

## Insights

# HOW TO AVOID PFI CONTRACT EXPIRY RISKS

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*Private finance initiative* (PFI) projects tend to be long-term, usually lasting for a period of 25 years or more. There is an active secondary market for equity interests in PFI projects: original project developers exit and new longer term investors hold projects to maturity. Notwithstanding this longer-term investment horizon, as time goes on, it is only natural that parties tend to focus more on day-to-day operations and portfolio management and less around the ultimate backstop of expiry.

However, contract expiry is becoming an increasingly pressing issue. There are over 550 current PFI contracts. Of those, 78 projects are due to expire before December 2027 and a further 91 projects will expire in 2028-2030. The nature of PFI contracts means that significant claims can arise in relation to hand-over of assets. Typical PFI contract structures employ limited equity and special purchase vehicles (SPVs). In addition, construction contractors have long since exited from their typical 12 year defects liability period in a 25+ year concession. This means that long-term investors can be exposed to contractual liabilities on expiry.

On 16 August 2021, the Infrastructure and Projects Authority (IPA) released a support plan for contracting authorities, *Managing the Risks of PFI Contract Expiry*. The support plan aims to prepare public authorities for the expiry of PFI contracts and the handover of PFI assets. The IPA's plan emphasises the importance of early engagement with the private sector and aims to smooth the transition process by undertaking a structured process of engagement with private sector counter-parties.

Here we consider how a collaborative approach between public and private sector might work in practice to both ease the expiry process and minimise adversarial, protracted and costly disputes.

## Background

In October 2018, the *government announced* that it would no longer use the PFI model but, as noted above, hundreds remain in existence and over 150 will expire in the next decade.

In June 2020, the National Audit Office (NAO) *published a report* identifying various risks associated with PFI contract expiry, including:

- Public authorities being under-prepared and under-resourced for the handover and expiry process (combined with the perception that the private sector is more prepared and better resourced).
- The quality and condition of assets at handover (private sector partners being characterised, perhaps unfairly, as prioritising the optimisation of returns to investors over ensuring quality of assets at handover).
- Continuity of services across the handover period (and concerns that the private sector will not provide the information the public sector needs to guarantee continuity of services).
- Costly and protracted disputes (This is a particular concern with earlier PFI contracts – before a more standardised approach was adopted – where there’s a greater likelihood that contract terms do not specifically address the handover process).

The IPA’s recent plan forms part of its response to the risks identified in the NAO’s report.

### **What is being suggested?**

In managing the risks of contract expiry, including those documented in the NAO report, the IPA proposes to:

- Undertake a health check of PFI projects expiring within 7 years to risk assess their readiness for expiry and to identify further actions.
- Publish specific “expiry guidance” and a “supporting toolkit” in autumn 2021, reflecting on lessons learnt from health expiry checks undertaken by the IPA so far.
- Prepare a PFI expiry training module for autumn 2021 and provide ongoing expiry advice and assistance to government departments.
- Engage with the private sector counter-parties, including investors, SPV managers, service contractors and others to build better relationships and share knowledge.
- Publish an expiry protocol, setting out the behaviours expected of investors and authorities in managing the process aiming to foster collaborative working, transparency and promote effective resolution of disputes.

The IPA’s plan focuses on readying the public sector through providing training, guidance and toolkits. It also plans to engage with the private sector to foster better public-private sector relationships and to create a protocol to encourage such collaborative working and support effective dispute resolution.

### **Collaborative working and promoting effective resolution of disputes**

How will this work in practice? We consider three aspects of collaborative working to assist in minimising disputes and promoting their effective resolution:

- early engagement and preparation;
- wider relationships; and
- collaborative dispute resolution

### *Early engagement and preparation*

Collaborative working requires preparation and early engagement in the handover and exit process from **both** sides. This means that both the public and private sector must understand:

- the contractual mechanism for handover and exit;
- the timeframes and key dates involved;
- any 'gaps' in the process or areas of contractual ambiguity;
- their contractual obligations on handover and exit;
- asset condition; and
- information necessary to maintain consistent provision of services on handover.

The NAO recommends that preparation starts 7 years before expiry but it's not a hard and fast rule. Where contract expiry is further away, the parties have more time to foster collaboration and minimise the risk of disputes on expiry. As such, there's every reason to commence early engagement on contracts that have longer to run too.

### *Wider relationships*

The IPA is keen to build better relationships with private sector actors involved in the handover and exit process. The IPA also intends to put in place a protocol to govern a collaborative handover process. It will be interesting to see how this process evolves.

A collaborative relationship is often easier to establish and maintain where there is a desire to create or maintain a longer-lasting working relationship. Since most PFI contracts are close to their expiry and handover process, opportunities for creating longer lasting working relationships may mean looking beyond the four corners of the PFI contract. This might involve considering opportunities for renewing contracts, renegotiating contracts and re-assessing service provision, configuration of estates (for instance, utilising the skills of the private sector partners to retrofit PFI buildings to meet the net zero/energy transition challenge) and additional development opportunities between the public and private sector.

## *Collaborative dispute resolution*

Even with a process of early collaboration, disputes, on some level, are likely to arise. The key is resolving a dispute before it escalates and positions become entrenched.

Arguably there's greater scope for disputes with earlier PFI contracts before there was a degree of standardisation of contractual terms and where contract terms are more likely to be unclear, ambiguous or inadequate for the handover and exit process. However, disputes are likely to arise in some form across all PFI contracts.

## *How to resolve disputes collaboratively*

One of the benefits of early engagement is early identification of problematic or ambiguous contract terms and areas of potential dispute. A collaborative dispute resolution process seeks to resolve potential areas of dispute proactively, swiftly and avoiding a costly protracted dispute and the adversarial and hostile environment that can go alongside formal dispute resolution.

Collaborative dispute resolution can involve working through a contractual tiered dispute escalation procedure (if there is one) or seeking to agree a similar process with the help of an independent third party, often a mediator who can structure a mediation process to suit the more complex nature of PFI disputes.

This process of agreeing a collaborative method of dispute resolution could be done proactively and before disputes arise. Alternatively, a collaborative method of dispute resolution could be adopted to suit the specific dispute, but this should be done promptly and before the parties become entrenched in their positions and relationships become strained.

## **What next?**

The IPA guidance is a useful reminder for anyone involved in PFI projects that it is best to prepare early and plan for the expiry period. As many PFI projects are structured to provide significant back-ended returns to equity investors (especially after the repayment of senior project debt) the economic impact of a complex dispute on expiry will not be welcomed by either party. It may be tempting to assume that handover will all proceed well and no issues will arise. However, taking proactive steps to identify the true position and adopting a collaborative approach is likely to reduce the risk of a complex dispute arising at the time of expiry.

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## MEET THE TEAM



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