The future of PPP and PFI contracts

Christian Oliver, director in Currie & Brown’s London office, discusses the expiry of private finance initiatives (PFI) and public-private partnerships (PPP) and looks at the focus for the construction industry over the next five to ten years.

More than 200 PFI contracts are due to expire in the UK over the coming 10 to 12 years. While most of these projects are accommodation-based, particularly across core strategic sectors such as health and education, PFI/PPP contracts have also been popular in other areas of public services including defence, waste and water, as well as roads and infrastructure.

The UK's National Audit Office recently warned that many public sector organisations are not suitably prepared for the lead-in time to the expiry of PFI contracts. Guidance is that preparations should begin at least five to ten years prior to scheduled contract end. This timing reflects the significant strategic decisions needed on the future of the assets in scope, along with the contractual and regulatory risks to be managed by both the public and private stakeholders.

Our view is that public sector organisations and private sector entities should sharpen their focus now on their approach to managing the expiry of PFI and PPP contracts across the UK.

Keeping control through careful planning

Major considerations include such fundamental factors as to what to do with facilities and related service provision on contract expiry — whether to retain or close off — and how to manage the significant costs and risks associated with the eventual return of facilities, land, assets and staff at expiry, as stipulated under the individual contracts.

Some key areas of focus include:

- Handback condition of assets and associated backlog maintenance and responsibility for contractual obligation
- Environmental considerations and regulations
- Drives to reduce carbon use
- Disclosure of commercially sensitive information at expiry
- Development of strategic partnerships for a continuation of contracted services
- Compliance with public procurement rules on projects where authorities elect to continue outsourcing services
- Ensuring suitable skill levels and approach to commercial management in cases where authorities elect to take services in-house

Ideally, a strategic and consistent approach would be established to manage such social economic contracts in relation to expiry across the UK public sector. However, the wide spectrum of PFI stakeholders means such consistency is not realistic.

Reining in the risks

The largest risk of continued lack of coherency across the public sector is the obvious risk of failing to secure value for money during expiry negotiations with the private sector, and vice versa for lenders/investors who fail to proactively manage their portfolios, losing value. The time needed to prepare for contract expiry will vary between individual projects depending on the complexity and the treatment of assets on expiry. Ultimately, and the largest social consideration on the back of the 800+ PFI contracts across the UK, is that a lack of preparation could push up the price of public services, or certainly cause disruption to these services.

At a basic level, it has become evident that some public sector bodies have failed and are continuing to fail to monitor the approach to asset management or maintenance by private sector operators.

There is a resultant lack of understanding within some authorities about the condition of those assets and a risk that those assets will be returned in poorer condition than the contract stipulates.

The potential for disputes arising from a misalignment of investor and authority incentives at contract expiry is also an issue for consideration, as is the fact that many of the early PFI contracts may not be clear about the roles and responsibilities of the parties at contract expiry and will rely on advisors to help facilitate and manage early engagement.

The expiry of such contracts raises major strategic and contractual considerations for all stakeholders. Public sector owners must decide what the future holds for assets operated and services provided under these PFI contracts, including whether they should:

- Seek to trigger extension clauses in their existing contracts with operators
- Re-tender the contract and seek another operator (potentially with a complete reconfiguration of the service required from the asset)
- Bring the asset back under public sector operation
- Mothball the asset
- Sell the asset if it is no longer needed

Contractual considerations

If given the option, private sector operators must decide whether they wish to continue operating services or assets, approach to renegotiate the price of any extensions, whether they are willing to compete for re-tendered contracts or see value in acquiring assets that may be put up for sale. Where handback is expected, both public and private stakeholders must agree the protocols for any handback surveys required to assess key asset condition. Although PFI contracts hold some form of standardisation in this regard, the contracts are open to interpretation.

As well as wider strategic issues, there are specific contractual issues to address and these will differ between projects and across sectors. Typical considerations are:

- How to address the **use and treatment of historical PFI assets** after the individual PFI contract ends, and any impact on the asset's residual value.
- How contract term **extensions within the terms of the contact might be triggered** so as to comply with public procurement regulations and also provide public-sector incentive.
- How the contract can legitimately **manage the handback of assets – empowering both the public and private stakeholders**. It is envisaged that there will be a high risk of disagreement about upgrade costs to bring individual asset condition up to handback standards.
- Risks of **disagreement on upgrade costs** required to bring individual asset condition up to handback standards.
- **Environmental risks** – especially across sectors such as water and waste.
- **Staffing and pension issues** – Transfer of Undertakings (Protection of Employment) Regulations (TUPE) protections. The TUPE regime will apply where there is a handback of operational services to the public sector on expiry of the PFI contract. Consideration must be given to any potential pensions issues to be addressed on expiry and where this risk sits.
- **Information and data transfer risk** balancing data protection law, commercial sensitivity and the need to have access to sufficient information to support service provision.
- **Digital solutions** and their future relevance.
- Backlog **maintenance** requirements.
- **Transfer of land.**
- **Lease arrangements** and other assets, such as stocks and spares, vehicles and equipment.

It is anticipated that approximately 50 contracts will expire in the next five years. As a result, it’s likely that serious challenges will be posed across the public sector. Organisations are typically underestimating the level of preparation (and time) required to facilitate a successful and viable exit and a number of public sector stakeholders may well lack the necessary in-house skills to deliver the expiry process.

There are a number of ways the public sector and private sector could begin to proceed with PFI expiry, five to ten years in advance:

1. The approach taken to day-to-day contract management sets the tone for exit	Private sector service providers and government departments often take different approaches to contract management. There is a concern public sector departments may have limited internal contract management capacity. One area of contract management for infrastructure requiring strong understanding and management is lifecycle asset management, particularly any requirement to replace assets at the end of their useful life in line with contract parameters. The majority of projects to expire over the next five years will have a lifecycle element. In many of these contracts under review, there is no requirement for the private sector to fully share asset condition information with the public sector, meaning many departments will be unaware of the true condition of the assets and the extent of any work required for ongoing service provision. This knowledge gap is a particular concern for assets such as hospitals or prisons where the level of regulation and implication of asset failure is severe.
2. Knowledge transfer and preparation prior to exit	The early PFI contracts were bespoke and did not necessarily fully set out the provisions for contract exit. Complex contract exit is rarely easy and if not managed accordingly will lead to disputes at contract end. The need for formal disputes should be avoided as it is both heavily resource intensive and time consuming. One mitigation to this will be to identify and anticipate disputes and ensure asset owners are prepared to run difficult contract negotiations. Early engagement and proactive planning/knowledge transfer with the incumbent service provider, along with an understanding of each of the stakeholders' objectives and approach to the contract negotiations, could also further mitigate the risk of potential disputes.
3. Planning the post-PFI/PPP landscape and operations	Whatever the outcome of these contracts, there will invariably remain a need for a service solution to be in place on contract exit. To achieve this the public sector needs to understand its requirements for the asset going forward. Some immediate considerations should include: ▪ Does the asset revert to the public sector at the end of the contract (not always the case in early PFI projects)? If not, does occupancy of the asset need to be secured and how is this to be managed? ▪ National requirements for ongoing service provision of PFI original contracts ▪ If a continuation of provision is agreed, is the asset fit for purpose and is refurbishment required? How does this link to asset condition obligations? ▪ Does the public sector have sufficient funding in place to re-model the asset, as may be required following a continuation of the contract? ▪ Does the private sector have sufficient knowledge to run a social economic asset? ▪ Is a new footprint strategy required?

- How does the public sector ensure a sufficient level of competition to drive value procurement?
- Does the public sector have the sufficient in-house expertise to manage and oversee the asset post-PFI expiry? How do they upskill?
- What new service contracts will need to be procured?

There are many risks and concerns surrounding the scale of the challenge facing our asset owners under PFI/PPP contracts in the near to medium-term future. The more planning that can be undertaken, the better the challenge posed by these complex processes can be managed. This lead time reflects the significant strategic decisions that need to be made about the future of such contracts as well as the contractual and regulatory risk to be managed by all parties.

Both public and private sector clients should work in tandem to work out what to do with facilities and related service provision upon impending contract expiry and any significant associated costs and risks. A lack of coherency could lead to risks for the public sector failing to secure value for money during expiry negotiations and ultimately failure. This cannot happen given the historical negative press afforded to the UK PFI industry.

Action is needed now to avoid disruption to or increasing costs of public services. The time needed to prepare for the expiry of such contracts will vary across contracts depending on the complexity and the treatment of assets on expiry. Both public and private sector stakeholders are well advised to agree timely protocols for negotiation and planning requirements prior to expiry.