CROSSRAIL LIMITED

PROCUREMENT SUB-COMMITTEE

SUBJECT: **Main Civils Contract – NEC conditions of contract – Paper 2**

SPONSER: [redacted]

MEETING: **13 January 2010**

Purpose

The purpose of this paper is to seek the Procurement Sub-Committee approval to a number of issues relating to the NEC conditions of contract which are currently being prepared for the main civils contracts.

Recommendation

It is recommended that approval is given to the various issues as set out below.

Background

This is the second paper presented to Procurement Sub-Committee to approve matters relating to the conditions of contract proposed for the main civils contracts. All matters in the first paper were approved save for the item relating to retention in respect of which the Procurement Sub-Committee requested a further submission (which is provided in this paper).

1. Approvals by Others

Background

The Works Information will set out which consents, approvals etc must be obtained by the Contractor and which will be obtained by the Project Manager. Where this responsibility is placed on the Contractor, whilst he will have to do all he is required by the Works Information to do in order to obtain any given approval, this does not necessarily mean that any delay in receiving these approvals will be at the Contractor's risk. One of the NEC compensation events is when "Others" (any third party) does not work within the time shown on the Accepted Programme. In the event, therefore, that the Contractor has done all he has to do to obtain the approval and provided that he is not at fault, but the third party is late giving his approval, the Contractor will be entitled to a compensation event.

Recommendation

The working group recommends that this is the correct position and that the Employer should take the risk of Others being late in giving approvals (even where the Works Information places an obligation on the Contractor to obtain the approval) and that there should be a compensation event in this situation **(Recommendation 1)**. The working group does not think the Contractor should be pricing this risk. The Contractor should show such approvals on his programme and the Project Manager must look at these carefully to ensure the time periods shown for obtaining approvals are achievable so as to avoid delay and potential compensation events.

2. Liability and insurance arrangements

Background

The basic position under the NEC3 is that each party indemnifies the other in respect of matters at their own risk. The contract sets out the Employer's risks and anything else is the Contractor's risk. The Employer's risks under NEC3 are:

- Claims, proceedings, compensation and costs payable which are due to
  - use or occupation of the Site by the *works* or for the purpose of the *works* which is the unavoidable result of the *works*,
  - negligence, breach of statutory duty or interference with any legal right by the *Employer* or by any person employed by or contracted to him except the *Contractor* or
  - a fault of the *Employer* or a fault in his design.

- Loss of or damage to Plant and Materials supplied to the *Contractor* by the *Employer*, or by Others on the *Employer*'s behalf, until the *Contractor* has received and accepted them.

- Loss of or damage to the *works*, Plant and Materials due to
  - war, civil war, rebellion, revolution, insurrection, military or usurped power,
  - strikes, riots and civil commotion not confined to the *Contractor*'s employees or
  - radioactive contamination.

- Loss of or wear or damage to the parts of the *works* taken over by the *Employer*, except loss, wear or damage occurring before the issue of the Defects Certificate which is due to
  - a Defect which existed at take over,
  - an event occurring before take over which was not itself an *Employer*'s risk or
  - the activities of the *Contractor* on the Site after take over.

- Loss of or wear or damage to the *works* and any Equipment, Plant and Materials retained on the Site by the *Employer* after a termination, except loss, wear or damage due to the activities of the *Contractor* on the Site after the termination.

- Additional *Employer*'s risks stated in the Contract Data.

CRL is in the process of purchasing an Owner Controlled Insurance Programme ("OCIP") which will cover:

- Damage to the works and completed works;
- Damage to existing structures;
- Damage to the TBMs (if the option to insure these under the OCIP is exercised); and
- Third party liability.

CRL needs to decide upon the appropriate liability regime which is aligned with the cover provided by the OCIP and which allocates liability for any losses which will not be recovered under the OCIP in the most appropriate manner.

Recommendations

The working group's view is that the liability regime under these contracts ought to be kept as simple as possible, avoiding numerous different provisions relating to different types of loss and recommends the following:

Deductibles

All works contractors will be insured parties under the OCIP. Where events occur which are:

(a) at the Contractor's risk, it is recommended that the Contractor should be liable for the relevant deductible and this will be a Disallowed Cost;

(b) at CRL's risk, it is recommended that CRL should be liable for the relevant deductible.

(Recommendation 2)

This is consistent with the standard NEC approach to risk allocation.

The deductibles under the proposed OCIP are as follows:

Construction/erection "all risks" and completed works and existing structures/compulsory purchased property each and every occurrence	Tunnelling Works Tunnels and related Section 1a Exclusion 1 claims and Maintenance (Section 1a Exclusion 2 claims)	GBP 1,500,000
	Stations, Wet Works and other Section 1a Exclusion 1 claims and Maintenance (Section 1a Exclusion 2) claims	GBP 1,000,000
	All other Works	GBP 250,000
Tunnel boring machines each and every occurrence	Tunnel Boring Machines	10% of adjusted claim minimum GBP 1,500,000
Third party liability each and every occurrence	Loss of or damage to property or Nuisance, other than below,	GBP 75,000
	Vibration, Removal, Weakening of Support	GBP 250,000
	Bodily Injury	NIL

It is considered that, in respect of lower value contracts, it may not present value for money to seek to impose these levels of deductibles on the contractors. It is therefore recommended that, for contracts below £10 million, CRL ought to take a share of the deductible (even where the loss arises as a result of an event at the Contractor's risk) **(Recommendation 3)**. The appropriate share (and how this is specified) ought to be decided on a contract by contract basis, taking into account the value of the contract, but it is recommended that the Contractor's share of the deductible under such contracts should not be greater than 50% of the values set out above **(Recommendation 4)**.

Contractors may price the risk of these deductibles (or their share thereof) and/or may seek to purchase additional insurance to cover their liability for the deductibles. The procurement process will need to define the extent to which CRL can seek visibility of such pricing. In any event, it is recommended that CRL should not pay for the Contractor to purchase additional insurance cover for the deductibles and therefore that any such insurance costs should be a Disallowed Cost **(Recommendation 5)**.

Losses which exceed OCIP limits of cover

The OCIP will contain a number of financial limits on the level of cover under the various types of insurance, both by way of overall limits and inner limits.

The overall limit of cover for all insurance under the OCIP other than third party liability cover is £2 billion in the aggregate. The limit of cover (per claim) for third party liability is yet to be fixed but is envisaged to be £250 million although this cover may be increased at a later stage in the project before the major civils work commences.

In addition to these overall limits, the OCIP will contain a number of inner limits e.g. a limit on tunnelling claims to the greater of 150% of the original construction cost or £30m.

In the event that an occurrence gives rise to losses in excess of any such limit, the contract needs to allocate liability for that excess.

The following options exist:

- Option 1: Pass the risk of any loss arising from an event which is at the Contractor's risk which exceeds the insurance coverage to the Contractor. Under this option, the Contractor may wish to purchase further insurance cover in excess of any OCIP limits which he does not consider to be sufficient. Contractors would probably expect CRL to pay for this additional insurance as Defined Cost.

  This option would conflict with the OCIP approach. CRL has chosen to purchase project-wide insurance for the benefit of all parties and one of the reasons for this is to avoid the cost of individual contractors' policies of insurance.

- Option 2: Pass the risk of any loss which arises from an event which is at the Contractor's risk which exceeds the insurance coverage to the Contractor and provide that the cost of any additional insurance shall be a Disallowed Cost.

  This option would mean that tenderers would instead have to price this risk even though the losses may not actually occur.

- Option 3: CRL retains the risk of any loss which exceeds the insurance coverage whether the loss arises from an event which is at the Contractor's or the Employer's risk.

  This option would mean that CRL would be liable for any losses above the level of insurance even when caused by the Contractor's negligence. Option 3 is the recommended approach **(Recommendation 6)**. It is aligned with the OCIP approach under which the Employer has purchased insurance which it considers to be sufficient for the needs of the project. Under this approach, the Contractor will be liable for the deductible (or an appropriate share thereof) applicable to losses arising from a Contractor's risk. It would not represent value for money to seek to allocate further liability to the Contractor when the level of insurance has been exhausted. CRL will have to pay for any losses which actually occur above limits of insurance but will not be paying either for additional contractor procured insurance or for a risk which may not occur.

It is envisaged that contractors will seek an indemnity from CRL for any losses which they incur in excess of the insurance limits and, in line with the above approach, it is recommended that CRL ought to provide such an indemnity subject to certain qualifications (relating to such matters as vitiating acts by the Contractor) **(Recommendation 7)**.

Uninsured losses and liabilities

Background

Certain liabilities of the Contractor e.g. liability for certain Defects, delay damages and costs paid to others to carry out work when the Contractor has failed to meet a key date, will not be insured at all under the OCIP and are not considered to be insurable losses.

In addition, the OCIP contains a number of specific limitations on the extent of cover e.g. certain consequential financial losses (such as liability for NACHS charges (LUL) and Schedule 8 losses (NR)).

In deciding upon the appropriate risk allocation for such liabilities, CRL needs to seek to incentivise the right behaviours from its contractors. Contractors should retain a sufficient level of liability so as to incentivise good performance but should not be required to retain a level of liability which might give rise to inflated prices and poor value for money or dissuade competent contractors from bidding.

Recommendation

It is recommended that, subject to the recommendations below, such losses should fall to the standard NEC approach to risk allocation, namely, that losses which arise from events at the Contractor's risk should be borne by the Contractor and vice-versa **(Recommendation 8)**.

It is likely that contractors will seek an overall cap on their liability, including their liability for these uninsured losses (especially if insurance costs are disallowed). It is recommended that, in principle, every contract should contain an overall cap applicable to all such losses and liabilities **(Recommendation 9)**.

The working group has considered whether CRL ought to offer a limit in its Invitation to Tender or wait for tenderers to submit proposals. It is considered that tender submissions are unlikely to propose an actual limit and may not therefore help CRL to establish what the appropriate level of liability should be. In addition, without a standard level of liability applying across all tenders, the assessment of tenders becomes difficult. It is therefore recommended that CRL ought to be inviting tenders based on a specified overall cap and specified individual sub-caps on liability which are set by CRL and that the appropriate levels should be determined on a contract by contract basis **(Recommendation 10)**. A further paper will be submitted to the PSG in January 2010 to address the appropriate cap, individual sub-caps and exclusions from the caps on liability under the tunnelling contracts, and to put forward principles for setting such caps and exclusions on following contracts.

3. Third party consequential financial loss

Background

Consequential financial loss incurred by third parties as a result of damage or injury may be covered under the OCIP unless CRL's liability for such loss has been incurred under an agreement and would not have been incurred at law in the absence of that agreement. Consequential financial loss which does not result from damage or injury will not be covered under the OCIP.

This principle will apply in respect of any liability of CRL to Network Rail for compensation paid to train operating companies under the Network Code.

However, the OCIP specifically excludes cover for CRL's liability to LUL and DLR for lost revenue / lost customer hours, irrespective of any damage/injury.

CRL needs to decide the extent to which it should seek to allocate liability for such losses to its contractors.

Recommendation

Where such consequential losses are covered under the OCIP, the usual principles set out above should apply, namely that the Contractor pays the deductible (where the loss is incurred as a result of an event at the Contractor's risk) and any losses in excess of the OCIP cover limits should be borne by CRL.

Where liability for such losses arises in circumstances such that there is no cover under the OCIP, the same approach as for other uninsured losses set out above should be adopted, namely that, where the loss is incurred as a result of an event at the Contractor's risk, the Contractor should be liable. However, it is recommended that this liability ought to be subject to an appropriate sub-cap for each claim which is determined for each contract **(Recommendation 11)**. On C330 (Royal Oak Portal) a cap of £100,000 per claim has been agreed with the contractor.

4. Security

CRL needs to decide upon the appropriate form(s) of security which it wishes to seek from its main contractors.

Parent company guarantee

Background

A parent company guarantee provides protection for the employer through a guarantee that the contract will be properly performed by its subsidiary. If the contractor is in breach of contract then the guarantor must perform in his place. The guarantee runs for the duration of the contractor's liability under the contract and the usual basis of a parent company guarantee is that the guarantor will have no liability greater than that of the contractor. A parent company guarantee will not normally have a cost implication although certain corporate groups do impose charges between group companies. The strength of the guarantee is only as good as the strength of the parent company and generally, therefore, clients will seek guarantees from the ultimate parent so that corporate restructuring cannot remove assets from the guarantor company. A parent company guarantee provides limited or no protection in the event of group insolvency.

Recommendation

It is recommended that CRL ought to continue to seek parent company guarantees from the ultimate parent company of all main contractors and, where the contract is a joint venture, CRL ought to require guarantees from the ultimate parent of each joint venture member **(Recommendation 12)**. It is, however, acknowledged that in certain situations, when requested by the contractor, the guarantee may be accepted from a parent company which is not the ultimate parent in the group and this decision would be made based upon guidance to be developed by CRL Finance and Legal. This guidance will be brought to PSG before the end of January 2010.

Performance bond

Background

Bonds provide protection for the employer against contractor default (breach or insolvency) for the duration of the contract either until Completion or until issue of the Defects Certificate (in which case the value of the bond may reduce in value at Completion).

Bonds guarantee payment by a bank or other financial institution up to a certain amount either upon demand by the employer or in the event the employer suffers loss. Unlike the form of parent company guarantee which has been adopted by CRL, the bond does not guarantee that someone will take over the contractor's obligations. Since it is given by a third party, a bond will provide protection in the event of insolvency of the contractor's group of companies.

Contractors will charge for the provision of a performance bond.

Performance bonds can be:

- Unconditional on demand: The bond may be called by the employer at any time and is not linked to contractor performance;
- Conditional on demand: The employer must follow a certain process in order to call the bond, including the identification of a reason; or
- On default bond: The employer must show that there has been a breach and that loss has been suffered (and may therefore have to go through a disputes process) before it can call on the bond. It can therefore be difficult and time consuming to obtain payment under an on default bond.

OGC guidance is that "unconditional on-demand bonds are essentially unfair and Ministers have said that they should not be used in government procurement".

The ODA requires the cost of a performance bond to be priced separately allowing a decision to be taken as to whether the option should be adopted.

On demand bonds are substantially more expensive than on default bonds.

Recommendation

It is recommended that Invitations to Tender ought to require a separate price for a 10% on default bond and a decision ought to be taken on receipt of tenders as to whether the option for the bond represents value for money taking the following into consideration:

- The identified risks associated with the default of the contractor;
- Whether a parent company guarantee is being provided by a company of sufficient strength such that a bond may not be required in addition (noting the risk of group insolvency); and
- The tendered price for the bond

(Recommendation 13).

Retention

Background

Retention is aimed to provide protection for the employer following Completion in the event of incomplete or defective work. Traditionally, retention has been achieved by withholding a certain percentage from each interim payment. Retention bonds are an alternative to cash retention and have recently become more common. Retention bonds are generally preferred by contractors as they are paid for upfront and do not have the same effect on cashflow.

Recommendation

It is recommended that, if a performance bond is to be obtained then, the contract should give the Contractor the right, after Completion, to substitute the performance bond with a 2.5% retention bond which remains in place until the Defects Certificate **(Recommendation 14)**.

5. Subcontractor collateral warranties

Background

CRL needs to decide upon the extent to which it will require collateral warranties from subcontractors. Such warranties would provide:

- a direct right of recourse against a subcontractor in the event of main contractor insolvency;
- a direct licence from the subcontractor for any intellectual property rights; and
- step-in rights allowing CRL to take on the subcontract directly if the main contract is terminated (whether for main contractor insolvency or any other ground for termination).

Recommendation

It is recommended that CRL ought to seek collateral warranties from subcontractors for key subcontracts where it would be critical to the project to be able to retain the subcontractor in the event that CRL's relationship with the main contractor was lost **(Recommendation 15)**. Any such key subcontract packages for each contract should be ascertained from the main contractor's tender submission and identified in the main contract.

6. Dispute resolution process

All of CRL's procurement contracts which involve "construction operations" will be construction contracts for the purposes of the Housing, Grants, Construction and Regeneration Act 1996. As such, they will be subject to a statutory right for either party to refer disputes to adjudication at any time.

The Project Development Agreement obliges CRL to establish "the Disputes Panel" on or before Review Point 4 and obliges CRL to permit the members to be available to assist the Sponsors to resolve any disputes. The Project Development Agreement does not prescribe the composition or role of the Disputes Panel. Although earlier discussions with the Sponsors envisaged the creation of a standing body in the form of a dispute review board, no commitment has been given by CRL in this regard and it is not thought that the Sponsors have any firm expectations or preferences.

Accordingly, the establishment of a panel of adjudicators in the manner recommended below is considered to be compatible with the Project Development Agreement obligations.

It is recommended that:

(a) CRL establishes a panel of adjudicators with a range of experience and expertise appropriate to the nature of the Crossrail works following consultation with relevant professional bodies **(Recommendation 16)**; and

(b) CRL appoints either the Institution of Civil Engineers or the London Court of International Arbitration as the nominating body in the event of failure to agree the appointment of an adjudicator to hear a dispute **(Recommendation 17)**.

It is proposed to enter into discussions with the Institution of Civil Engineers to explore the establishment of a panel of adjudicators under its auspices, in a similar manner as the Olympic Delivery Authority. The outcome of those discussions, and the details of the proposed panel and terms of appointment, will be the subject of a subsequent paper.

It is normal to provide a mechanism for the avoidance/resolution of disputes before the point of reference to adjudication (even though the statutory right to go straight to adjudication cannot be excluded). Four options may be considered:

(a) a general obligation on both parties to use reasonable endeavours to resolve any dispute which may arise by means of prompt discussions in good faith at a managerial level appropriate to the Dispute (the approach taken by CRL to date);

(b) a structured dispute escalation process identifying increasingly senior managers and executives with time limits for decisions;

(c) a right to go to mediation; and

(d) a dispute avoidance procedure involving external advisers.

The last mentioned approach has been adopted by the Olympic Delivery Authority, which has set up the "Independent Dispute Avoidance Panel". From informal discussions with the Olympic Delivery Authority, it is understood that they have not to date experienced any disputes or had the need to make use of this panel. As this is an innovative approach and as it has not (so far as CRL is aware) been adopted on other projects, there is as yet no available evidence as to its value. Furthermore, it does involve a substantial standing cost.

It is recommended that CRL adopts option (a) above **(Recommendation 18)**. It is considered that this approach provides sufficient flexibility for executives on both sides to discharge their managerial responsibilities for avoiding and resolving disputes. It is always open to the parties to agree on a formal escalation process or to engage a mediator, in the light of the nature of a particular dispute and the circumstances at the relevant time.

The third stage of the dispute resolution process requires a choice to be made between arbitration and litigation in the event that either party wishes to challenge the outcome of an adjudication. It is recommended that CRL provides for disputes to be referable to the courts rather than to an arbitrator **(Recommendation 19)**. This would be consistent with the approach taken by CRL to date and by the Olympic Delivery Authority and the general trend in construction contracts.