

Value Testing PFI Projects: The Danger Zones

Part 2: Practical Dangers

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This is Part 2 in the series on Value Testing PFI Projects. In *Part 1: Procedural Dangers* we explored:

- the difference between benchmarking and market testing
- the necessity for transparency and fairness during the market test process in order to avoid potential challenges from “disgruntled” bidders
- dealing with conflicts of interest
- setting a sensible timetable

In this *Part 2: Practical Dangers* we will consider the real difficulties with market testing, in particular:

- effecting variations
- making contract amendments
- reviewing tenders
- selecting the preferred bidder
- mobilisation issues

Changes

Market tests are an opportune time in the contract term for the Authority and the Project Company to take stock of how the contract is working in practice and whether any changes need to be made to the documents to either catch up contractually what is already happening on site, make changes to the services (by adding to or reducing the scope of service, or indeed creating or removing a whole service line) and / or to clarify any contractual “wrinkles” which have come to light or been the subject of dispute.

The Authority and the Project Company should ascertain as soon as possible the extent of changes, variations and consequential contract amendments required. If there are complex or numerous changes, an easy and efficient way of effecting these may be for the Authority and the Project Company to agree to deal with them by way of a single Notice of Change. Some example wording is:

“In accordance with paragraph • of Schedule • (*Changes / Variations*) of the Project Agreement dated • the Authority hereby requests the Project Company to implement all Changes and consequential amendments to the Project Documents as required by the Authority during the [first] market test”.

This may appear to be over-simplistic and outside of the Change provisions of the Project Agreement. However, for projects where there is to be a complete overhaul of the service specifications (for example, to incorporate up to date requirements such as NHS National Cleaning Standards 2007, Better Hospital Food and Agenda for Change in the health sector, to adjust volumes to reflect the current operational requirements and make significant amendments), it may not be possible to list with sufficient certainty all of the amendments and knock-on amendments required. However, the Project Company will want the comfort of a widely drafted Notice in order to press ahead with the changes to ensure the market test timeline is not put at risk.

In these circumstances, it is likely that the Project Company will have difficulty in providing a Response in strict accordance with the Change Procedure set out in the Project Agreement because the changes and amendments will only be definitively known once the preferred bidder has been selected and all contract

negotiations have been concluded and consents obtained. As such, in order to give both the Authority and the Project Company comfort, a pragmatic option is for the Project Company to respond in general terms, for example:

“We refer to the Authority’s Notice of Change issued under Schedule • of the Project Agreement requesting, inter alia, Changes and consequential amendments to the Project Documents as required by the Authority during the [first] market test.

As the Authority’s Notice of Change has arisen in the context of the market test, the Project Company is unable to provide a detailed response as required by the Change Procedure. In the circumstances, the Parties agree that the Changes and amendments as required by the Authority during the [first] market test will be reflected and indeed effected within the express terms of the documentation agreed with the Authority and executed by the new provider of the soft services at the conclusion of the market test.”

The above is only one suggested way to simplify what could be a complex variation process but this option requires co-operation by both parties and may not be the best way to deal with changes on all projects. However, regardless of the process adopted, in order for the variation process to run smoothly and without complication, the Authority needs to understand at the outset the likely costs involved in implementing such changes (i.e. the estimated percentage increase / decrease to the unitary payment) to ensure that such changes are affordable. If the changes are complex and / or are likely to affect the payment mechanism and / or risk profile, it is strongly recommended that a technical advisor is appointed as early as possible to assess and present the consequences of these changes to the Authority, Project Company, funders and shareholders. Without such consent, any amendments made are likely to be a waste of time and money.

Contract Amendments

If changes are made to the service specifications, a deed of amendment to the Project Agreement may be required to deal with the changes and knock-on changes to the Project Agreement (in particular to the services, payment and performance schedules). These may be extensive and the time required to incorporate these changes (especially as they will usually require Authority and funder review) should not be underestimated.

In the event that the incumbent provider of the soft services is replaced as a result of the market test, new documents will need to be drafted and entered into between the Project Company and the new soft services provider – such as a new facilities management agreement (reflecting all the required changes), a parent company guarantee and/or a parallel loan agreement.

It gets more complicated if the incumbent provider of the soft services is also the provider of the hard services and the incumbent is replaced by a new soft services provider as a result of the market test. Firstly, it is likely that the original facilities management agreement covered all (both hard and soft) services. As such, two facilities management agreements will be required which may, as a result of the changes, have different payment mechanisms and performance requirements. This will not only require sophisticated contract drafting, but may also involve more complex administration for the Project Company going forward.

Secondly, there will be interface issues between the two service providers which will need to be dealt with by way of an interface agreement. For example, if there is a leaking pipe, the hard services provider will be required to undertake maintenance, and the soft services provider will be needed to clean up. However, what happens if the hard services provider prevents the soft services provider from completing

its cleaning service request within the time allocated? The hard services provider would argue that it is not in breach under its facilities management agreement because it completed its maintenance task in time, but the soft services provider would dispute any deduction levied on the basis that it only failed to complete its services due to an act of prevention on the part of the hard services provider. The Project Company cannot carry this “deduction risk”, and so either the issues need to be resolved between the parties at service provider level, or the Authority needs to agree to waive deductions in these circumstances. The latter is, clearly, not attractive from the Authority’s perspective. However, where an interface agreement was not contemplated in the original project documents, it may be a difficult persuading the incumbent hard services provider to enter into an interface agreement with the new soft services provider as it would place stricter obligations on it than required under the original hard service facilities management agreement.

The Bidders and Contract Award

Given that the incumbent has lived the contract, knows the areas of profit and loss, has data knowledge, no mobilisation costs and no TUPE and pensions issues, it is already ahead of the other bidders in the “market test race”. It is therefore unsurprising that market test results published to date confirm that the incumbent wins the majority of competitions. As such, in order to ensure that service providers continue to participate in market tests where they are already on the “back foot” and are unable to recover their bid costs, the Project Company must ensure that the process is carried out transparently and fairly all the way through.

The Project Company (in conjunction with the Authority and Technical Advisor) must set (but not necessarily disclose to the bidders) the evaluation criteria and assess the tender responses fairly and in accordance with the agreed criteria. Any deviation from the criteria could give rise to a challenge from an unsuccessful tenderer. The Project Company must give bidders the opportunity to receive feedback of why their tender response was unsuccessful in accordance with the fundamental principles of transparency and fairness of the EC Treaty.

Mobilisation

Where there has been a replacement in service provider, the main concern for Authorities with the whole of the market test process is the “change over”. With lives, security breaches and even possible criminal charges at stake in the event of an unsuccessful handover of the services, a well thought out mobilisation plan is non-negotiable. Staff transfers (including consultations), bulk pension transfers, transfer of equipment, the removal of the replaced service provider’s equipment, the importation of the new service provider’s equipment and the likelihood of co-operation by the replaced service provider all need to be factored into the mobilisation plan. The key is ‘buy-in’. Where the incumbent has “lost” the contract, the Project Company needs to act as a facilitator to ensure co-operation from all parties in order to fulfil the contract requirements. Authorities should also consider giving the new services provider a “deduction holiday” for a period of, say, 3 months without deductions in order to achieve effective and full service delivery.

Practical Tips

- Ascertain early on what changes are required to the service specifications and whether any contract amendments are needed.
- The Authority and the Project Company should agree how best to document these changes in light of the market test (for example in one Notice of Change).

- Be aware of interface issues – the Project Company cannot hold any service provider interface risk.
- The Project Company must ensure that all tenders are considered and evaluated in accordance with the evaluation criteria and feedback is given to unsuccessful tenderers.
- The Project Company must get all party 'buy-in' to the mobilisation plan.