply to any repeated test.

**ACCEPTANCE
CERTIFICATE,
NOTICE OF NON
COMPLETION
AND SNAGGING
LIST**

35

35.1 MOD PFI PAv2 differs from some accommodation-specific PFI contracts in that there is no automatic link between completion of Asset Provision and Service commencement. Whilst completion of Asset Provision for a given Service Level may be necessary for Service commencement, acceptance of Service commencement only occurs when the relevant Services Availability Requirements set out in Schedule 7 Part 2 and referenced in the Core Table in Schedule 1 have been met. Depending on the way in which the Core Table is structured, this may be before Asset Provision of some of the Specified Assets is completed (for example if Existing Assets are used to provide the Services), on completion of Asset Provision or some time after Asset Provision has been

completed.

If the inspection under Clause 33 (Inspection) shows that a Service Level meets the relevant Services Availability Requirements and, if used for the project, the Specified Assets have passed the relevant Commissioning Tests or Joint Commissioning, the Certifier issues its Acceptance Certificate for the Service Level. Providing the Services Availability Requirements have been met, minor defects ("**Snagging Items**") in the relevant Specified Assets will not prevent the Certifier issuing its Acceptance Certificate for a Service Level and there are provisions for the rectification of Snagging Items in Clause 35.2. If, however, the Services Availability Requirements for the Service Level have not been met, the Certifier informs the Parties of outstanding matters which the Contractor needs to address before the Acceptance Certificate can be issued and the processes in Clause 33 and, if relevant, Clause 34 should be repeated.

Snagging Items **35.2** These provisions deal with the Contractor's obligation to rectify Snagging Items once it has commenced a Service Level. The Contractor is not given an indefinite programme for rectification of such items, but must instead comply with the Snagging Programme, which is a programme agreed between MOD, the Contractor and the Certifier. If the Contractor has not rectified the Snagging Items within the period required by the Snagging Programme, MOD can employ another contractor to carry out the required work and deduct the costs paid to this contractor from any monies due to the Contractor.

DATES ON WHICH SERVICES COMMENCEMENT MAY OCCUR AND EFFECT OF ISSUE OF ACCEPTANCE CERTIFICATE **36**

36.1 In some projects, the Contractor may complete Asset Provision of a Specified Asset and be ready to commence a Service Level before the relevant Planned Services Commencement Date. However, the Certifier is not allowed to issue the Acceptance Certificate for the Service Level before the Planned Service Commencement Date. If it would be in MOD's interests to accept early service commencement, bearing in mind the guidance in SoPCv4 paragraph 4.6, acquisition teams should consult the PFU if they wish to amend this Clause.

PART 8 – CONTRACTOR’S EQUIPMENT, GOVERNMENT FURNISHED ASSETS, EXISTING ASSETS, EXISTING CONTRACTS AND MESS PROPERTY

PART 8 37
DEFINITIONS

If the Contractor is being provided with assets previously owned by MOD (whether on loan, as "**Government Furnished Assets**", or through transfer of title to the Contractor, as "**Existing Assets**", which are re-transferred to MOD on expiry or termination of MOD PFI PAV2), or if the Contractor will need the benefit of contracts previously entered into between MOD and a third party ("**Existing Contracts**") the yellow shaded provisions in Part 8 (Contractor’s Equipment, Government Furnished Assets, Existing Assets, Existing Contracts and Mess Property) should be used.

GFA and Existing Assets (specified in Schedule 9) can take many forms, including office consumables, IT systems and equipment spares; provision of land and buildings would be provided as Existing Assets. Irrespective of their nature, the provisions in Part 8 reduce the risk transfer to the Contractor for defects in these assets.

If Government Furnished Assets or Existing Assets meet the tests for Specified Assets set out in "Starting Out" above, they should also be included in the list of Specified Assets.

GOVERNMENT FURNISHED ASSETS 39

39.1
to
39.4

Because GFA are loaned to the Contractor, the provisions in this Clause set out:

- the Authority's obligations to ensure the GFA meets the required standards and is made available when required, and
- the Contractor's obligations to maintain and repair them and to allow MOD to inspect their condition.

The condition in which the Government Furnished Assets must be maintained and any restrictions surrounding their storage or use (such as the requirement to store ammunition in an approved armoury) should be specified in Schedule 9 Part 1.

Acquisition teams should state in Column B of the Tables in Schedule 9 Parts 1 and 2 the specification and condition of the GFA and Existing Assets at the time they will be provided to the Contractor. These Parts should also specify the maintenance (if any) MOD has undertaken and the documentation (if any) which will be provided.

Defects	39.5	This sets out the provision of GFA to the Contractor in accordance with the Contract and the Contractor's responsibilities for reporting any failure by the Authority to do so.
EXISTING ASSETS	40	In some circumstances there may be a need for MOD to transfer Existing Assets to the Contractor - Existing Assets are items where MOD will transfer title to the Contractor for the purposes of provision of the Assets/Service.
EXISTING CONTRACTS	41	<p>In some projects, it may represent value for money or be necessary to the Services for MOD to transfer to the Contractor existing contracts which it has entered into with a third party ("Existing Contracts"). However, MOD's legal obligations (for example, to pay any fees or allow the third party access to land) under such contracts cannot be transferred ("novated") to the Contractor without the consent of the third party. This consent can be given as a term of the Existing Contract or the third party can consent after the Existing Contract has been entered into.</p> <p>This Clause requires the Contractor to use reasonable endeavours to seek the third party's consent (if it has not already been given as part of the terms of the Existing Contract) to the transfer of the Existing Contract.</p>
	41.1	<p>MOD can choose either to terminate the relevant Existing Contract, in which case both Parties are relieved of their obligations relating to the Existing Contract, or for the Contractor to act as MOD's agent in relation to the Existing Contract. Under common law, an agent has authority to bind its principal (MOD), and Clause (b) therefore restricts the Contractor's ability to act in relation to the Existing Contract so that it does not prejudice MOD's position.</p> <p>If the novation of an Existing Contract is fundamental to the project, the Parties may wish to make its grant a Condition Precedent, thereby allowing the Contract to be terminated if the third party's consent is not obtained.</p>
Novation of Novating Contracts and Terminating Contracts	41.2	If the third party's consent to a novation is given MOD, the Contractor and the third party will need to enter into a separate deed of novation to effect the transfer. No standard form of deed of novation is contained within MOD PFI PAV2, but the terms to be included in the deed are given in Clauses (a) to (c).
Failure to Novate Novating Contracts and Non-Novating Contracts	41.3	As there is no obligation on a third party to consent to a novation from MOD to the Contractor (unless such consent is a term of the Existing Contract), this Clause governs the position if the third party's consent cannot be obtained.

Costs and Revenues Relating to Existing Contracts

41.5 The costs and revenues relating to any novated contract fall to the Contractor with effect from the date of novation. The clause also sets out the procedure for any amounts outstanding at the date of novation.

MESS PROPERTY

4.2 These provisions deal with the ownership and obligations of the MOD and the Contractor in relation to Mess Property.

PART 9 – TRANSFER OF TITLE
TITLE IN 43
EXISTING
ASSETS

If surplus land forms part of the Existing Assets to be transferred to the Contractor, the MOD should ensure that, in completing the provisions in Schedule 9, it receives value for money for any transfer. This may include structuring the land transfer (whether by way of lease or freehold transfer) so as to:

1. prevent title being transferred before the Service Commencement Date for the Service Level which uses the surplus land as a Specified Asset or alternatively, if surplus land is to be transferred on signature of MOD PFI PAV2, considering the value of money of imposing liquidated damages for delay in Service commencement (see guidance on Clause 31);
2. use either part of Clause 44.1 (Title to the Assets on Termination or Expiry) to deal with re-transfer of the surplus land to the MOD for no additional compensation other than that provided by Part 26 (Compensation on Termination) or for an additional residual (market) value payment on a termination of MOD PFI PAV2 (see guidance on Clause 44 below);
3. take into account the tax treatment relevant to the surplus land.

The issues surrounding surplus land are complex, and acquisition teams must seek specialist advice on this aspect from their financial and legal advisers.

TITLE TO THE 44
ASSETS ON
TERMINATION
OR EXPIRY OF
THIS CONTRACT

SoPCv4 Chapter 20 44.1

Most commonly, MOD PFI projects will involve Assets which have no market value (known as “residual value”) on expiry of the Contract Period. i.e. where there is no market for the Assets or it is undesirable on security or other grounds for the Contractor to retain and use the Assets after the project has expired or has been terminated. In these circumstances, it represents value for money for MOD to take back the Assets on expiry or termination and the first option at Clause 44.1 should be used.

In a limited number of projects, such as provision of defence housing outside the wire, there is a ready market for the Contractor to dispose of the Assets to the private sector, and where these are built on Contractor Sites, no security constraints in it doing so. In these projects, the second option

at Clause 44.2 should be used.

Acquisition teams should always consult their financial advisers on the issue of residual value of the Assets relevant to their particular project, but if the answer to the following questions is "yes", in general Clause 44.1 should be used:

1. are there legal or security constraints which would restrict the Contractor's use of the Assets if they were transferred on expiry or termination of MOD PFI PAV2. For example, do the Assets include security-sensitive training equipment or course materials or buildings inside the wire?
2. would it be costly for the Contractor to convert the Assets from the use made of them by MOD for the project to an alternative use for which there is a ready market?
3. does MOD require long-term use of the Assets after the project is over?

In relation to compensation on termination (see guidance notes on Part 26), residual value may impact upon the compensation payable by MOD. Further guidance on the issues to be considered by acquisition teams when deciding whether MOD should retain residual value risk is also given in SoPCv4 paragraph 20.2.

PART 10 – TRANSFER OF TITLE IN NON-CORE UNITS FOR DEFENCE HOUSING PROJECTS

- 45 – These provisions are only suitable for Defence Housing
56 projects.

PART 11 – THIRD PARTY USE OF ASSETS PRIORITY

- 57 The Contractor may wish to use the Specified Assets to provide services to third parties as well as to MOD ("**Third Party Use**"). In general this should be welcomed by acquisition teams, as it will involve either a reduction in the Unitary Charge or MOD's receiving a share of fees charged by the Contractor to third parties for their use of the Specified Assets. Appropriate protections for MOD to ensure that there are no security or other risks in, and that the Services are not degraded by reason of, the Third Party Use are built into Part 11.

There are two types of Third Party Use which may be made of the Specified Assets:

1. use which is contemplated by the Contractor at the time of its bid and which is reflected in a reduction in the Unitary Charge proposed at the bid stage;
2. use which is proposed by the Contractor during the Contract Period (see guidance on state aid below).

For the first type of Third Party Use, the Contractor will set out its proposals in Schedule 12. Acquisition teams should check that this contains full details of the service the Contractor will provide to the third parties. If the Contractor has discounted the Unitary Charge to give MOD credit for a share in the Contractor's fees for this type of Third Party Use, credit for this discount should form part of Clause 60 (the Clause itself should not be deleted as it covers the second type of Third Party Use which may arise unexpectedly during the project).

Persons undertaking Third Party Use will always be Contractor Related Parties (even if they are service personnel, for example paying a fee to use a gym out of hours) and will be the responsibility of the Contractor insofar as they are undertaking Third Party Use (see guidance notes on Clause 7).

State Aid

Acquisition teams should be aware that if MOD allows the Contractor to undertake Third Party Use during the project which was not contemplated at the bid stage, it may be granting a "state aid" to the Contractor, which is not permitted under UK or European Law.

State aid is any advantage or assistance given directly or indirectly by the public sector using state resources for no countervailing benefit which distorts competition by favouring one bidder over other bidders. In the context of a PFI project, state aid might arise if the Contractor uses MOD's assets or buildings as part of the project and pays no fee to MOD for doing so. In these circumstances, if the Contractor is allowed

to use those assets or buildings to provide services to third parties, it has a competitive advantage over other contractors who would have to buy or lease their own assets or buildings. This means that the price charged to third parties by the Contractor can be less than the prices charged by other contractors, thereby distorting competition for the Third Party Use services.

In order to avoid Part 11 of MOD PFI PAV2 giving rise to a state aid, MOD must charge the Contractor a market fee to use the Specified Assets for Third Party Use. Because the ramifications for MOD giving a state aid are significant, advice should always be taken from the MOD's Director Commercial Law if this type of Third Party Use is proposed by the Contractor.

THE TP OUTLINE PROPOSAL **58** Irrespective of whether the Third Party Use is contemplated at the Commencement Date or arises during the currency of the project, this Clause enable the Contractor to submit a Third Party Outline Proposal.

THE TP USE PROPOSAL **59** In addition to any TP Outline Proposal submitted by the Contractor, the Contractor is required to submit a TP Use Proposal addressing all the issues in Clause 59.2 MOD's interest in these matters is to check that there will be no security or other risk implications in allowing the proposed Third Party Use, that the Services will not be degraded by the proposed Third Party Use and to see an estimate of the Contractor's costs and revenue from the Third Party Use.

59.6 MOD can refuse consent to Third Party Use, either contemplated at the Commencement Date or which arises during the currency of the project, for any reason and at any time.

THIRD PARTY INCOME SHARE **60** This Clause gives MOD the right to take a share of the Contractor's income from Third Party Use – the "**Third Party Income Share**".

At Clause 60.2.1 the "**Third Party Income Share**" requires acquisition teams to agree the details of the share with their bidders. These details must always be discussed with financial advisers.

PART 12 – PAYMENT AND BASE CASE

BASE CASE	65	<p>The Financial Model or Base Case is the computer spreadsheet model for the project, used as a transparent tool to calculate the pricing of the project, taking into account all of the relevant cost and economic variables that affect pricing. It is also used by funders to test the robustness of the project economics to variations in the size and timing of cash flows as well as variations in economic factors. It will incorporate statements of the Contractor's cash flows including projections of all expected expenditure, revenues, financing and taxation of the Project Operations; profit and loss accounts and balance sheets for the Contractor throughout the Contract Period; and details of all assumptions, calculations and methodology used in their compilation and any other documentation necessary or desirable to operate the model. The construction of the Base Case should be consistent with the terms of the Financing documents and Contract and should accurately reflect the priorities in which payments are made out of cash flow revenues and the consequences in the event that there is a shortfall in the cash available to make such payments.</p> <p>The Base Case will be used to set the price at financial close and accordingly it will form a Schedule to the Contract. Custody arrangements will also be required to ensure the integrity of the model and data within it are protected. The Base Case can, however, be expected to change over the life of the project as changes to the project are made, so it is necessary to have an agreed procedure for making changes to the model and hence the Unitary Charge.</p>
PAYMENT PROVISIONS	66	<p>In general the MOD will pay the Contractor a monthly Service Charge for the provision of services under the Contract. Payment will be made following presentation of an invoice and the amount due shall be calculated in accordance with the Payment Mechanism set out in the Contract.</p>
Report and Invoice	66.2	<p>In MOD PFI PAv2 all of the Contractor's claims for money (whether this is Unitary Charge, or other amounts payable such as payments for a Minor Change or Major Change or payments under the MOD's indemnities on Measures in a Crisis) are processed on the same form and in the same manner. The Contractor submits payment claims for each "Payment Period" (calendar month) covering retrospective amounts due from the previous Payment Period.</p> <p>Two systems are available for acquisition teams to choose from – the MOD standard payment system and the MOD P2P system. Whichever system is used, the Contractor must submit the "Relevant Form" (non P2P system) or "delivery label" (P2P system) together with a full breakdown of the amounts claimed in the form of a report, together with supporting documentation to allow the MOD to properly assess the claim for payment.</p>
Payment	66.4	<p>The latest date by which the MOD can pay the Contractor is fixed by reference to the "Relevant Day" which is thirty days</p>

after the later of:

1. the date of completion of the Services for the relevant Payment Period; and
2. either the day on which the Authority's Representative receives a valid delivery label, or receives a valid request for Payment Approval (depending on whether the P2P system is used).

DISPUTED AMOUNTS 67

This Clause governs MOD's rights to dispute and withhold sums from any amounts claimed by the Contractor.

VAT ON PAYMENTS 68

SoPCv4 Para 12.4

This Clause is derived from DEFCON 513 (Value Added Tax) which has been agreed with industry and is used as standard in all MOD contracts. Guidance as to its use can be sought from MOD's Commercial Services Group.

RIGHTS OF SET-OFF 69

SoPCv4 Paras 12.1,12.2,and 12.3

Although MOD PFI PAv2 contains various obligations on the Contractor to pay monies to MOD, for example on indemnity claims, in practice MOD may wish to simply set-off these amounts from the next instalment of the Unitary Charge. This right is not reciprocal. If the Contractor owes money to MOD, it cannot require a reduction in the Unitary Charge to set-off these amounts unless MOD is willing to agree this. If MOD does not agree, the Contractor will be obliged to pay amounts to MOD at the time stated in the relevant Clause of MOD PFI PAv2.

INTEREST ON LATE PAYMENT 70

- 70.1** If the MOD is 30 or more Business Days late in making a payment to the Contractor, it must also pay interest at the "**Prescribed Rate**" until it makes the payment. Once the 30 Business Day threshold has been exceeded however, simple interest runs from the date payment was due, not the date 30 Business Days later.

Under the Late Payment of Commercial Debts (Interest) Act 1998, a late payer must pay interest at a "substantial" rate. In MOD PFI PAv2 this substantial rate is the Prescribed Rate, which is fixed at 2% above a clearing bank rate (acquisition teams may select the bank to be used). The purpose of the second half of Clause 70.1 is to document the Parties' agreement that the Prescribed Rate will not be open to challenge under the Act on grounds that it is not a substantial rate.

The principles relating to interest on amounts which MOD disputes are covered in Clause 67.4.

INDEXATION 71

Indexation of the Unitary Charge is carried out annually on the "**Indexation Review Date**" by applying the index or indices specified in the Payment Mechanism in Schedule 13 (see also the guidance notes on Clause 2.2). Acquisition teams should specify the Indexation Review Date prior to issuing the MOD PFI PAV2 as part of their ITT/ITN and should not leave it to be negotiated with the Contractor during the bid stage.

PART 13 – PAYMENT WHERE ASSET PROVISION INVOLVES CONSTRUCTION OPERATIONS DEFINITIONS

72 The Construction Industry Tax Deduction Scheme governs the payment of taxes in relation to construction projects. An employer of a construction contractor must make a deduction from all payments for labour of an amount on account of the Sub-contractor's tax and National Insurance contribution liability and provide evidence to the MOD that it will be doing so. The Clause sets out the process that the MOD will follow in relation to such deductions should the Contractor not provide the required evidence.

PART 14 – VALUE FOR MONEY
VALUE FOR MONEY REVIEW **73**

PFI contracts generally contain a mechanism for assessing the value of the Services on a periodic basis. If the project is for services which can easily be contracted out to a ready market, such as cleaning and catering of accommodation, provisions for benchmarking or market testing the Unitary Charge (and its subsequent variation) are used to ensure the project's continuing value for money over the Contract Period. However, for MOD's PFI projects there may be no ready market for all or a significant proportion of the Services if these are very specialised and can only be provided by one or two contractors, or if they require specific security clearance.

MOD PFI PAV2 therefore replaces the periodic review of the Contractor's input costs that is undertaken on a benchmarking or market testing exercise with a periodic review of the Contractor's (output-based) internal rate of return throughout the life of the project ("**Actual Equity IRR**"). The Actual Equity IRR includes any cash flows in relation to sub-debt provided by the Shareholders.

The periods for MOD to conduct this review (the "**VFM Review Dates**") should not be specified by acquisition teams before the ITT/ITN is issued. Otherwise, the Contractor may structure its debt and other payments so that its Actual Equity IRR is minimised at the periods MOD undertakes the VFM Review thereby minimising the likelihood or the amount of the excess IRR. Due diligence over the Contractor's financing documents should also show whether the Contractor has structured its financial affairs with this end in mind.

Contractor's Provision of Details of Actual Equity IRR

73.4 The information provided by the Contractor under this Clause is central to MOD's understanding of the Contractor's Actual Equity IRR during the period from the previous VFM Review Date. A detailed explanation of its calculation and the Contractor's assumptions underlying the calculation therefore accompanies the calculation of the Actual Equity IRR submitted by the Contractor. The only matters the Contractor is allowed to ignore in computing the Actual Equity IRR are those set out in Clauses (a) to (e), principally because the MOD PFI PAV2 either provides an alternative mechanic for MOD to receive a proportion of these amounts (for example, in Part 11 (Third Party Use) and Part 15 (Refinancing)) or because the costs or gains are for the Contractor's account only.

Acquisition teams should only include (a) if the formula for calculating the Authority's Third Party Use Income is based on the Contractor's profit and not its revenue, otherwise MOD will be taking a double share under Part 11 (Third Party Use) and this Clause.

Authority's Review of Actual

73.5 and If MOD does not agree with the details submitted by the Contractor under Clause 73.4, it has 30 Business Days to

Equity IRR **73.9** notify the Contractor that it is appointing an independent auditor to review these details. Failure to notify the Contractor within this period means that MOD will accept the Contractor's calculation of its Actual Equity IRR by default.

In this Part of MOD PFI PAV2, the normal Dispute Resolution Procedure (Part 27) does not apply. The independent auditor's determination of the Actual Equity IRR is final and binding on both Parties.

Excess IRR **73.6** The purpose of the "**Authority's VFM Payment**" is to avoid disproportionately high profits being made by the Contractor, over and above the IRR level it has bid ("**Threshold Equity IRR**"). If Actual Equity IRR in a VFM Review Period exceeds the Threshold Equity IRR, MOD takes a share of such excess (the "**Equity IRR Excess**") in accordance with the Table.

The figures in the Table are bands and are cumulative. For example, if the Threshold Equity IRR is 12%, with a Table as follows:

Equity IRR (expressed as a percentage above the Threshold Equity IRR)	Excess as a percentage above the Threshold Equity IRR	Authority's VFM Share
0 to 30%		20%
30% to 40%		40%
40% to 50%		50%
More than 50%		60%

and an Actual Equity IRR of 15.9%, the MOD's VFM Share will fall partly into the 0 to 30% band, covering the proportion of the excess above the Threshold Equity IRR up to 15.6% (i.e. 130% of 12%) and partly into to 30 to 40% band (i.e. covering the remaining 0.3% of the excess). The MOD's VFM Share in this example will be 20% of the excess above the Threshold Equity IRR up to 15.6% and 40% of the excess above the Threshold Equity IRR from 15.6 to 15.9%.

The MOD's VFM Payment is calculated by multiplying the Equity IRR Excess by the MOD's VFM Share.

The MOD's VFM Payment is placed in a bank account until termination or expiry of the Contract and cannot be withdrawn except in accordance with Clause 73.8. All withdrawals need the joint signatures of MOD and the Contractor.

Adjustment of VFM Bank Account After the VFM Review Date **73.7** The Contractor will normally wish to take back all or part of the MOD's VFM Payment in the bank account if its Actual Equity IRR falls below the Threshold Equity IRR on subsequent VFM Review Dates and these provisions allow this to be done. However, MOD can never be obliged to make any payments, other than the amount in the VFM Bank Account, to preserve

the Contractor's Actual Equity IRR.

**Adjustment of
VFM Bank
Account on
Termination or
Expiry**

73.8 At the end of the Contract, a final calculation of the Contractor's Actual Equity IRR over the project is carried out.

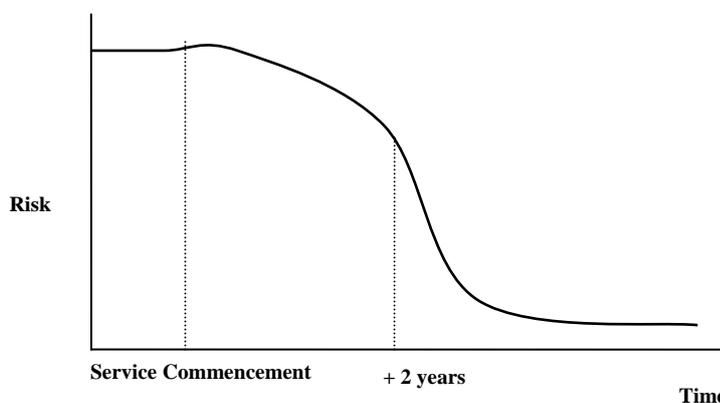
If the Actual Equity IRR is less than the Threshold Equity IRR then a payment is made from the VFM Bank Account to the Contractor (subject to the balance in the account not falling below zero) so that the Actual IRR equals the Threshold Equity IRR. Any remaining funds in the VFM Bank account are paid to the MOD.

If the Actual Equity IRR is greater than the Threshold Equity IRR then the MOD is paid any funds remaining in the VFM Bank Account.

PART 15 – REFINANCING
SoPCv4 Chapter
34

Refinancing is the Contractor's rescheduling of its debt during the project. In most PFI projects, the Contractor's risks are greatest during the Asset Provision phase because it has no certainty as to when it will achieve commencement of the Service Levels and therefore begin to receive Unitary Charge payments. The funders therefore price the debt they provide to the Contractor to take account of these risks. The risks for both the Contractor and its funders reduce slightly during the early years of the Service Provision phase, as the Contractor "beds in" the Specified Assets and its procedures for delivering the Services, and are considerably reduced during the latter part of the Service Provision phase once efficient Service delivery procedures are in place.

A graphical representation of the Contractor's risk for a PFI project might therefore look like this:



Accordingly, the Contractor's debt is likely to be most expensive during the time from financial close until it has fully commenced all Service Levels. This reflects the funders' risk that the Unitary Charge will not be paid when anticipated because the Contractor is late in commencing Service. The Contractor may be able to obtain cheaper debt once this risk has reduced. Because MOD is paying for the Contractor's debt service as part of the Unitary Charge, which is fixed on financial close at the more expensive debt rate, rescheduling its debt in this way has an obvious advantage for the Contractor. The provisions in Part 15 (Refinancing) are intended to give MOD at least half of any benefit ("**Refinancing Gain**") the Contractor makes when it reschedules its debt.

REFINANCING **74**
OBLIGATIONS

The provisions in this Clause deal with the calculation of the Refinancing Gain and its payment to MOD. As soon as acquisition teams become aware of a potential refinancing of their project, they should seek specific guidance on this aspect from the PFU.

PART 16 – SUPERVENING EVENTS AND MEASURES IN A CRISIS

This Part of MOD PFI PAv2 deals with unexpected events which occur during the currency of a project and for which the Contractor is granted some relief or compensation.

COMPENSATION 75 EVENTS

SoPCv4 Para 5.2

"**Compensation Events**" are events which, if they occur, and do not arise from the Contractor's fault, entitle the Contractor to be compensated for the effect of the event. One distinction between Compensation Events and Relief Events is that Compensation Events are events over which the MOD has some control, whereas Relief Events are events which are generally (but not solely) under the control of neither Party. In addition, Compensation Events entitle the Contractor to claim an extension of time as well as compensation. Relief Events entitle the Contractor to relief from termination (and possibly other obligations), but MOD pays no compensation.

Compensation Events are listed in Clause 2.1 and, as well as the SoPCv4 Authority breach event which is covered in (a), there are six other events (b) to (g) which do not arise as a result of Authority breach, but where MOD accepts that it should grant a Compensation Event. This list should only be extended on genuinely project-specific grounds, and should not, for example, include ground conditions even if surveys cannot be undertaken, as the correct mechanism to deal with this is to carve out affected land from the Contractor's ground risk by including it in Clause 14.4.4(f).

Although the SoPCv4 Authority breach event which is listed in (a) can only apply during the Asset Provision Period, under MOD PFI PAv2 claims for certain Compensation Events may be made both before and after the Service Commencement Dates for affected Service Levels. Whether a claim may be made before or after will depend on the type of Compensation Event as some of the Compensation Events may only arise or be discovered after the Service Commencement Date for an affected Service Level which prevents or impedes Service Provision for one or more Service Levels.

Compensation Events entitle the Contractor to an extension of time in which to commence Service Provision for affected Service Levels (i.e. an extension to the Planned Service Commencement Date), to relief from Deductions for affected Service Levels which have already commenced and to payment for additional costs or lost revenue. Acquisition teams may also elect to include a right to postponement of the Long Stop Date (failure to commence a Service Level by this date gives MOD a right to terminate for Contractor Default).

Procedure for Compensation Event Claims

75.2

Under this Clause the Contractor's claim for compensation as a result of a Compensation Event can come in either one or two parts:

1. The first, to be given as soon as possible and, in any event, within 20 Business Days of the Contractor becoming aware of the Compensation Event causing, or being likely to cause any of the consequences listed in this Clause, is a simple notification that the Contractor will be making a claim as a result of a Compensation Event;
2. The second (which may be combined with the first or given within 10 Business Days after the first part of the Contractor's claim) is a detailed breakdown of the claim itself. This takes the form of:
 - a. details of any extension of time to the Planned Service Commencement Dates for affected Service Levels and, if relevant, the corresponding Long Stop Dates (together with a revised draft Asset Provision Programme under Clause 27.2 (Time for Submission of Asset Provision Programme));
 - b. details of any relief from its obligations (including relief from Deductions for affected Service Levels which have already commenced) required by the Contractor;
 - c. details of the "**Estimated Change in Project Costs**" (financial compensation) claimed. This should be set out in the form of a calculation in accordance with the definition of Estimated Change in Project Costs;
 - d. supporting evidence for any of the above to enable the MOD to properly assess the Contractor's claim.

Notification and provision of information within the periods above is not a prerequisite (condition precedent) to the Contractor making a Compensation Event claim, but there is a sanction in Clause 68.4 for the Contractor's delay in making its claim.

Effect of a Compensation Event

75.3

Although the Contractor is required to submit its detailed estimate of the Compensation Event claim under Clause 75.2, compensation payable by the MOD is not directly linked to the time periods, relief or Estimated Change in Project Costs claimed by the Contractor in this estimate. Instead, MOD compensates the Contractor by way of:

1. an extension of time which is reasonable for the Compensation Event (which may be more or less than that originally claimed by the Contractor depending on the actual delay suffered by the Contractor). In assessing this extension of time MOD should not grant an extension for any period of concurrent delay, i.e. a period where the Contractor was already in delay irrespective of the Compensation Event. This is what is meant by the reference to "direct cause" in Clause 75.2.1(c)(i). Use of the Asset Provision Programme may be helpful in these circumstances to separate delay caused by the

Compensation Event from the Contractor's own delay;

2. the actual costs incurred or revenue lost by the Contractor as a result of the Compensation Event (rather confusingly these are entitled actual Estimated Change in Project Costs by SoPCv4). If the Unitary Charge is calculated by reference to MOD's usage of the Specified Services (see guidance on Schedule 13) or Third Party Use is being undertaken at the time of the Compensation Event (whether this is built into the Unitary Charge or arises during the Contract Period) the Payment Mechanism will need to deal with assumptions as to MOD's usage or the Third Party Use revenue to be applied to affected Service Levels as a result of the Compensation Event;
3. relief from obligations (including Deductions) which is reasonable for the Compensation Event (which may be more or less than that originally claimed by the Contractor). In assessing this relief the principles of concurrency discussed above apply equally in that MOD should not grant relief for any period where the Contractor would have incurred the Deductions irrespective of the Compensation Event.

Payment of the Contractor's actual Estimated Change in Project Costs is dealt with in two ways. Payment of the Operating Expenditure and financing costs element of the actual Estimated Change in Project Costs is by way of adjustment to the Unitary Charge calculated so as to put the Contractor in a no better and no worse position in accordance with Clause 65.3 (see the guidance notes on Clause 2.3). Payment of the Capital Expenditure element of the actual Estimated Change in Project Costs is by way of a lump sum payment using the standard invoicing provisions in Part 12 (Payment and Base Case).

Finally, all extensions of time, relief and payments to be granted or made by the MOD on a Compensation Event are subject to the Contractor's duty to mitigate the effects of the Compensation Event in Clause 75.2.1(c)(ii). MOD should discount any such extension, relief or payment if the Contractor has failed to mitigate the effects of the Compensation Event by acting in accordance with Good Industry Practice.

**Late Provision of
Notice or
Information**

75.4

If the Contractor does not submit its notification of a Compensation Event claim within the period required by Clause 75.2.1(a) or full details of the claim within the period required by Clause 75.2.1(b), it may still make the claim, but this Clause allows MOD to reduce the extension of time or relief granted or compensation payable by deducting compensation for the period of delay.

A worked example is as follows:

The Contractor makes a Find of ordnance on 2nd January (D Day). It notifies MOD's Representative and the police

immediately as it is required to do under Clause 14.4.4(b)(iii) but it does not submit its detailed claim for compensation until D+20 Business Days. In these circumstances, MOD should reduce any extension of time or relief granted by 10 Business Days and should discount the actual Estimated Change in Project Costs incurred by the Contractor by 10 Business Days worth of financing costs and Operating Expenditure. Any Capital Expenditure which could have been reduced or avoided in the 10 Business Day period should also be discounted.

RELIEF EVENTS 76

SoPCv4 Para 5.3

"Relief Events" are events which are usually (but not exclusively) outside the control of either Party. They differ from Force Majeure Events in that the probability of a Relief Event is usually greater than for a Force Majeure Event. Depending on the project, however, the impact of a Relief Event may be just as great as a Force Majeure Event.

Relief Events are listed in Clause 2.1 and differ from the SoPCv4 definition of Relief Events in that the MOD PFI PAV2 caters for Services and Specified Assets located outside the UK and, in the case of equipment projects only, the shortage of power, fuel or transport event (d) is limited to national rather than regional or local shortages. This list (and SoPCv4), however, originated from projects involving an element of construction works and acquisition teams may amend it on project-specific grounds. For example, marine projects may include certain sea states or aviation projects may include winds above a certain force as Relief Events. Adding events which are not genuinely specific to a particular project or type of project should, however, be avoided, and in no circumstances should an event arising from the Contractor's own act or default be included in the list of Relief Events.

Relief Events entitle the Contractor to relief from termination of MOD PFI PAV2. Acquisition teams may also elect to include relief from the Contractor's other obligations under the Contract, having regard to HMT's Guidance on Value for Money and the implications of including or not including these references. However, in no circumstances should the Contractor be entitled to relief from Deductions as a consequence of a Relief Event, as it is a fundamental principle of PFI contracts (including MOD PFI PAV2, see Clause 69.4) that the risk of failure to provide the Services to the required standards (Service Performance Deductions) or to achieve availability (Unavailability Deductions) on a Relief Event should remain with the Contractor, irrespective of whether it is able to obtain insurance cover for these Deductions. There is also no provision for any compensation to be paid by the MOD on a Relief Event.

A Relief Event occurring before the Services Commencement Date for an affected Service Level may also entitle the Contractor to a postponement of the Long Stop Date (see guidance above on Clause 75).

Procedure for Relief Event Claims

76.2 Under this Clause the Contractor's claim for relief as a result of a Relief Event can come in either one or two parts:

1. The first, to be given as soon as possible and, in any event, within 10 Business Days of the Contractor becoming aware of the Relief Event causing, or being likely to cause any of the consequences listed in this Clause, is a simple notification that the Contractor will be making a claim for relief as a result of a Relief Event;
2. The second (which may be combined with the first or given within 5 Business Days after the first part of the Contractor's claim) is a detailed breakdown of the relief required.

Acquisition teams should note that if the provisions for step-in on a Relief Event are to be used (see guidance on Part 17 (Authority Step-In)) the time periods in this Clause should be set on the basis of MOD's operational requirements and, in particular, the Contractor's notice of a Relief Event should be provided within a sufficiently short time so as to allow MOD to step-in to preserve or provide the affected Services.

Notification and provision of information within the periods above is not a prerequisite (condition precedent) to the Contractor making a claim for relief, but there is a sanction in Clause 76.5 for the Contractor's delay in making its claim.

Effect of a Relief Event

76.3 If the provisions for step-in on a Relief Event are used (see guidance on Part 17 (Authority Step-In)), the MOD may choose to step-in to the Contract to provide any Service affected by the Relief Event and, if termination is allowed under Clause 80.4.1, may elect to terminate the Contract. In all other circumstances, although MOD will still levy Deductions (see below), these will not count towards any Contractor Default thresholds. The Contractor will also receive relief from termination for other Contractor Default events.

MOD should also grant the Contractor a reasonable extension of time to the Planned Service Commencement Dates and/or Long Stop Dates for affected Service Levels and, if the yellow shaded provisions are included, other relief.

No Relief From Deductions

76.4 During and following a Relief Event, the Contractor's provision of Services may be affected. However, MOD should still make Deductions in the normal way. The Contractor may be able to recoup these Deductions through its Business Interruption Insurance.

Late Provision of Notice or Information

76.5 If the Contractor does not submit its notification of a Relief Event within the period required by Clause 76.2.1(a) or full details of the claim within the period required by Clause 76.2.1(b), it may still make the claim, but this Clause allows MOD to reduce the extension of time or relief granted by deducting compensation for the period of delay.

FORCE MAJEURE 77
EVENTS

SoPCv4 Para 5.4 77.1 In order to qualify as a "**Force Majeure Event**" the event must not just fall within (a) to (c) of the definition in Clause 2.1, but it must directly make it impossible for the Contractor to comply with all or a material part of its obligations, whatever measures the Contractor might take.

If the project directly contemplates Service Provision in theatre or during hostilities these circumstances will need to be excluded from classification as Force Majeure Events if the Contract is to continue during these events. In order to do this, acquisition teams should create a separate section in the MOD's Requirements, Contractor's Proposals, Services Availability Requirements and Payment Mechanism dealing with the provision of the Services in wartime. Clause 77 may also need to be augmented to provide for the unintended consequences of war which can reasonably be contemplated by the Parties at the time the Contract is negotiated. In these circumstances, acquisition teams should consider the interface between "war" as used in the definition of Force Majeure Events and "war" as defined in any insurance policy. However, even if Services will be provided in wartime, "war" should remain as a Force Majeure Event. This is because it is not possible to anticipate all the consequences of war. Accordingly if such an unanticipated consequence were to occur and if this caused an inability to comply with the Contract, then the usual relief triggered by force majeure applies.

If a Force Majeure Event occurs, the Contractor must notify MOD as soon as practicable, giving the details required by Clause 77.1. The Parties should then meet to discuss in good faith how (if at all) the effects of the Force Majeure Event can be mitigated to allow the project to continue.

Effect of a Force 77.3 A Force Majeure Event relieves the Contractor of the obligation to carry out Asset Provision and/or Service Provision, and all other obligations which the Force Majeure Event prevents it from carrying out. MOD is similarly relieved of its obligations which the Force Majeure Event prevents it from carrying out. However, MOD should still make Deductions during and after the occurrence of a Force Majeure Event.

In certain circumstances, the occurrence of a Force Majeure Event may lead to termination of the Contract under Clause 133 (Termination on a Force Majeure Event or on Uninsurability), but MOD will not be able to terminate for Contractor Default if and to the extent that the Contractor Default has arisen from the Force Majeure Event. For example, if the effect of a Force Majeure Event is to prohibit Service Provision for three months, the Contractor may incur Deductions above the thresholds which would ordinarily allow MOD to terminate for Contractor Default limbs (k), (l) or (m), but if the failure to provide the Services is caused by the Force Majeure Event, no Contractor Default termination right will arise. A more difficult situation will arise if the Contractor fails

to commence provision of the services by the Long Stop Date (Contractor Default limb (j)) but it was already in delay prior to the occurrence of the Force Majeure Event. In these circumstances of concurrent delay specific legal advice should be taken if the MOD is contemplating termination of the Contract.

MEASURES IN A CRISIS 78

In addition to step-in rights referred to below, MOD also requires a right within all PFI contracts to take actions during a period of tension, transition to war or hostilities or where it is directed to respond to any national or international emergency, disaster or other unforeseen risk ("**Measures in a Crisis**"). Here, MOD is the sole arbiter of whether such an event has occurred and whether action is required.

As part of its action on Measures in a Crisis, MOD can require the Contractor to use all reasonable endeavours to comply with any instruction it issues, not just instructions normally contemplated by the Contract, such as:

1. cessation of Third Party Use and removal of any third party assets from the Authority Site;
2. suspension or cessation of the Services or changing the Services without reference to the contractual change mechanism in Part 18 (Changes and Change in Law);
3. redeployment of employees/assets in accordance with the MOD's instructions.

Authority's Indemnity on Measures in a Crisis

78.6 Because MOD is given such wide rights on Measures in a Crisis, the Contractor is fully compensated for all effects of the action MOD takes ("**MIAC Required Action**"). This includes both full payment of the Unitary Charge and an indemnity from MOD to the Contractor covering all Direct Losses and all reasonable Indirect Losses suffered by the Contractor. This covers both the Contractor's direct costs of complying with MOD's instructions and its indirect costs, for example through loss of revenue for Third Party Use (which is limited to the amount payable under the approved Third Party Use contract).

PART 17 – AUTHORITY STEP-IN
AUTHORITY 80
STEP-IN

SoPCv4 Chapter
29

The grounds on which the MOD can step-in to the project mirror those in SoPCv4, with the exception of an additional (optional) right of step-in on a Relief Event. This right may be used by acquisition teams working on operationally critical projects where, if the Specified Assets are damaged, or Service Provision is impaired by a Relief Event, the provisions relating to Relief Events (Part 15) and Damage to the Specified Assets, Indemnities and Contractual Claims (Part 24) are considered insufficient to preserve Service continuity, and the right to levy Deductions is of a lower priority than ensuring Service Provision. In these circumstances, acquisition teams need to fully consider whether it may be appropriate to include in the draft Contract the right for MOD to step-in to the project to take emergency action to reinstate any Specified Assets damaged by the Relief Event and/or to continue Service Provision.

The ability to step-in on a Relief Event is intended to be used in place of the right to terminate on a Relief Event which was contained in MOD's Guidance on SoPCv2. However, MOD PFI PAv2 retains a limited termination right if, in order to step-in, it would be necessary for the MOD to incur Capital Expenditure above the threshold (see guidance on Clause 73.4).

An example of a project where step-in on a Relief Event might be appropriate would be in an operationally critical vehicle-based project where the Relief Event affected the factory that was building the vehicles. It is very unlikely that the same Relief Event would simultaneously be affecting all similar vehicle manufacturers and so MOD could step-in to the Contract and procure the necessary vehicles from an alternative source.

Effect of Step-in
on a Relief Event

80.4

If, having thought through the aspects concerning operational criticality, acquisition teams decide to include this optional right to step-in on a Relief Event, they **must** also include the right for MOD to subsequently terminate the Contract. This may prove necessary if, in order to step-in, MOD would need to incur Capital Expenditure above a threshold or if a certain element or percentage of the Service was disrupted by the Relief Event (to be set on a project-specific basis). In these circumstances, this Clause allows MOD a limited time period following the Contractor's notice of a Relief Event in which to decide to terminate the Contract; compensation will be payable to the Contractor as for a Force Majeure termination, less the Contractor's insurance proceeds (see guidance on Clause 127). If the termination right is not exercised within this period, or if the threshold is not exceeded, MOD's only available option will be to step-in.

On step-in, the Contractor is relieved of its obligations to provide the relevant part of Asset Provision or Service

Provision. MOD pays the Unitary Charge less its costs incurred to step-in (both Operating Expenditure and Capital Expenditure) as this shortfall in Unitary Charge should generally be recoverable by the Contractor from its insurers. However, irrespective of the costs of stepping-in incurred by MOD, the Contractor should always receive that proportion of the Unitary Charge necessary for the Contractor to service its senior debt (principal repayments and interest) during the period of step-in. Acquisition teams should consult their insurance advisers if they intend to use this optional Clause, to make sure that the Contractor's insurance will cover any reduction in the Unitary Charge made by MOD to cover its costs of stepping-in.

**Other
Consequences of
Step-in on a
Relief Event**

80.5 If MOD has reduced the Unitary Charge by amounts to cover its Capital Expenditure incurred on step-in, and this Capital Expenditure has been used to reinstate all or part of the Specified Assets, this may affect the amount the Contractor can recover from its insurance. If MOD's reinstatement of the Specified Assets whilst stepped-in prejudices or reduces the monies recovered by the Contractor from its Physical Damage or Property Damage insurance, MOD will be responsible for making up any shortfall by paying the relevant amount into the Joint Insurance Account.

The Contractor should notify MOD within the defined period of its receipt of any insurance proceeds. MOD's payment into the Joint Insurance Account should be made within the period required by Clause (b).

PART 18 – CHANGE AND CHANGE IN LAW

SoPCv4 Chapters 13 and 14

The Change procedure in MOD PFI PAV2 differs from that in SoPCv4 in a number of ways:

1. It unifies the separate SoPCv4 change procedures for an Authority Change, a Contractor Change, a Minor Change and a Change in Law into a single procedure covering all of these types of change, accompanied by a travelling change notice which passes between MOD and the Contractor;
2. It contains more detailed competitive tendering procedures for "**Major Changes**" over a threshold value (to be inserted on a project-specific basis);
3. To reflect the ability of MOD PFI PAV2 to deal with complex Service phasing, it compensates the Contractor for a General Change in Law which takes effect during the service period for Service Levels which have achieved their Service Commencement Date, rather than by reference to a single service commencement period;
4. It contains provisions for a Change to be urgently instructed, without formal agreement of the Contractor's detailed estimate for the Change. These provisions are intended to be used where the Change is required for urgent operational reasons and needs to be implemented before the formal estimate is agreed;
5. There is no requirement for Changes to be limited to Changes in Service. The Change procedure is intended to cover all types of Change, including contractual variations and changes in Sub-contractors or the Parties' Representatives;
6. A Change (including a Change necessitated by a Change in Law) can occur during either the Asset Provision or the Service Provision phase for any or all Service Levels.

It is left to acquisition teams to choose (on a value for money basis and having regard to any applicable EU procurement rules) whether the Contractor will be given an exclusive right to undertake variations to the Specified Assets.

STEP 0 - INITIAL ENGAGEMENT OF THE PARTIES 82

- 82.1** This encourages an initial engagement between the Parties, ahead of any formal change request, to consider the need for any change or raise awareness of a possible change. Where the MOD is considering proposing a change it can then raise a "**Notice of Possible Future Change**"; where the contractor considering proposing a change it can raise

this as a proposal.

82.2 Where such a MOD Notice of Possible Future Change or Contractor proposal is raised then the Contractor is required to provide a rough order of magnitude estimate of the potential impact of the Change. If either party wishes to proceed with the change then a Notice of Change is raised under STEP 1.

**STEP 1 –
PREPARING THE
NOTICE OF
CHANGE**

83

83.1, Either Party can initiate the Change procedure by sending the proforma Notice of Change (Schedule 14) to the other. If the Contractor wishes to make a change that has no affect on any of the Contractor's obligations under this Contract, and does not increase the costs, risks or liabilities of the Authority, then provided it is not an Administrative Change, a Minor Change, Medium Value Change, a Major Change, an Urgent Change or a Change in Law it can do so without MOD approval.

**83.2
and
83.3**

As part of the unified process, the Party proposing the Change ("**Change Proposer**") should show the type of Change in Section 1 of the Notice of Change by ticking the appropriate box. Changes are grouped into the following types: an "**Administrative Change**", a "**Minor Change**", a "**Medium Value Change**" or a "**Major Change**" any of which may also be triggered by a "**Change in Law**", which should also be shown by ticking the appropriate box on the Notice of Change. If MOD is the Change Proposer it should also set out in Section 1 of the Notice of Change:

1. sufficient details of the Change for the Contractor to complete its estimate of the cost and other effects of the Change in Section 2 of the Notice of Change ("**the Estimate**");
2. for Higher Value Changes only, whether MOD intends to fund any Capital Expenditure required for the Change itself or whether it requires the Contractor to use reasonable efforts to seek this funding externally (for example from the Senior Lenders or any Contingent Funding Agreements).

The distinction between the types of Change is based on both a qualitative materiality test and a quantitative financial threshold (set on a project-specific basis) which can either be a fixed sum (indexed) or a percentage of the yearly Unitary Charge (without Deductions).

Changes in Law do not, of themselves, amount to a Change in the project. However, in order to comply with Clause 16.1, the Contractor may need to change either the Specified Assets or the Services following a Change in Law,

and for this reason, the MOD PFI PAV2 uses the unified Change procedure to deal with a Change necessitated by a Change in Law as well as other types of Change (although the compensation payable to the Contractor may differ). A "**Change in Law**" is defined in the same terms as SoPCv4 but the definition of "**Guidance**" differs from SoPCv4 as the MOD PFI PAV2 requires all relevant Guidance to be listed in the definition in Clause 2.1. This is to distinguish Guidance (which is not specific to, or set by, MOD) from the Authority's Policies which are specific to MOD (such as DEFCONs and DEFSTANs). The Contractor is subject to the Change in Law compensation regime for a Change in Law necessitated by a change in Guidance, whereas a Change necessitated by a Change in Authority's Policies is subject to the general compensation regime (see also guidance notes on Clause 16).

The Change in Law compensation regime divides Changes in Law into three types:

1. "**Discriminatory Changes in Law**" are those which apply expressly and specifically to the project (and not to other similar PFI projects) or specifically to the Contractor (and not to other companies) or to private finance companies and not to other types of company. If these changes are reasonably foreseeable at the Services Commencement Date for the affected Service Levels, the Contractor bears the cost of implementing the Change in Asset Provision or Service Provision to take account of the Discriminatory Change in Law (because it is expected to have priced for this). Otherwise MOD bears the cost. An example of a Discriminatory Change in Law for a simulator training project might be a Change in Law which requires all PFI simulator training providers (but not other simulator training providers) to employ a specialist designated safety officer at each simulator;
2. "**Specific Changes in Law**" are those which specifically refer to projects which are the same as or similar to the project or to the holding of shares in companies whose business is providing projects the same as or similar to the project. If these changes are reasonably foreseeable at the Services Commencement Date for the affected Service Levels, the Contractor bears the cost of implementing the Change in Asset Provision or Service Provision to take account of the Specific Change in Law. Otherwise MOD bears the cost. An example of a Specific Change in Law for a green-fleet equipment supply project might be a requirement for all military tracked vehicles (but not, say, construction tracked vehicles) to reduce carbon emissions to a specified level.
3. "**General Changes in Law**" are all other Changes in Law other than Discriminatory or Specific Changes in Law. As for other types of Changes necessitated by a Change in Law, if these are reasonably foreseeable at

the Services Commencement Date for the affected Service Levels, the Contractor bears the cost of implementing the Change in Asset Provision or Service Provision to take account of the General Change in Law. Otherwise the cost is shared between the Parties (see guidance on Clause 84.10). An example of a General Change in Law might be an increase in the national minimum wage or an employer's national insurance contributions, or a requirement for all buildings to have automatic fire suppression devices installed.

Although changes in tax law are treated in the same way as any other Changes in Law, Changes in the VAT rate or the scope of VAT Legislation are treated slightly differently. If the Service supplied to MOD becomes subject to VAT for the first time, or subject to an increase in VAT, MOD will be responsible for the VAT, or increased VAT payment on the Unitary Charge under the provisions of Clause 68. However, the Contractor bears the risk and cost of changes in VAT in respect of its own costs, such as amounts payable to Sub-contractors. If a Change in Law changes the scope of the VAT Legislation and, for example, the Contractor cannot set-off VAT payable by MOD on the Unitary Charge against the Contractor's own VAT payments on services supplied to it by Sub-contractors, MOD is responsible for paying the difference under Clause 80.6 (see guidance on this Clause below).

Acquisition teams should note that the definition of Change in Law assumes that Asset Provision and Service Provision will be provided in the UK. If the project involves Asset Provision or Service Provision outside the UK, a project-specific derogation will need to be sought. In addition, the definition of "**Legislation**" may need to be revised to include relevant non-UK Legislation with which the Contractor must comply, always bearing in mind that changes to such foreign legislation will be caught by the Change in Law provisions and therefore that the scope of non-UK legislation may impact upon value for money.

Details of the Change	83.3.2	If a Major Change will involve Capital Expenditure, MOD may either ask the Contractor to seek funding for this expenditure or elect to fund all or part the Capital Expenditure itself. MOD can do this at the outset of any Change it proposes (by ticking the appropriate box in Section 1 of the Notice of Change) or at any time during the time the Contractor is seeking funding for Capital Expenditure from the market, which is 30 Business Days.
STEP 2 – PREPARING THE ESTIMATE	84	
Failure to Agree the Classification of the Change	84.1	Because the classification of a Change as either an Administrative Change, Minor Change, Medium Value Change or Major Change, does not depend on the financial value of the Change alone, but also looks at the likelihood

that the Change will affect the Contractor's ability to deliver the project, the Parties may not agree on the appropriate classification for a proposed Change and either Party may refer to the Dispute Resolution Procedure (Part 27) to classify the Change. If MOD is the Change Proposer and the Contractor does not agree with its classification of the Change, the Contractor should send its dispute notice to MOD under Clause 144 before expiry of the time period required by Clause 84 for it to provide the Estimate for the type of Change indicated in the Notice of Change.

- 84.3.2 These Clauses set out the time periods in which the Contractor must complete its "**Estimate**" (Section 2 of the Notice of Change) if MOD is the Change Proposer. These periods are customisable on a project-specific basis for each of the classifications of change. If the Contractor is the Change Proposer it should send the Notice of Change to the Authority's Representative with Sections 1 and 2 already completed to allow MOD to properly assess the Change.
- 84.5.2
- 84.9.2

If MOD is the Change Proposer and the Change is a Major Change the Contractor should also provide a separate estimate (not the Estimate) of any third party costs it will incur in preparing the Estimate if it wishes to recover these costs under Clause 86.4.

Matters to be Covered in the Estimate

- 84.4 The Contractor is encouraged to give the fullest possible details of the effect of the Change in its Estimate. In order to recover relief, compensation or for other changes to be made to the MOD PFI PAV2, the Contractor must identify in the Estimate that such relief, compensation or changes are required. To assist the Contractor to provide the fullest possible Estimate, details of the matters which should be covered if relevant are given in this Clause, and these are further broken down by the examples given in Section 2 of the proforma Notice of Change in Schedule 14.
- 84.6
- 84.9.4

The only exception to this requirement to provide a full Estimate is an Administrative Change, which is a Change with no cost (either increase or reduction) or which involves no increase in the likelihood that the Contractor will fail to deliver the project. For Administrative Changes, such as a change in the Contractor's Representative, the Contractor may provide an abbreviated Estimate.

Calculating the Estimated Change in Project Costs and/or Capital Expenditure – Higher Value Change (Major Change)

- 84.9.6 If the Change is a Major Change over the threshold value (to be set on a project-specific basis), this Clause sets out a detailed competitive tendering regime for the Contractor to seek prices from at least three Sub-contractors (only one of which may be the Contractor's Sub-contractor or other Associated Company) to ensure that the Contractor's price for the Change attributable to Sub-contract costs is competitive. In certain projects, there may not be two Sub-contractors other than the Contractor's Associated Companies which are capable of performing the work entailed in the Change. In these circumstances, the Parties should agree amendments to this Clause using the Project

Management Procedure (Schedule 19).

Once the number of proposed tenderers has been agreed, the remainder of this Clause sets out the process for tendering the Change. The identities of the proposed tenderers ("**Prospective Tenderers**") is first proposed by the Contractor and MOD may object to any of those proposed under Clause 84.9.6(ii)(2). Once the identities of the Prospective Tenderers have been agreed, Clause 84.9.6(ii)(3) contains the requirement for the Parties to agree the criteria on which tender responses will be judged. When deciding these, MOD should allow the Contractor to accept the most economically advantageous tender (for it as well as MOD), rather than the lowest price as the Contractor may need to add a risk margin to the prices proposed by tenderers who are not its Sub-contractors to reflect the increased risk it will bear in appointing such an entity.

When tender responses are received, the Contractor will notify MOD of those Prospective Tenderers who have submitted responses which are compliant with the tender criteria ("**Compliant Tenderers**") and also which of the Compliant Tenderers it wishes to appoint. At this stage, MOD may object to the proposed sub-contractor under Clause 84.9.6(iii), but because it has agreed the criteria on which tenders are to be judged in Clause 84.9.6(ii)(3), it should not generally object to a Compliant Tenderer which has satisfied the criteria.

**Allocation of
Estimated Change
in Project Costs
and/or Capital
Expenditure
between the
Parties**

84.10

The Table in this Clause sets out the required cost allocation for all types of Change.

1. If the Change results in a cost increase MOD bears the full cost of any Change not necessary to comply with a Change in Law which it proposes or which the Contractor proposes and which MOD accepts (although there is no requirement on MOD to accept any Change proposed by the Contractor except a Change necessary to comply with a Change in Law). MOD also bears the full cost of Specific and Discriminatory Changes in Law. The Contractor bears the operating and capital costs of all General Changes in Law with the exception of Expenditure over the Contractor's Share (which is specified on a project-specific basis in Clause 2.1) for General Changes in Law (Major Changes) proposed after the Service Commencement Date for affected Service Levels.
2. If the Change results in a cost decrease, the net decrease (i.e. with the Contractor's costs of implementing the Change deducted) is shared between the Parties in the ratio to be agreed on a project-specific basis under Clause 84.2.2.

The costs of Minor Value Changes are calculated using the Minor **Rates**, to be inserted in Schedule 14 Part 2. The costs of Major Changes are those agreed in Section 3 of the Notice

of Change.

Value for Money of the Estimate	84.11	In order to protect MOD's position on Change, these Clauses ensure that the Contractor's price for the Change is fair, and that it gives credit to MOD for cost reductions that will flow from the Change as well as cost increases. For example, if MOD requires a new heating system in a building, this will involve it paying the Capital Expenditure for the new system, but the Contractor's maintenance costs over the remaining life of the project may be reduced, and MOD will receive credit for this reduction through a recalculation of the Unitary Charge.
Change Refusals	84.14	
Changes Proposed by the Contractor	84.14.1	MOD has the right to refuse a Change proposed by the Contractor at any time (up to and including Step 4 – Confirmation or Withdrawal of the Notice of Change (Clause 86)) and for any reason. The only exception to this is a Change proposed by the Contractor which is necessary to comply with a Change in Law, which MOD cannot refuse. If a Change proposed by the Contractor is necessary to comply with a Change in Law and the Parties cannot agree the Estimate, the Dispute Resolution Procedure (Part 27) should be used to determine the Estimate.
Changes Proposed by the Authority	84.14.2	The Contractor's rights to refuse a Change proposed by MOD are contained in the specific grounds for refusal given in this Clause, including where the Change is illegal, unsafe or would significantly affect the Contractor's ability to deliver the project. Although the Contractor can refuse the Change proposed by MOD at any time until it is confirmed or withdrawn by MOD, the Contractor should invoke any refusal under this Clause as early as possible, having regard to Clause 12. Acquisition teams should take account of Senior Lenders' sensitivities to changes who (even if the Contractor receives compensation for the Change) may resist a Change which alters the risk profile of the project (Clause (f)). Acquisition teams should consider on a project-specific basis whether to include reasonable objection by the Senior Lenders as an additional ground for the Contractor's refusal to implement a Change.
STEP 3 – AGREEING THE ESTIMATE	85	
Evaluating the Estimate	85.2	This sets out the MOD's approach to evaluating the Estimate.
Documenting Agreement of the Estimate	85.3	For all Changes, this Clause sets out the agreed impact of the Change by repeating in Section 3 of the Notice of Change the matters contained in the Estimate as amended by the Parties' agreement during the Change process.

**STEP 4 –
CONFIRMATION
OR WITHDRAWAL
OF THE NOTICE
OF CHANGE**

86

For all Changes other than Changes necessitated by a Change in Law it always remains MOD's right to reject the Change at any time during the Change process until this stage.

Once Section 3 of the Notice of Change has been agreed and completed, and the Contractor has signed the Equality of Information Statement in Section 4 of the Notice of Change if the Change is a Major Change, MOD can either:

1. accept the Change and its effects as set out in Section 3 of the Notice of Change by signing Sections 4 and 5;
2. withdraw the Change, if it is the Change Proposer, by notifying the Contractor;
3. refuse the Change, if the Contractor is the Change Proposer, by notifying the Contractor.

MOD cannot, however, refuse a Change which is proposed by the Contractor to comply with a Change in Law because the Contractor has a duty under the Contract to comply with Legislation (Clause 16). In these circumstances, the process for agreeing the Estimate in Clause 85 provides MOD with the comfort that the Contractor's prices are fair.

This is one section of the MOD PFI PAV2 where the Project Manager cannot act on behalf of MOD. Any Notice of Change to be confirmed by the MOD must be signed by the Commercial Officer (see guidance on Clause 90).

86.4

If MOD has proposed a Major Change and the Contractor has incurred third party costs in preparing an Estimate and (if relevant) undertaking the competitive tendering process, it is appropriate that MOD should reimburse the Contractor for these costs if it withdraws the Change. As part of the Change process (Clause 84.1), the Contractor can provide MOD with an estimate of these third party costs. If it has done so, MOD should reimburse these costs if the criteria in Clause 86.4 are satisfied.

**STEP 5 –
IMPLEMENTATION OF
CHANGES**

87

**Contractor's
Obligations**

87.1

Section 3 of the Notice of Change will set out the detailed obligations of the Contractor to undertake the Change, such as the timing and certification process for any works and will also set out the relief and payment it is entitled to as a result of the Change. The Contractor should perform the

works or Services entailed in the Change in accordance with Section 3 of the Notice of Change.

**Authority's
Obligations**

**87.2 to
87.5** If MOD is responsible for payment for the Change in accordance with the Table in Clause 84.2, the procedure is as set out below.

1. Capital Expenditure is paid by MOD to the Contractor as a lump sum or sums using the standard payment provisions in Part 12 (Payment and Base Case) if:
 - a. MOD has elected to fund the Capital Expenditure for a Change which it has proposed by ticking the relevant box in Section 1 of the Notice of Change (Clause 85.3.2);
 - b. MOD does not initially elect to fund the Capital Expenditure for a Change which it has proposed, but subsequently does so before the Contractor has returned the Estimate (Clause 84.9.4(a)(xi));
 - c. the Contractor has not been able to obtain external funding during the period before it is required to return the Estimate and MOD has confirmed the Notice of Change or it is deemed confirmed in the case of a Change necessary to comply with a Change in Law (Clause 86.2.1 or 86.3).
2. Alternatively, Capital Expenditure is paid by MOD to the Contractor by way of an adjustment to the Unitary Charge so as to put the Contractor in a no better and no worse position in accordance with Clause 84.2.1 and Clause 65.2 (see also guidance on Clause 2.3).

In the case of a Change necessary to comply with a General Change in Law, references to Capital Expenditure in the paragraphs above should be read as references to the Capital Expenditure remaining after the "**Contractor's Share**" has been deducted and applying only to Service Levels which have already reached Service commencement. The Contractor's Share on Defence Housing Projects on which residual value risk is transferred will be 100% in all cases as the Contractor will take the benefit in the residual value uplift to the capital value of the Assets (see guidance notes on Clause 44.1).

Operating Expenditure is paid by MOD to the Contractor by an adjustment of the Unitary Charge to take account of indexation (Clause 71). There are no benchmarking and market testing provisions in the MOD PFI PAV2 and so the Contractor is expected to select the appropriate indices for inclusion in the Payment Mechanism to compensate it for Changes necessitated by General Changes in Law. The Contractor may be compensated for Operating Expenditure for other types of Change in accordance with Part 14 (Value for Money).

**Irrecoverable
VAT on Change in
Law**

87.6

In accordance with the guidance in SoPCv4 paragraph 14.10, MOD does not distinguish between changes in tax law and other Changes in Law.

With regards to VAT, an increase in the rate of VAT will be paid by MOD as part of the Unitary Charge. However, changes in the VAT Legislation may also affect the Contractor, where Services which were previously subject to VAT (and for which the Contractor could therefore recover its input VAT) become exempt from VAT. In these circumstances, this Clause states that the Contractor's position will be preserved and MOD will pay any element of "**Irrecoverable VAT**" which the Contractor cannot set off against input VAT as a result of a Change of Law.

**IMPLEMEN-
TATION OF
URGENT
CHANGES**

88

In some projects, the nature of the Change required may be sufficiently urgent that the normal process for agreeing the Estimate would take too long thereby prejudicing MOD. For example, a training project may need to implement a Change to the design of a pilot training simulator to reflect a change in the underlying platform as a matter of urgency to train pilots for operations.

If acquisition teams wish to instruct an urgent Change, they may do so by sending the Contractor the Notice of Change with Sections 1 and 5 completed. The Contractor provides MOD with a rough estimate of the costs of proceeding with the urgent Change and will begin to carry out the urgent Change in parallel with completing the standard process for agreeing the Estimate. If the Estimate is subsequently agreed between the Parties, the Change will proceed normally as stated above. However, if the Estimate cannot be agreed, the Contractor is entitled to recover any costs it has incurred in carrying out works or performing Services relating to the urgent Change up to a maximum of the costs estimated under this Clause.

If the Change is not formally confirmed under Clause 79.2, MOD can instruct the Contractor to discontinue performance of an urgent Change at any time subject to paying the Contractor's costs up to this maximum.

PART 19 – PEOPLE AND SUB-CONTRACTORS
CONTRACTOR'S REPRESENTATIVE 89

Authority of Contractor's Representative

89.1 The Contractor's Representative is the key person involved in the management of the project on behalf of the Contractor. He has full authority to act on behalf of the Contractor for all purposes.

Change in Contractor's Representative

89.3 It is assumed that the Contractor's Representative will have staff to help him to perform his duties but the purpose of Clause 89.3.1 is to allow the Contractor to appoint an additional Contractor's Representative, or to replace the named Contractor's Representative. Any additional or replacement Contractor's Representative must be proposed as an Administrative Change and agreed through the Change procedure (Part 18) in the usual way.

Because the Contractor's Representative is such a key person, he must be available at all times as required by the Contract. If the Contractor's Representative will be absent for a period (such as a holiday), but the Contractor does not wish to change his Representative under Clause 89.3.1, Clause 89.3.2 allows the Contractor's Representative to nominate a delegate to carry out his functions with MOD's consent. MOD should not withhold or delay consent to a delegate unreasonably. An example of when it might be considered reasonable to withhold consent could be if the project involved Secret Matters or other security sensitive matters and the proposed delegate did not have the same level of security clearance as the Contractor's Representative.

Delegation does not, of itself, prevent the person who delegates from also carrying out the functions of the Contractor's Representative himself. If delegation is intended to cancel the original Representative's authority to act for the period of the delegation, the Contractor should propose an Administrative Change.

The Contractor's Representative may, in his notice under Clause 89.3, specify a period in which the delegate will assume his powers, in which case power will revert to the Contractor's Representative named in the Contract on expiry of this period. Alternatively, the Contractor's Representative's notice may provide that the delegation is effective until cancelled by further notice.

AUTHORITY'S REPRESENTATIVE	90	
Authority of Authority's Representatives	90.1 and 90.2	MOD has two Representatives to act as key persons to manage the project on its behalf: the Project Manager and the Commercial Officer. The only difference in their authority is that the Commercial Officer has full authority to act on MOD's behalf for all purposes whereas the Project Manager has authority to do anything other than confirm a Change (unless its an Administrative Change).
Change in Authority's Representative	90.3	There are provisions for changing either of MOD's Representatives or appointing further Representatives in Clause 90.3. These are the same as the provisions governing changes in the Contractor's Representative.
NOTICES TO REPRESENTATIVES	91	
		Clause 91 should be read in conjunction with Clause 147 to see the methods by which communications may be made to each Party's Representative.
SUB- CONTRACTORS	94	
SoPCv4 Chapter 16	94.1	Acquisition teams should note that if their project involves Secret Matters, Clause 94.1 must be included. The effect of this Clause is that references to a Sub-contractor under Clause 94 means a sub-contractor to the Contractor at any tier. If the project does not involve Secret Matters, Clause 94.1 should be deleted, leaving the definition of a Sub-contractor to mean the Asset Provider, the Service Provider and any other Sub-contractor to the Contractor only.
Approval of Sub-contractors and the Terms of Sub-contracts	94.6	These Clauses provide that the Contractor may replace a Sub-contractor or add an additional Sub-contractor by using the Change procedure (Part 18). If the project involves Secret Matters and the Sub-contractor to be replaced is perhaps two or three tiers removed from the Contractor, it might be appropriate for the change in Sub-contractor to be an Administrative Change. However, the Contractor may also use the Minor Change or Major Change processes to replace a Sub-contractor. An additional or replacement Sub-contractor must be a " Suitable Substitute Sub-contractor ". This is defined in Clause 2.1 as being both a " Suitable Third Party " and having the financial and organisational ability and technical competence to undertake the relevant works or Services.
MATTERS TO BE INCLUDED IN SUB- CONTRACTS	95	
		Although MOD takes a less invasive role in controlling the terms of Sub-contracts in a PFI project than it might in a conventional procurement, certain matters need to be

included in Sub-contracts to protect MOD's position in relation to, for example, security issues, and to ensure that the Sub-contracts will be adequate if MOD needs to step-in to a Sub-contract under its rights in the Collateral Warranty (see guidance on Clause 6.1).

These matters are specified in this Clause. When approving a replacement or additional Sub-contractor under the Change process in Part 18, MOD should check that the proposed Sub-contract complies with this Clause.

**CHANGES TO SUB- 96
CONTRACTORS
AND THE IMPACT
ON DEDUCTIONS**

Because the Contractor takes the risk of poor performance of the Sub-contractors, it has an interest in ensuring they can perform Asset Provision or Service Provision effectively. The Contractor and its funders are therefore likely to want to replace a defaulting Sub-contractor well before any triggers for MOD to terminate the Contract for Contractor Default are reached.

No relaxation of the Deductions regime in the Payment Mechanism should be allowed by acquisition teams on the replacement of a Sub-contractor, in accordance with the guidance in SoPCv4 paragraph 9.4, but MOD does recognise that a replacement Sub-contractor may take time to mobilise its resources and finalise its procedures so that Asset Provision or Service Provision can be delivered effectively. Accordingly, although MOD will still make the relevant Deductions in respect of the Services performed by the new Sub-contractor, the Contractor can elect on a maximum of 2 occasions during the Contract Period for Deductions attributable to a defaulting Sub-contractor to be cancelled for the purposes of assessing Contractor Default termination only and for it to have a grace period of two months not to be terminated for Contractor Default arising from Deductions incurred by the new Sub-contractor.

**PART 20 – SECURITY
DEFINITIONS 96**

Part 20 (Security) is one of the areas of the MOD PFI PAV2 where, if the project involves Secret Matters, a Sub-contractor means a Sub-contractor to the Contractor at any tier. However, acquisition teams should always establish from the outset their security requirements for the full contract term, including those which should be reflected in this MOD PFI PAV2. In doing so, they should consult with MOD's Directorate of Security (MODSy), also known as the Industrial Security Group, particularly if the project will involve sites (either Authority Sites or Contractor Sites) outside the UK and Northern Ireland.

**SECURITY
REQUIREMENTS 100**

The Security Requirements and Security Proposals deal with MOD's specific requirements for the project relating to security issues and the Contractor's proposals to meet these requirements.

In order to avoid reiterating standard security documentation, the Security Requirements are deemed to include the requirements of DEFCON 76 and the Manual of Protective Security (if the project involves only Contractor Sites and does not involve Secret Matters) or JSP 440 (in all other cases).

Acquisition teams are advised to seek guidance from MOD's Directorate of Security on the contents of the Security Requirements and when reviewing the Security Proposals.

**PERSONNEL
SECURITY 102**

Security Clearance 102.1

Depending on the nature of the project, and the work that an employee is intended to perform, the Security Requirements will set out the level of security clearance required for all or specific categories of employee of the Contractor or a Sub-contractor, at one or more of the following levels:

1. Basic Check. This is not a security check per se but allows access to protectively marked material up to the level of Confidential;
2. Counter Terrorist Check. This looks for specific connections of the employee. It does not of itself allow access to protectively marked material;
3. Security Check. This is suitable for persons who have general or long term access to protectively marked material at the level of Secret and occasional access to

protectively marked material at Top Secret level;

4. Developed Vetting. This is suitable for persons who have general or long term access to protectively marked material at Top Secret level

Clause 102.1 makes the Contractor responsible for obtaining security clearance for all employees to the level specified by the Security Requirements. Refusal of security clearance is a risk borne by the Contractor. If the Contractor is not a List X company, the Contractor's responsibility is discharged by providing a completed security clearance application form to MOD at least 30 Business Days before the relevant employee begins to perform work in connection with the project. If the Contractor is a List X company, it must itself apply for security clearance by direct application to the Defence Vetting Agency.

Security clearance to the appropriate level is necessary for an employee to receive a pass to access an Authority Site under Clause 102.3.2.

**Admission to 102.3
Authority Sites**

The Contractor must also provide MOD with a list of all employees who are intended to enter Authority Sites. Employees who have the appropriate security clearance will be issued a pass to access the Authority Site under Clause 102.3.2. No Contractor Related Party may access any Authority Site without a pass unless they are an emergency reactive worker, in which case such worker must be accompanied by an employee of the Contractor or its Sub-contractors who is in possession of a pass.

Clause 102.3.5 provides the authority for MOD to refuse admission to employee or have an employee removed from an Authority Site. Refusal of admission or removal by MOD without giving notice to the Contractor under Clauses (b) to (d), or on any other grounds under Clause (e) entitles the Contractor to relief from Availability and/or Service Performance Deductions in respect of any Services on which the person refused admission or removed would have been engaged. Under Clause 102.3.6 this relief lasts for a reasonable period to enable the Contractor to make alternative arrangements to replace any person who is refused admission or removed.

SECRET MATTERS 103

The security principles which govern Secret Matters are confidentiality, availability and integrity. These are reflected in MOD PFI PAV2 in various ways. For example, the confidentiality of Secret Matters is preserved using Clauses 103.1 to 103.4.

**CO-OPERATION
FOR SECURITY
INVESTIGATION**

104

104.1 and 104.3 MOD may conduct a security investigation at any time if there is a breach of Part 20 (Security) by the Contractor or a Sub-contractor. This investigation may be conducted by MOD's Representative, the Establishment Security Officer at the relevant Authority Site, or any other representative of MOD. Its purpose is to determine if a breach of Part 20 (Security) has occurred, recover any compromised material, establish any weaknesses in the Contractor's adherence to the Security Requirements and the Security Proposals, make recommendations to MOD or the Contractor or take any other action.

Under Clause 104.3, the Contractor must, and must procure that its Sub-contractors will, give reasonable co-operation to the person undertaking the security investigation. In addition, Clause 104.2 gives MOD specific rights in connection with the security investigation.

**Results of
Authority's
Security Audit**

104.5

If MOD's security investigation reveals that the Security Proposals do not comply with the Security Requirements, the Contractor must amend its proposals. The Contractor is obliged to comply with the Security Proposals under Clause 101.2.

**BREACH OF
SECURITY**

105

In certain circumstances, the Contractor may have committed a sufficiently serious default in relation to security issues that MOD considers it amounts to a "**Breach of Security**".

On a Breach of Security, MOD can instruct the Contractor to terminate a Sub-contract (at any tier) if the circumstances in Clause 104.2 arise. In addition, a Breach of Security amounts to a "**Prohibited Act**" and MOD can invoke the procedures leading to termination on Prohibited Acts (see guidance notes on Clause 134).

PART 21 - TUPE CONDO AND SPONSORED RESERVES

In relation to TUPE, the provisions referred to in Schedule 15 cover only the situation of an initial TUPE transfer of MOD staff to the Contractor. A different set of provisions needs to be used in addition or substitution if previously outsourced staff will be transferred to the Contractor. The pension requirements will also differ between groups within the Contractor's workforce.

The Clauses in Schedule 15 only cover TUPE transfers that occur in the UK, and are not appropriate for use where the scope of a project is (wholly or partly) outside the UK, where the Acquired Rights Directive applies but is implemented in host nation regulations, or countries outside the EU where there is no transfer legislation.

For all matters relating to employment issues, acquisition teams will need to consult the MOD's Central Legal Services – Commercial Law and Director Commercial Systems on these issues.

There are no provisions in MOD PFI PAV2 relating to CONDO (Contractors on Deployed Operations) or Sponsored Reserves. If either of these apply to a given project, acquisition teams should insert the relevant DEFCON in this section.

PART 22 – INTELLECTUAL PROPERTY, INFORMATION AND DISCLOSURE
SoPCv4 Chapter 27 **General**

Acquisition teams should always establish from the outset their IPR requirements for the contract term, including those which should be reflected in this MOD PFI PAv2. In doing so, they should consult with MOD Defence Intellectual Property Rights (DIPR). They should, as far as possible, adopt the Clauses including the blue shading if the project is primarily equipment or training based and remove the blue shading if the project is primarily accommodation based and will not involve complex IPR. If a project's IPR requirements cannot be met using these standards, or necessitate a deviation from the selected standard, an alternative clause or deviation from the selected standard should only be used with the approval of DIPR.

Ownership of IPR

IPR in the tools, equipment and information brought in by the Contractor to develop and run the Service should remain with the entity who originally owns that IPR. In cases where the Contractor is formed as a Special Purpose Vehicle for the purpose of receiving the Contract, these would normally be his Sub-contractors or other third parties.

IPR in information provided by the MOD as GFI to the Contractor to develop and run the Service should also remain with the entity who originally owns it. This includes IPR owned by the MOD itself.

In general terms and consistent with MOD policy, IPR generated by the Contractor and its Sub-contractors in the performance of the Contract should be owned by the entity who generates it, on the basis that these entities are best positioned to exploit it and will be building upon their existing IPR and expertise. MOD may however consider that it should own certain categories of information. This includes that over which MOD considers it essential MOD should retain full control without having to account to the Contractor for its disclosure and use, for example MOD civilian and Service personnel records, and that provided by the MOD to the Contractor (IPR owned by the MOD or a third party MOD contractor) which the Contractor may build upon during the course of the Contract.

Third Party Rights

A. In Information provided by the Authority ("Legacy IPR")

Legacy IPR, and particularly existing information and software used by the MOD to support existing equipment and provide exiting services, may be required by a PFI contractor to provide the Service, particularly in an initial period before the Contractor is able to embed his own Service solution. However, pre-existing third party restrictions on its disclosure and use may apply to this IPR, which can act as a barrier to the development and operation

of the Service, or distort the competition where members of one consortium for the Contract may hold key IPR required by the members of a competing consortium.

MOD may in certain cases have the right to authorise use of third party Legacy IPR, especially where it has acquired licence rights of use under earlier contracts. Even when these licence rights do exist, their limitations mean the PFI Contractor should not normally be authorised to use it for any purpose beyond performance of the Contract for MOD. MOD sale/disposal of legacy equipment or software to the PFI contractor does not solve this problem.

Care should be taken to ensure that where MOD is likely to need to provide further Legacy IPR in the future during the course of the Contract and has not yet contracted for that IPR with other contractors, the IPR requirement of the Contract is taken account of in those future contracts.

To reduce risk that Legacy IPR owners within one bidding consortium might withhold licence rights to prevent another consortium for using it and, so distorting the outcome of the competition, each bidding consortium should accept obligations, ideally imposed as a condition of bid entitlement for the Contract, to make their Legacy IPR needed by other consortia available on fair and reasonable terms. These obligations would be without prejudice to any licence rights the MOD itself may hold from earlier contracts etc. to make the IPR available to each consortium. The terms of availability may include licence fees and other restrictions, which may have an impact on the receiving consortium's bid, but less so than if those rights were not available at all.

Acquisition teams should question the need to provide Legacy IPR if the consortium members themselves own it, but there may be instances where that the IPR is embedded within reports, manuals etc, that cannot easily be disentangled from IPR owned by other entities.

B. In Other Information used by the Contractor

In addition to Legacy IPR, the PFI Contractor will almost certainly need to use pre-existing IPR owned by its Sub-contractors, and by third parties other than those referred to in A. above.

To minimise risk to MOD, the Contractor's use of key third party IPR brought in from non-MOD sources should require MOD prior consent. A record of consents already given or given in advance should be maintained, preferably annexed to the Contract.

Obtaining consent should require the Contractor to provide MOD with information on licence terms granted to the Contractor by the third party. This provides MOD with an opportunity to intervene if those terms (including licence fees) are unreasonable or inconsistent with the rights granted to MOD in the Contractor's own IPR.

These licence terms must recognise that MOD or another contractor may need to use the licensed IPR themselves if the Service is to be taken back in-house on a temporary or permanent basis, or is to be continued using a replacement contractor. This may mean that the re-transfer, sub-licensing or assignment of the third party licence rights must be included in the Contract. However, some third party IPR, such as Commercial Off The Shelf (COTS) software, may be so readily available from some third party IPR owners that additional rights from the Contractor in that IPR may not be required.

MOD's Licence to Contractor

MOD should grant the Contractor and its Sub-contractors a licence in its own IPR, and a sub-licence in third party-owned Legacy IPR to the extent that relevant rights are available to MOD to do so, to permit the Contractor to perform the Contract.

Contractor's Licence to MOD

MOD will require a royalty-free licence right in all IPR owned by the Contractor and its Sub-contractors which is either brought in as background IPR to the Contract or actually generated under the Contract. A licence is not needed where by virtue of the Contract conditions, some of the Contractor-generated IPR is MOD-owned (see above).

This licence right should as a minimum entitle the MOD:

1. to receive and use the specified output of the Service, including all information deliverables,
2. to enable MOD or another contractor selected by the MOD to take over the Service in the event of Step-In, early Contract termination, or Contract expiry.

This will require the Contractor to keep proper records of everything he does or uses, and make these available to MOD if needed. In the cases of (ii), MOD will require far greater access to Contractor IPR.

Wider rights may be required in certain Contractor IPR, recognising the fact that the Service is to be embedded within the wider business of MOD and that the generation of much IPR will be paid for and directed by MOD's requirements under the Contract. These rights should entitle MOD to reuse the IPR on other projects with other MOD contractors as well.

Rights in Information/Software relating to Assets

In some cases, a PFI project may be centred around the Contractor's provision of key new assets needed to provide the Service, such as accommodation, facilities, equipment and software systems that the Contractor itself will own. It should be assumed that through its Unitary Charge payments over the life of the Contract, MOD will fund production and delivery of the assets as well as the detailed design and development of any bespoke elements of the

assets, unless the Contractor can demonstrate otherwise. This could for example involve the integration of a number of COTS items by an equipment Sub-contractor (an equipment supplier). MOD may well be obliged to buy the assets off the Contractor if the Contract terminates early, and may also have an option to purchase the equipment at Contract expiry. Once the equipment does become MOD property, the equipment supplier becomes, in effect, a conventional equipment contractor to MOD.

From an IPR perspective, some detailed technical information and associated user rights relating to the assets may form part of the deliverable Service information because MOD civilian or military personnel may need to operate and perform basic maintenance on the assets in use. A greater depth of information and software and associated rights of use will be required if the assets become MOD property (by virtue of the termination and expiration terms of the Contract). A practical and cost-effective method of acquiring these rights may lie in taking the same reserved rights in the assets as the Service provider himself takes from the asset providers. Holding data & software in escrow should be considered, as much to protect the Service provider from his sources of supply as MOD.

Rights from Sub-contractors

The Contractor should be responsible for ensuring he puts legally-enforceable, back-to-back licensing arrangements in place with his Sub-contractors to ensure MOD enjoys the same licence rights with those Sub-contractors. To ensure consideration flows from MOD to these Sub-contractors in exchange for these rights, MOD should have the right to withhold its consent for the placement of any Sub-contract where the Contractor fails to put the associated arrangements in place. These arrangements would grant the same rights to MOD in the Sub-contractors IPR as are granted through the Contract in the Contractor's own IPR, and should preferably be contained with the Sub-contractors themselves by exploiting the Contractors (Rights of Third Party) Act 1999 to the benefit of MOD. Exceptionally, MOD may require that licences be granted directly to MOD by certain Sub-contractors under separate agreements, which again should be put in place as a pre-condition of MOD consent to the placement of the associated Sub-contracts.

Where the Contractor or Sub-contractor licences-in IPR from third party, the licence rights should enable MOD to use the IPR in the same manner as the contractor's own IPR (see above). Indemnities should be provided to MOD if the Contractor is unable to secure these rights. However, as a fallback position MOD should be able to accept for itself or a replacement contractor the same third party licence terms as those given to the PFI Contractor or Sub-contractor.

Record Keeping

The Contractor should be required to keep full and complete record of all the work performed and all the IPR created

and/or used to enable rapid access by MOD or its nominated alternative contractor should the need arise, in order that Step-In, termination of expiration rights can be exercised.

Maintenance of full records with the independent escrow agent should be considered as an added safeguard.

Indemnities

Full IPR indemnities should be provided by the Contractor to the MOD should any infringement of third party IPR occur in the course of the Contractor providing the Service of the MOD receiving it. This indemnity should extend for the duration of the Contract, and include any period of Step-In and the provision of the Service by MOD itself or another Contractor.

The exceptions are where the Contractor is specifically instructed by MOD to use IPR, or where infringement arises from MOD negligence, MOD use of IPR for a purpose other than for which it was supplied, or MOD use of IPR to modify equipment not authorised by the Contractor. In the former case, MOD should indemnify the Contractor.

Commercial Exploitation

Recognising that much of the IPR to be used and/or generated under the Contract will be MOD/Crown-owned, the Contractor will require a licence from MOD to use at least some of this IPR in order to provide an equivalent Service to others for third party revenue generation purposes.

The Contractor should be granted this licence in order to tie in with those other parts of the Contract which deal with the commercial exploitation of the Service. However, specific consent must be obtained from DIPR in each case, and the IPR to be used properly identified.

CONFIDENTIALITY 113

SoPCv4 Chapter 26

Acquisition teams should note that specific guidance on the Freedom of Information Act (FOIA) is available on MOD's Acquisition Operating Framework (AOF) and should also consult MOD Director Intellectual Property Rights (DIPR) if issues arise in relation to these provisions.

These clauses set out the requirements for publishing information relating to the Contract. In deciding which information should be classified as "**Commercially Sensitive Information**", acquisition teams should be mindful of FOIA and MOD guidance and undertake proper due diligence to avoid MOD being in a position where it is required to disclose information under FOIA which has been designated as Commercially Sensitive. For example, Commercially Sensitive Information could cover specific bid information for specific periods (to be inserted in Schedule 16) but broad categorisations are not appropriate.

If MOD intends to charge in respect of copying costs etc under section 8 FOIA and paragraph 6 of the Fees Regulations and wishes to pass through the benefit of such charging to the Contractor, acquisition teams may extend the provisions in Clause 114.7 to accommodate this. The Fees Regulations currently allow a rate of £25 per hour to be taken into account in determining whether the relevant threshold for costs under paragraph 4 of the Fees Regulations has been reached.

It is up to the Parties to decide whether costs associated with any future change in MOD's FOIA cost recovery policy should go through the Change procedure in Part 18.

If the Environmental Information Regulations are relevant to the project, acquisition teams may include equivalent provisions in this Clause dealing with these costs under Section 8 of the Environmental Information Regulations.

SoPCv4 Chapter 25

The insurance provisions in Part 23 (Insurance) are based upon "suitable" and "required" drafting in accordance with SoPCv4 Chapter 25 Insurance. The insurance provisions assume that the subject matter of the project is "build and facilities management" only. If the project involves complex service delivery and risks relating to areas such as marine, aviation, training, simulators and other technology risks or if the Services will be provided outside the UK (or deployed), acquisition teams should consult with the MOD's insurance adviser to agree appropriate insurance provisions relative to the scope and insurable risks associated with the project.

Expert insurance advice is available from Willis Limited, MOD's accredited insurance advisers. Principal PFI advisers are Simon Young (0117 976 9323) and Chris Lloyd (0117 976 9344). Procedures to be followed in obtaining their advice and support are set out in Defence Instructions & Notices (DIN) 2010DIN08-009: FI 30/07: General Insurance Brokerage Advice and Assistance (and its successors).

Chapter 25 Insurance of SoPCv4 contains detailed explanatory notes and rationale behind the insurance provisions contained in Part 23 (Insurance) of the MOD PAv2. Principles resting behind each of the insurance clauses are provided, and in addition commercial mechanics such as the Insurance Premium Risk Sharing Schedule are described in terms of how they should operate and the intent behind the MOD position to be adopted.

Support is available to acquisition teams via the PFU and Willis in terms of any technical insurance or commercial queries particularly in relation to the application of insurance guidance to individual project scenarios.

PART 24 – DAMAGE TO THE SPECIFIED ASSETS, INDEMNITIES AND CONTRACTUAL CLAIMS
DAMAGE TO THE SPECIFIED ASSETS 122

Damage to the Specified Assets is a significant risk for the Contractor because it may:

1. mean that the Contractor cannot comply with its obligations in Clause 17 (Condition of the Specified Assets and Delivery of the Services); and
2. result in the Contractor incurring Deductions because it cannot properly perform the Services.

This is so during both during the Asset Provision phase, when the damage to a Specified Asset may delay commencement of a Service Level and thereby the Contractor's receipt of the Unitary Charge, and during the Service Provision phase, when the damage may increase or trigger Deductions incurred by the Contractor.

In certain circumstances, the Contractor may be able to claim some relief if the damage was caused by a Relief Event such as a fire or flood (for further details see the guidance on Clause 76) and may be able to claim a Compensation Event if the damage to the Specified Asset was caused by an event such as MOD's breach of the Contract.

However, in all cases, the Specified Assets will still need to be reinstated, and this Part deals with the reinstatement works.

The risk relating to damage to the Specified Assets lies with the Contractor, unless the damage is caused by an employee or contractor of MOD or of an Authority Related Party, does not count as fair wear and tear, and has arisen other than as a result of the damaged item being used for its reasonable and proper purpose ("**Authority Damage**").

From this definition it can be seen that MOD only takes the risk of negligent damage. Purely accidental damage will not be caused by "the damaged item being used for its reasonable and proper purpose" and damage caused by the Contractor and Contractor Related Parties is always the responsibility of the Contractor.

Costs of Reinstatement

122.5

MOD pays the Contractor's costs to reinstate the Specified Assets on Authority Damage unless the Contractor can carry out the reinstatement works without incurring additional costs and by using its site-based personnel and resources during normal working hours and without affecting their ability to perform the Contractor's other obligations under MOD PFI PAV2.

For damage other than Authority Damage, the Contractor is always responsible for the costs of reinstatement. It may be able to recover these costs from its insurance, but the recovery or otherwise of insurance proceeds does not alter the Contractor's risk.

**REINSTATEMENT
ON AN INSURED
EVENT** **123**

SoPCv4 Para 25

If damage occurred to the Specified Assets, and insurance policies were not in place, the MOD may ultimately have a right to terminate the Contract and pay compensation on a Contractor Default basis. Both the Contractor and the Senior Lenders are concerned to prevent this and these provisions, together with those in Part 23 (Insurance) are intended to avoid this.

**Contractor's
Obligations** **123.2**

If the relevant damage to the Specified Asset is insured (irrespective of whether it is Authority Damage or not), the Contractor must submit a "**Proposed Reinstatement Plan**" to MOD's Representative for approval if it makes a claim or receives insurance proceeds in respect of the damage which are above the threshold amount (to be set on a project-specific basis).

MOD's Representative should notify the Contractor within 10 Business Days as to whether it accepts or rejects the Proposed Reinstatement Plan. Although he must act reasonably in refusing to accept the plan, it is automatically reasonable to refuse if the proposed contractor for the reinstatement works is not a Suitable Substitute Sub-contractor (see guidance on Part 19).

**Economic
Reinstatement
Test** **123.5**

This wording is optional because SoPCv4 specifically states that it should only be allowed in the Contract if there is a high risk of total destruction of the Specified Assets, such as in a project for a single Specified Asset e.g. a building. If it is unlikely that total destruction would occur (and consequently at least part of the Contractor's Unitary Charge income stream can be maintained), this Clause is not appropriate.

The "**loan life cover ratio**" is a ratio of the net present value of the projected revenues of the project (during the estimated period that the debt will remain outstanding) as against debt outstanding on the day on which any cash flow net present value is being calculated. The "**net present value**" of a project is usually calculated by making various assumptions as to the variables which would affect the project's cash flow (such as product prices, operating costs, foreign exchange rates) and then projecting what the project's net cash flow will be over its life, relying on those assumptions. The aggregate net cash flow is then discounted at a discount rate to produce a net present value – this will change over time and will be periodically updated.

The Contractor's funding agreement will set out "loan-to-value" ratios, which are a statement to the Contractor from the Senior Lenders that they will be prepared to continue their lending to the project provided the ratio of loan value to the value of funds being generated by the project/its net present value remains at that set out in the funding agreement. The loan life cover ratio is therefore a good indicator of how the delay impacts on the Senior Lenders' entitlement to debt repayment and margin, and whether they should be required to continue funding the project, or are able to take the insurance proceeds.

If the loan life cover ratio falls below the default level set out in the funding agreement then the Senior Lenders are entitled to be paid out of the Joint Insurance Account an amount which is the lesser of the value of the insurance proceeds, and the Base Senior Debt Termination Amount. Before this payment is made, however, and if the optional provisions for step-in on a Relief Event are included in the Contract, any costs which MOD has incurred on stepping-in to the project under Part 17 and which it has not already deducted from the Contractor can be claimed by MOD (for further details, see the guidance notes on Part 17).

For further guidance on these issues, acquisition teams should consult their financial advisers.

DEATH AND PERSONAL INJURY, DAMAGE TO PROPERTY AND THIRD PARTY CLAIMS 124

Contractor's Indemnity 124.2

SoPCv4 Para 24.3

The Contractor gives MOD an indemnity against any liability MOD suffers as a result of the Contractor or Contractor Related Parties causing death or personal injury or damaging MOD's property (excluding land and buildings forming part of the Specified Assets) or in respect of legal liability incurred by MOD.

This indemnity deliberately does not require the Contractor to be negligent or to have breached the Contract, but there are some limitations on its operation in Clause 125.2.2.

OTHER INDEMNITY CLAIMS 125

Authority's Indemnity 125.2

MOD gives a limited number of indemnities to the Contractor relating to payment on Measures in a Crisis (see guidance on Clause 71) and IPR issues.

**CONDUCT OF
INDEMNITY
CLAIMS** 126

Because a Party providing an indemnity ("**Indemnifying Party**") will be responsible for funding the other party's ("**Indemnified Party**") losses as a result of claims by a third party which are covered by the indemnity, the Indemnifying Party has an interest in minimising the likelihood of success or the value of those claims. This Clause allows the Indemnifying Party to take over conduct of the claim from the Indemnified Party.

**CONTRACTOR'S
CLAIMS IN
RELATION TO THE
CONTRACT** 127

SoPCv4 Para 24.6

Generally, a Party which breaches its obligations under a contract will be liable to pay general damages to the other Party. It may also have equitable rights. The purpose of this Clause is to exclude the Contractor's rights to claim general damages from MOD or to seek an equitable remedy on MOD's breach of Contract, if the Contractor is either entitled to claim a Compensation Event for the breach or if it is given another express remedy under the Contract.

**AUTHORITY'S
CLAIMS IN
RELATION TO
SERVICE FAILURE** 128

By including Deductions in the Contract, MOD accepts that its sole remedy for the Contractor's failure to adequately deliver the Services is through the Payment Mechanism.

PART 25 – TERMINATION

SoPCv4 Chapter 21

Termination of a PFI contract and the associated payment of compensation on termination (see guidance on Part 26) is an extremely complex and significant step, potentially involving MOD in incurring major liabilities. It should not be contemplated by acquisition teams unless they have sought specific advice from both the PFU and MOD's Central Legal Services – Commercial Law .

Termination falls into two categories. It will be either a termination by the Contractor for an Authority Default or termination by MOD:

1. for no reason (Authority Voluntary Termination);
2. on Contractor Default (including Persistent Breach);
3. on the Contractor's breach of the Refinancing provisions (Part 15);
4. on a Prohibited Act (including a Breach of security);
5. on a Relief Event (if the optional provisions for step-in on a Relief Event are used);
6. on a Force Majeure Event or following an Uninsurable risk.

TERMINATION BY THE CONTRACTOR 131

SoPCv4 Para 21.1

There is only one circumstance in which the Contractor can terminate the Contract, namely on an "**Authority Default**".

An Authority Default is defined in Clause 2.1 as:

1. an expropriation, sequestration or requisition of a material part of the Assets and/or shares of the Contractor by MOD (or another person) other than when MOD is exercising its contractual rights;
2. failure by MOD to make payment of a defined amount, which is typically an amount exceeding one month's Unitary Charge;
3. MOD's breach of an obligation which substantially frustrates or renders it impossible for the Contractor to perform the project for a defined period;
4. breach by MOD of the restrictions on transfer and assignment.

In other circumstances, such as a breach by MOD short of that in bullet point three, the Contractor's primary remedy

is through the Compensation Event regime.

TERMINATION BY THE AUTHORITY 132

Authority's Voluntary Termination 132.2

SoPCv4 Para 21.5

MOD can terminate the Contract at any time and for any reason, such as a change in government policy, on giving 20 Business Days notice to the Contractor. However, this type of termination is likely to be prohibitively expensive for MOD and should be avoided if at all possible.

Termination for Contractor Default 132.4

SoPCv4 Para 21.2

A "**Contractor Default**" is defined in Clause 2.1 as including:

1. breach of any obligation (which has a material and adverse effect);
2. Persistent Breach;
3. insolvency;
4. breach of the Contractor's assignment/transfer obligations;
5. breach of the Change of Ownership provisions;
6. Abandonment of the project;
7. failure to commence any given Service Level by its long stop date;
8. the incurring of Deductions above the thresholds to be specified on a project-specific basis;
9. failure to take out and maintain the Required Insurances.

In order to trigger "**Abandonment**", the Contractor must carry out no Asset Provision, when this is contemplated by the Asset Provision Programme, on any Site for either a continuous period (to be specified on a project-specific basis) or during a non-continuous period (to be specified on a project-specific basis) taken over a Year. The Contractor will not have Abandoned the project if it is relieved by the Contract of its obligation to carry our Asset Provision, for example on the occurrence of a Compensation Event or Relief Event.

Termination for Persistent Breach 132.6

SoPCv4 Para 21.2.3

"**Persistent Breach**" covers a repeated number of (possibly minor) breaches over a defined period. However, breaches which are caught by the Deductions regime in the Payment Mechanism are excluded. An example of a Persistent Breach could include prolonged failure to serve a notice on MOD which is required by the Contract.

Before the Contract can be terminated for Persistent Breach, MOD must comply with the warning procedure

which provides that the Contractor is served a formal preliminary notice (Clause 133.6.1) that a certain type of breach has been persistently occurring and, if the breach continues or recurs in accordance with the periods specified in Clause 133.6.2, a **Final Warning Notice**.

Termination for Prohibited Acts

SoPCv4 Para 21.4

132.10

"Prohibited Acts" include Breaches of Security and cover the actions of the Contractor, its employees, sub-contractors (at all tiers) and their employees or any other person.

The Contractor is given a chance to avoid termination if it procures the:

1. termination of the individual's employment (where that individual is acting independently of their employer); or
2. termination of the relevant Sub-contract (where a sub-contractor's employee is not acting independently).

SoPCv4 Chapter 21

A detailed explanation of the compensation payable by MOD on termination of the Contract is outside the scope of these guidance notes. However, the Table and guidance below gives a summary of the heads of compensation that will be payable on the different termination scenarios:

Event	Base Senior Debt Termination Amount	Junior Debt / Equity	Redundancy liabilities	Sub-contractor Break Costs
Termination by the Contractor	Yes	Yes	Yes	Yes
Authority Voluntary Termination	Yes	Yes	Yes	Yes
Force Majeure, Uninsurability or Relief Events	Yes	Some	Yes	Yes
Prohibited Acts or Refinancing Breaches	Revised Senior Debt Termination Amount			
Contractor Default	Market value			

The amounts making up each of these categories can be

significant and there is also a minimum payment which must be made to the Contractor if the Contract is terminated by the Contractor or there is an Authority Voluntary Termination.

The "**Base Senior Debt Termination Amount**" comprises:

1. Senior Debt plus Permitted Borrowing (including interest and Default Interest) outstanding, and break costs on hedging arrangements payable to Senior Lenders

less

2. All credit balances in Contractor's bank accounts (excluding the Joint Insurance Account), any claimable Contingent Funding Liabilities, break costs on hedging arrangements payable by the Contractor, Additional Permitted Borrowings (including interest) and other amounts received by Senior Lenders as a result of enforcing any rights they may have.

The "**Revised Senior Debt Termination Amount**" differs from the Base Senior Debt Termination Amount in that the base amount includes Default Interest and certain advances from committed standby facilities, but deducts Additional Permitted Borrowing. The revised amount does include Additional Permitted Borrowing, but deducts Distributions made to shareholders whilst any Additional Permitted Borrowing is outstanding.

Equity investors are paid out using one of three options:

1. payment of the "**Base Case Equity IRR**". This is a measure of the internal rate of return expected to be earned by private sector capital invested in the project as junior debt and equity;
2. payment on an **open market valuation** basis where the valuation is carried out by an accountant nominated by agreement between the Parties on the basis of the "**Relevant Assumptions**";
3. payment based on the **base case return at termination** i.e. the amount which (if it is paid on termination) gives equity investors the internal rate of return projected in their Base Case from the date of termination to the amount which would have been expected at the Expiry Date. This differs from the Base Case Equity IRR in that the shareholders will receive what they projected for part of the Contract Period, but take the risk of a lesser performance for that part of the Contract Period during which the project is actually operational.

The Contractor's "**redundancy**" costs are likely to be limited, as it will have few employees because it has passed its responsibilities down to the Asset Provider and Service

Provider and is therefore left with little more than an administrative role. However, as the Contractor is a special purpose vehicle, there will be no work for any of its employees once the Contract terminates, and the Contractor will be entitled to claim redundancy costs in its compensation package as shown in the Table.

When calculating "**Sub-contractor Breakage Costs**" acquisition teams should note that this includes both existing and future losses of the Contractor directly related to the termination of the Sub-contract, including:

1. cancellation of ordered goods and materials;
2. expenditure already incurred in anticipation of future works or services;
3. demobilisation costs;
4. Sub-contractor redundancy payments;

The Sub-contracts or arrangements have to be on reasonable commercial terms and made in the ordinary course of business and the losses mitigated. Assessing MOD's liabilities on termination is one reason for acquisition teams to conduct due diligence over the Sub-contracts.

**SURVEYS ON
TERMINATION
AND RETENTION
FUND**

134

SoPCv4 Chapter 23

In the final months of the Contract Period, MOD surveys all or any of the Assets to check whether the Contractor has complied with its obligations under Clause 17 and whether the Assets are likely to achieve the Handback Standard on expiry of the project.

If the survey shows the Contractor has failed to maintain the Assets in accordance with Clause 17, MOD's Representative should notify the Contractor of the required standard for the Assets and give the Contractor a reasonable period to bring the Assets up to this condition. In addition, MOD can deduct from any monies due to the Contractor (including any instalments of the Unitary Charge) either the full cost of the survey and any associated administrative changes (if more than the threshold percentage of the Assets are shown to have failed) or a pro rata proportion of the cost of the survey and any associated administrative changes (if less than or equal to the threshold percentage of the Assets are shown to have failed). The percentages inserted in (i) and to (ii) should be the same.

Clauses 134.2.2(a) and (b) are particularly useful in equipment projects, where there may be multiple Assets to be surveyed and it does not represent value for money for MOD to charge the full cost of the survey to the Contractor if

only one Asset is shown to have failed. This is particularly so if some of the Assets to be surveyed are not in the UK. If there is only one, or a small number of Assets, acquisition teams may delete the threshold percentages and use sub-clause (b) only.

Because the Unitary Charge remaining to be paid to the Contractor until the Expiry Date may not be sufficient to cover the cost of any work needed to rectify the Assets and ensure they meet the Handback Standard ("**Outstanding Work on Handback**"), if the final survey reveals that such work is needed, MOD can retain the cost of this work from any payments of the Unitary Charge subsequently due to the Contractor. The amount retained by MOD should be placed in an interest-bearing account.

If the Contractor completes the Outstanding Work on Handback within the later of the reasonable period specified in Clause 134.2.1(b) and the Expiry Date, MOD should pay the retention to the Contractor under Clause 134.3.2 and, if any monies remain in the retention account, Clause 134.5. However, if the Outstanding Work on Handback is not completed by this date, MOD can withdraw monies from the retention account or set-off sums from any instalments of the Unitary Charge falling due to pay for the Outstanding Work on Handback to be completed, either by MOD itself or another contractor.

PART 26 – COMPENSATION ON TERMINATION

COMPENSATION ON TERMINATION BY THE CONTRACTOR OR ON AUTHORITY'S VOLUNTARY TERMINATION 137

SoPCv4 Para 21.1.3 SoPCv4 Para 21.5.3

Because the only ground on which the Contractor can terminate MOD PFI PAv2 (with the exception of the "no fault" Force Majeure Event termination (see guidance on Clause 134) is for an Authority Default, it is right in these circumstances that the Contractor is fully compensated. Similarly, if the MOD terminates the Contract without fault on the part of the Contractor (Authority Voluntary Termination), the Contractor should also be fully compensated. Both of these situations are therefore likely to result in the most expensive of the termination compensation payments for MOD.

The "**Relevant Assumptions**" are that there is no default by MOD, that the sale is on a going concern basis and that no restrictions exist on transfer of share capital. The effect of any Additional Permitted Borrowing is also disregarded, but the actual state of the project (e.g. any increased Operating Expenditure or maintenance) is taken into account.

COMPENSATION ON TERMINATION FOR REFINANCING BREACHES OR PROHIBITED ACTS 139

SoPCv4 Para 21.6.2

SoPCv4 Para 21.4.3

The Table above shows that the Contractor bears the costs of termination on this ground, with the exception of the amount payable to its funders after the senior debt calculation is carried out.

COMPENSATION ON TERMINATION FOR CONTRACTOR DEFAULT 140

SoPCv4 Para 21.2.5

In MOD's conventionally procured projects, there would generally be no compensation payable to a contractor whose own breach (default) has caused MOD to terminate the Contract. The position is different in a PFI project, when MOD may still pay compensation even if it is the Contractor's own defaults that have caused MOD to terminate MOD PFI PAv2. This is because if MOD did not pay such compensation it would obtain a windfall gain.

Retendering Election 140.1

The amount MOD pays on termination for Contractor Default is calculated using one of two mechanisms:

1. the retendering procedure;
2. the no retendering procedure.

Under the retendering procedure MOD's payment to the Contractor acts essentially as a "pass through" of monies paid to MOD by a third party contractor who will take over the Services. This means that MOD does not need to pay compensation out of its own funds.

MOD can only elect to use the retendering procedure if:

1. it serves 20 Business Days notice of its intention to do so on the Contractor;
2. at that time the Senior Lenders have not already stepped-in to the Contract under their Direct Agreement (under which they would have to prove to MOD that there is a Liquid Market) or already transferred the Contract to a Suitable Substitute Contractor;
3. there is a "**Liquid Market**" i.e. there are at least two other contractors, experienced in operating contracts in the PFI Market, who are able to provide the Services. This is certainly likely to be the case in accommodation projects, but complex equipment projects may have no Liquid Market.

Retendering Procedure

140.2 This is the process for running the retendering procedure and calculating the Highest Compliant Tender Price and the Adjusted Highest Compliant Tender Price.

The "**Highest Compliant Tender Price**" is the highest price offered for the Contract by a "**Compliant Tenderer**" and if there are no Compliant Tenderers, then the price is zero. Once the highest price is ascertained MOD will want to adjust it to reflect the Post Termination Service Amounts (see below), the tender costs which it has had to pay out during the tender process and any other amounts which it is entitled to set off against amounts due to the Contractor under the general set-off provisions in MOD PFI PAV2.

After the Termination Date MOD will bring in alternative contractors to carry out the Services in place of the Contractor. It is, however, recognised that the tender process will take some time and that interest will be continuing to accrue on senior debt without any income stream for the Contractor to pay it off. MOD therefore agrees to continue making some form of payment to the Contractor during this period, and the amount paid ("**Post Termination Service Amounts**") is deducted from the compensation paid to the Contractor on termination once this has been determined.

Having deducted the Post Termination Service Amounts, MOD then increases the Highest Compliant Tender Price by:

1. credit balances on its bank accounts;
2. insurance proceeds and other amounts due to the Contractor;
3. Post Termination Service Amounts to the extent that they are a negative amount – i.e. MOD makes a further reduction to reflect the fact that it has had to pay rectification costs and availability Deductions which are more than the Unitary Charge would have been for the period between termination and payment of compensation, and which would have been deducted from the compensation payment.

This gives the "**Adjusted Highest Compliant Tender Price**". Of course the Adjusted Highest Compliant Tender Price could result in a figure which is less than zero, in which case the Contractor will have to pay the negative balance to MOD.

No Retendering Procedure **140.4** This is the basis on which MOD's compensation on termination will be calculated if there is no Liquid Market.

COMPENSATION ON TERMINATION FOR FORCE MAJEURE OR ON UNINSURABILITY **141**

SoPCv4 Para 21.3.2 From the Table above, it can be seen that the senior debt payment and the redundancy and sub-contract break costs payment made after termination for Force Majeure or Uninsurability are the same as those made on an Authority Default. The difference between the two termination scenarios is in the amount paid to equity investors, who on a Force Majeure termination are kept whole in terms of the nominal equity they put into the project (whether as sub-debt or shares), but do not get the returns they had projected had the project not been terminated.

The provisions on Uninsurability (Clause 120) interface with this compensation calculation.

MISCELLANEOUS COMPENSATION PROVISIONS **142**

Gross Up of Termination Payments **142.1** Unexpected tax liabilities on amounts received by the Contractor can produce a shortfall in the amounts it needs to repay to the Senior Lenders. Tax withheld needs to be accounted for, and the "gross-up" obligation requires MOD

SoPCv4 Para 22.2 to pay an additional sum to ensure that the Contractor receives what was due before any tax withholding is effected. Otherwise, because the Senior Lenders have priority of repayment over equity and junior debt, shareholder funds or additional loans may be necessary to fund shortfalls in repayments to the Senior Lenders.

Provided the termination is not for Contractor Default, the Contractor is entitled to receive all compensation on termination payments gross.

Set-off on Termination

142.2

MOD can set off payments which are due to it from the Contractor (such as Deductions) against the compensation on termination payment it must make except if the termination is for Force Majeure or Uninsurability, a refinancing breach, a Prohibited Act or an Authority Default.

SoPCv4 Para 22.4

TIME FOR PAYMENT OF THE TERMINATION SUM

143

MOD can elect to pay the senior debt element of any termination compensation, or estimated fair value compensation, in instalments. This should not be problematic for the Senior Lenders, who have calculated their margin on the basis that they will be repaid over time.

SoPCv4 Para 22.5

PART 27 – DISPUTE RESOLUTION

SoPCv4 Chapter 28

The Dispute Resolution Procedure² in the contract number MOD PFI PAV2 (the "Contract") is set out in Part 27 at Clause 144. The Dispute Resolution Procedure can be broken down into three steps, namely:

- Alternative Dispute Resolution (Clause 144.2)
- Adjudication (Clauses 144.3)
- Arbitration (Clause 144.4)

The procedure is very structured. The Parties are required to follow detailed procedures and, in particular, to adhere to a strict timetable. In certain cases, timings can be varied by agreement between the Parties.

Notwithstanding the fact that the dispute process may have been put in motion, it is always open to the parties to explore the possibility of reaching an amicable settlement of the dispute at the same time. This "twin-track" approach can often be successful.

As the Disputes Resolution Procedure escalates, so do the risks involved in each stage of the process. In particular, there is a significant shift in the amount of control that the Parties have over the outcome of the dispute. At the early stages, which involve internal meetings, the outcome of the dispute is entirely within the control of the Parties. If one party is not prepared to agree the outcome, there can be no resolution. As the process moves towards Adjudication or Arbitration, the Parties lose control over the outcome. Furthermore, the legal and other professional costs involved in the process escalate. Whereas the internal meetings can take place without legal advisers, legal representation would be necessary as a dispute escalates to Adjudication/Arbitration. Similarly, as the dispute escalates, increasing amounts of management time will necessarily be taken up in the process. Should the matter end up with Arbitration, it is likely that a significant number of individuals within each organisation will have to devote a considerable amount of time for the preparation and attendance at the Arbitration hearing.

ALTERNATIVE DISPUTE RESOLUTION

144

The internal escalation provisions are set out in Clause 139 of the Contract. Clause 144.2 is mandatory and requires the Authority's Representative and the Contractual Representative/Project Manager for a project management group to meet in good faith to attempt to resolve the dispute promptly. If no such resolution can be reached, there is the option of further escalation to the Acquisition Team Leader and then to the Executive Board. These subsequent internal escalation stages are not, however,

² This new guidance on the Dispute Resolution Procedure in MOD PAV1 has been reproduced courtesy of Shepherd and Wedderburn LLP.

mandatory.

On a practical level, careful consideration should be given as to when to notify the Contractor of a "Dispute" in accordance with the terms of Clause 144.2 of the Contract. Once there has been a notification under Clause 144.3, the dispute resolution procedure will kick in and the Parties may be inclined to focus more on the procedure, rather than the resolution of the underlying dispute. There are real benefits to be gained from early informal resolution of any dispute before the formal disputes procedure has been activated. Clearly there will be costs savings, as well as a reduction in the amount of management time taken up in dealing with the problem. Furthermore, an informal resolution is far more likely to result in less damage to the underlying relationship with the Contractor. In contracts that involve parties working together over an extended period of time, it is important to ensure that disputes do not give rise to an irreparable breakdown in the relationship between the Parties.

Bearing in mind the benefits of an informal resolution prior to the disputes procedure being activated, it is important to be careful not to start the process inadvertently. The Contractor may interpret an informal letter as a formal notification under Clause 144.3 of the Contract. In order to avoid this, it may be worth pointing out to the Contractor in any such communication that you are not seeking formally at this stage to invoke the provisions of Clause 144.3.

If informal negotiations continue, notwithstanding the activation of the formal dispute resolution procedure, then it is open to the Parties to extend the time limits in the internal escalation process. Any extension of time, including any stay of the formal process, would need to be by agreement between the Parties. It cannot be done unilaterally.

ADJUDICATION 144.3

This clause sets out in considerable detail the process to be followed by the Adjudicator and the Parties.

There are a number of advantages to Adjudication/Expert Determination. These are as follows:

It is a relatively quick process. By way of example, the Parties are required to submit their respective arguments to the Adjudicator within 7 days of his appointment. The entire process can be completed within approximately 5 weeks. This is in stark contrast to Arbitration or Court proceedings.

The costs involved in an Adjudication are relatively low compared to the costs of Court proceedings/Arbitration. .

There are, however, disadvantages in seeking to resolve a

dispute by Adjudication. These include:-

The decision of the Adjudicator is binding only if both Parties accept it. The other party has the right to refer the matter to Arbitration if they are not satisfied with the decision. The Adjudication Determination will not necessarily bring the dispute to a conclusion.

Adjudications Determinations can involve a considerable drain on management time. Considerable time can be taken up in preparing the submissions to the Adjudicator..

If successful, a party cannot recover the costs involved in the process. However, the corollary of this is that, if a party is unsuccessful, he does not have to pay the other side's costs.

Adjudication proceedings are, by their very nature, adversarial therefore there is a substantial risk to the ongoing relationship between the Parties. This is particularly the case bearing in mind the obligation under Clause 144.5 of the Contract. This requires the Parties to continue to perform all of their obligations regardless of whether a Dispute is in the process of being resolved.

ARBITRATION 144.4

The provisions relating to Arbitration are set out in Clause 144. of the Contract. These provisions also need to be read in conjunction with the provisions of the Arbitration Act 1996. By the time the Dispute has reached Arbitration, it is clear that the Parties have lost a considerable degree of control over the outcome of the Dispute. The Dispute will be decided by the Arbitrator. His decision is final and binding.

Proceedings before the Arbitrator will take place in private. This has a certain advantage over Court proceedings which by and large take place in public. The Arbitration process does, however, give the Parties some certainty, since there are only limited rights of appeal. There are, however, a number of disadvantages with Arbitration. These include the following:

- The costs involved in the process are likely to be substantial. The costs will be comparable to the amount that would be spent in relation to formal court proceedings.
- The drain of management time will be even more acute. A considerable amount of time will need to be devoted to the preparation for the Arbitration, including attendance at the final Hearing.

Arbitration can be a slow process, however in the case of the Contract, the Arbitrator is expected to complete the process within 3 months of his appointment. In practice, it may be

difficult to comply with such a strict timetable.

There is no question that Arbitration proceedings are adversarial, therefore there is likely to be significant damage to the ongoing relationship between the Parties. It is difficult to see how personal relationships cannot deteriorate when, for example, each of the Parties' representatives have been cross-examined in the course of the Arbitration Hearing.

Related Disputes 144.6

The Contractor and its Sub-contractors may request the right to join their disputes into a Dispute under MOD PFI PAV2 if the same issues are involved. This must be resisted by acquisition teams as it will only increase the time and cost of the process for MOD. The MOD PFI PAV2 does, however, recognise that Sub-contractors, who will inevitably be bound to some degree under their Sub-contracts to accept the outcome of Dispute decided under MOD PFI PAV2, will want some control over the way that their claims are presented by the Contractor.

The MOD PFI PAV2 therefore contains provisions for the Contractor to put forward in its Dispute with MOD arguments made by its Sub-contractors.

ESTOPPEL IN DISPUTES CONTEXT

There are various types of Estoppel that can arise under English law. These include the following:

Promissory Estoppel - there are three key elements to promissory estoppel:

- A promise by one party that it will not enforce its strict legal rights against the other.
- An intention on the promisor's part that the other will rely on that promise.
- Actual reliance by the promisee on that promise

Proprietary Estoppel - the three main elements necessary to establish a proprietary estoppel claim, which generally (but not invariably) relates to land, are:

- Assurance: The defendant (D) must represent or assure the claimant (C) that C will obtain an interest in property.
- Reliance: C must rely on D's representation or assurance.
- Detriment: C must incur a detriment as a result of his reliance on D's representation or assurance.

If C succeeds in making out his case, the court compels D to transfer to C an interest in the property that is proportionate

to the detriment that C has suffered, so preventing D from behaving unconscionably: D is estopped from reneging on his assurance.

Estoppel by convention

Estoppel by convention may arise where both Parties to a transaction act on an assumed state of facts or laws, the assumption being either shared by both or acquiesced in by the other. The Parties are then precluded from denying the truth of that assumption, if it would be unjust or unconscionable to allow them (or one of them) to go back on it.

Estoppel involves some form of "waiver of rights". It is a means by which equity can intervene when one party to an arrangement has reasonably and honestly relied upon the other party's representation.

Consider the following case study:

(i) The Contractor agrees to provide maintenance services across a PFI state (eg service personnel housing) on behalf of the MOD.

(ii) Issues arise in respect of the condition of the properties.

(iii) The Contractor agrees to carry out work on 50 out of 100 properties. The MOD allows the Contractor to carry out this work.

(iv) The MOD then brings a claim in respect of the remaining 50 properties.

(v) The Contractor disputes the claim on the basis of "waiver of rights". It alleges that the MOD is estopped from requiring the Contractor to carry out work on the remaining 50 properties.

How can a party avoid estoppel/waiver issues arising?

One of the ways in which the MOD can protect itself is by relying on the "no waiver clause". This is set out at Clause 155 of the Contract and provides as follows:

"155. Waiver

155.1 No term or provision of this Contract shall be considered as waived by any Party unless a waiver is given in writing by that Party.

"155.2 No waiver under Clause 155.1 shall be a waiver of a past or future default or breach, nor shall it amend, delete or add to the terms, conditions or provisions of this Contract unless (and then only to

the extent) expressly stated in that waiver."

Therefore, if the waiver is to be valid the MOD must agree to it in writing. Secondly, the waiver must be expressed to be a "waiver". If the representation which is alleged to be a waiver does not expressly contain words to this effect, it is difficult to see how it can operate as a waiver under the terms of Clause 155.2.

There are various other ways to ensure that the MOD does not fall into the trap of waiving any rights under the contract. One of the most important of these is the use of "without prejudice" communications. The without prejudice rule will generally prevent statements made in a genuine attempt to settle an existing dispute, whether made in writing or orally, from being put before the court as evidence of admissions against the interest of the party which made them.

In any communication with the Contractor that involves any form of compromise/settlement with the MOD not relying upon its strict legal rights, the communication should be marked "without prejudice". It is important to note that, just because a communication is marked "without prejudice", it does not necessarily mean that a court will regard it as such. It must constitute a bona fide attempt to try to settle a dispute.

If "without prejudice" communications result in an agreement between the Parties, it is important to ensure that any agreement includes the "no waiver" wording. If not, notwithstanding the terms of Clause 155 of the Contract, there is a risk that the contractor will subsequently argue that the MOD is estopped from insisting upon its strict legal rights under the Contract.

In the case study referred to above, if an agreement were reached, here is some suggested wording that should protect the MOD from subsequent claims of estoppel: -

"For the avoidance of any doubt, the MOD will be prepared to accept your offer to repair the 50 properties on the strict understanding that this is entirely without prejudice to the MOD's rights in connection with the remaining 50 properties. The Contractor acknowledges that the MOD has not waived any of its rights in respect of the remaining 50 properties."

**PART 28 – GENERAL
COMMUNICATIONS 145**

- 145.2** If a communication is too urgent to wait for it to be sent by post, fax or email, telephone numbers for the various representatives are given in this Clause. However, because telephone communications do not have contractual status, they must always be followed up with a written confirmation within the time periods required by MOD PFI PAv2
- 145.3** This Clause deals with the time at which notices are assumed to be effective. If a response is required, this Clause does not require the response to be given within a set time. Acquisition teams should have regard to the various Clauses in MOD PFI PAv2 which specify a reply as these may contain a requirement for the reply to be given within a set time. If no period for reply is specified in the relevant Clause, Clause 12.1 requires each Party to act co-operatively in fulfilling the purpose and intent of MOD PFI PAv2, and so a reply should not be delayed unnecessarily.

**ENTIRE
AGREEMENT**

- 152** The purpose of an entire agreement clause is to prevent the Party relying on it from being liable for any statements or representations (including pre-contractual representations) except as expressly set out in the Contract. This Clause therefore makes it clear that the full contractual terms are to be found in MOD PFI PAv2.

SCHEDULES

SCHEDULE 1 – AUTHORITY'S REQUIREMENTS

This Schedule contains the Core Table, the list of Specified Assets, the Asset Provision Requirements, the Service Provision Requirements, Security Requirements and any constraints on the Services. All of these must be drafted by acquisition teams and in final form before issue of the ITT/ITN. Further guidance on the Core Table, and the list of Specified Assets is given in "Starting Out" above.

The Asset Provision Requirements should not include any specification of the Assets themselves, which will be specified by the Contractor in the Asset Provision Proposals.

Note: MOD Commercial policy and guidance on Sustainable Procurement (available via the Acquisition Operating System) should be complied with, e.g. complying with mandatory Government standards (e.g. Buy Sustainable – Quick Wins); Defence Estates instructions must be followed for procurements that have an estate and/or construction elements (e.g. Defence Related Environmental Assessment Methodology (DREAM); and all new equipment projects must comply with Project Oriented Environmental Management Systems (POEMS) and Project Oriented Safety Management Systems (POSMS).

SCHEDULE 2 – CONTRACTOR'S PROPOSALS

This Schedule contains the Asset Provision Proposals, Service Provision Proposals and Security Proposals. These will be drafted by the Contractor in response to the ITT/ITN and refined during the bidding process.

SCHEDULE 3 – DOCUMENTS AND DATA REFERRED TO IN PART 1 (PRELIMINARY PROVISIONS)

This Schedule contains details of the Conditions Precedent (see guidance on Clause 5.2), and the form of the Collateral Warranty to be provided by Sub-contractors (see guidance on Clause 6.1 and notes below). Parts 3 to 9 contain data and lists of the various documents which are relevant to the project.

Part 1 should be completed by acquisition teams insofar as they are able, and Part 8 must be completed, before issue of the ITT/ITN. The remaining Parts will be completed during the bidding process.

What is a Collateral Warranty?

1. A Collateral Warranty is a form of contract that runs alongside, and is usually supplemental to, another contract to give a third party (party C) rights in the other contract entered into by two separate Parties A and B.
2. For example in the building industry collateral warranties are used to create a direct legal relationship, particularly duties, between the construction team designers (e.g. architects,

engineers, quantity surveyors) and the building contractor and a third party (other than the employer/property owner/developer) such as a funder, purchaser or tenant usually for a fixed period after construction has ceased. A collateral warranty may also clarify a relationship which might otherwise exist only by implication of law. See Annex A diagram 1.

3. Although collateral warranties are generally encountered in relation to the construction of a new building, they may also be relevant in relation to the manufacture of a piece of new equipment.

Why are they needed?

4. Following the House of Lords decision in *D & F Estates v Church Commissioners* in 1988, the law developed in such a way that it is no longer possible for Parties who have an interest in a building to sue the designers and/or contractors, the construction team, for defects in a building arising out of their negligence unless they have a contract with them.
5. This means that normally the only party who can sue the construction team for negligence are the original employers. By having the construction team grant collateral warranties in favour of those third parties having an interest in the building, the third parties are also able to sue the construction team for negligence.
6. So, where an architect (party B) is appointed to design a block of flats for a developer (party A) and the developer intends to sell the block of flats to a housing association (party C), due to privity³ of contract the architect would normally only be contractually liable to the developer should defects arise. The collateral warranty establishes a contractual relationship between the housing association (party C) and the architect (party B) enabling the housing association to bring a claim against the architect in respect of any defects.
7. Third parties now expect warranties to be granted in their favour so it is important for employers to have the ability to obtain warranties in favour of these third parties.

Who will require collateral warranties and who are they needed from?

8. In the case of a traditional procurement, collateral warranties will be required by purchasers, tenants and bodies funding the development such as banks. The employer/property owner/developer (party A) may also require warranties from sub-contractors, particularly those with a design responsibility, where no direct contractual relationship exists (party D). See Annex A diagram 1.
9. In the case of a PFI procurement the relationship between the Parties is slightly different – see Annex A diagram 2. The MOD (party C) enters into a project

agreement with an SPV (party A). The Funder (party E), usually a consortium of banks, lends money to the SPV to carry out the project. The SPV enters into a variety of sub-contracts with various consultants/contractors (party B) for the design and construction of the project assets. There may also be sub-sub contractors (party D). In a PFI the MOD and the Funder will require collateral warranties, though in the case of the Funder the warranty is really a form of step in agreement, known as the Direct Agreement (see paragraphs 10 and 13 below).

10. In either a traditional or PFI procurement, party C will require warranties from the construction team (party B) and in some cases from the sub-sub contractors (party D). In the case of a PFI procurement the funder (party E) will require a Direct Agreement with the MOD (party C) and the SPV (party A). See paragraph 13 below.

Limitations of Warranties

11. Collateral warranties usually try to put the beneficiary of the warranty in the same position as the original employer: if there are restrictions on the employee's liability in their appointment or contract then these are likely to apply to the warranty.

Step in rights

12. In a traditional procurement the collateral warranty in favour of the funder will include step in rights giving the funder rights to take over as the employer in place of the original employer if (i) the finance agreement is terminated or the funder is entitled to terminate it because of the employer's default; or (ii) circumstances arise entitling the contractor/consultant to terminate its appointment with the employer e.g where the employer fails to pay.
13. In a PFI procurement, the funder enters into a form of step in agreement with the SPV and the MOD known as the Direct Agreement. This allows the funder to step in and run the Project Agreement and take over the sub-contracts with the construction team.
14. In a PFI project the MOD will also have separate collateral warranties with the construction team (party B) and sub-subcontractors (party D) which allow either the MOD or its substitute to step-in to the SPV's place and take over the sub-contracts in the case of termination of the Project Agreement due to SPV default. This right is subsidiary to the funder's primary right under the Direct Agreement.

Are collateral warranties needed for a service provision contract where there is no bank finance (eg Government Funded service)?

15. Given the above it is clear that the MOD should seek collateral warranties under a Government Funded service procurement strategy in just the same way as

it would under a PFI procurement strategy since it needs to ensure it has rights against the Parties contracted by the SPV to design and develop the service.

16. However the MOD PAv2 Collateral Warranty template (Schedule 3 Part 1) needs modifying to remove reference to the Direct Agreement as this is not required when there is no bank finance. Legal Advice will be required to make the necessary changes to the template. (There will be a series of other consequential changes required to MOD PAv2 where there is no bank finance. The major changes will involve removal of the clauses relating to refinancing, modification of the VfM and compensation on termination provisions).

Diagram 1
STRUCTURE IN A TRADITIONAL PROCUREMENT

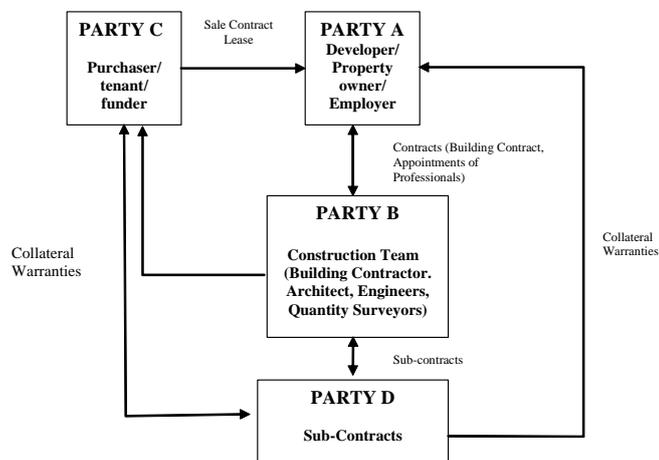
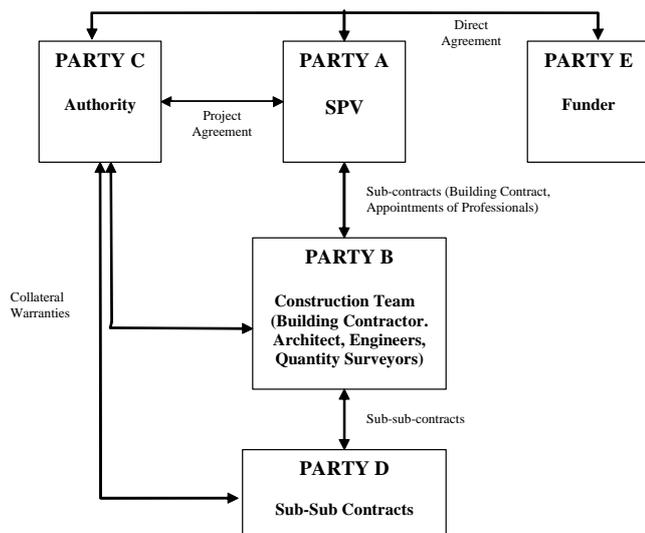


Diagram 2
STRUCTURE IN A TYPICAL PFI PROCUREMENT



SCHEDULE 4 – DOCUMENTS AND DATA REFERRED TO IN PART 2 (SITE ISSUES)

This Schedule contains details of the Authority Sites to be used in relation to the project. Acquisition teams may wish to allow the Contractor to submit variant bids on the basis of using Contractor Sites, but these details should still be completed before issue of the ITT/ITN so that the Contractor can properly conduct due diligence and price its liabilities in respect of Authority Sites.

SCHEDULE 5 – DOCUMENTS REFERRED TO IN PART 3 (QUALITY AND PERFORMANCE STANDARDS)

Both Parts of this Schedule must be completed before issue of the ITT/ITN.

SCHEDULE 6 – DESIGN REVIEW PROCEDURE REFERRED TO IN PART 4 (DESIGN OBLIGATIONS)

This Schedule should be completed before issue of the ITT/ITN. Acquisition teams should have a good idea of which data they will expect to see as Reviewable Design Data once the list of Specified Assets has been developed.

When completing the Table in Schedule 6 to list Reviewable Design Data, acquisition teams should note that the Item in column 1 should be, or should be a part of, a Specified Asset. This is necessary in order for the design review provisions to integrate with the remainder of MOD PFI PAv2, such as Clause 17.1.3.

**Effect of
Authority's
Representative's
Comments**

3.3

It is essential in a PFI project to clearly distinguish between a design development and a design variation – the former is properly dealt with using the mechanism in Schedule 6, whilst the latter should be submitted to the Change procedure (Part 18).

SCHEDULE 7 – DOCUMENTS AND DATA REFERRED TO IN PART 6 (TIME AND PROGRAMMES)

Acquisition teams should complete this schedule before issue of the ITT/ITN (although the Asset Provision Programme may well be revised during the bidding process). Part 3 should not be used unless Clause 31 applies (see guidance above).

SCHEDULE 9 – DATA REFERRED TO IN PART 8 (GOVERNMENT FURNISHED ASSETS, EXISTING ASSETS AND EXISTING CONTRACTS)

If provisions for Government Furnished Assets, Existing Assets or Existing Contracts are used, Parts 1 to 3 of this Schedule should be completed before issue of the ITT/ITN. The Contractor will complete Part 4 during the bidding process.

SCHEDULE 10 – TRANSFER OF RESIDUAL VALUE PROVISIONS REFERRED TO IN PART 9 (TRANSFER OF TITLE)

If the Assets will have a residual (market) value to the Contractor at the end of the project, provisions should be inserted in this Schedule following SoPCv4 paragraph 20.5.7

and detailing:

1. MOD's right to take over the Assets if it pays the Contractor compensation for that value;
2. MOD's right to re-tender the project, in which case the successful incoming contractor will pay that value to the Contractor;
3. MOD's right to walk away from the project, leaving the Contractor to realise the value of the Assets.

For further guidance on these issues, see SoPCv4 paragraph 20.5

SCHEDULE 12 – PERMITTED USE REFERRED TO IN PART 11 (THIRD PARTY USE OF ASSETS)

This Schedule should be completed by the Contractor if it proposes Third Party Use at the commencement of the project.

SCHEDULE 13 – PAYMENT MECHANISM REFERRED TO IN PART 12 (PAYMENT AND BASE CASE) **SoPCv4 Chapter 10**

This Schedule contains a template Payment Mechanism designed to be as flexible as possible through the use of colour coded text. In addition it can also be used for projects which do not involve training service provisions (by deleting the provisions with grey shading).

The fundamental principle that underpins this template and the the development of any PFI payment mechanism is that the MOD must be clear regarding “what” is the service that is actually being purchased under the Contract and what “units” the service is being delivered in. With these points in mind, insofar as is possible a payment mechanism should be designed to link payment to the delivery of the “units” of service in such a fashion as to incentivise delivery of the amount and quality of services specified in the MOD’s statement of requirement.

In PFI contracts the “units” for which payment is frequently made include either one or a combination of:

- Periods of service availability (eg Payment is made for a serviced facility or a service being available for use)
- Units of value delivered (eg training courses run, or personnel attending or passing them)
- Incremental change or improvement delivered from an agreed baseline.

In both instances the Contractor will have to satisfy clearly defined criteria for payment to be triggered. The criteria will depend on the nature of the services being purchased, for example, in an availability based payment mechanism, it will be necessary to define what constitutes “availability”.

It is frequently the case that the MOD's payment is based on the purchase of a specified volume of "units" of service delivery that represent the full capacity of the available service. For example in respect of an accommodation project – the MOD may be seeking to purchase the full available capacity of a serviced facility for the Contract term, but with a monthly payment calculated on the basis of the number of days for which the accommodation services were available during that month.

It is possible however for the MOD to contract to purchase less than the full capacity of the total service and this introduces the concept of "volume" or "demand" risk. This will result in a payment mechanism which includes an element of payment linked to the volume of service purchased. For a volume related element to be appropriate however a contractor must either be able to vary its costs in proportion to variations in its revenue or find alternative purchasers of the excess capacity not required by the MOD so as to ensure it can make a profit. The extent to which a contractor will accept volume risk in respect of a PFI contract is dependent on the nature of the services purchased and whether an alternative market exists for them.

It should be noted that in contracts where the service required by the MOD, and consequently payment, vary by volume, it is usual for MOD to commit to purchase a guaranteed level of capacity during the Contract. This usually results in sufficient payment being made by the MOD for a contractor to meet its fixed costs. This is often described as a "take or pay" arrangement.

Payment mechanism will also contain a performance or "service credit" regime to incentive delivery of the services to an agreed quality standard. The quality standards to which each element of the overall service are to be delivered will be set out in a series of "service levels agreements" set out in the statement of requirement. The service credit regime will define a set of defined outcomes which are considered to represent shortfalls in service quality. For each incident there will be a defined "service credit" (or deduction) against the revenue paid to the contractor representing the value of service lost by the MOD as a consequence of the occurrence of the outcome. The values of service credits are usually agreed as part of a negotiation between the MOD and contractors.

Acquisition teams should consult with their financial advisers in the design and detailed drafting of a payment mechanism and service credit regime suitable for their project and service requirement.

Matters to be included in the Payment Mechanism

The Payment Mechanism needs to contain provisions other than those dealing solely with payment. Acquisition teams will need to include items such as:

1. a breakdown of each element of the Unitary Charge;

2. provisions for indexation of the Unitary Change;
3. any methodologies applicable to adjusting the Unitary Change when compensation is calculated on a Change or as a result of a Compensation Event, for example assumptions which need to be made if the MOD is taking demand risk;
4. how any costs "passed through" to MOD, such as utility charges, will be dealt with;
5. the mechanism for making Deductions from the Unitary Charge, in the event of poor performance (Service Performance Deductions) or unavailability (Unavailability Deductions) and the criteria to be satisfied for availability, which should interface with the Services Availability Requirements in Schedule 7 Part 3.

Involvement of financial advisers will obviously be critical in developing and reviewing the Payment Mechanism.

If import and/or export duty applies to any aspect of the project, the Payment Mechanism will also need to make provision for their treatment.

Final Payment Period

2.2.2

Towards the end of the Contract Period, the Unitary Charge remaining to be paid to the Contractor may not be sufficient to cover any amount MOD needs to deduct or withhold. MOD PFI PAV2 therefore contains various provisions for MOD to retain amounts from the Unitary Charge to ensure that MOD is not left in a negative cash flow situation if the Contractor does not properly perform its obligations. Some of this retention is to cover the condition of the Specified Assets and to ensure that the Contractor rectifies any defects in the Specified Assets before they are handed back to MOD on expiry (see guidance notes on Clause 134). This Clause deals with retention to cover the Contractor's performance of the Services and to ensure that MOD has withheld a sufficient amount so that it can set-off any Deductions the Contractor incurs at the end of the Contract Period.

A worked example of this Clause, assuming there are ten payment periods, is as follows:

Payment Period	Deductions incurred in previous Payment Period	Retention
1	£100	Nil
2	£110	Nil
3	£100	Nil
4	£100	Nil

5	Nil	Nil
6	£50	Nil
7	£30	Nil
8	£10	Nil
9	Nil	£48.33
10	Nil	£31.66

MOD should reconcile any retention withheld under this Clause in the subsequent Payment Period, so that, in the example above, MOD should give credit to the Contractor for the retained £48.33 in Payment Period 9 in Payment Period 10 i.e. the amount to be paid to the Contractor in Payment Period 10 will be £16.67 (£48.33 - £31.66). If the figures are such that the retention is insufficient to cover the Deductions actually incurred, the Contractor must pay the balance to MOD with interest at the Prescribed Rate.

SCHEDULE 14 – DOCUMENTS AND DATA REFERRED TO IN PART 18 (CHANGES AND CHANGE IN LAW)

This Schedule contains the proforma Notice of Change to be completed for all Changes pursuant to Part 18 (Changes and Change in Law).

SCHEDULE 15 – DATA REFERRED TO IN PART 21 (TUPE, CONDO AND SPONSORED RESERVES)

The TUPE provisions within MOD PFI PAV2 are indicative of those required by a project in which TUPE applies. However acquisition teams **must** consult Central Legal Services – Commercial Law and Director Commercial Systems for the latest guidance and wording and not rely on the wording provided in MOD PFI PAV2.

Schedule 15 is the only area of MOD PFI PAV2 where MOD warrants that the data it provides to the Contractor is accurate and complete (see guidance on Clause 11) and acquisition teams should therefore take all possible steps to ensure that the list provided in Schedule 15 Part 1 is not varied after issue of the ITT/ITN and that all other data and information on employees given by MOD under Part 21 and this Schedule is accurate and complete.

Part 1 – Employee Transfer Arrangements on Entry

This Part covers the transfer of employees to the Contractor at the start of the contract both out of the MOD and from existing contractors.

Appendix 1

This is the data provided to the Contractor during the bidding process on which it has submitted its final price in relation to the costs of TUPE transfers. This should include all data both for Authority employees and existing contractor employees and it should be as accurate as possible. It is important that this data is frozen because it is the benchmark on which adjustments to the Unitary Charge, resulting from changes to the data, are made. The current

drafting only provides for adjustments in relation to data relating to Authority Employees because this is the only data over which the Authority has control. In respect of existing contractor employees, the Contractor is expected to price the risk of the data being inaccurate.

Appendix 2

This is the data for ex-Authority employees. These are separately identified because there are separate pension requirements and they can be on enhanced terms.

Appendix 3

This is the detailed employee information which is to be provided prior to the transfer including information (such as employees name) which is not provided earlier due to the Data Protection Act.

Appendix 4

This requires the insertion of the Actuary's Letter which provides the actuarial assumptions for any bulk transfer terms for any Authority Employees transferring their accrued pension into a Contractor's broadly comparable pension scheme.

Part 2 – Employee Transfer Arrangements on Exit

Part 2 to Schedule 15 provides the clauses for TUPE transfers of the Contractor's employees at the end of the Contract or part way through it. The terminal redundancy indemnity only covers Authority Employees which transferred to the Contractor because this is the limit of what is allowed by HM Treasury policy.

SCHEDULE 16 – DATA REFERRED TO IN PART 22 (INTELLECTUAL PROPERTY, INFORMATION AND DISCLOSURE)

Part 1 of this Schedule should be completed by acquisition teams before issue of the ITT/ITN. Part 2 can be left to be finalised during the bidding process.

SCHEDULE 17 – DOCUMENTS REFERRED TO IN PART 23 (INSURANCE)

Parts 1 and 2 (Asset Provision Period Insurance and Service Provision Period Insurance)

For an accommodation-based PFI project, the Required Insurances will typically include:

1. "all risks" insurance of the Specified Assets, for example, the buildings. It is generally required only during the Asset Provision phase;
2. delay in start up (advanced loss of profits), which compensates the Contractor for losing Unitary Charge because it does not commence Service Provision on the Planned Service Commencement Date;
3. third party liability insurance for the Asset Provision phase;
4. property damage insurance. This compensates the Contractor for property damage during the Service Provision phase;
5. Business interruption insurance. This compensates the Contractor for loss of income (i.e. for Deductions imposed by MOD) on specified events such as Relief Events;

6. third party and product liability insurance for the for the Service Provision phase.

There may be other insurances which the Contractor will take out such as professional indemnity insurance, but that MOD does not derive a benefit from. Projects involving marine or aviation assets, or which involve marine transportation of assets, will also need specialist insurance to be included in this Schedule.

If damage occurs to a Specified Asset whilst it is being constructed or manufactured during the Asset Provision phase, the "all risks" cover will provide the cash to reinstate the damage. From MOD's point of view this means that there will not be an adverse "hole" in the Contractor's financial projections, and a chance of the project continuing. Even if the Senior Lenders refuse to continue funding the project and the Contract is terminated on an application of the economic reinstatement test (see guidance on Clause 118.5) the proceeds of this insurance should be offset against any compensation payment which MOD is required to pay on termination.

Delay in start-up cover provides relief where Relief Events (i.e. risks which MOD has not agreed to bear by treating them as Compensation Events), cause a delay to the commencement of a given Service Level, with a consequent reduction in the Unitary Charge. This type of delay has the ability to impact badly on the assumptions made in the Base Case, and could lead to the Contractor's insolvency, through no fault of its own. It is therefore in MOD's best interests to ensure that the project continues, and acquisition teams should generally expect this type of insurance to be in place.

Professional indemnity insurance which is taken out to cover negligent acts of the Contractor and other insured parties is treated differently to the other Required Insurances. Although those negligent acts are likely to have the same effect as the events causing damage and delay, and the consequent need to call upon an extra source of funding, they are acts which the Contractor is required to manage itself. It is not acceptable for a public entity such as MOD to effectively underwrite an act of negligence of a Contractor by including professional indemnity insurance in the Uninsurability provisions and if this insurance is included in Schedule 17, Clause 114 must be amended accordingly.

Part 3 (Endorsements)

Endorsements are extra wording which are drafted into the insurance policies to clarify to whom insurance proceeds should be paid and the extent of the Parties' (and the Senior Lenders') rights and obligations as co-insureds). The standard endorsements likely to be required include:

1. waiver of subrogation rights against the Senior Lenders;
2. no duty of disclosure on the Senior Lenders;
3. no rights of contribution for the insurers against any other policies held by the Senior Lenders;

4. insureds to be treated as separate entities;
5. Senior Lenders to be additional insureds under the policy for the purpose of their security interest;
6. non-vitiating endorsement;
7. notification of cancellation, reduction or suspension;
8. no obligation on the Senior Lenders to pay the premium on any policy;
9. assignment to the Senior Lenders of the benefit of any claim made under the project insurances
10. loss payee endorsement, to pay all proceeds above a certain amount into the Joint Insurance Account (see guidance on Clause 116).

SCHEDULE 18 – DIRECT AGREEMENT

Direct Agreement Consult MOD PFU for a draft template

SCHEDULE 19 – PROJECT MANAGEMENT

Dispute avoidance is commonly recognised as good practice throughout the commercial world, including in relation to PFI projects. Acquisition teams should draft their own custom procedure for this Schedule, which covers all issues needed to build a strong working relationship between MOD and the Contractor, for example by holding monthly progress meetings, so that where possible, problems can be anticipated and solutions developed before they become formal disputes.

SCHEDULE 20 – COLLATERAL WARRANTY

This Schedule contains a draft template Collateral Warranty

SCHEDULE 21 – DOCUMENTS REFERRED TO IN PART 11 (THIRD PARTY USE OF ASSETS)

This Schedule contains a Third Party Report Income Pro Forma

SCHEDULE 22 – DOCUMENTS REFERRED TO IN PART 2 (SITE ISSUES)

This Schedule contains a template to record surveys of Authority Sites carried out by the Authority and/or the Contractor.

SCHEDULE 23 – DOCUMENTS REFERRED TO IN PART 3 (QUALITY AND PERFORMANCE STANDARDS)

This Schedule contains the Timber Procurement Policy.

FINAL STEPS

Once acquisition teams have worked their way through MOD PFI PAV2, customising it for their project, the final steps before it is ready to be issued as part of an ITT/ITN are to

ensure that the Contract covers all relevant risks identified in the Risk Register.

Because MOD PFI PAV2 is a generic document, it does not contain Clauses relevant to only one project or to a particular type of project. For example, training PFIs often use military instructors to provide the service, and provisions will need to be inserted in Part 21 (TUPE, CONDO and Sponsored Reserves) to cover the legal and pastoral responsibility for these service personnel. Similarly if the Contractor's personnel will be deployed or are Sponsored Reserves, this Part will need additional provisions to cover this.

If a project risk is identified in the Risk Register but is not covered in MOD PFI PAV2, acquisition teams should discuss with the PFU where it should best be inserted. Many provisions of MOD PFI PAV2 cannot be amended without HMT approval, such as adding extra Compensation Events or Relief Events, and the PFU will act as the liaison between Infrastructure UK (HM Treasury's agent) and the acquisition team if these provisions need to be amended for project specific reasons.