

Laying down the law

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All change

In the first of a series of four articles on common areas of dispute and how to avoid them, **Charlotte Heywood** and **Darren Fodey** of Stephenson Harwood LLP provide their tips on dealing with change under franchise agreements

Many readers will be familiar with the change mechanism in franchise agreements and will recognise both the advantages and potential pitfalls associated with the process. In summary, the change mechanism allows the financials set out in the franchise agreement to be opened up and amended if a change event occurs.

Put simply, the mechanism recognises that you cannot possibly pre-contractualise everything that may occur over the life of the franchise and allows for in-contract amendments to be made following a prescribed process, in order to offer certainty to both parties as far as possible.

Although we refer to 'franchise agreements' throughout this article, the points made apply equally to other models based on the DfT franchise model, such as the TfL concessions and also the Grant Agreement in Wales.

Change – how it works

If a change happens then the prescribed process must be followed and the payments due to or from the train operating company (TOC) may then change. The result can work both ways: in favour of either the TOC, or the procuring authority. In simple terms, the process is as follows:

1. A change event as defined occurs and is notified to the procuring authority.
2. The amendments required to the financial and/or operational models that underpin the agreement are then established (either by agreement or by reasonable determination of the procuring authority). These amendments only apply to the 'relevant inputs' to the models, or to the data that is used in those models that is directly affected by the change event.
3. The amendments to the 'relevant inputs' or data within the models are then



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applied, before a run of the models is performed to generate new results.

4. The new results are used to re-state the elements of the periodic payment, which will result in an adjustment to the franchise payment to the extent that the new results are different from the original data.

Potential for disputes

In our experience, the operation of the change mechanism can be the cause of significant disputes. The sums involved can be large, emotions on both sides can be strong and, in certain circumstances, the future viability of the franchise could be at stake. This is particularly relevant given the current challenges being faced by many TOCs, where passenger numbers are not following historic trends for reasons that are unclear.

It starts at the very beginning

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At the negotiation stage, issues often arise that require amendments to the models used for tender purposes, but, understandably, in the pressure to get agreements concluded it is often agreed

that the models will be updated following completion. Such agreements are often verbal, or, if they are recorded in writing, are often done informally or in side letters, or even within the record of assumptions - which does not form part of the concluded franchise agreement.

Such agreements are often not legally binding and are uncertain, which can create significant difficulties. In order to avoid this, ensure that clear wording is included within the franchise agreement confirming which changes are required and when and how such changes will be dealt with.

The definition of what constitutes a change must also be carefully considered at the negotiation stage; if the definition is not met, the process will not be triggered. If the definition is not clearly and specifically drafted, it will likely lead to disputes as to what constitutes a change, and/or result in a TOC finding that circumstances occur which fundamentally change the financial reality of it operating the franchise.

Where possible during the competitive bidding process, particularly where significant future circumstances are anticipated, these should be built in - perhaps with appropriate clarification questions being asked during the bid process to seek answers on how those circumstances will be addressed.

In-life management

Franchise agreements are lengthy and complex documents. However, it is crucial that all those who deal with administering them are familiar with the definition of change and the details of the change mechanism, which often varies between franchises.

The first question, when a possible relevant event occurs, is to determine whether it is a change as defined. This is usually a lengthy definition that covers numerous events - with a number of individual components - and is not limited to obvious variations to the agreement.

Not all changes will result in adjustments to the franchise payments; only 'qualifying changes' do. These are changes which automatically qualify as such, or ones whose financial impact is greater than a certain threshold. The TOC bears the financial impact up to this threshold in any year, although changes below the relevant threshold can be aggregated together within that year in determining whether the threshold is met.

Give notice

A common issue is a failure to give proper notice of change events, particularly those that the TOC does not expect to be qualifying changes, perhaps because it is below the threshold, or the impact is not yet clear.

If a TOC considers that a change will be a qualifying change, then it must give notice to the procuring authority stating this

and confirming that it requires the change process to be engaged. The timing of the notice is critical as it must usually be given within six months of the TOC becoming aware of the change and a failure to do so could result in the TOC losing its right to an amendment to the franchise payments. Giving notice promptly is therefore essential.

Failure to give notice in the format required can result in disputes. Notice must be given to the right party, to the right address, and in the correct format, each of which are prescribed by the franchise agreement. While this sounds obvious, these are long term agreements and as the parties become familiar with each other they understandably tend to develop usual practices; for example, sending correspondence by email rather than by hard copy letter. This will typically not cause any issue until such time as a dispute occurs and the other party takes the point that the contract has not been properly complied with. When dealing with change, it is important not to fall into the trap of relying on usual practice and to ensure that all procedural requirements are followed, particularly if the franchise agreement contains a 'no waiver' clause.

Another common mistake relates to changes with a financial value less than the relevant threshold (so not yet Qualifying Changes but could be aggregated together to become one). It is still important to follow the contractual process for notifying these, even if the modelling process will not be triggered, to ensure that the change has been properly notified and can then be aggregated in due course if needed.

Other impacts of change

It is important to consider whether or not a change will also have an impact on the TOC's ability to meet other requirements set out in the contract, such as standards of performance like cancellations and capacity requirements - as these can often be overlooked.

Notice will usually have to be given as soon as reasonably practicable and before the revised inputs to the model have been agreed or determined. Generally, the TOC's risk of failing to meet one of the performance requirements should be 'held constant' (i.e. it should remain the same following the change).

If the effect of a change means it is more difficult to meet a performance requirement, the requirement should be relaxed, and vice versa. Again, the changes to the relevant standards of performance required as a result of a change are to be made either by agreement, or by the reasonable determination of the procuring authority.

The process

The process of dealing with the impact of a change can be lengthy and the parties often work collaboratively for extended

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periods to try to understand and agree the amendments required to the relevant models and the revised inputs. As part of this process, the TOC will often perform numerous test runs of those models, or of bespoke side models that have been created to assist with the process.

This can, however, lead to disputes as to the status of the particular documents,

models and results. It is, therefore, critical to clearly agree – in writing – whether particular documents and actions are being performed as part of the change mechanism or not. This will avoid situations where, for example, a particular side model produces an unsatisfactory result that is then said to be binding. It must be clear when any ‘revised inputs’ and/or amendments to the models have been agreed and when the ‘Run of the Financial Model’ is actually being carried out.

Given that the process can be time consuming, it is worth remembering that the franchise agreement usually includes a mechanism for interim adjustments to the periodic payments, pending the outcome of the change process. The requirement is for the procuring authority to make estimated revisions, acting reasonably and with regard to the information available to it at the time. In our experience, this is often overlooked or not used, which can have an adverse impact on cash flow.

Disputes can often arise as a result of the procuring authority exercising its power to ‘reasonably determine’. Such determinations are binding, unless it is agreed or is found to have been unreasonable. In such circumstances, the TOC will need to refer the dispute to the relevant dispute

resolution process and will need to be able to clearly demonstrate on what basis the procuring authority’s determination was unreasonable and why the TOC’s alternative is reasonable.

Top tips for avoiding disputes

In summary, our top tips in connection with the change process are:

- Think about change and how it will be dealt with during the negotiation process and, in particular, make sure that any agreements to amend the models are included in the franchise agreement, and are specific and legally binding.
- When a change occurs, ensure the process is properly followed, including the giving of notices.
- When dealing with the impact of a change, do everything in writing, making very clear the status of particular documents or adjustments. While we cannot guarantee that this will avoid disputes from arising, it should make the position clearer and any dispute easier to resolve.

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