The future of PFI

Summary of key points made during the panel discussion

on 26 January 2017 including contributions from the industry delegates

Venue: Beale & Company Solicitors

Panel:

Sir Antony Edwards-Stuart (Chair)

Stephanie Barwise QC (Atkin Chambers)

Andrew Goddard QC (Atkin Chambers)

Tom Pemberton (Beale & Company Solicitors LLP)

1. Overview and background

1.1 There has been a steep decline in the number of PFI contracts achieving financial close. According to statistics published by the Government, around 455 PFI contracts achieved financial close in the peak years between 2000 and 2007 whereas only two projects closed in the 12 months ending in March 2016 (the latest date for which statistics are available).

1.2 The decline reflects the challenging financial and political environment since the beginning of the credit crunch and the election of the Coalition Government in 2010. The latter was sceptical (as is its successor Conservative Government) about the net benefits of the "first generation" of PFI contracts since the launch of the PFI programme by the Major Government in 1992.

1.3 The onset of austerity from 2008 caused many authorities to struggle to meet their financial commitments under their PFI contracts, as highlighted by a number of recent reported cases, notably *Laing O'Rourke Construction Limited vs Healthcare Support (Newcastle) Ltd and Newcastle upon Tyne Hospitals* [2014], *Portsmouth City Council v Ensign Highways Ltd* [2015] and *Amey Birmingham Highways Ltd v Birmingham City Council* [2016]. Our chairman (as trial judge in *Laing O'Rourke* and *Portsmouth City Council*) and our two panellists from Atkin Chambers played various important roles in these cases.

1.4 On a more positive note, in its latest Autumn Statement, the Government announced its intention to publicise a pipeline of PF2 projects in early 2017 (still awaited as at the date of this note) which has been long expected since the coalition government launched PF2 in 2012 with its report "A new approach to public private partnerships".

2. Key factors in determining whether or not a PFI project will be successful

2.1 In his opening remarks, and with the benefit of his experience of being the trial judge in two of the cases referred to above, Sir Antony set out three main factors which can decide whether or not a PFI contract will be successful or not as follows:

- The quality of the drafting of the contract: Poor drafting of these notoriously complex contracts greatly increases the risk of a dispute by encouraging the parties to take entrenched and polar positions on their respective interpretations of the contract.

- Financial pressures on the parties: Economic and other developments after the PFI contract is concluded may put one or more of the parties under financial pressure, leading to behaviours resulting in disputes such as those seen in the cases referred to above. For example, our chairman stated that the PFI contract which was the subject of the dispute in the *Portsmouth City Council* case, was a prime example of a PFI contract working well, until the Council became constrained by funding cuts. They then purported to apply the service points mechanism in the contract in such a way (wrongly, as our chairman held) as to put pressure on the Contractor to re-negotiate the contract in order to avoid termination.

- Personalities of the main players: The personalities of those in charge of the respective parties set the tone. If they display unreasonable expectations and behaviours, this filters down into their organisations, increasing the likelihood of intractable payment and performance issues.

3. Good faith obligations in PFI contracts

3.1 It was noted that in the absence of an express good faith obligation, there is no universal duty under English law to act in good faith, subject to limited exceptions (insurance contracts being one of the longest established).

3.2 Where there is an express obligation to act in good faith, the question arises as to the scope and extent of the duty. Much depends on the precise terms of the "good faith obligation" and how this should be interpreted in the context of the contract as a whole. For example, the obligation is often expressed to apply only to specified terms of the contract, and not to others such as the terms governing payment and termination respectively.

3.3 Where there is a good faith obligation, it may not involve much more than an obligation not to mislead the other party. It is unlikely to import a positive obligation on a party to act against its own commercial interests.

4. Can the independent tester be truly independent?

4.1 It was noted that the position of the independent tester (often referred to as the independent certifier) is different from that of a contract administrator (CA) or project manager (PM) under a standard form contract such as JCT or NEC3. While a CA or PM typically has a contractual duty only to the Employer, the independent tester typically is jointly appointed by both the Authority and the Project Co, and furthermore he is usually required to provide collateral warranties to the Construction Sub-Contractor and the Operator.

4.3 The result of this is that the independent tester owes concurrent duties to all the key project parties, with obvious potential for being targeted for a claim in the event of a dispute as to whether a certificate of completion of the construction stage (and accordingly commencement of services and payment!) should be issued or whether the Project Co/Construction Sub-Contractor must carry out further construction/snagging works before that stage is reached. Where there are several phased sectional completions, the risk is multiplied. The Authority and the Operator are likely to be lined up on the opposite side of any dispute from the Project Co and the Construction Sub-Contractor. This can place the independent tester in a difficult position when attempting to hold the balance fairly between the parties, particularly where

they disagree about the criteria to be achieved in order for a completion certificate to be issued (as in the *Laing O'Rourke* case).

4.4 The independent tester is in a particularly difficult position if the drafting of the Project Agreement lacks clarity, for example by imposing a fitness for purpose obligation on the Contractor but not properly defining what that means. (This underlies the importance of giving the independent tester the opportunity, before the Project Agreement is finalised, to comment on the contractual provisions which it will be administering, such as those relating to testing, acceptance and completion.)

4.5 It was commented that the independent tester is almost always given protection by a liability cap which can be related to the amount of its fees, but is more usually commensurate with its PI insurance. While this gives it important protection, it was pointed out that this is of small comfort to a tester if he is the subject of a claim by one or more of the key project parties.

4.6 It was suggested that one way to free the independent tester to focus on fulfilling its duties in a professional and independent manner would be to give it contractual immunity. In principle this should "work" provided that the key project parties have the opportunity to have a decision or certificate issued by the tester opened up and reviewed/revised. However, the general view was that this is unlikely to be accepted as the way forward in today's "claims conscious" culture where all professionals should be able to insure their liability, at least to some extent.

4.7 A further suggestion was that there could be three independent testers, with one of them having a "casting vote" in the event of a disagreement between the other two. While this would entail additional project costs, it should result in overall savings if it avoids the need for the parties to have recourse to formal dispute resolution.

5. How should scope change be addressed?

5.1 A key criticism of "first generation" PFI contracts is that they do not make adequate provision for technological change and changes in demand over the lifetime of a long term contract. The case of Balmoral High School, a secondary school in Belfast built under a PFI contract in 2002 but which closed in 2007 because of falling pupil numbers, illustrates the risk arising from demographic change and population movements. The private sector is in no position to predict or manage this risk.

5.2 One of the major challenges for future PFI/PF2 contracts will be the management of change. The "holy grail" is to incentivise the Contractor to deal with change in a way that benefits all the parties. As a minimum, this necessitates contract terms which provide the Authority with sufficient flexibility to require change while providing a proper compensation mechanism for the Project Co.

5.3 There was some discussion of a mechanism for sharing the risk of scope change in order to encourage a collaborative approach to managing change. It was suggested that this should be underpinned by a mechanism providing for a review of the operation of the contract at regular intervals, with an option for either party to terminate if it is not working for them. This had been a feature of the two London Underground PPP contracts, both of which were terminated early for reasons unconnected with the "periodic review" mechanism/break clause.

5.4 It was pointed out that investors will take a different view of the risks and returns from a PFI contract which includes a break clause from one which does not, and this would need to be factored into the financial model.

5.5 It was also pointed out that due consideration would need to be given to EU procurement law, as enacted in England by the Public Contracts Regulations 2015 in particular. The impact of Brexit on future procurement law remains to be seen, but as it stands, in order to avoid being in breach of the Regulations, the Authority needs to consider initiating a new competitive tender process if it requires a material change to the Output Specification, or indeed any change which might be said retrospectively has the effect of a fundamental change to the nature of the underlying contract such that an unsuccessful tenderer might argue it (as opposed to the contractor in fact selected) would have been awarded the contract.

6. The future of PFI following the Autumn Statement

6.1 With the benefit of experience of "classic" PFI, parties should be able to negotiate terms which avoid some of the difficulties encountered in "classic" PFI projects including those discussed above, although it was commented that it is not possible to write a contract that provides a detailed "road map" for every conceivable event. An appropriate good faith obligation and related terms should however incentivise the parties to adopt a collaborative approach in dealing with unexpected issues.

6.2 One of the main points of interest arising from the government's policy on PF2 is the participation of the public sector in the Project Co, with a shareholding of anywhere between 30% and 49% to be held by central government on behalf of the taxpayer. The participation of the public sector should make projects more "bankable" for the private sector on the basis that the latter will not be bearing all the risk. However, it was commented that public sector participation could create a tension between central Government's duty to maximise returns for the taxpayer, and the relevant Authority's interest in securing the best possible service for the users of the facility concerned.

6.3 The point was made that there is also a tension between the long term nature of a PFI contract and the short term horizons which investors typically have in assessing profitability. A change in shareholder behaviour may therefore be necessary to make PF2 work.

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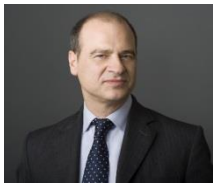

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