PFI GUIDANCE NOTE

Service Failure Points and Replacement of Sub-Contractors

In recent PFI deals, issues have arisen in relation to what happens if a poorly performing service provider is replaced. In particular, it seems there is some confusion over how to interpret guidance, set out in the form of a letter from Mr Geoffrey Spence, (at that time the head of PFI procurement policy), published by HM Treasury in April 2003. The purpose of this note is to clarify how the Spence guidance should be applied in NHS PFI schemes.

Background

From time to time, service delivery in a PFI scheme may slip below the required standards. This may result in deductions from service payments and the award of "Service Failure Points" (SFPs). The purpose of awarding SFPs is that it allows Trusts to identify where there has been consistently poor performance over a longer period. It also allows Trusts to implement remedies under the contract, such as increased monitoring of service delivery and step-in. The ultimate sanction is termination of the Project Agreement.

SFPs are awarded to the Project Co. Normally Project Co will also award SFPs to its sub-contractors on a pass-through basis, depending on which sub-contractor's failure to perform has led to the award of SFPs. This is dealt with in the relevant sub-contract, which will also set out the procedures for giving warning notices and thresholds for termination of the sub-contract.

Although the Trust will expect to approve the terms of each sub-contract, it has no direct role in setting the thresholds for warning notices and termination of sub-contracts. These are a matter for negotiation between Project Co and each of the sub-contractors providing services. Project Co will wish to ensure that it is able to manage the performance of its sub-contractors and the thresholds for warning notices and termination in the sub-contract are an important tool in doing this. Trusts will wish to see that thresholds for termination of sub-contracts are not set at too low a level, since the Trust will wish to avoid the disruption resulting from frequent replacement of service providers. However, Project Co will normally ensure that it has the right to replace a grossly under-performing sub-contractor well before the number of SFPs accruing to Project Co itself places the whole project at risk of termination.

If Project Co accrues a significant number of SFPs in respect of an individual service, it will receive a warning notice, giving it the opportunity to improve its performance. If it continues to perform badly, the Trust will have the right to increase its monitoring of performance and possibly even to step-in to provide the relevant service itself (perhaps bringing in its own service provider). The Trust has no specific right to require the replacement of a service provider (with one limited exception[1]). It is for Project Co to take this decision, relying on its rights under the sub-contract.

[1] This is set out in clause 44.6 of the NHS standard form contract.

If Project Co decides to terminate the contract of one of its service providers, it does not have an automatic right to introduce a replacement. It must obtain the Trust's agreement, although the Trust cannot unreasonably refuse. In practice, the main concern of Trusts will be to ensure the highest quality of service delivery. If this can be achieved by replacing a poorly performing service provider, many Trusts will be willing to give approval, subject to considering the precise terms on which a replacement is sought.

Where a new service provider begins to provide services, it normally starts with a clean sheet, although clearly this is something for agreement between Project Co and the new contractor, not the Trust. The new service provider does not inherit the SFPs awarded to its predecessor. If it did, it would start with a number of SFPs that exceeded the termination threshold on day one, leaving it at risk of having its contract terminated at any time.

The Spence Guidance

The question covered in the Spence guidance is this: when a Trust agrees to a request from Project Co to replace a service provider, what happens to the SFPs awarded to Project Co in respect of the same service? Are they also "wiped clean"?

As indicated above, Project Co is awarded SFPs whenever any of its sub-contractor service providers fails to meet the required levels of service delivery. That means that Project Co is likely to accrue a greater number of SFPs than each individual service provider. There is also a threshold at which Project Co itself has accrued so many SFPs that the whole PFI contract becomes liable to termination. This is needed as a sanction against consistently poor performance across the whole project over a prolonged period.

As a general principle, if a service provider is replaced, the SFPs which Project Co has accrued in respect of that service should not be wiped clean. Otherwise, the sanction of termination for consistently bad performance would simply not exist for practical purposes – Project Co would be able to avoid it by continually replacing its service providers. That is not satisfactory. There needs to be a greater incentive on Project Co to manage the performance of its chosen sub-contractors.

The precise level at which the termination threshold is set in the Project Agreement is determined by each Trust on a project specific basis. As noted above, the termination threshold in individual sub-contracts is set by Project Co. It is very difficult to prescribe a standard approach, but clearly the level of SFPs at which Project Co itself becomes liable to termination would normally be significantly higher than the termination threshold for an individual service. It is worth emphasising, however, that the differential in termination thresholds is within Project Co's control.

There are some contracts where Project Co is only required to provide a limited number of FM services. If one of those services happens to account for the vast majority of the costs and key deliverables, a situation may arise where the number of SFPs awarded at Project Co level is very close to the SFPs that will be attributable to one service. The best example of this is a hard FM only scheme, where the estates services often account for the vast majority of service deliverables.

In such cases, the threshold for Project Co termination may not be significantly higher than the termination threshold for the hard FM service provider (although as noted above this is a matter for Project Co to agree with its sub-contractors. It is not something the Trust can control). If that happens, then it may be difficult to find a suitable replacement service provider, if the incumbent has to be replaced for poor performance. A potential replacement contractor may be reluctant to take over if it sees a risk that the award of a small number of additional SFPs, which would be well below the termination threshold for the service provider itself, might put the Project Co at risk of termination. Termination of the Project Agreement would inevitably mean that individual sub-contracts would also fall away.

It is cases like this that the Spence guidance is aimed at. The guidance notes that, in such situations, Trusts should consider if it is desirable to give relief. This may take the form of providing relief from the award of SFPs for the relevant service for a short period after the new provider takes over, or accepting a wipe clean of SFPs at Project Co level. It is by no means mandatory upon Trusts to give any relief at all, if the circumstances make this inappropriate.

Relief from the award of SFPs

This is one of the two alternatives suggested in the Spence guidance.

The new standard form payment mechanism gives relief from deductions from service payments for a period of 3 months where a new service provider is bedding-in. However, no relief is given from the award of SFPs. This is because there has to be some sanction against poor performance.

It is not recommended that Trusts extend the relief during a bedding-in period such that there are no SFPs awarded, in addition to there being no or reduced financial penalties for minor service failures. It is important that Project Co is given a greater incentive to ensure that service quality is maintained, even during a bedding-in period. Subject to the comments below in the numbered paragraphs 1-5, Trusts may wish to consider awarding a reduced number of SFPs during the bedding-in period or possibly awarding no SFPs during the bedding-in stage, in return for removing the provisions giving relief from financial deductions. This would be consistent with the suggestion made in the Spence guidance.

Wipe-clean of SFPs awarded to Project Co

This is the second alternative suggested by the Spence guidance. It would mean that the SFPs awarded to Project Co in respect of the services delivered by the service provider being replaced would be removed. In a case such as the replacement of the hard FM service provider in a hard FM-only scheme, this would effectively mean that it became almost impossible to terminate the Project Agreement for a period of several months after the introduction of the new service provider. This is because rights of termination arise where a large number of SFPs are awarded in a consecutive period, typically about 6 months (but sometimes these periods vary – PFU has seen longer and shorter periods than this). Where there is effectively only one service, the wipe-clean of all historical SFPs will mean that only disastrous performance by the

new service provider will lead to termination during the first 6 months after it takes over. Agreeing to waive the award of SFPs during a 3 month bedding-in period would probably have a similar effect.

Trusts considering a request by a Project Co to agree to provide relief from SFPs where Project Co is seeking to replace a service provider[2] should have regard to the following matters:

1. The Trust should satisfy itself that there is a genuine risk that (unless there is a wipe-clean at Project Co level as well) it would be difficult to find a replacement service provider, because there is little difference between termination thresholds for Project Co and the hard FM service provider. In the vast majority of cases, this should not happen. The termination threshold in the sub-contract should be set at a level that allows for termination before the Project Agreement itself is under threat. In the case of schemes that have yet to reach financial close, Trusts should satisfy themselves that this is the case when approving the terms of the sub-contract.

2. Trusts should take a sceptical approach to requests for relief from SFPs in such circumstances. The Project Co should take account of the need for headroom between the SFP termination thresholds in the Project Agreement and the sub-contract at the time it negotiated the terms of its sub-contract. If it gets this wrong, there should be no automatic assumption that the Trust will help.

3. Trusts should not consider giving relief in contracts where soft FM services are within the scope of the scheme, for the reasons given below.

4. If the Trust believes it is appropriate to give relief, it should aim to do so on terms that, while addressing the legitimate concerns of replacement service providers, ensure that Project Co still has an incentive to deliver good performance. If Project Co knows that it will always be let off the hook completely if it gets rid of a service provider, it may have little incentive to manage that service provider's performance diligently.[3]

5. In accordance with the Spence guidance, there should be no more than two occasions during the term of the contract on which relief should be given to Project Co. That applies whether the form of relief given is a period of grace from the award of SFPs or a wipe-clean of points for Project Co.

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[2] This applies to Trusts whose PFI scheme has already reached the operational stage and where the contract itself does not contain specific provisions for what happens in situations like this.

[3] One possibility would be to introduce some limits on the availability of relief. As noted in this guidance, it would be normal to have some headroom between the threshold for termination of a sub-contract and termination of the Project Agreement. This provides some flexibility for Project Co to deal with its under-performing sub-contractors without leading to termination of its own agreement. However, if not drafted precisely, it might also result in a situation where Project Co did nothing at all about managing sub-contractor performance apart from terminating the sub-contract shortly before reaching the Project Agreement termination threshold. That is one of the dangers of giving an unconditional right to a wipe-clean of SFPs on the replacement of a sub-contractor. It may be necessary to limit the relief to situations where Project Co has taken appropriate action within a reasonable period, measured either in time or before a specified number of additional SFPs have accrued.

Should provisions for relief be included in the Project Agreement?

The guidance set out above applies where Trusts are asked for relief when a service provider is replaced during the term of the contract. The assumption is that there are no relevant provisions in the contract itself. Recently, some bidders have sought to specify in the Project Agreement exactly what will happen in such circumstances.

There should never be an automatic right for Project Co to replace a sub-contractor. In accordance with clause 50 of the standard form contract and the Spence guidance, the Trust should always have the right to approve the new appointment, as long as approval is not unreasonably refused.

As long as the ultimate right of approval is retained, then in principle there is no reason why, if approval is given, the approach to be adopted when giving relief cannot be specified in the contract. However, this should only be necessary in very few cases and then after discussion with and approval from PFU. The reason is that, if Project Co has given thought to the issue of finding a replacement sub-contractor at the pre-contract stage, it should also have given thought to setting termination thresholds in its sub-contracts at an appropriate level. That ought to mean that the need for relief never arises. Trusts may be approached late in the day, during the run-up to financial close, by a bidder that has spotted the point rather late and prefers to seek a concession from the Trust to re-opening discussions with its service provider(s). Needless to say, Trusts should be unsympathetic to such requests.

Trusts wishing to consider including a provision in their Project Agreement should follow the guidance set out at points 1 to 5 above.

In addition, Trusts should have regard to whether the bidding consortium has consistently made clear its requirements when bidding in competition with others. PFU has noted a tendency for bidders to raise this issue for the first time at a late stage in the negotiations after the appointment of a preferred bidder. If that happens, Trusts are advised either to reject the proposal or, if minded to accept, to analyse, with help from their financial advisors, the likely impact on the Project Co and the value for money implications of agreeing. It may (for example) be appropriate to seek a downwards price adjustment. It may turn out that, when the respective termination thresholds are examined, to permit two wipe-cleans at Project Co level (for example) would mean the Trust would be unlikely ever to be able to exercise a right to terminate the Project Agreement. If so, the request to include provisions in the contract should be declined. In any event, there should be no assumption that bidders have an automatic right to a wipe-clean of SFPs at Project Co level, even in hard FM-only schemes.

A further point for Trusts to consider in such situations is whether (assuming the scheme is hard-FM-only) the traditional approach of deleting clause 44.6 of standard form (see footnote 1 above) should be abandoned. If Project Co seeks an automatic right to relief if it replaces a hard FM service provider, it should be prepared to accept that the Trust will have a right to insist on the replacement of the service provider as an alternative to termination.

Where is the Spence guidance inapplicable?

The Spence guidance is not applicable in schemes where a large number of services are to be provided. This would include most if not all soft FM schemes. The logic is very simple. In such cases, there should be a significant difference between the thresholds for replacement of an individual service provider in its sub-contract and for termination of the Project Agreement. The logic that underpins the Spence guidance (one service representing the vast majority of potential SFPs) simply does not arise.

It is of course possible that all services may be delivered to a uniform and very poor standard, so that all of them attract high levels of SFPs. However, this is something that Project Co should be given every incentive to address very quickly. This is not a situation where the Trust should be rushing to give relief to Project Co.

There are schemes where it just so happens that the same service provider is to be appointed to provide all of the relevant services, including both soft and hard FM. In such cases, it has sometimes been suggested that there should be a right to a wipe-clean of SFPs at Project Co level if the service provider is replaced (either for all services or just for one service). This proposal is said to be supported by the Spence guidance, which suggests that wipe-clean may be acceptable where there is only one service provider.

PFU has noted that there is some ambiguity in the Spence guidance, which is one reason why this clarification is being issued. As a matter of principle, this interpretation is not in the spirit of the guidance and (while there have been occasions where, in view of the ambiguity, it has been necessary to accept some dilution of this principle) in future it should not be accepted by Trusts.

The justification for a wipe-clean of SFPs at Project Co level should be determined by the number of different services being provided and the relative weighting of those services, not by the number of different service providers that Project Co intends to engage. It is not acceptable for the commercial terms of the Project Agreement to be different simply because Project Co happens to have decided to engage one service provider, as opposed to (say) six different service providers. This will not result in a level playing field between consortia which choose to use a variety of service providers and those who favour a single FM provider.

Trusts should be aware that, although there may only be one service provider, to which all FM services are sub-contracted by Project Co, it is likely that each of the different services will be capable of operating on a stand-alone basis. This allows for the requirement in the NHS Standard Form contract that, where soft FM is market tested, the Trust can insist on separate contract awards for different services, if that produces better value for money for the Trust. A prudent Project Co will always have the ability to remove one or more services from its sub-contract, so that it can manage its sub-contractor properly. If necessary, a poorly performing service can be terminated and another sub-contractor brought in. The argument that everything is different in the case of schemes with a single FM provider at sub-contractor level is not sustainable.

It is true that all services could be provided badly, so that similar numbers of SFPs accrue at service provider and Project Co level. However, as noted above, this is something that Project Co should be encouraged to address as soon as possible, not protected against.

Having clarified the interpretation of the Spence guidance, PFU will expect the approach outlined above to be followed in the case of schemes reaching financial close after the date of this note.

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