Infrastructure and Projects Authority

PFI Guidance Document

Navigating the risks of PFI project distress

Part 4 Contract termination and Direct Agreements

Reporting to Cabinet Office and HM Treasury

Guidance structure

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Contract termination and Direct Agreements

- Termination can have serious financial and budgetary consequences for contracting authorities and may carry a significant risk of prolonged and costly litigation.
- A consensual termination may accelerate resolution of issues, avoid prolonged litigation and transfer control of the assets/premises but must be value for money.
- Contracting authorities may be able to step-in to service provider contracts under a Direct Agreement to ensure service continuity. In practice this often does not happen because it exposes contracting authorities to greater risk and/or their rights are subordinated to lenders.

Part 4 is recommended for contract managers and in-house financial and legal teams wanting more explanation of contract termination and the operation of Direct Agreements.

When projects are in distress and relationships break down, it can be natural for contracting authorities to think that contract termination, and removal of the project company and its service providers, is the best solution. However, contract termination carries jeopardy for contracting authorities and should, generally, be a last resort when attempts at constructive resolution have failed. Contracting authorities should take appropriate advice if they are considering contract termination. Contractor default termination is a particularly complex area and contracting authorities are likely to require detailed legal advice on the termination process and the risks of challenge.

The PFI contract sets out the different types of early termination. Typically (but not always) these include:

- *Voluntary termination:* a contracting authority can choose to terminate the PFI contract voluntarily (i.e. not linked to events of default by either party);
- *Authority Default:* contracting authorities have limited obligations under the PFI contract and, therefore, this is most likely to occur where there is non-payment by the contracting authority;
- *Contractor Default:* where there is an event of default caused by the project company, the contracting authority may have the right to terminate for contractor default (subject, where the default is capable of remedy, to the project company's rectification rights). Commencement of project company insolvency proceedings is usually a project company event of default;
- *Force Majeure:* limited to certain specific events, as set out in the contract, which the parties agree are beyond the parties' control.

These different termination routes drive materially different outcomes for contracting authorities. The diagram below summarises the key factors, being:

1. the ability of the contracting authority to control the process and outcome;
2. the impact on risk transfer to the private sector; and
3. the financial impact on the contracting authority (including implications for budgets).

Voluntary termination usually has the largest financial impact on the contracting authority and transfers risk from the private sector back to the authority. On the other hand, it typically allows the contracting authority greater control over the process and outcome. However, it is rarely value for money for contracting authorities to voluntarily terminate their PFI contracts -more information on this is provided in the HM Treasury *PPP Policy Note: Early termination of contracts*[1]

Contractor default termination maintains more risk transfer to the private sector (through the contract retendering process or the compensation calculation) but the contracting authority has less control over the process and outcome, particularly where termination involves an insolvency practitioner and/or prolonged litigation.

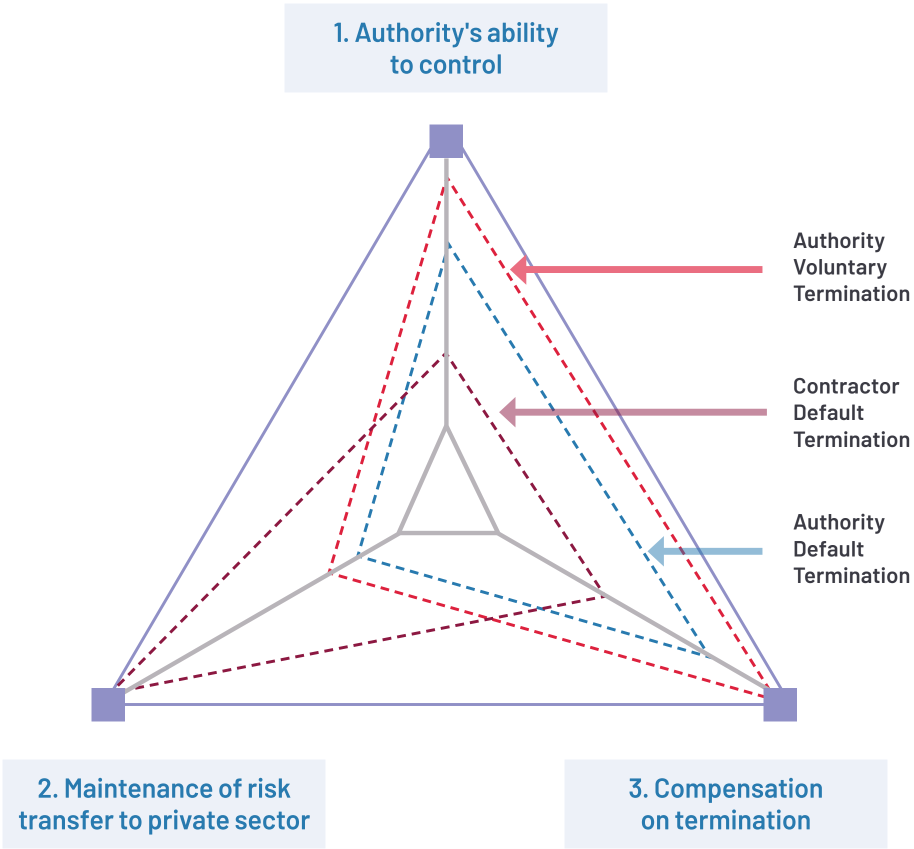
1 https://assets.publishing.service.gov.uk/media/5a80c69fed915d74e33fc567/PPP_terminations_policy_note.pdf

Contract termination and Direct Agreements

Where contract termination is a possibility, contracting authorities need to examine and understand the implications of the different termination routes as part of their strategic options assessment. A thorough risk analysis should be undertaken before any action is taken to terminate a PFI contract, including consideration as to whether termination will deliver a better outcome compared to other possible resolutions. This analysis should include an assessment of the risk of disputes over the grounds for, and type of, termination (e.g. where a contracting authority is levying large payment deductions that subsequently lead to project company insolvency there can be disputes over whether the termination is on the grounds of Authority or Contractor Default).

There can be merit in considering a consensual termination, and associated negotiated settlement, if this enables the contracting authority to accelerate the resolution of issues, avoid prolonged litigation and obtain control of the assets/premises. However, this needs to be shown to be better value for money for the contracting authority than the alternatives, including a non-consensual termination. This can involve a complex assessment requiring an evaluation of the costs and benefits of different outcomes. Wider impacts, including on the continuation of any PFI grant, also need to be considered.

Impact of different termination routes



2 https://assets.publishing.service.gov.uk/media/5a80c69fed915d74e33fc567/PPP_terminations_policy_note.pdf

Contract termination and Direct Agreements

What are the consequences of Contractor Default, Authority Default and Authority Voluntary termination?

Significant risks arise for contracting authorities when contracts terminate early. Where contract termination is unavoidable, proper and timely preparation is essential to navigate these risks effectively. This section highlights some of the key issues.

	Contractor Default Termination	Authority Voluntary/Authority Default Termination (these typically have the same consequences under the PFI contract)
Termination payments	Most PFI contracts include two potential options on contractor default: Retendering of the PFI contract or No Retendering (earlier contracts may only have one option). *Retendering:* if the PFI contract is retendered in the market, then there is no termination compensation payment from the contracting authority to the project company as the PFI contract is, effectively, transferred to a new provider. However, retendering is usually only applicable where it can be demonstrated that there is a *Liquid Market*. Determining whether or not there is a Liquid Market is a complex area, and open to dispute, and needs to be considered carefully with the contracting authority's advisers. *No Retendering:* if the contract is not retendered, the contracting authority may have to make a substantial compensation payment to the project company, with the consequential impact on cash and budgets (see below). Compensation payments are, generally, intended to reflect the *fair value* of the contract. The compensation does not take any account of the amount of debt the project company owes, but is intended to reflect the value of the PFI contract, taking into account the remaining unitary charge payments and the costs to the authority of having to rectify any problems and to service and maintain the facilities. Contracting authorities should not receive an economic windfall as a result of project company termination. Where there are significant problems in the project (e.g. due to rectification works required or under-pricing of service costs) this should be reflected in a reduced compensation payment. Compensation payments can be negative – for example, where there are very high rectification costs - creating a theoretical sum due from the project company to the contracting authority. However, the contracting authority is unlikely to be able to recover such sums where the project company is insolvent and so will still have to meet these additional costs itself, i.e. it may have to spend significant amounts to get the facilities back to the condition they were meant to be in. Contractor default termination compensation will typically be less than the equivalent to be paid on voluntary termination, as it is reduced to account for rectification costs and increased costs of service delivery. The calculation of termination payments can be complex, requiring specialist support, and is likely to require preparatory work to have been completed (e.g. condition surveys).	The contracting authority is likely to have to make a substantial compensation payment to the project company, with the consequential impact on cash and budgets (see below). Generally, the contracting authority has to put the PFI company in the same position it would have been had the PFI contract run its full course. SOPC contracts include the following compensation: – senior debt outstanding and break costs on any hedging instruments; – PFI company redundancy costs; – subcontractor break costs; – one of (i) an amount that gives investors the Base Case return on their investment to date OR (ii) the value that the shareholder equity and loans could be sold in the open market OR (iii) the value of future shareholder payments discounted at the Base Case IRR. The contracting authority may have the right to set-off certain amounts due to them but this is usually subject to paying a minimum amount equal to the senior debt. Given the compensation calculation above, voluntary termination is rarely value for money for a contracting authority. However, there are limited circumstances where voluntary termination can offer value for money (even with the transfer of service and asset risk). Where this is the case, the budgetary implications of voluntary termination still need to be considered carefully *(see PPP Policy Note: Early termination of contracts[2]).*

2 https://assets.publishing.service.gov.uk/media/5a80c69fed915d74e33fc567/PPP_terminations_policy_note.pdf

Contract termination and Direct Agreements

	Contractor Default Termination	Authority Voluntary/Authority Default Termination (these typically have the same consequences under the PFI contract)
Service & asset risk	Unless the PFI contract is retendered, contractor default termination transfers the risk of service delivery and asset maintenance back to the contracting authority. The risks inherent in preparing for contract expiry - operational disruption, lack of service continuity, financial loss and reputational damage - are all relevant on early termination (no-retendering) and contracting authorities should refer to existing guidance on *Preparing for PFI contract expiry*[3]. However, unlike expiry, where the contracting authority has time to plan for the transfer of the assets and services, early termination (no-retendering) can be unplanned and can happen quickly (especially where it is caused by project company insolvency). Contracting authorities should not underestimate the work and associated risks involved in taking back responsibility for the PFI services and assets. For example: *Defects:* if there are major defects and/or compliance issues that need to be rectified after termination, contracting authorities will have to take on responsibility for funding (see budget considerations below) and managing the works. The authority will need to employ contractors to carry out the works and to recruit staff to manage the process. The outturn costs of the works may be higher than expected (and higher than assumed in calculating the termination payments), impacting on the authority's budgets. *Services:* contracting authorities will need to assume responsibility for the services, including TUPE transfers of relevant staff. They may be required to maintain the facilities and service levels after termination at the same level as required under the PFI contract, to avoid the facilities deteriorating. This will require a considerable increase in staffing and commitment of management time. There are also risks to service continuity in the periods following the issue of a termination notice, and following termination of the PFI contract, especially if service providers are unpaid because lenders have swept the cash. Contracting authorities will need to consider these risks carefully to avoid unexpected disruption to service delivery.	Similar risks apply to voluntary termination as they do to contractor default termination (no-retendering). Voluntary termination may give the contracting authority more control over the timing of the termination process and, therefore, may enable it to be better prepared for the transfer of assets and services. However, whereas the compensation payable on contractor default termination (no-retendering) accounts for any additional costs to the contracting authority of taking back (and future provision of) the services and assets, voluntary termination compensation does not – the contracting authority has to pay the termination compensation and meet any additional costs.

3 https://assets.publishing.service.gov.uk/media/621c877de90e0710bdc09a96/IPA_Guidance_-_Preparing_for_PFI_Contract_Expiry.pdf

Contract termination and Direct Agreements

	Contractor Default Termination	Authority Voluntary/Authority Default Termination (these typically have the same consequences under the PFI contract)
Disputes & litigation	Prolonged and costly legal disputes are possible as lenders seek to recover as much of their loan as possible. Disputes can arise over some, or all, of the following: – the form of termination: whether the project company or the contracting authority is entitled to terminate the contract; – the grounds for termination: whether the contracting authority has the grounds for contractor default termination; – retendering/no retendering: whether or not there is a Liquid Market and, therefore, whether Retendering or No Retendering termination compensation is appropriate; and – the quantum of any compensation: where there is No Retendering, the Estimated Fair Market Value is calculated based on subjective assessments of future costs and assumptions to be applied to revenues and costs (such as inflation). The risk of disputes is likely to depend on how much termination compensation the contracting authority calculates as being due – if it is high (and sufficient to largely repay the lenders) then the risk of disputes is likely to be lower than if the compensation payment is very low/zero. The costs of litigation on a disputed contract termination can run into millions of pounds, even for smaller PFI projects. There is no guarantee that contracting authorities will fully recover these costs in any judgement or agreed settlement. Litigation can last for several years and require significant commitment of senior management time.	Voluntary termination is less likely to be acrimonious or to lead to significant disputes and litigation because the contracting authority pays out the lenders and shareholders, and the amounts are more definitive and less open to dispute. Where the contracting authority seeks to set-off amounts due against the termination compensation, there is potential for disputes over these amounts. In relation to Authority Default termination, where a contracting authority makes financial deductions/stops payments as a result of project performance issues, potential disputes may arise over whether the contracting authority had the contractual right to make the deductions/stop payments and, therefore, whether the contracting authority's actions contributed to any subsequent insolvency of the PFI company. Disputes and litigation can, therefore, arise over whether termination should have been on the grounds of Contractor Default or Authority Default.
Budgets	Early termination (no-retendering) can have significant budgeting, accounting and fiscal implications for contracting authorities, sponsoring departments and wider government. Contracting authorities need to ensure they have sufficient budget allocations; for central government this will include the appropriate Resource Departmental Expenditure Limits (RDEL) and Capital Departmental Expenditure Limits (CDEL). Local government contracting authorities may be in receipt of revenue grants to support their PFI payments and they will need to consider whether and how early contract termination impacts these grants - it is likely that such grants will cease on termination. Further detail on budgeting and other financial issues relating to the early termination of PFI contracts can be found in HMT's PPP Policy Note: Early termination of contracts . Contracting authorities should take advice, where necessary, on the budgetary implications of terminating their PFI contracts. They may also need approvals from their sponsoring department and/or HM Treasury.	The same considerations apply as for contractor default termination (no-retendering), albeit the budgetary impacts will be different.

Contract termination and Direct Agreements

What happens when a contractor default termination notice is issued?

When a contracting authority issues a termination notice for contractor default, it triggers a number of parallel and sequential processes under the PFI contract, the lender direct agreement and other direct agreements/collateral warranties with service providers. It is essential that contracting authorities take appropriate advice and contact their sponsoring department (and, where relevant the IPA) before issuing a termination notice.

What are direct agreements?

Direct agreements establish the rights and priorities of the contracting authority and the lenders in relation to the project company and its key subcontractors (e.g. service providers), and they have particular relevance in situations of project distress.

The diagram below illustrates the typical direct agreements entered into by the project parties. This may include:

- The lender direct agreement;
- A direct agreement with the construction subcontractor;
- A direct agreement with each service provider (subcontractor); and
- Direct agreements with important second tier subcontractors providing specialist services important to the build, design and operation of the project asset.

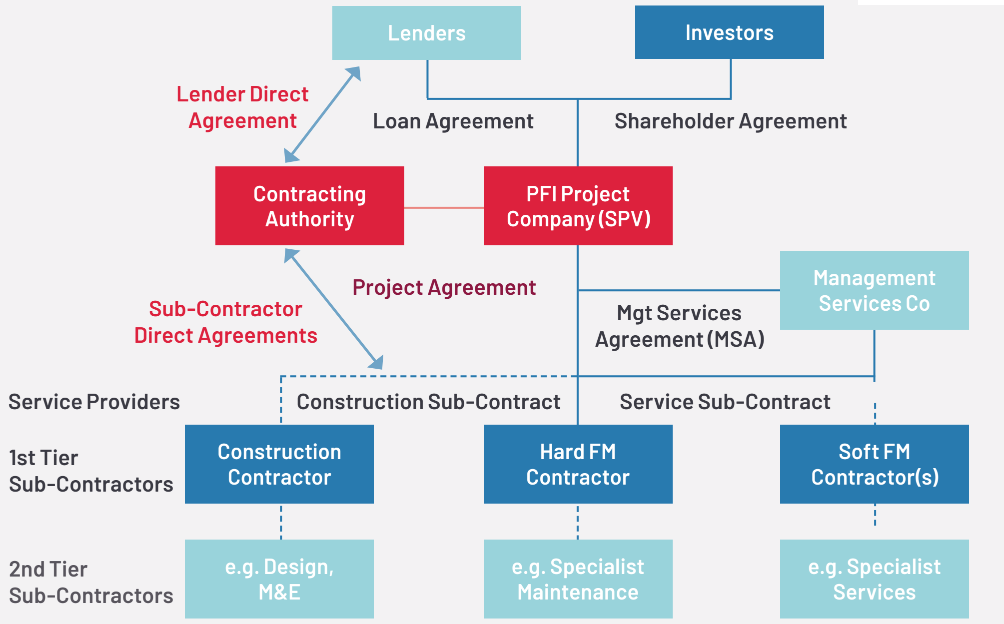
The direct agreements with subcontractors can also be known as collateral warranties or step-in agreements, but for ease of reference are referred to as direct agreements here.

The various direct agreements interact with each other and contracting authorities need to carry out a detailed contract review with their advisers to understand which direct agreements take priority and when.

Lender/contracting authority Direct Agreement: the lender direct agreement with the contracting authority (also frequently known as the Funder Direct Agreement) does a number of things, including:

- creation of lender step-in rights when a contractor event of default has arisen under the PFI Contract. The contracting authority gives the lender a period of time to decide whether to step-in to the PFI contract to rescue the project before the contracting authority terminates the PFI contract;
- confirmation of the rights of the lenders under their direct agreements with subcontractors to take action to preserve the subcontracts and that these rights have priority over those of the contracting authority in the period prior to the termination of the PFI contract - i.e. the contracting authority cannot step-in to the subcontracts before the lenders have decided whether to step-in to them;
- confirmation that, even after termination of the PFI contract, the lenders' *Accrued Rights* against subcontractors (to make claims for historic breaches in order to recoup any shortfall in repayment of the debt) take priority over the rights of the contracting authority against the subcontractors.

Typical and generic commercial structure showing direct agreements



Contract termination and Direct Agreements

Contracting authority/subcontractor Direct Agreement: for the purposes of this guidance, this serves two main functions:

- agreement by the subcontractor not to terminate their subcontract as a result of project company breach (typically non-payment of service fees) for a period to allow the contracting authority to take over the role of the project company under the subcontract and to rectify the breach;
- agreement that (in any event) the contracting authority may, on termination of the PFI contract, take over the role of the project company under the subcontract provided that it rectifies any pre-existing breaches of the subcontract.

It should be noted that lenders will, in parallel, have entered into separate direct agreements with the subcontractors. These prevent the subcontractors terminating their subcontracts while the lenders are deciding whether to rescue a project using their rights under the lender direct agreement. As above, these take precedence over the contracting authority's rights.

The step-in periods for the lenders and the contracting authority are normally sequential, so that the contracting authority has an opportunity to take on the subcontracts after the lender's period has ended.

What happens in practice

Whilst, in theory, a direct agreement allows the contracting authority to step-in to the contractual obligations of the project company to the subcontractors, in practice the contracting authority may be reluctant to do so. This is because direct agreements require the party stepping-in to the contract to assume all the outstanding liabilities of the entity it is replacing. For example, if the contracting authority steps in to the project company's contract with a service provider, it will assume any outstanding liabilities the project company has to that service provider.

In addition, the operation and sequencing of the rights of the contracting authority, lenders and subcontractors under the various direct agreements can be complicated and may, in practice, prevent the contracting authority stepping-in when it needs to.

For the reasons above, it is often the case that a contracting authority may not be able, or willing, to step-in to the service subcontracts to ensure service providers are paid and/or service continuity is maintained. Contracting authorities should seek early advice as to the working of the various direct agreements, particularly in relation to any subcontracts they wish to preserve during and/or after termination.

This advice should consider issues such as:

- what rights the contracting authority has to take action to preserve key subcontractors prior termination of the PFI contract (to maintain service continuity);
- when the various step-in periods begin and end under each direct agreement;
- whether the step-in periods protecting the contracting authority run in parallel or in sequence with those of the lenders;
- whether there are mechanisms for the contracting authority to recover (from the project company) any payments made directly to a subcontractor before termination of the PFI contract;
- if the contracting authority does step-in to a subcontract, how any accrued rights of the lenders (to make claims against the subcontractor) will impact on service performance; and
- whether there are any gaps in the contractual rights of the contracting authority which may necessitate prior negotiation with lenders and subcontractors in order to establish the right to preserve service continuity.

Given the practical issues with stepping-in to subcontracts under the direct agreements, the contracting authority may, instead, consider paying subcontractors directly where they perceive a risk to service delivery (this might be inside or outside of the PFI contract). However, this must be considered carefully in the context of the wider suite of project contracts (including service provider subcontracts, direct agreements etc), as it can potentially leave the contracting authority exposed if the PFI contract subsequently terminates - for example, if direct payments to service providers cannot subsequently be set-off as part of the compensation on termination calculations. Contracting authorities should take appropriate advice on whether/how they can make direct payments to subcontractors and any risks that this might expose them to.

Contract termination and Direct Agreements

Direct agreement timelines

When a termination notice is issued by a contracting authority, lenders have a period of time (often 90 days) to decide whether to *step-in to* the project company's position under the PFI contract, or to novate the contract to another party. Stepping-in may require the lenders to inject new monies into the project to finance the rectification of any performance issues.

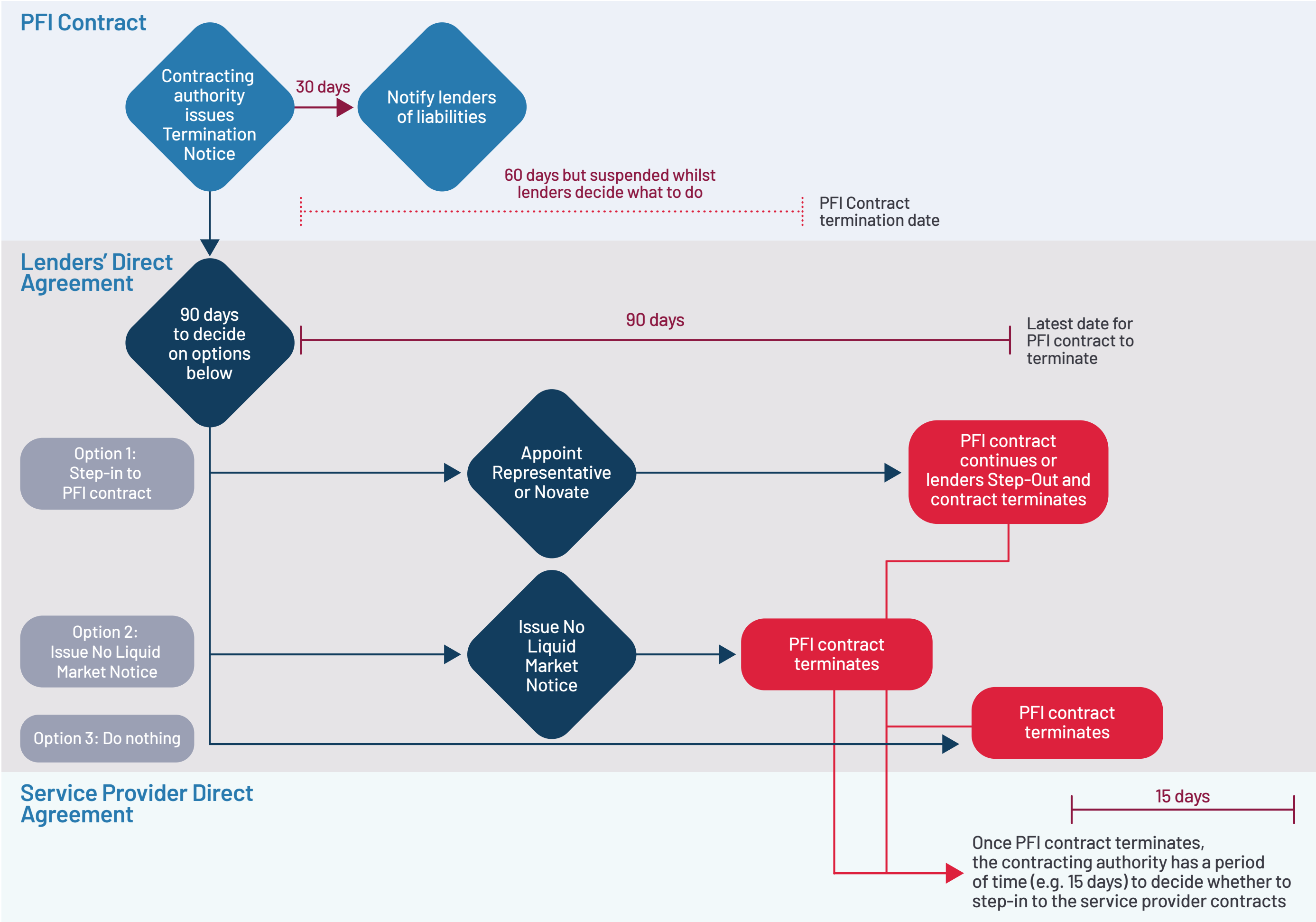
During this period the contracting authority cannot terminate the PFI contract unless lenders confirm they do not intend to step-in or novate the contract. If lenders do not step-in (or they step-in and then step-out), and the PFI contract terminates, then the contracting authority has a period of time (e.g. 15 days) to decide whether to step-in to the project company's position under the service provider contracts, in order to maintain service continuity.

If the contracting authority does not step-in to the service contracts when the PFI contract terminates, the service provider contracts should also terminate. Contracting authorities then have three options:

- sign a new contract with the existing service providers;
- procure new service providers; or
- self-deliver the services.

The diagram below shows a simplified and illustrative example of how the PFI contract, lenders' direct agreement and service provider direct agreement timescales might operate.

Example of termination timescales



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