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Avoiding disputes at expiry of PFI projects

In this article we review the conclusions of the recent report from the National Audit Office (NAO) into the expiry of PFI contracts and set out our views on the most likely areas of dispute at handover and how to avoid them.

The NAO Report

The NAO has recently published its report into the expiry of PFI contracts and conclusions as to whether government is making appropriate preparations to manage expiry. The report was partly prompted by concern that the playing field between the public and private sector in this area is fundamentally unequal, particularly given that on the private sector side many projects are concentrated in the hands of very few funds when compared to their large number of public sector counterparties. The private sector therefore has the advantage of being able to take a portfolio approach to expiry negotiations and will inevitably have much more experience of the issues.

75 authorities with PFI projects due to expire in the next 7 years provided data to the NAO and, unsurprisingly, more than a third of respondents confirmed they expect to end up in formal dispute with the project company, in particular in relation to the quantity and cost of required rectification work. Interestingly, one of the recommendations of the report is that HMT provide funding to assist financially constrained authorities in formal disputes "where it is value for money and practical to do so".

Many of the key findings of the report will make unhappy reading for government:

1. The public sector does not take a strategic or consistent approach to managing PFI contracts as they end. Responsibility for management is fragmented with no central oversight.
2. Authorities need to prepare for contract expiry adequately in advance – whilst most authorities begin preparations more than 4 years in

advance of expiry, a period of 7 – 8 years is more realistic.

3. Many authorities have insufficient or no knowledge about the assets' condition. For example, less than 25% of respondents were able to confirm whether planned maintenance work had been completed and 50% do not maintain an asset register.
4. Government has a piecemeal approach to retaining consultants. Expertise and knowledge is not shared. Furthermore, resources are tight – 30% of respondents anticipated not having sufficient staff to manage the expiry process – and many authorities report lacking the required skills.
5. There is a misalignment of investor and authority incentives at contract expiry that creates a potential for disputes, particularly where the cost of completing rectification work is greater than any performance penalty for not doing the work.
6. Early PFI contracts are likely to contain significant ambiguity around the roles and responsibilities of the parties at expiry. Clauses are drafted poorly and open to interpretation. Only one third of authorities surveyed were clear about who is responsible for what in relation to expiry.

In light of the above, the report makes a number of recommendations as to how government can better prepare. The emphasis is very much on taking action sooner rather than later and on encouraging collaboration, so it seems certain that we will soon see increasing activity from authorities in this area.

This is particularly because the report identifies that it will be difficult to recover payments from project companies post expiry and emphasises that disputes should be resolved before the contract ends.

Recommendations include:

1. Actively engaging with project companies to jointly identify and clarify ambiguous clauses well in advance of expiry (which may require contract amendment), or going through formal dispute resolution sooner rather than later if this is not possible.
2. Agreeing tiered dispute resolution procedures in order to try to settle disputes before formal proceedings become necessary.
3. Improving contract management in terms of: monitoring maintenance and lifecycle funds; ensuring any backlogs of lifecycle maintenance are carried out; and conducting asset condition surveys well in advance of expiry to give enough time to complete the identified work and resolve any disputes.
4. Identifying contractual rights to maintenance information from project companies and robustly challenging any variance in planned vs actual maintenance expenditure.
5. Involving wider stakeholders, in particular funders, before their debt has been repaid and the 'equity tail' kicks in.
6. Ensuring robust records, management procedures and staff handover processes so that knowledge of the contract is not lost.

The Issues

Whilst it is clear that government is concerned that it is on the back foot in relation to expiry, the types of disputes that could arise are likely to be costly, time-consuming and counter-productive for all involved, particularly for project companies that wish to extract final equity returns and for FM service providers who may want to tender to continue to provide services. Many proactive steps can be taken now to try to avoid disputes arising or at least to narrow the issues if they do arise.

Resources

It is not just authorities that will find dealing with expiry resource intensive. Project companies and FM providers should consider in due time how they will adequately resource this and what external support they may need.

Procedure

The sooner the parties start putting in place plans for an orderly handover, the more likely it is to be a success and minimise the risk of disputes. A crucial part of this is to identify the 'procedural' steps for handover. Many early PFI contracts do not include basic provisions relating to the timeline to expiry, an asset register, procedures for identifying the amount, cost and responsibility for paying for rectification work, transfer of documentation, procedures for how knowledge and skills will be transferred, treatment of confidential data etc. Contracts should be reviewed and the parties should try to agree the procedure for handover as soon as possible (which may require amendments to the contract).

The parties should at least be clear as to the timeline for the steps to expiry, how they will identify any works that need doing (for example, will they use a jointly appointed independent surveyor), and how disputes in relation to the scope and / or responsibility for the works will be resolved. It is far better to agree these items now than to wait until the parties are in dispute and then find it impossible to even agree on the procedure.

Post-handover

Part of this process will involve ascertaining the authority's intentions post-handover, i.e. how does it envisage providing the FM and other services in the future and are there opportunities either in terms of short-term contracts or longer term relationships for FM contractors or even project companies going forwards. Expiry could be an opportunity to refresh these public / private sector partnerships and to align the relevant parties' interests at a time when they are naturally diverging. Even for project companies that intend to exit the market, if the FM contractor is incentivised by the opportunity to continue providing the services post-handover, this may minimise the risk of disputes upon handover.

Asset condition

A crucial part of minimising the risk of disputes will be the carrying out of asset condition surveys well in advance of expiry (even if the PFI contract does not allow for this, we consider it a sensible step that could be agreed between the parties now). This will allow any issues to be identified and ideally rectified. At the very least it will give the parties knowledge of the extent of any problems and allow them to plan

how to best tackle and resolve them in the lead up to handover.

Maintenance Records

From a practical point of view, maintenance contractors and project companies should ensure that their maintenance records are up to date and that any known issues or maintenance backlogs are dealt with as soon as possible and not left until close to expiry. Employees with knowledge of the project and the maintenance regimes should be consulted and any knowledge or information gaps in the maintenance history should be identified and filled in so far as possible. This will put both FM contractors and project companies in the best possible position to defend themselves if allegations of lack of maintenance are made as expiry approaches.

Contractual rights and obligations

Whilst it may be tempting to wait until the authority identifies any defects or maintenance problems, we expect to see authorities being far more proactive in the coming years as a result of the NAO's findings. We expect to see more information requests, the intention to carry out multiple asset condition surveys and more willingness to take steps such as withholding of unitary payments. It is therefore also important for project companies and maintenance contractors to be aware of the extent of the authority's contractual rights to do so.

Ambiguous contract terms

Significant issues are likely to arise where handover provisions do not include any reference to the condition of assets upon expiry (which 25% of respondents to the NAO confirmed was the case in their PFI contracts). Handback requirements may or may not be to the same standards as the maintenance contract. From our experience we think that problems will likely arise where the provisions relating to standards of maintenance or responsibility for rectification of latent defects are simply not clear and / or are contradictory.

As a first step, any ambiguous or contradictory contract terms should be identified and clarified if possible. It is crucial for project companies to understand the extent of the maintenance contractor's liability to rectify latent defects as in our experience this is often simply not understood or it is unclear. Clarifying this will allow the parties to understand their respective risk profiles.

This also supports the approach of carrying out latent defect surveys in good time, which is equally relevant for those projects where expiry is further away and the building contractor's liability for defects has not yet expired. In these cases project companies should consider undertaking surveys as soon as possible in order to identify any latent defects and compel the building contractor to rectify them before its liability to do so expires. Even though the FM provider may be liable for deductions from the unitary charge, it is usually much better for project companies to claim against the building contractor while they are still liable – not least because the building contractor's cap on liability is likely to be greater than the FM provider's.

Conclusions

Whilst disputes may seem inevitable given the competing interests at play and the contractual issues, it is hoped that taking practical and proactive steps now to prepare for handover and identify risks will minimise this possibility.

To summarise the steps we think all project companies and FM contractors should be taking well in advance of expiry:

1. Confirm internally what involvement you want to have with the project post-handover (if any) and start conversations with authorities about their intentions post-handover;
2. Set up clear lines of communication with all relevant parties;
3. Start thinking about how handover will be resourced and the resources that will be needed including external consultants;
4. Carry out reviews of the relevant provisions in the contracts (including the specific handback provisions but also the provisions regarding the standard of maintenance, and responsibility for latent defects) and identify any unclear or contradictory terms;
5. If the contract is not clear, try to agree a procedure for handover and resolution of disputes including how any disputes as to the correct interpretation of the contract will be dealt with;
6. Try to agree the carrying out of asset condition surveys well in advance of handover and consider agreeing to multiple asset condition surveys even if the contracts do not provide for this;

7. Consider carrying out latent defects surveys now and certainly before the building contractor's liability for the same expires;
8. Ensure maintenance records are up to date and identify and fill any knowledge or information gaps;
9. Carry out any known maintenance back logs and correct issues as soon as possible;
10. Understand your risk profile in terms of liability to rectify latent defects, your obligations in terms of providing information to the authority and the authority's rights to make deductions from the unitary charge.

Finally, there is an industry point here. The media coverage of PFI in the last decade has been progressively more toxic. In reality, there are enough examples of PFI projects working well in practice to argue that overall PFI has been a success for the UK rather than the disaster the media routinely suggests. It would therefore be a great shame if the industry allowed itself to fall into multiple handback disputes that would simply support the rather lazy narrative that PFI is just a bad thing. As we have suggested, many of the issues on handback can be addressed by the straightforward practical steps outlined above. Otherwise, the fear is that handback will be good for lawyers but no one else – and who wants that.

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