

Construction Online Update

April 2006

OsborneClarkepublications

Contents

Welcome to the latest edition of the Construction Update. The update is written by members of Osborne Clarke's construction team and contains a summary of recent cases and articles on issues affecting the industry. Please click on the links below to find out more about each of the topics.

1. Articles	3
Is this the end of Equivalent Project Relief in PFI Projects?	3
Valuing variations it's not fair	4
Ofcom Update: fibre access for newbuild premises and community broadband access networks	6
2. Adjudication Society	8
3. News	9

1. Articles

Is this the end of Equivalent Project Relief in PFI Projects?

In *Midland Expressway v Carillion Construction Limited 2005*, Mr Justice Jackson the Senior Judge in the Technology & Construction Court, confirmed what has always been thought in PFI circles that the building contractor's right to adjudicate at any time in accordance with the Housing Grants Construction & Regeneration Act 1996 (the "Act") cannot be avoided under the building contract, nor are "pay when entitled" clauses enforceable.

In PFI the main contract known as the project agreement is generally made between the public authority and a special purpose company ("Project Co"). This Project Co is set up purely for undertaking this one particular project and has no assets other than the funds it receives from the authority under the project agreement. Project Co then in turn engages a contractor under a design & build contract.

Two types of provisions which are common in PFI projects include: restricting the rights of the contractor to adjudicate until Project Co's rights under the project agreement have been determined; and that the Project Co only has to pay the contractor when it itself is entitled to be paid under the project agreement. Together, these provisions are referred to as "equivalent relief provisions".

Clearly both of these fall foul of the Act, as the Act provides the following:

- Section 108 provides that in relation to a "construction contract" (as defined by the Act) that either party is entitled to refer a dispute or difference to adjudication at any time and such right cannot be excluded by contract.
- Section 113(1) provides that a provision making payment under a construction contract conditional on the payer receiving payment from a third party is ineffective, unless that third party is insolvent. The purpose of this provision is to outlaw "pay when paid" provisions in construction contracts.

The problem is that the project agreement is not a construction contract for the purposes of the Act, but the building contract between Project Co and the contractor is covered by the Act.

Additionally, as has been mentioned above, Project Co has no income other than the funds it receives under the project agreement. Therefore, to overcome the anomaly the building contract will often contain provisions which attempt to avoid the Act in order to ensure that the Project Co is not liable for any additional payments or to provide any remedies to the contractor which it itself is not entitled to under the project agreement.

The *Midland Expressway* case deals with the M6 Toll Road. Midland Expressway Limited ("MEL") entered into a project agreement with the Department of Transport for the design, build, finance and operation of the M6 Toll Road. MEL was a special purpose company.

MEL entered into a building contract with CAMBBA (a joint venture made up of Carillion, Alfred McAlpine, Balfour Beatty and Amey) to design and construct the road.

The building contract contained a provision that CAMBBA could not commence an adjudication under the building contract until such time as any corresponding dispute had been determined under the project agreement. It also contained a provision that MEL did not have to pay any sums due under the building contract until such time as it was entitled to be paid under the project agreement.

CAMBBA brought a claim in adjudication, against MEL in the region of £10m for changes in the road layout. MEL sought to have CAMBBA's adjudication restricted by injunction pending final determination of its own claim under the project agreement. MEL had notified the authority of the potential claim and invited it to join in the adjudication, not surprisingly the Department of Transport declined this invitation.

Mr Justice Jackson rejected MEL's claim, stating that Section 108(2) of the Act allowed a party under a construction contract to adjudicate at any time, therefore any measure by MEL to attempt to prevent adjudication was unenforceable.

Mel's second argument was that they had no liability to pay CAMBBA until such time as they themselves were entitled to be paid under the project agreement, arguing that they were merely acting as a conduit between the Department of Transport and CAMBBA.

Mr Justice Jackson also dismissed this argument, and stated that this was the situation which Parliament had had in mind when it passed the Act and that pay when paid clauses were unenforceable and could not be relied upon. MEL had tried to get around the pay when paid position, by wording it as pay when entitled to be paid clause, Mr Justice Jackson, stated that such a provision could not be avoided by circumlocution.

Although the *Midland Expressway* case has generated a great deal of interest in PFI circles, it merely confirms what has generally been thought to be the position: equivalent relief provisions are unenforceable.

Emily Lake



Valuing variations: "it's not fair"

Variations are a fact of construction life. Increasingly, even traditionally procured projects are under designed with much of the final design being completed after the main contractor is appointed and as the works are progressing. This leads to numerous variations.

The manner in which variations are valued is a constant and recurring source of dispute between the parties to a construction contract. The fact is that main contractor's profit margins have been reportedly less than 5%. The manner in which variations are valued can often make a significant impact on the profitability of a project and accordingly provides fertile ground for disputes.

Most standard forms of contract set out three basic rules for valuing variations which despite minor differences can generally be summarised as follows:

Rule 1 – where work is of a similar character executed under similar conditions to work priced in the Bill of Quantities it should be valued at the rates and prices contained in the Bills.

Rule 2 – where work is not of a similar character and is not executed under similar conditions the rates and prices in the Bill of Quantities are used as the basis for valuations so far as may be reasonable.

Rule 3 – a fair valuation shall be made.

Rule 1 is generally not a problem. Problems do occur with Rule 2 especially where one or other of the parties seeks to avoid a rate that appears excessively high or low. This and the leading case of *Henry Boot Construction Limited v Alstom Combined Cycles Limited* was addressed in the August 2005 Edition of the Construction On-line Update [Click here](#)

If a contract administrator cannot use Rules 1 or 2 to value variations, then the default is Rule 3, i.e. "a fair" valuation shall be made. What is "fair" is often a subjective and emotive subject which can often lead to parties claiming "*It's not fair*". However, there is some judicial guidance regarding Rule 3 and how a contract administrator should approach valuing a variation and what elements of costs can be brought together to ensure such valuation is fair. In *Henry Boot* His Honour Judge Humphrey LLoyd stated:

"A fair valuation generally means a valuation which will not give the contractor more than his actual cost reasonably and necessarily incurred plus an allowance for overhead and profit".

This gives judicial backing to the prevailing view that a fair valuation is a cost plus valuation. Establishing costs reasonably incurred is a record based exercise but as HHJ Humphrey LLoyd stated, the actual costs should be reasonably and necessarily incurred. This would allow a contract administrator to disallow costs where there has been inefficiency or non-productivity.

However, the assessment of the allowance for overheads and profit prevents more of a problem. The case of *Weldon Plant Limited v The Commissioner for New Towns* [2000] gives clear judicial guidance on how this is to be approached.

The facts

Weldon entered into a contract with The Commissioner for New Towns for the construction of a reservoir. The contract was based on the ICE Conditions, 6th Edition with Specific Amendments.

The material to be excavated consisted of clay and gravel. The material had a market value and as such the rate Weldon put into the contract for its removal was minus £3.60²m.

The contract provided that Weldon could, at its own risk, excavate below the required level to obtain more gravel which it would be entitled to sell. During the course of the contract, the engineer issued a site instruction which required Weldon to excavate all the gravel below the designed level. Weldon did this, but disputes arose regarding payment for this additional excavation. Weldon considered that the instruction constituted a variation as the contract only provided that it had the option to excavate additional material from below ground level, whereas the instruction made it mandatory. On this basis they considered the contract rates did not apply and that they should be entitled to a fair valuation.

The arbitrator held that it was a variation and that the appropriate variation rule was a fair valuation. Problems arose with the arbitrator's fair valuation. The reasons given for not adding overheads and profit were that with respect to overheads, Weldon had failed to establish that it had either incurred additional overheads or that it had been denied the opportunity of recovering overheads by the variation. With respect to profit he held that this was never recoverable.

Weldon was dissatisfied and appealed, stating that the arbitrator had erred in law, in that he had attempted to value the variation as though it were a loss and expense claim, i.e. where they had to prove loss, rather than a fair valuation of a variation.

The case was heard in the Technology & Construction Court before His Honour Judge Humphrey Lloyd QC, the same Judge as heard the *Henry Boot* case. The Judge agreed with Weldon. He stated that in his judgment clause 52.1 of ICE

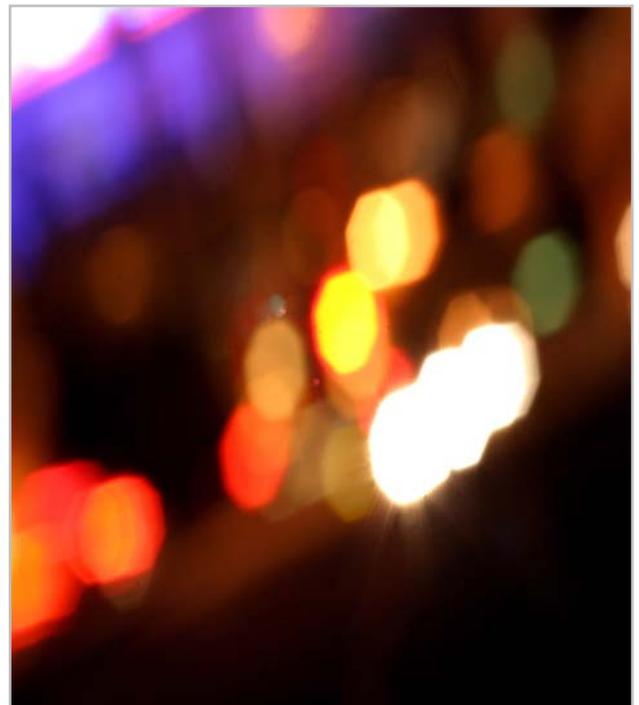
contemplates that the contractor will be able to recover in the value of a variation those elements included in the contract rates or prices for overheads and profit.

With regard to profit he stated that a contractor is in business to make a profit on the costs of deploying its resources. Accordingly, an employer must pay profit in a valuation made under any rule and if he did not do this the valuation would not be fair.

His reasoning was based on the fact that each rate in a bill of quantities is deemed to include an allowance for overhead and profit. If Rule 1 or 2 were used for valuation then applying the existing rate pro-rata would mean that the new rate would include an overhead and profit element. Thus an allowance for overhead and profit was an integral part of Rules 1 and 2 and accordingly the same level of overhead and profit should be allowed in a fair valuation under Rule 3.

In summary, the Judge confirmed what had been the prevailing practice for years, i.e. that a fair valuation should include the same level of allowance for overhead and profit as is included in all the other rates in the priced bill of quantities – if this is not done it would not be fair.

Peter O'Brien



Ofcom Update: fibre access for newbuild premises and community broadband access networks

Developers, constructing new builds or undertaking refurbishments, will need to consider telecommunications specifications in order to maximise the value of their investment. This can cause problems, as the developer may inadvertently become a communications network provider.

Should the developer provide a network and take on the regulatory burden or simply construct a "dumb" building with the necessary ductwork in it?

One problem for the unsuspecting developer is that they routinely struggle to assess whether they are communications network providers. This can cause problems with their business cases.

Fortunately help has arrived. On 2 March 2006 Ofcom published a guidance document in respect of fibre access for new build premises and community broadband access networks. It was produced in response to various approaches made by new build property developers, not normally considered as communication, service or network providers to Ofcom for guidance on regulatory questions surrounding the building of fibre access to new build premises. These approaches were made, as increasingly developers wished to build in fibre access from the start of their developments in order to provide telecommunication services.

The focus of the guidance is not on commercial aspects, but on the implications of existing regulation for new build fibre access networks and community broadband networks.

There are also clear commercial implications to developers when considering fibre access for new build premises. For the purpose of the guidance, fibre deployments to new build premises are the deployment of local access infrastructure to new build premises at the time of construction by the development company, which can be effected using a wide range of business models with varying levels of investment and involvement in ongoing operations and maintenance. These range from the provision of ducting only with the ability for network providers to lease space within the ducts, to full scale fibre access network and core network deployment and service provision (both wholesale and/or retail). Some proposed approaches include a combination of these options. The levels of

investment and ongoing involvement will affect the extent to which the property developer is affected by the guidance.

When considering land assembly, development criteria and the specifications for a project the developer therefore needs to give early thought to the regulatory aspects of the project and how that will effect the specification for the new build and the skills needed for the project team. The design, specification and construction of the mechanical and electrical works can be crucial to the success of the project. This needs to be reflected in the design obligations assumed by the mechanical & electrical engineer and the construction obligations of the mechanical & electrical sub-contractor. A fitness for purpose obligation may be advisable.

The choice of business model adopted will be influenced on a case-by-case basis by the varying requirements of potential occupiers. Some may be looking for a turnkey solution, where the provision and responsibility for ongoing maintenance of any network provision and fibre access would remain with the developer and/or an external supplier. Others may wish to install the infrastructure and arrange for maintenance themselves.

Following on from the question of what business model or mix of models is required is the question of what are the implications of the varying levels of service provision that a developer might offer. If a developer is simply providing ducting or dark fibre the level of regulation will be minimal. However if they look to provide either wholesale or retail services there are a number of considerations that will need to be made. Some of these considerations are what the guidance document seeks to answer. Those discussed include:

- provision of voice services over fibre access networks, in particular access to the emergency services and the provision of caller identity information;
- deployment of parallel local access networks by competing infrastructure providers;
- implications of the Universal Service Obligation;
- approach to ex ante regulation, including BT's Undertakings to Ofcom under the Enterprise Act 2002 and the formation of Openreach; and
- provision of network access.

A link to the consultation document can be found at:

<http://www.ofcom.org.uk/telecoms/ioi/orp/fibreaccess/fibreaccessguidance.pdf>

What are the commercial implications if the developer does assume the role of a network provider? The developer should take advice from appropriately qualified professionals with telecoms expertise. This should include obtaining proper advice from a mechanical & electrical engineer and from an architect when designing specifications. The developer and its professional team will also need to consider the life cycle of the building. Who will maintain the network equipment and how does that effect the business appraisal for the project? In assessing these commercial objectives the developer will need to consider if the construction of a dumb building would provide greater net returns by effectively transferring the responsibility for the provision of to the occupier.

The developer/occupier will have a right to connect in to BT's existing network. Under the Universal Service Obligation, BT are obliged upon reasonable request, to provide certain specified telecommunications services at a uniform price across the UK. This, together with other competing parallel access networks, offers strong competition to any potential developer looking to deploy fibre access as part of their development. There are also alternatives. Developers could remove the need for fibre access altogether by looking to fixed wireless access solutions instead. This is an often-used method in business parks.

In public buildings (such as airport terminals), mobile operators may wish to install their own base stations and there are also wireless hotspot infrastructures that can be made available for the public to log into. The developer, if it is to keep the asset and operate a network, may look for revenue share from income generated from infrastructure located within the building. Mobile operators and fixed line operators may try and use their code powers to force landowners to allow access for installation and location of infrastructure.

Whether the developer takes on this responsibility or not, it would always make sense for the developer to arrange for service/infrastructure to be delivered to the network termination point (whether BT lines or wireless access).

From a construction perspective, the developer needs to:

- Understand the options in the telecoms market so it can make an informed decision and factor this in to the business appraisal;
- Choose a team of suitably experienced construction professionals who understand the telecoms options and specify accordingly;
- Draft forms of appointment to reflect the professional team's expertise which requires them to specify and consider network options using best practice; and
- Understand the likely rate of technological advance as ductwork and telecoms equipment may become redundant quickly. The ability to maintain and upgrade network equipment will be an important strategic and costs issue. The design therefore needs to ensure that the intended use of the building is flexible.

Jonathan Brooks and Sam Hawke



2. Adjudication Society

The next Adjudication Society Event in the South West will be a mock adjudication on 8 June 2006 (5.30pm coffee/registration) at Clarke Willmott (contact: sclarke@clarkewillmott.com).

Full details to follow shortly.

If you are not already a member of the Adjudication Society but would like to join and participate in other events throughout the year, you can find joining details on the website on www.adjudication.org



3. News

Draft Regional Spatial Strategy

All those involved in the development industry in the South West should be aware that on 10 March 2006, the Regional Assembly approved the Region's first Regional Spatial Strategy. This draft strategy has a series of policies and proposals which will have a major effect on the future development potential of land within and around cities in the South West. We will be preparing a fuller briefing note but in the meantime if you have any queries, please contact our Planning Partner

Kevin Gibbs

Partner

t +44 (0) 117 917 4222

f +44 (0) 117 917 4223

kevin.gibbs@osborneclarke.com

For more information or advice on any of the topics covered in this publication, please contact your usual Osborne Clarke contact or:

John Redmond

Head of Construction

t +44 (0) 117 917 3458

f +44 (0) 117 917 3459

john.redmond@osborneclarke.com