Legal Aspects of Procurement and Power Projects

USAID-Funded Economic Governance II Project

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Procurement in Context

What do we Mean by Procurement; its Importance

- Refers to the purchase of plant, equipment, materials and services, and construction of works, i.e. contracts – particularly today, infrastructure contracts:
  
  “Procurement” defined: a process of identifying a need, specifying the requirements to fulfil that need, identifying potential suppliers, soliciting bids and proposals, evaluating bids and proposals, awarding contracts or purchase orders, tracking progress and ensuring compliance, taking delivery, inspecting and inventorying the deliverable, and paying the supplier.

- “Procurement” is most often used within governmental organizations. More specific terms are "purchasing" and "acquisition".
Procurement in Context

What do we mean by Procurement; its Importance (Cont.)

- Legal aspects: negotiating and writing contracts, advising on important clauses, project management, advising on and assisting in resolution of disputes - important team member

- Iraq Ministries will enter into significant procurement contracts:
  - Especially the MoE, as purchaser
  - Construction and rehabilitation of works
  - Purchase of plant, materials, services

- International vendors familiar with international legal standard contracts
Procurement in Context

Donor Funded and Privately Financed (or Partly-financed) Projects

- Will be a mix of these
- Initially, likely to be donor funding however:
  - MoE responsible for carrying out the project, including award of contracts
  - Loan agreement will govern rights and obligations of the MoE and the provider of the loan or credit
  - Procurement/tender contracts will govern rights of MoE and vendors
- But the Loan Agreement will stipulate the form of these contracts and method of contracting:
  - Iraqi lawyers, procurement advisors and project managers need to understand procurement method and legal issues/terms involved
Private participation in infrastructure contracts will mean greater complexity – because all parties share the risks of the project:

- Many different parties with competing interests
- Many contracts – complex matrix
- Each party depends on performance of all parties
- Each risk must be identified and its impact assessed, and that risk assigned to the party that can most effectively control it
- Therefore, much negotiation and drafting
Procurement in Context

Role of MoE Personnel

- Negotiating and drafting contracts and clauses
- Planning and project management
- Monitoring and performance
- Finance
- Contract issues and disputes, eg. delays
Effective Negotiations

“Avoid ineffective conflicts”

Requires that you

- Think strategically and act tactically; and
- Act professionally; and
- Be diplomatic and flexible

Basic Rules: Make the Subject Matter Clear

- Prepare your materials in advance – be, and appear to be, professional
- Define the purpose and key terms of negotiation – structure the subject matter
Effective Negotiations

Basic Rules: Make the Subject Matter Clear (Cont.)

- Know what you want and what they want – communication is important:
  - Ask questions, understand the other side and ensure they understand you
  - Summarise and agree what’s been discussed at points during the meeting

- Distinguish between people and substantive issues:
  - Be flexible – adapt style/approach if it helps the situation
  - Don’t be afraid to ask/seek explanation if you need to
  - Become the teacher if other side inexperienced
Effective Negotiations

Basic Rules: Understand Different Phases Negotiations go Through
- Generally 4 Phases:
  - Opening/non task-sounding
  - Exploration/task-related exchange of information
  - Bidding/negotiating/concessions
  - Settlement/non-settlement

Basic Rules: Control the Development of Negotiations
  - Use agenda and timetables – focuses attention
  - Take breaks; don’t be bullied into all night negotiations – not effective
  - If aware of a strategy being used ("good guy/bad guy" routine) – tell them
Effective Negotiations

Basic Rules: Control the Development of Negotiations

- Widen the areas of negotiation – avoid getting stuck on single issues:
  - Add areas where you can give something; or
  - You sense you can gain something from them

- Choose the right time to say “No” – if 5 issues and one is critical to you, agree on the 4 first

- Be consistent:
  - In disclosing information
  - In arguments
  - Otherwise you will not gain trust and respect of other side
Effective Negotiations

Basic Rules: Positive Tactics

- Breaks or recesses – chance for internal discussions
- Delegation of subject matter upwards – negotiation on a higher level
  - But caution: limit the times you do this
- Third party’s assistance as negotiator or arbitrator/mediator:
  - Provides neutral, fresh approach to tough situation
  - Can provide new momentum
  - Can perform a face-saving function
Effective Negotiations

Basic Rules: Negative Tactics

- Tricks and fairness

- What is my BATNA (Best Alternative To a Negotiated Agreement)?
  - Would my interests be better served by dealing with other parties or focusing on other possible outcomes?

- How should I react if the other party with whom I have to negotiate threatens me or my company? What kinds of threats might they raise?
  - If you think about these issues before negotiation starts, you will be far better prepared for whatever they might throw at you
Effective Negotiations

Basic Rules: Negative Tactics (Cont.)

- What if their offer or proposal is seriously off the mark or inappropriate?
  - Don't explode; play it with a poker face, stay silent
- Keep asking yourself, "What is the point of this interchange?" Why is the party with whom you're negotiating saying or doing something particular?
- Never – ever – say something contrary to your interest
- Bullies are afraid of failure – tell them, "I'm afraid we may fail to reach agreement"
International Negotiations

National Characteristics Play Important Part in International Arena

- Give consideration to this fact and adapt style accordingly
- But do not become subservient to counterpart’s foreign culture
- But understand and respect their culture
- While keeping your own courtesies

Negotiating with People from the USA

- Do not consider an impersonal – “time is money” – approach as impolite
- Or an informal approach to be sheer friendliness – rather, their usual way
- Will be:
  - Technically well-prepared; and
  - Will look for pragmatic solutions
International Negotiations

Negotiating with People from the USA (Cont.)

- Professionalism very important to Americans:
  - Thorough preparation
  - Well-structured agenda
  - Leading negotiations in pragmatic, serious way
- Achieving results more important than building a good or long lasting relationships
- Once contract concluded, US partner will regard it as binding and lasting
- Avoid making US partner lose face
International Negotiations

Negotiating with People from the UK and Western Europe

- Climate and personal relationship less important than achieving the result
- Serious attitude and professionalism and preparation very similar to the US
- Also avoid making partner lose face

For both US and UK, Western Europe Negotiations, Consider

- The organization you are dealing with
- The specific industry or service-sector of your partner
- Their competence
- Their personality (their needs and constraints)
International Negotiations

Negotiating with People from Japan

- Japanese believe negotiations require much time and planning – reserve extra time
- Climate is important – relationships and long-term considerations as important as the results
- Preparation is meticulous – will want details of every area
- Japanese refrain from saying “No”. Will either:
  - Circumscribe; or
  - Answer in both the affirmative and negative
- If circumstances change, will feel free to renegotiate and change the agreement (or part of it)
- Avoid making your partner lose face
International Negotiations

How Negotiations in Arab World are Perceived

- Very hospitable and favourably disposed towards their partners
- Climate of and communications during negotiations very important – decisions often based on personal impressions supplemented by facts
- Sometimes not available because of observance of religious and cultural customs
  - Very important to respect them
- Reserve extra time
- Dealings are sociable and enjoyable
- Difficulties in saying “No” – anxious to avoid loss of face on either side
- Oral agreement signals commitment, but if circumstances change, will believe renegotiation or modification is necessary
International Negotiations

My Personal Perceptions of Iraq

- Very hospitable and favourably disposed – welcoming of their partners
  - Dealings are pleasant and sociable
- Personal relationships very important – signs of bad faith, impatience or disrespect reflect badly, are not easily dismissed or forgiven
- But there can be many interruptions or delays – other business conducted at same time
- Extremely modest about their own present difficulties and personal dangers faced
  - Very brave people who do not complain
- Observance of holidays can be difficult for foreigner:
  - We may not be aware of them
  - Sometimes on short notice
International Negotiations

My Personal Perceptions of Iraq (Cont.)

- Strict hierarchy of authority that is sometimes not made clear – leads to difficulties in
  - Decisions being made: restrictions on authority and/or delays in what we may believe are administrative decisions
  - Objectives or circumstances being changed by senior figures not involved in meetings
  - Difficulties in saying “No”; while we are able to with ease, perhaps too easily
  - Information being shared

- Extra time usually needed

- Training is often needed, but Iraqis are very quick to learn
International Negotiations

Major Mistakes in International Negotiations

- Not enough understanding/knowledge of differences in:
  - Ways of thinking
  - Origins, history, culture
  - Government and political processes
  - Status of individuals and customs of business

- Insufficient attention to the need to save face – the need to:
  - Keep cool under pressure; and
  - Refrain from showing anger, losing composure or even showing respect
International Negotiations

Major Mistakes in International Negotiations (Cont.)

- Insufficient recognition of decision-making process
  - Includes lack of attention to internal communications and procedures
- Insufficient understanding of the role of personal relations and personalities
- Not allocating sufficient time for negotiations
  - Allow time for getting to know other side, sharing experiences and accepting hospitality;
  - Plan for delays you may expect to happen
- Lack of experience with, or thought given to, using interpreter
International Negotiations

Suggestions in Using Interpreter

- Brief the interpreter ahead of time
- Speak loudly, clearly and – above all – slowly
- Avoid slang or little known phrases
- Explain major concepts in several different ways
- Exercise patience and allow note taking – allow time to clarify
- Think about possible areas of misunderstanding
- Be pleasant and have frequent breaks
Project Management

Why Projects Succeed

- Organization structure suited to the project and team
- Team participates in forward planning
- Project manager committed to established schedules and budgets
- Project manager committed to performance goals
- Absence of bureaucracy
- Clearly established success criteria
- Effective status and progress reporting
Project Management

Why Projects Fail

- Project manager has inadequate or insufficient authority
- Lack of project planning – generally or as a team
- Insufficient involvement of project team in problem solving
- Improper structuring and use of status and progress reports
  - Or ineffective reports generated
- Lack of:
  - Management skills
  - Technical skills
  - Administrative skills
- Unrealistic project goals and/or schedules
Teamwork – Some Suggestions

- Limit number of participants
- Appoint one member to control time and procedures
- Define precisely each individual member’s role
  - Engineering and/or technical
  - Finance
  - Legal
  - Administrative
- Support your team and present united picture
  - Body language, gestures during negotiations
Overview – Traditional Approach to infrastructure Projects

- Public infrastructure projects – ie. for the MoE, power plant construction (can be water, oil and gas facilities)
- Employ a particular form of structured or project financing to build projects
- Very different from traditional approach of utilities in financing and constructing major facilities – where the MoE would assume all risks of the plant itself, ie:
  - Contract with a construction company to build, but
  - Would itself maintain and operate the facility
  - Purchase or supply fuel without a facility-specific contract
  - Receive output and sell energy/capacity in normal course, without specific off-take (power purchase) contracts
- Thus, with traditional approach, MoE finances the plant and therefore takes all risks
Overview – Traditional Approach to infrastructure Projects (Cont.)

- All projects face risks: What if:
  - Demand for power suddenly drops, because a major industry fails or economic conditions worsen?
  - Fuel source suddenly ceases to be available in sufficient quantities, either supply quantity or delivery failure? The price of fuel is increased?
  - Transmission lines fail? Local distribution company has a network failure?
  - Turbines do not perform to specification, because of inherent design fault or operator does not perform routine or major maintenance?
  - Major catastrophe occurs, either natural disaster or terrorist or insurgent activity?
  - Government changes environmental laws, eg. regarding emissions
Overview – Traditional Approach to infrastructure Projects (Cont.)

- All these risks affecting the project’s performance lie with the utility
- Utilities around the world decided not to accept these risks – prefer to have major investments “off balance sheet”

Overview – Structured/Project Finance Approach

- With forms of structured or project financing (BOO, BOT and BOOT transactions)
  - Financiers provide the funding but look to the project earnings for loan repayments, not the sponsors (or the utility)
  - Credit assessment based on the project, not creditworthiness of borrower
  - Security is taken by financiers over project assets – limited or no “recourse” against borrower
Overview – Structured/Project Finance Approach (Cont.)

- Means that the banks must be completely satisfied with all aspects of the project
  - Secure, firm obligations to provide long term fuel supply
  - Construction standards, turbine performance covered by warranties
  - Capabilities and standards of performance of O&M contractor
  - Secure, long term, firm off-take agreement – ie. purchaser of output accepts market risk itself (ability to sell power at sufficient price)
  - Secure, long term delivery contracts (transmission, distribution)

- Means extra discipline must be exercised in concluding contracts – much more complex

- Lead time can be lengthy; significant up-front costs
Power Projects – Introduction to Structured Finance

All Parties Share Risks of Project, not just the MoE or Sponsor or JV.

- Requires that complex issues be resolved:
  - Many parties involved
  - Correspondingly significant number of interlocking contracts
  - Each party depends on performance of all parties, not just its counterpart

- Each risk must be identified – what are the risks?

- Likelihood of each risk occurring must be assessed – how likely?

- The impact on the project of the risk occurring determined – what impact?

- For each risk to be assumed (or layed off, eg. through insurance) by the party that can most effectively control it – which party takes the risk?
All Parties Share Risks of Project, not just the MoE or Sponsor or JV.

- Each party must then be satisfied with:
  - the risk allocation
  - the creditworthiness of the risk assumer; and
  - the reward flowing to the risk assumer
Confidentiality Agreements and Heads of Agreement

Confidentiality agreements

- Fairly standard agreements, but there are issues to note
- Review them carefully
- Proving loss v. liquidated damages
- Return of information

Negotiation agreements: lock-out clauses

- Do you want to commit?

HoA: key issue – binding or non-binding?

- Description of parties’ intentions or contractually obligating you?
The Parties and Contracts

Government Corporation or Agency

- Ministry of Electricity, through a project company, or government corporation will:
  - Initiate the project
  - Conduct the tendering process and evaluation of tenderers
  - Grant to the sponsor the "concession" – right to build, own and operate the facility

- Government agency or company therefore must have powers to:
  - Enter contracts with other parties for the performance of the MoE’s functions – construction and operation of the project
  - Make payments under the contracts – purchase output or “service” that will be provided by the facility
  - Grant long term lease of, or sell, the site to sponsor
  - Provide necessary approvals, authorizations and consents for construction
The Parties and Contracts

Government Corporation or Agency (Cont.)

- Legal Issues
  - Legislation and regulations under which the authority is constituted must be scrutinized
  - Does the corporation or agency have the necessary powers to enter contracts and perform other obligations?
  - If not, actions will be ultra vires (beyond authority)

- Guarantees and Comfort
  - Where a corporation or agency enters into project contracts, government’s assistance to the project may also be required in form of undertakings or guarantees
  - Assurance that project company will be in a position to honour its financial obligations
The Parties and Contracts

Sponsor

- Usually a consortium of interested corporations
- Typically include a construction company, an operator, financing institution, and others
- Prepares the proposal to construct, operate and finance the project in response to the invitation from the government
- Sponsor may be a company, partnership or an unincorporated joint venture
- Investors in the sponsor are “equity investors” – provide non-loan capital, usually up to around 20% of total project costs
- Equity providers look for high returns – up to 20%-25% - as compensation for assuming major risks inherent in such a project
The Parties and Contracts

Construction Contractor

- Often one of sponsors
- Will take significant risks, because government often dictates general design of the infrastructure
- Will be required to provide completion guarantee, meaning construction contractor takes:
  - Construction risk (on time, within budget and to specifications); and
  - Commissioning risk (depending on the nature of the infrastructure)
- Lenders will require balance sheet of sufficient size and strength with access to capital giving real substance to completion guarantee
- Competing interests: Sponsor will seek a fixed price and time contract; contractor will require price and time variations to remedy cost increases or delays outside its control
The Parties and Contracts

Operations and Maintenance Contractor

- Will usually enter long term contract with sponsor
- May also inject equity into project
- O&M contractors accept little risk in the form of up-front capital or costs – simply seek to make profit from operating infrastructure more efficiently than government-run project

Financiers

- Syndicate of banks usually provides debt funding to sponsor – will require:
  - First security over the infrastructure created (mortgage over land and infrastructure fixtures and plant)
  - Security over all project contracts
The Parties and Contracts

Financiers (Cont.)

- Rights to “step in” in event of default
- Will perform complete review of all project contracts to assess the allocation of risks and how that allocation impacts their credit approval

Other Parties

- Fuel supplier
- Insurers
- Plant and equipment suppliers
- Engineering and design consultants
- Other consultants
- All will involve their lawyers, finance and tax advisors
The Parties and Contracts

Off-take Agreement (Power Purchase)

- Key document in infrastructure project – contract between government agency/company and sponsor under which government agrees to purchase output from the power plant at agreed prices and volume

- Viability of project – “bankability” – depends on:
  - Reliability of the cashflows under off-take agreement; and
  - Each party performing its respective obligations

- Performance standards: warranties given by sponsor very critical element – deal with:
  - Quantity of output from project
  - Quality of output from project
  - Timing within which output is required by government
The Parties and Contracts

Off-take Agreement (Power Purchase) (Cont.)

- Consequences of failure to meet performance standards also dealt with:
  - Liquidated damages; or
  - Right to call an event of default

- Tariff structure: sponsor’s objective in negotiating agreement will be to minimize its market risk. Will do this usually by structuring cashflow in two parts:
  - Availability fee: payable by government in return for sponsor making plant available, irrespective of actual output; designed to cover sponsor’s fixed costs; and
  - Usage fee: regulates price per unit the government will pay for actual amount of output; will cover any balance of fixed costs and variable costs

- Other models, such as “cost of service”
The Parties and Contracts

Off-take Agreement (Power Purchase) (Cont.)

- Tariff negotiations will reflect:
  - Desire of sponsor to minimise its market risk; and
  - Government’s desire to shift market risk to private sector

- Effect of default on tariff – competing interests:
  - Government will want to reduce tariff if sponsor is in default;
  - Sponsor will resist, because this will affect cashflows, and therefore ability to meet bank debt repayments; sponsors prefer liquidated damages

- Tariff negotiations will also cover escalation (increases) in tariff. Base will be agreed, but:
  - Must be indexed in accordance with agreed formula to ensure it stays in line with possible cost movements over project life; and
Off-take Agreement (Power Purchase) (Cont.)

- Adjusted to cover cost of unforeseen circumstances occurring, such as new law or regulation that raises operating costs (e.g. environmental or employment matters) or new tax that reduces return on investment

- Sponsor wants upward, government will want downward, movement

- Heavily negotiated

- Financiers, too, will want a right to increase their costs charged to sponsor under banking agreements, to meet increases it may incur – will need to flow through to the tariff
The Parties and Contracts

Construction Contract

- Favoured form of contract is turnkey design and construct fixed price contract
- *Force majeure* delays; costs of any delays are always significant
- General comments on *force majeure*
  - *Force majeure* literally means “greater force” or “superior force”
  - Clause excuses a party from liability if some unforeseen event beyond the control of that party prevents it from performing obligations under the contract
  - Typically, *force majeure* clauses cover natural disasters or other "Acts of God", war, or failure of third parties – eg. suppliers and subcontractors – to perform their obligations to the contracting party
  - Only intended to excuse a party if the failure to perform could not be avoided by the exercise of due, or reasonable, care by that party
  - When negotiating *force majeure* clauses, make sure the clause applies equally to all parties
The Parties and Contracts

Construction Contract (Cont.)

- Risk of delays in large construction projects – *force majeure* delays:
  - Usually contractor would receive extension of time (the government would take this risk) but no extra payment
  - But depends: negotiated Contract Sum will have built into it a margin for no-fault delays (but this margin must then be built into off-take agreement)

- Where delay is caused by sponsor, more difficult – allocated differently under structured finance projects as against traditional projects:
  - Contractor would usually receive extension of time and extra money (delay costs); *but* in BOT or BOOT transaction
    - Sponsor is not in position to make any extra payment; and
    - Government will refuse to accept delays or to pay delay costs; and
    - Financiers very unlikely to accept risk of extra payment by sponsor
The Parties and Contracts

Construction Contract (Cont.)

- Result? Contractor may be left without remedy where sponsor in default
  - Solution is to “back-to-back” sponsor’s obligations under construction contract into the off-take agreement, but this is very difficult
  - One example of complexity
  - Often financing does not become non-recourse until construction complete and successful commissioning of power plant has been achieved

- Underperformance – a failure to deliver, in accordance with the construction contract, a power generating plant that either:
  - Produces the specified (contracted) output; or
  - Is available to the contracted extent
The Parties and Contracts

Construction Contract (Cont.)

- Again, position is different with BOT or BOOT transactions:
  - Traditional construction contract – contractor simply pays damages to owner to compensate for level of underperformance
  - BOT structure – many different and significant consequences:
    - Government relying on plant to meet country’s electricity demand (structured its capital expenditure program on successful completion); any relief under off-take contract will not compensate;
    - Financiers’ security is diminished;
    - O&M contractor has to operate and maintain under-performing plant for long period; return is diminished
  - Loss may be too large for contractor to bear – so may end up with the government or financiers (assuming sponsor has limited resources)
The Parties and Contracts

Construction Contract (Cont.)

- What if underperformance is the fault of sponsor? Eg. fuel supplied to plant is below specification – contractor not responsible
  - Fuel supplier is liable (it will have accepted that risk)
  - Conclusion: sponsor must back-to-back its obligations under construction contract with its remedies under fuel supply contract and off-take agreement

Default: Termination and Step In Rights

- Fundamental contractual right of government and financiers in BOT projects
- If sponsor is in default under off-take or financing agreements, government and financiers must have right to “step in”
  - Take over obligations of sponsor under construction contract and O&M contract
The Parties and Contracts

Default: Termination and Step In Rights (Cont.)

- Such right always dependent on first curing any payment defaults of sponsor
- Construction contractor and O&M contractor should therefore have no concerns
  - Failure of government or financiers to cure would mean contractors have right to terminate and walk away

Default, Remedies, Termination

- Interdependency of contracts: default under one contract will trigger default under others
  - Are each parties’ obligations reasonable?
  - Are defaults dealt with consistently?
The Parties and Contracts

Default, Remedies, Termination (Cont.)

- Mismatching of risks can be disastrous: all parties must perform thorough review of all documents and the allocation of risks under them

Long Term Contracts

- Nature of infrastructure projects – contracts last 15 or more years
- Impossible to foresee events that might occur that may effect parties’ obligations, and not easy to cover by contract
  - Legal concepts of *force majeure*, frustration, implied terms, fundamental breach may not help long term contracts once in operational phase
  - How do Iraqi courts view these concepts?
Dispute Resolution

International Arbitration

- Likely that international investors and donors will demand international arbitration of contract disputes
- Private international business dispute resolution through arbitration a very important practical development since WWII
- Advantages:
  - Confidential
  - Qualified arbitrators
  - Quicker, less adversarial and less expensive than court proceedings
  - More likely to be recognised and enforced in Iraq than foreign judgment
Dispute Resolution

International Arbitration (Cont.)

- Arbitration much further developed than conciliation – much more significant body of rules

- Main arbitration proceedings and venues:
  - ICC (International Chamber of Commerce) headquartered in Paris – ICC International Court of Arbitration founded in 1923
  - London Court of International Arbitration, founded in the City in 1891
  - American Arbitration Association, operating since 1930
  - Arbitration Centre of the Official Franco-German Chamber of Commerce and Industry
  - Court of Arbitration of the Zurich Chamber of Commerce
  - UNCITRAL Arbitration Rules (United Nations Commission on International Trade Law), established in 1966 – in respect of international trade disputes