Infrastructure
and Projects
Authority

PFI Guidance Document

Navigating the risks of PFI project distress

Summary

Reporting to
Cabinet Office
and HM Treasury

Guidance structure

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Foreword

Matthew Vickerstaff,
Deputy CEO of the IPA

The independent White Fraiser report, commissioned by the Infrastructure & Projects Authority (IPA), has created substantial engagement across the PFI market about how to improve contract outcomes and plan for expiry. We are encouraged by the report's findings that there are improvements that all parties involved in the operation of PFI contracts can make to their behaviours. We also agree with the report's warning that without such improvements being made there is a real risk that the prevalence of major disputes will only increase, and become commonplace.

This guidance forms the first part of the IPA's response to the White Fraiser report. Recent experience has underlined the importance of managing contracts effectively, especially when they are subject to major disputes and project distress. As highlighted in the report, serious contract disputes are the exception rather than the rule. However, additional guidance is warranted given the complexities involved in distressed projects, the interface with insolvency law, and the importance of ensuring continuity of public services.

Of course, it is better for PFI contract parties to address contractual and performance issues before they lead to project distress. PFI projects rely on a complex suite of contracts, involving multiple parties, typically including contracting authorities, project companies and their shareholders, lenders and construction and service subcontractors. Each party has different interests and objectives, and these will often drive behaviours and may test overall alignment of interests. But PFI contracts operate most effectively when based on strong, professional relationships, underpinned by appropriate behaviours.

Whilst the Nolan principles must form the bedrock of behaviours for all PFI contract parties, we believe that the practical way to improve behaviours is through effective contract management. We will, in due course, be producing guidance on contract management to address a number of key themes identified in the White Fraiser report, and in other work, including:

- the need for clarity of strategic objectives in managing PFI contracts. This will address concerns in the report that parties are not acting in a strategic manner in their contract management and that this is adversely impacting relationships;
- the roles and responsibilities of the parties involved in the contract and their likely motivations, including the role of service providers, management service providers and SPV directors;
- how to achieve greater consistency in the way contracting authorities manage PFI contracts, including appropriate ways to incentivise improved performance without compromising relationships; and,
- the benefits of data and information sharing between the private and public sectors in enabling effective contract management and how that can support effective and equitable relationships.

We would like to thank the following organisations for providing comments on the draft guidance:

Amberside Advisors
Bevan Brittan
Grant Thornton
Just Contract Management
P2G
Pinsent Masons
PwC UK
Semperian PPP Investment Partners

Effective contract management and relationships require all stakeholders to be fully engaged. We will continue to work with stakeholders and expert communities across the industry to support the development of resilient, professional and constructive relationships through the application of good contract management. We will also develop guidance (and additional frameworks/forums where appropriate) to address some of the practical proposals in the White Fraiser report. Specifically, this will focus on the following areas:

- Dispute Resolution Forum; and
- Reset opportunities.

About this document

1. Who is this guidance for?

This guidance has been prepared by the IPA's PFI Centre of Excellence. The IPA is the government's centre of expertise for infrastructure and major projects, working across government to support the successful delivery of all types of major projects.

The guidance is aimed at PFI contracting authorities, including Senior Responsible Owners (SROs), senior leaders and PFI contract management teams. Private sector contract managers, service providers and asset owners may also benefit from some or all of the guidance.

2. What is the purpose of the guidance?

This guidance is intended to help contracting authorities identify, understand and manage the risks that arise when PFI projects become distressed, including the associated risks of project company insolvency and contract termination. After reading this guidance you should understand:

- how contractual problems and disputes can escalate to project distress, potentially leading to project company insolvency and contract termination;
- what the consequences can be when this happens;
- the causes of distress and the steps you can take to avoid distress escalating;
- what support is available to help you manage and avoid these scenarios; and
- how you can prepare to ensure you are best able to navigate the legal, commercial, financial and operational risks that project distress brings to your business operations.

3. When is this guidance relevant to me?

You should read this summary now to be able to recognise the signs of a distressed project and understand the associated risks.

If your project is already exhibiting signs of distress, you should act now. Part 1 explains what you should do and when.

4. Who should read this document?

This guidance document is set out in a number of separate parts:

- This summary provides an overview of the guidance;
- Part 1 explains what contract managers should do if they have a distressed project, including how to develop a legal, commercial, financial and operational strategy;
- Parts 2 to 4 provide more detailed information on insolvency, project company financial distress and contract termination. Whilst these are not essential reading, they are recommended for contract managers and in-house financial and legal teams as they provide additional information on these topics.

What	Who should read it (as a minimum)	Approximate time to read
Summary	SROs, senior leaders and contract managers	45 minutes
Part 1	Contract managers	30 minutes
Parts 2 to 4	Contract managers and in-house financial and legal teams wanting a more detailed explanation of these issues	20 minutes each

5. Important note

Insolvency and contract termination are complex areas and you should take appropriate professional advice where necessary. This guidance document provides an overview of the issues and is not intended to be a substitute for formal advice. Inevitably the guidance document simplifies a number of complex issues.

PFI contracts vary between projects, depending on when they were signed, which sector they are in and what project-specific issues apply. You should, therefore, review your contract carefully. This guidance is not intended to override the provisions of your contract and action should not be taken without careful consideration of the details of your own project. **As such, this guidance cannot be relied on as legal or any other form of advice, or professional opinion.**

Key takeaways

1	2	3	4
A distressed project is one that is experiencing significant contractual, relationship and/or financial problems that materially increase the risk of the PFI contract terminating early.	Project distress usually stems from underlying performance issues but is often exacerbated by poor behaviours by one or more of the contract parties. Unless these behaviours are properly addressed by all parties, it can be difficult to resolve the issues causing distress.	If the issues causing project distress are not dealt with, they can escalate, increasing the risk of project company insolvency and/or contract termination.	Project company insolvency and contract termination carry significant jeopardy for contracting authorities. Insolvency proceedings are outside of the contracting authority's control (and can happen without warning), materially change contract relations and can disrupt service delivery. Contract termination can have serious financial and budgetary consequences for contracting authorities, carries a significant risk of prolonged and costly litigation and accelerates expiry risks.

5	6	7
Constructive negotiations, supported by robust, professional relationships and behaviours, can often resolve project distress. The IPA recommends that a collaborative approach be taken by all parties. The consequences of failing to reach constructive resolution will be time consuming and costly for all parties and, ultimately, detract from the core service delivery purpose of the project.	If your project is showing signs of distress, proper and timely preparation is critical. This should include a clear legal, commercial, financial and operational strategy and well-defined action plans, covering both "Plan A" (resolving the issues) and "Plan B" (failure to resolve the issues). We provide specific guidance on the issues you should consider.	Help and support is available from your sponsoring department and/or from the IPA's PFI Centre of Excellence (Email: pfiadviceandsupport@ipa.gov.uk)

Project distress

- Project distress is usually a result of underlying poor performance, typically evidenced by large unitary charge deductions, financial losses by subcontractors, service failure points nearing termination levels or protracted and multiple disputes.
- Most distressed projects find a way to resolve these issues through negotiation and dispute resolution, although this can be costly and time consuming if badly managed.
- Where shareholders do not take adequate remedial action, lenders may choose to intervene either to rescue the project or to wind up the project company.
- A small number of projects cannot resolve the issues causing distress. These projects typically end in project company insolvency and/or PFI contract termination.
- If you have a distressed or potentially distressed project you need to develop a clear strategy and action plans, including Plan A (resolution) and Plan B (non-resolution).

1. Why is this guidance needed?

PFI project distress can have a detrimental impact on the delivery of public services and resources, as well as increasing the risk of financial losses for shareholders, lenders, service providers and contracting authorities. When project distress becomes acute, it can lead to project company insolvency and/or contract termination, both of which carry significant jeopardy for contracting authorities.

> "All stakeholders are braced for [expiry] disputes. Advisory teams are on standby and the ripple effects of increasing litigation is already being felt "on the ground" and is hampering performance and delivery of PPP projects."
>
> DLA *Project Autumn* report on PFI expiry, 2022[1]

Only a small proportion of PFI projects experience distress. However, the scope for disputes and distress is likely to increase as:

- the public sector starts to manage their PFI contracts more rigorously; and
- more projects near expiry and arguments arise over contractual requirements for the hand-back of assets.

Most projects in distress will resolve problems through negotiation and, where necessary, contractual routes to resolving disputes. However, this can be a prolonged and costly process, especially where parties take a finger-pointing and overly inflexible contractual approach, and/or have a reactive fix-when-fail mentality rather than proactively fixing issues. **Spending money fixing problems is, generally, better than spending money on disputes and litigation.**

Constructive resolution of problems should, therefore, be the preferred solution for most projects. However, the IPA recognises some projects have issues that are too large to resolve and that a small number of projects will end up in termination. Contract termination can result in an accelerated and early expiry, but with the added risks that come from the termination process. Whereas contracting authorities have years to plan for expiry, they may have only weeks or months to manage termination, especially if it is precipitated by project company insolvency.

There are myriad issues to be considered: from continuity of service delivery, condition of the assets, availability of budgets and risk of litigation; to practical issues over access to the facilities, spares and operating manuals. These issues may need to be managed against the complex backdrop of an acrimonious and contested termination process.

Where termination arises as a result of project company insolvency, contracting authorities should be aware that all of the above issues will need to be considered in circumstances where the statutory responsibilities of an Administrator or Liquidator under insolvency law can override normal PFI contractual relationships.

If you have a distressed project, either due to the risk of contract termination and/or project company insolvency, proper and timely preparation is critical. This should include a clear legal, commercial, financial and operational strategy and well-defined action plans, covering both "Plan A" (resolving the issues) and "Plan B" (failure to resolve the issues).

These plans will help you to navigate the different potential outcomes. In doing so, you need to consider "acceptable" versus "optimum outcomes", taking account of the significant risks that arise when problems are not resolved and distress escalates to project company insolvency and/or contract termination.

1 www.dlapiper.com/en/news/2022/09/dla-piper-findings-from-public-private-partnership-consultation

Project distress: causes and signs

2. What causes project distress?

A distressed project is one that experiences significant contractual, relationship and/or financial problems that materially increase the risk of the PFI contract terminating early.

This definition is intentionally broad because the causes of project distress can be wide-ranging. However, experience suggests that distress typically results from one or more of the following:

- unresolved contractual issues;
- relationship breakdown; and/or
- project company financial stress.

Where your project has one or more of these problems, then it may be an indicator of project distress.

Unresolved contractual issues

Most PFI projects encounter performance issues at some point during their term, but these do not typically cause project distress. Under normal circumstances, contracting authorities address underperformance through the application of payment mechanism deductions, service failure points and other contractual remedies. This is usually sufficient to ensure the project company and service providers rectify the problems causing the underperformance.

However, some projects experience more significant performance and contractual problems. If these issues are not adequately addressed and resolved they can cause project distress. Whilst contractual issues vary project-by-project, there are a number of common problems:

Construction defects: some projects have defects in the original design and construction of the assets, such as leaking roofs, electrical and ventilation defects and failure to meet required performance levels. This requires rectification works to be carried out and there may be consequential unavailability deductions and service failure points. Widespread defects can be very expensive and time-consuming to fix, causing operational disruption to the contracting authority. There can also be disputes about whether a defect exists at all and, if it does, who is responsible for it – i.e. was it the result of poor construction, poor maintenance or failure to carry out lifecycle works. This may be a particular issue where problems arise after the end of the construction contractor's statutory liability period.

Compliance issues: where projects fail to meet the required statutory and/or compliance standards (e.g. fire-stopping), rectification works will be required and there may be consequential unavailability deductions and service failure points. As with construction defects, widespread compliance failures can be expensive and time-consuming to fix. There can also be disputes about whether or not performance parameters have been adequately met.

Service provider performance issues: failure to perform the services (e.g. hard or soft FM) to the standards required, including failure to properly log help desk calls, can result in payment deductions and service failure points. The application of historic deductions and payment ratchets can have a significant financial impact on project companies and their service providers. Disputes can arise over the interpretation of performance requirements and the application of the payment mechanism.

Other issues: there are a range of other contractual issues that can arise, including over:

- lack of clarity on room data sheets
- unnotified changes of facility use
- responsibility for damage
- application of benchmarking and market testing procedures
- indexation of payments
- insurance cost sharing
- temporary repairs, and
- application of unavailability deductions e.g. unavailable but used and whole-facility unavailability.

Significant and unresolved contractual problems can cause project distress when they:

- lead to high levels of financial deductions or significant additional costs for the project company, affecting its financial viability and increasing the risk of insolvency;
- trigger events of default under the PFI contract and potential contract termination; and/or
- trigger events of default under other project contracts, including the loan agreement and/or the service provider subcontracts - these contracts are intended to trigger events of default before the PFI contract.

Project distress: causes and signs

Relationship breakdown

Professional and productive relationships are critical to the successful operation of PFI contracts and a breakdown in relationships and trust can be both a symptom and a cause of project distress.

PFI contracts are complex arrangements, involving multiple parties including contracting authorities, project companies, shareholders, lenders, construction contractors and service providers. They are often argued to be relational contracts - this is a legal concept that can apply to long-term agreements that require substantial mutual commitment, cooperation and communication between the parties.

Relational contracts are underpinned by a number of core principles, including:

- an intention to have a long-term relationship;
- a commitment to collaboration; and
- a potential implied term that roles must be performed with integrity and fidelity.

When relationships and trust breakdown, it can undermine these core principles and lead to more disputes and greater project distress.

Whilst it is arguable that PFI contracts in general may be relational, the determination of whether they are or not should be a matter of construction in the light of the facts of each individual case.

Relationship problems often stem from an underlying disagreement about project performance and/or differing contractual interpretations. However, this can be exacerbated by poor behaviours, in particular where parties:

- act in an unprofessional or unreasonable manner;
- engage in finger pointing rather than getting on with fixing problems;
- take an overly inflexible contractual approach; and/or
- have a reactive fix-when-fail mentality.

"Anything that can be done to reduce either the number of disputes in operating PFI Contracts, or the percentage of disputes being referred to formal dispute resolution is, in our view, in the public interest... We often heard consultees express concern that "value had been lost from the project" as a result of the dispute and, on further enquiry, it became clear that this comment was either referring to the amount of time and money that had been spent by all parties on legal costs, and/or the erosion of trust/goodwill between the parties that had arisen as a consequence of the relevant dispute."

White Fraiser Report, 2023[3]

"Any relational contract of this character is likely to be of massive length, containing many infelicities and oddities. Both parties should adopt a reasonable approach in accordance with what is obviously the long-term purpose of the contract. They should not be latching onto the infelicities and oddities, in order to disrupt the project and maximise their own gain."

Court of Appeal: Amey Birmingham Highways Ltd v Birmingham City Council[2]

If poor behaviours are left unaddressed, they can lead to a breakdown in relationships and an erosion of trust. This can have a number of detrimental effects, including:

- more contractual disputes;
- erosion of goodwill when contract flexibility is needed;
- staff retention problems; and
- negative impacts on individuals' mental health.

Ultimately, relationship breakdown can lead to a point where differences between the parties appear to be irreconcilable.

Disputes: projects that terminate early often have a long history of contractual disputes, usually with a number of failed attempts to resolve and settle these disputes prior to termination.

Whilst disputes can sometimes be managed successfully, without damaging relationships, this requires careful management and a clear delineation between the legal proceedings and other operational matters. There is a risk that positions can easily become entrenched and disagreements can feel personal. When this happens, it can lead to a deterioration in relationships and trust, and there is a risk that project distress escalates further.

Disputes also tend to be costly, both in terms of management time and involvement of legal and technical experts. Where disputes are resolved in the contracting authority's favour, the resulting financial impact (e.g. significant additional project company costs and/or financial deductions) can accelerate project company financial distress.

Where a contracting authority is involved in major, or prolonged, disputes with the project company, or there are significant disputes between the project company and its subcontractors, this is likely to be a sign of project distress.

2 www.keatingchambers.com/wp-content/uploads/2018/04/Interpretation-of-PFI-Contracts.pdf
3 www.gov.uk/government/publications/white-fraiser-report-private-finance-initiative-sector/white-fraiser-report

Project distress: causes and signs

Project company financial stress

Project company financial stress can result from actions taken by a contracting authority in response to contractual and performance issues e.g. service performance failures or defects/compliance issues leading to large payment deductions. However, other problems can also impact a project company's financial viability, including:

- higher than budgeted operating or lifecycle costs;
- significant costs to rectify defects and/or compliance issues;
- lower than expected third-party revenues or revenues linked to usage/demand;
- adverse changes to financial and economic assumptions, such as inflation and tax rates; and/or
- financial model errors (e.g. technical errors with the model calculations or incorrectly modelled revenues and costs).

When financial stress becomes acute, it can lead to project company insolvency. It is important that you understand:

- the wider commercial and financial structure that underpins your project;
- the potential for performance and contractual issues, and accompanying payment deductions, to cause project company financial stress;
- why your project company might not be able to access new money to resolve problems; and
- what capacity your project company has to absorb the financial consequences of project distress.

PFI project companies are almost invariably set up as special purpose vehicles (SPVs) i.e. their only purpose is to deliver the PFI contract. The project company passes construction and service delivery risk down, as far as possible, to its subcontractors - lifecycle risk can remain with the project company or be passed down to a service provider. Whilst the intention of this structure is to minimise the project company's financial exposure by passing down deductions and rectification costs to its subcontractors, financial issues can remain at project company level. Part 2 explains this in more detail; however, it usually arises because:

- payment deductions exceed the service provider (subcontractor) liability caps;
- construction problems arise after the end of the construction contractor's statutory liability period (usually 12 years from construction completion);
- payment deductions are disputed between the project company and its subcontractors;
- lifecycle costs exceed the budgeted amounts (where this risk lies with the project company rather than a service provider);
- a service provider becomes insolvent and has to be replaced at a higher cost; or
- the project company is taking risk on third party revenues or volume risk (e.g. gate fees on volumes of waste or hospital retail units and car parks).

When contracting authorities make large payment deductions, these might be flowed down by the project company to the relevant subcontractors or, for the reasons above, they might remain with the project company, causing financial stress.

PFI project companies are typically financed on a limited-recourse basis. This means that the shareholders (and lenders) do not usually have any obligation to put more money into the project company if it is in financial difficulty. This is an important consideration for a contracting authority with a distressed project, because it means that the project company may have very limited financial capacity to fix problems. If the contracting authority is also making large payment deductions, this may exacerbate the project company's financial distress.

Where financial issues do get stuck at project company level, there are typically two ways the project company can resolve them:

I. **the project company uses its own reserves:** project companies may be able to use cash in their bank accounts (with lender consent), and/or future cash flows that would otherwise have been paid out to shareholders, to fix problems. Contracting authorities should be mindful of potential problems where monies reserved for future maintenance are used to fix current problems. If the amount of cash available to the project company is insufficient to meet the costs of fixing the problems, there is a risk that the project company will become insolvent; or

II. **the shareholders and/or lenders put more cash in:** typically, there is no obligation on shareholders or lenders to put more money into a project company. Where there is a funding gap that cannot be bridged by the project company, shareholders and/or lenders may be willing to do so where (i) the additional money will properly resolve the problems (ii) the monies can be repaid with a return/margin and (iii) they have access to new money (some shareholders may not have access to new money to resolve the problems). Lenders may also consider restructuring/rescheduling their loans to provide the project company with more liquidity.

Project distress: causes and signs

Part 2 explains some of the ways in which contracting authorities can look for signs of project company financial distress, including how to access relevant information, and the diagram below summarises these. Contracting authorities should check their PFI contracts to confirm what information the project company is required to provide e.g. the lender financial model and lender information.

Contracting authorities should also monitor the financial strength of key project company subcontractors, especially if they are showing signs of financial stress. Subcontractor financial stress could be the result of large payment deductions/rectification costs being flowed down to them from the PFI contract. The Government Commercial Function has issued separate guidance on how to do this (*Guidance Note on Corporate Financial Distress*[4]).

4 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1165661/Corporate_Financial_Distress_Guidance_Note.pdf

Project distress: what happens next

3. What happens when projects are in distress?

When projects are in distress, there are three likely pathways:

- resolution of the issues;
- lender intervention; or
- project failure.

Resolution of the issues

Distressed projects do not usually end up in termination or with lenders intervening. In most cases, the parties find ways to resolve problems through negotiation and, where necessary, use of contractual dispute resolution procedures. However, even where this is the case, poorly managed contract disputes can take months or even years to conclude, can be very costly for all parties and can have a detrimental impact on contract relationships.

The IPA recommends that a collaborative approach be taken to resolving PFI contract issues and disputes to avoid the jeopardy that comes with escalating distress, including disruption to services and potential project company insolvency and contract termination.

Whilst there can be many reasons why some projects successfully resolve distressed situations and others end up in prolonged disputes or termination, some key themes are:

Behaviours and relationships: resilient, professional and constructive relationships are critical for successfully resolving contractual issues and maintaining trust between the parties. Good behaviours underpin professional and constructive relationships, whilst poor behaviours can compound existing contractual problems and disputes, and undermine trust.

Poor behaviours, inconsistent with the Nolan principles[6], should be identified, addressed and where necessary escalated locally to senior leaders to resolve. Where relationships have already broken down, all parties should consider how best to get them back on track including, where necessary, a change in personnel.

Transparency: it is important that contract parties are open and transparent about the problems facing projects. The parties need to be willing to share appropriate information and to get all the problems on the table. Otherwise, they can resolve one issue only to find that new problems come up, requiring more negotiation and disputes. This repeated cycle of problem-negotiation-dispute-resolution erodes trust and distracts from normal service delivery.

Preparation: contracting authorities that have a well-developed strategy for dealing with project distress are better able to set clear and realistic expectations to resolve it. It is unlikely that all parties can achieve their "optimal" outcomes when trying to resolve difficult issues and in most cases an "acceptable" outcome will be better than no resolution at all. Having realistic objectives requires an understanding of the drivers and constraints for the different contract parties and the consequences of different potential outcomes.

Constructive dialogue: resolution of contractual issues requires the right environment for constructive dialogue. This may require ground rules to be set for negotiations, agreement on who needs to be in meetings to make decisions, consideration of appropriate forms of dispute- resolution, including involvement of mediators where necessary, and setting clear expectations for outcomes. Advisers may need to be involved, but should advise rather than be allowed to determine outcomes.

It is important that the people involved have the right skills and experience, are capable of making decisions and can approach the discussions constructively. Where there have been long-running problems and disputes, it can be difficult for people to draw a line under previous issues and behaviours. However, it is important that all parties are able to take an objective view of what needs to be done going forward.

This may require a change in personnel from business as usual. This should not be viewed as failure or backing down, it is simply a recognition that a different approach may be needed to support constructive discussions.

> "We...recommend that greater reliance is placed on "The Seven Principles of Public Life" (also known as the "Nolan" principles)... reports of poor behaviours should be dealt with corporately at a local level, in line with the Nolan Principles, and supply chain members working on PFI projects should be accorded the same respect as public employees."
>
> White Fraiser Report[5]

5 www.gov.uk/government/publications/white-fraiser-report-private-finance-initiative-sector/white-fraiser-report
6 www.gov.uk/government/publications/the-7-principles-of-public-life/the-7-principles-of-public-life--2

Project distress: what happens next

Access to funding: resolving contractual problems often means spending more money, e.g. to fix construction defects or improve service performance. This money might need to come from contractors, service providers, shareholders, lenders and/or from contracting authorities (but note, contracting authorities should not, generally, pay to resolve contractual issues unless the issues are their responsibility e.g. there are changes to authority requirements or betterment).

Sometimes, rather than proactively fixing contractual problems, parties may want to pursue secondary contractual claims to get subcontractors to resolve the problems – this can delay and exacerbate issues.

The extra money needed to resolve issues will depend on the size of the problem – e.g. wide-spread construction defects can cost millions of pounds to put right. Where projects are already under financial distress this can be particularly challenging. If the parties are unable or unwilling to spend money to fix problems, then the risk of escalating project distress, project company insolvency and/or contract termination increases.

Lenders intervene

Lenders can play an important role in situations where there is project distress, but often they become actively engaged too late in the process, when it can be difficult to resolve issues.

Project companies have obligations to provide lenders with regular reports on project performance – operational and financial – and lenders typically have rights to influence or control significant project company decisions (through a *controls matrix* or *reserved consent/discretion* requirements in the loan agreement). Therefore, lenders should be aware when projects become distressed and have the ability to influence outcomes through their controls. Bringing lenders into discussions at an early stage (before distress escalates) can be useful in resolving issues.

However, lenders usually monitor projects through a portfolio management team, which may have a lot of other projects to monitor. They may not have the capacity or skills to get involved in complex contractual issues. When project distress increases, loans often move from the portfolio management team to a restructuring/distressed asset team, and lender engagement is likely to increase.

In certain circumstances, lenders may choose to intervene directly in projects (often described as "*step-in*") to take action themselves to resolve project distress. Lenders can usually intervene when there is an *event of default* under the loan agreement with the project company. Generally, loan agreement events of default are intended to trigger before events of default under the PFI contract, to give time for lenders to act before the PFI contract can be terminated. For example, lenders will typically set service failure point thresholds at levels below those set as events of default under the PFI contract. The table below shows examples of typical differences between PFI contract and loan agreement events of default.

When lenders consider whether or not to intervene, they first need to assess the cost of fixing the problems and the cost and risk of stepping into contractual disputes between the parties. They may then decide to try to rescue the project company, which might include changing the management (e.g. introducing a turn-around team), putting more money in or restructuring the loan. Alternatively, they may decide to close the project company down to try to recover as much of their loan as possible by sweeping any cash in the project company and pursuing contractual claims against defaulting subcontractors and the contracting authority (e.g. for compensation on termination). In either case, they may appoint an insolvency practitioner to act on their behalf (see Part 3 for further information).

Events of default	PFI Contract	Loan Agreement
Major project party insolvency events		✔
Project company insolvency events	✔	✔
Breach of performance or availability termination thresholds	✔	✔ But at lower levels than the PFI contract
Breach of financial ratios tests		✔
Material Adverse Effect		✔
Abandonment	✔	✔

Project distress: what happens next

Lenders can sometimes intervene at holding company level rather than project company level, depending on how the financing and security documents operate. A PFI holding company's only role is to own the shares in the project company (see the PFI structure diagram in Part 2). By appointing an insolvency practitioner to the holding company, lenders may be able to take effective control of the project company without triggering insolvency-related events of default under the PFI contract (depending on how it is drafted). This means that the existing shareholders lose control and allows lenders (via the insolvency practitioner) to change the management team and, potentially, utilise any project company cash flows to resolve contractual issues. However, lenders may be reluctant to take these steps without a clear route to resolving the issues. This approach can also be difficult where there is a large group of lenders involved.

Project failure

A small number of distressed projects have problems that cannot be resolved because the issues are too large (such as facility-wide defects) and/or because the parties are unable, unwilling or unavailable (if they are no longer in existence) to resolve them. These projects may have experienced months or years of negotiations and disputes, possibly with lenders intervening, but eventually they reach a point where one of the following occurs:

Project company insolvency: if the project company is in significant financial distress, the project company's directors, or its lenders, may conclude that the company is no longer financially viable and commence insolvency proceedings and the appointment of an insolvency practitioner (see Part 3). **It is important for contracting authorities to be aware that insolvency proceedings are usually outside of the contracting authority's direct control and can happen with very little warning.** Once project company insolvency proceedings commence, this usually gives the contracting authority the right to issue a termination notice under the PFI contract.

Contract termination: where there is a project company event of default which is not capable of remedy, or is unremedied under the PFI contract, the contracting authority may issue a termination notice. Subject to the lenders' rights to intervene, the contract will then terminate on a given date. Some distressed projects have outstanding PFI contract events of default but the contracting authority chooses not to issue a termination notice whilst the parties try to resolve the problems. However, it is important that contracting authorities take legal advice before doing this to ensure they preserve, as far as possible, their future rights (or balance any loss of rights against the benefits of allowing more time to resolve issues).

Project distress – insolvency and termination

4. Consequences of project company insolvency and contract termination

Parts 3 and 4 explain the potential consequences for contracting authorities of project company insolvency and contract termination in more detail.

Project company insolvency

Insolvency is a highly regulated area and can be complex, particularly in relation to PFI projects. Contracting authorities should take appropriate advice if they believe there is a risk that financial distress could lead to project company insolvency, or if project company insolvency proceedings have commenced.

There are different types of insolvency proceeding; some try to rescue the company (e.g. Administration) while others close the company down (e.g. Liquidation). When an insolvency practitioner is appointed, the directors and shareholders lose control of the project company - the insolvency practitioner takes control and has responsibility for managing the operations of the project company. However, the insolvency practitioner may have little, or no, PFI experience and may need to appoint specialist advisors.

The statutory duties of an Administrator, Administrative Receiver or Liquidator, and the associated provisions of insolvency law, can override normal contract relations and lead to significant operational disruption. The insolvency practitioner's primary duty is to look after the interests of creditors (usually the lenders) - they do not owe a duty to the contracting authority or to service providers, except as potential creditors. Anything that the insolvency practitioner does which is not deemed to be in the best interest of creditors opens them up to personal liability claims and, in some cases, criminal proceedings.

There is no obligation on the insolvency practitioner to continue to provide services or to pay the service providers under their contracts - they will only do this if they believe it will result in a better outcome for creditors. The insolvency practitioner can also sweep any cash in the project company and pay it to lenders, including cash that was meant to be used to pay service providers. As a result, project company insolvency may result in service providers being unpaid for several months, even though they are providing the services. Alternatively, service providers may stop providing services if they remain unpaid, causing disruption to the contracting authority.

Direct agreements and collateral warranties (which can also be known as step-in agreements) are intended to protect lenders and the contracting authority when PFI contract termination occurs (including following project company insolvency), especially where there is a risk to service continuity. However, experience suggests that direct agreements and collateral warranties often prioritise the rights of lenders over those of the contracting authority and can carry significant risk for the contracting authority. For these reasons, the contracting authority may not be able, or willing, to use the direct agreements/ collateral warranties to ensure service providers are paid and service continuity is maintained (see Part 4 for more explanation).

The contracting authority may, instead, consider paying subcontractors directly where they perceive a risk to service delivery (payments could be made under the PFI contract or made separately to the PFI contract). However, any such payments must be considered carefully, as they can potentially leave the contracting authority exposed if the PFI contract subsequently terminates - e.g. if direct payments to service providers cannot subsequently be set-off as part of any compensation on termination calculations. In these situations, contracting authorities should take legal advice on their contracts to understand whether they can make direct payments and whether there is a risk of incurring double liabilities.

Corporate Insolvency and Governance Act 2020: the Corporate Insolvency and Governance Act 2020 (CIGA) introduced a number of new procedures and measures to seek to rescue companies in financial distress, including:

- Restructuring Plan under Part 26A of the Companies Act 2006
- Company Moratorium under Part A1 of the Insolvency Act 1986
- Restriction on termination clauses under s 233B of the Insolvency Act 1986 .

Whilst these have not been fully tested to date on PFI projects, contracting authorities and their advisors should consider the potential implications of CIGA as part of any project company insolvency analysis.

7 https://commonslibrary.parliament.uk/research-briefings/cbp-8971/

Project distress – insolvency and termination

Contract termination

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 brings significant risk for contracting authorities and should, generally, be considered as a last resort when other attempts at constructive resolution have failed.

There are two principal termination routes for contracting authorities:

Authority Voluntary Termination: the contracting authority can choose to terminate the PFI contract voluntarily (termination is not linked to events of default by either party); and,

Contractor Default Termination: where there is an event of default caused by the project company, the contracting authority may have the right to terminate the contract.

These termination routes drive materially different outcomes for contracting authorities, including:

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).

In general, voluntary termination gives the contracting authority more control over the process but transfers more risk back to the contracting authority and usually results in significantly higher compensation payments. Contractor default termination maintains greater risk transfer to the private sector and typically results in lower compensation payments (or no compensation if the contract is retendered), but carries significant jeopardy for contracting authorities, including the issues listed below - some of these issues also apply to voluntary termination (see Part 4 for more detail):

- Termination payments: depending on whether contract retendering or no retendering applies, contracting authorities may have to make substantial compensation payments to the project company, with the consequential impact on cash, capital and revenue budgets (see below). Contracting authorities do not, generally, 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.

  The calculation of termination payments can be a complex area requiring specialist support and is likely to require preparatory work to have been completed (e.g. condition surveys).
- Disputes and litigation: prolonged and costly legal disputes are possible as lenders seek to recover as much of their loan as possible. Disputes can arise over the form of termination, the grounds for termination, retendering versus no retendering and/or the quantum of compensation. 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 low/zero.

  Litigation costs for disputed termination cases can run into millions of pounds, even for smaller PFI projects;
- Service and asset risk: unless the contract is retendered, early 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);
- Defects: if there are major defects and/or compliance issues that need to be rectified after termination (no-retendering), contracting authorities will have to take on responsibility for funding and managing the works, including the risk cost overruns;
- Budgets: early termination can have significant budgeting, accounting and fiscal implications for contracting authorities, sponsoring departments and wider government.

Contracting authorities need to consider these issues carefully and should discuss them with their sponsoring departments and/or HM Treasury before taking action to terminate a PFI contract (HM Treasury approval is always required prior to a voluntary termination).

In practice, there may 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. It is important that assessment is done before any litigation is commenced.

Project distress – what you should do

5. What should you do?

The first step is to consider whether your project is showing signs of distress, or has issues that could lead to project distress.

If your project is operating satisfactorily, with effective contract management on both sides, and evidencing robust but professional relationships and good operational performance, then there may be no need to take further action. You should continue to monitor the situation as projects can move from satisfactory performance to distress over time, especially as they near expiry.

If your project is showing signs of distress - e.g. significant performance and contractual issues, disputes or issues that have been continuing unresolved for some time, poor relationships, and/or project company financial stress - then you should consider what further action you need to take.

Part 1 of this guidance sets out the issues you should consider, depending on the level of distress your project is experiencing. Preparation is critical. By developing a legal, commercial, financial and operational strategy that includes both Plan A (resolving the issues) and Plan B (failure to resolve the issues) you will be better placed:

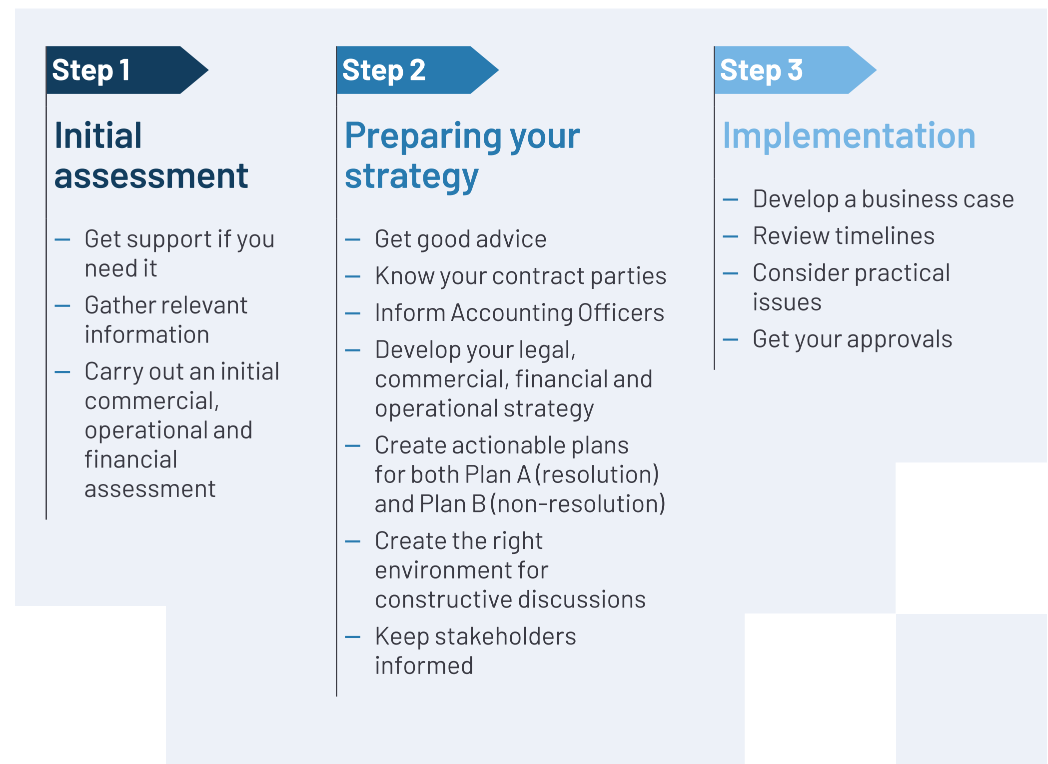
- to understand the issues causing distress and the positions and drivers of the different parties;
- to be clear what you want to achieve under different potential outcomes and to be able to communicate this to stakeholders;
- to get the internal and external support you need;
- to have actionable plans in place to navigate different pathways (e.g. Plan A resolution and Plan B non-resolution), including decision points where you may need to change pathway;
- to secure senior management and key stakeholder buy-in and understand what approvals are required and when;
- to protect your legal position in the event there is subsequent litigation/contract termination; and,
- to understand the practical steps to implementing your plans.

You will need to be realistic about what is achievable. You should consider "acceptable" versus "optimum" outcomes, taking account of the significant risks that arise when problems are not resolved and distress escalates to project company insolvency and/or contract termination.

As a public sector body, you will have a statutory Duty of Best Value or a requirement to demonstrate value for money. In the context of distressed projects, best value/value for money may not always mean applying contractual remedies to their fullest extent, e.g. if applying the maximum possible payment mechanism deductions would lead to project company insolvency and a worse overall outcome for the contracting authority, then that might not represent best value/value for money.

The economic, financial and operational consequences of different potential outcomes should be considered carefully as part of your overall strategy. In any event, the contracting authority should still record deductions and seek to preserve its right to deduct those deductions in the situation where the project subsequently terminates.

Summary of steps to take



Project distress – what you should do

The checklist below is aimed at SROs/senior leaders within contracting authorities. More detail is provided for contract managers in Part 1. The list is not intended to be exhaustive but to give an idea of the types of questions you should be asking.

1 Do you understand the current issues affecting your project, including:
- the impact on your business operations?
- the size of the problems, e.g. the cost of fixing defects or compliance issues, the size of deductions relating to performance issues?
- where there is a dispute, the financial consequences if the contracting authority, or the project company, is successful?
- the financial consequences if the problems are not resolved?

2 Do you feel that other relevant senior managers have been sufficiently briefed. (e.g. your Section 151 Officer or equivalent)

3 Do you understand the risks if problems are not resolved, including the risk and potential consequences of project company insolvency and contract termination?

4 Are you satisfied that the issues are properly reflected in your corporate risk register?

5 Does your contract management team have the right resources and support to manage the problems or do they need additional support (from your internal teams, your sponsoring department, the IPA and/or external advisers)?

6 Are you satisfied that your external advisers have the right skills and experience to deal with the complex issues that can arise with project distress, project company insolvency and/or termination, as these are specialist areas?

7 Do you have an agreed legal, commercial, financial and operational strategy, including:
- Plan A (resolution) and Plan B (no resolution) NB this will likely include considerations to ensure service continuity
- acceptable versus optimum outcomes and any 'red lines'?

8 Is there a clear timetable in place, with actions and responsibilities clearly allocated?

9 Do you have the right governance and reporting arrangements in place to ensure you are kept properly informed about progress?

10 Do you understand the decisions you will need to take and the likely timing of those decisions?

11 Have you considered whether decisions are covered by delegated authority, require board approval and/or need broader stakeholder approval (e.g. from your sponsoring department, HM Treasury)?

Is decision making authority and delegated decision-making authority agreed and communicated to officers?

12 Do you understand the potential time commitment for senior management?

13 Are you satisfied that the right people (from both sides) are involved in trying to resolve the problems?
- are senior decision makers engaged from both sides?
- are lenders aware of the issues/engaged (do they need to be)?
- do the people involved have the right skills and experience?
- are they exhibiting the right behaviours, in line with the Nolan Principles?
- are they able to draw a line under previous issues and behaviours and take an objective forward-looking view?

Do you (and/or the project company) need to consider a change in personnel from business as usual, particularly where existing relationships have broken down?

14 Have the IPA/your sponsoring department been advised of your project distress status?

Infrastructure and Projects Authority

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