

BUILDING A MODEL OF A SUPPLY CONTRACT ADAPTED TO THE NEEDS OF A CONSORTIUM OF PURCHASERS

Francis Charpentier, Yves Ruggeri, Cynthia Perret, Joël Saltsman, (France Telecom Orange), Al Brown, Vito Pavone (AT&T), Nikki Shone (Southern Cross), Dieter Sieber (DT AG), Seng Keat Ooi (Singtel), John Horne (SubOptic EC)

Email: francis.charpentier@orange.com

France Telecom Orange, International Backbone Network Factory, 61 rue des Archives 75003 PARIS FRANCE

Abstract: This paper discusses the use of contract models for the construction of submarine cable systems and underlines the difficulty of building an ideally balanced model contract. A first model contract was published at the Suboptic 2010 conference but it was not adapted to the case of a consortium of purchasers and moreover, consortium parties felt it tended to reflect a supplier's viewpoint, in spite of the use of commentaries to balance such a view. A working group of consortium parties therefore decided to build a new consortium model contract with the goal of publishing it as a second model. This paper introduces this second model and summarises the main issues for which negotiations usually take place between suppliers and consortia.

1. INTRODUCTION

A model contract was developed for the Construction of a Submarine Cable system by a group of stakeholders of the industry for the last SubOptic conference in 2010 [1]. Although it is designed for a full cable construction project, the model can also be applied to cable upgrades. In fact, many upgrades are implemented contractually as contract variations (CVs) of construction contracts.

But what is a model contract anyway? Model contracts are frequent in business life. Companies use model contracts for their daily business to standardize their relationship with their customers and to speed up the process of signing deals. An example is the sale of a mobile phone subscription. Even individuals may want to use model contracts, for example a person owning a house who wishes to rent it out

will often use a publicly available model of a rental agreement.

Model contracts can be initiated by sellers or buyers. They should provide ready-to-sign text with only a small number of blanks to fill in. People ideally want model contracts to be approved by legal experts, or at least, they want some evidence that contract clauses are properly written and will protect their interests. A contract can be compared to software (with definitions of variables, executable instructions, and comments) to be interpreted by parties for the duration of the deal, and in case of dispute, by the Court. Undoubtedly contract users want contracts to be as reliable as well tested software.

Do model contracts make sense for large projects like submarine cable construction projects? Indeed they do, they save a lot of time, building a contract from scratch is a huge effort. Such model contracts will

now incorporate a large number of blank spaces to fill in specific information, such as price, amounts, quantities, dates, durations, and any other figures or optional fields as may be needed. How to fill in those blanks provides the first obvious area for negotiations.

In fact, consortia of telecom operators have been using models of supply contracts already for some time.

They usually package the contract model into an Invitation To Tender (ITT) sent to a number of competing suppliers, with two essential parts:

- the General Terms and Conditions (the actual contract language proposed for the contract)
- the Technical Specifications (in fact can be seen as the Technical terms and conditions)

Consortia expect the respondents to comply with both the general terms and technical terms.

The negotiation then takes place between the parties, the key elements of the negotiation being threefold: the price, the technical compliance (technical quality), and the compliance with the general contractual terms. Consortia pay a great deal of attention to the contractual terms. They usually maintain for the duration of the negotiation a detailed, clause by clause, list of all compliances or changes accepted. This enables them to keep track of the concessions made by either side of the negotiation.

The contract as finally signed is derived from the terms and conditions proposed in the ITT, but they are often changed as the result of prolonged and tough negotiations.

2. THE FIRST MODEL CONTRACT (SUBOPTIC 2010)

The ITT model contracts are generally very large and detailed templates of about 60 pages (for the general terms and conditions only) and the wording is sometimes verbose and redundant. The working group that produced the 2010 model contract had the following goals:

- simplify the language;
- produce a balanced document accommodating the purchasers' and suppliers' point of view.

General rules adopted for writing the contract model were to avoid:

- repeating clauses;
- introducing clauses that rephrase legal obligations;
- agreements to agree;
- including values that may form part of a negotiation between parties (e.g. duration of warranty, liquidated damages); therefore blank spaces were inserted in the model instead of specifying such values;
- duplicating technical specifications in the general terms.

The result was a text with elegant crisp language and only 30 pages in length. The structure was the following:

- contract language to serve as the actual model;
- guidelines or commentaries to most of the clauses, to explain how the contract language may typically be negotiated and modified by the parties.

The 2010 working group was led by suppliers and although the feedback from purchasers had been requested, the contract language tended to reflect the view of suppliers with the commentaries acting to balance the overall view.

Of course, it was understandable that the suppliers wanted to publish their own model contract to counterbalance the one they typically have had to respond to in the ITTs.

While in the past ITT models were only provided in a confidential manner, the new and novel approach of the 2010 working group was to publish the contract model, in an open source manner, just like the model contracts published for individuals wishing to rent a house.

3. CAN A MODEL CONTRACT BE BALANCED ?

The working group did consider whether it might make sense to try and produce an ideally balanced model contract, in the sense of a model half-way between the 2010 model favourable to suppliers and an ITT model favourable to purchasers. We asked ourselves if it would be possible to achieve this goal and how long it would take.

The existence of an ideal model contract would mean the important elements of the negotiation would have to be predetermined. This exercise would necessitate conducting a real negotiation on a virtual project between a group of suppliers and a group of purchasers. In a real life negotiation, the need to conclude a deal induces both sides to make concessions during the negotiation, the consortium wanting to launch the project as soon as possible, and the supplier wishing to make a sale and secure future revenue. But in a virtual negotiation exercise, no matter how serious the involvement of participants may be, there is no business pressure to ensure disagreements are resolved, and such an exercise is unlikely to result in an agreed template.



Moreover, parties do not really value a medium point in contract language. Each side has its own preferred model as the starting point, and wants to make as few concessions as they can during the negotiation. Thus it is more valuable for each side to have a view of the starting point of the other side.

These considerations led the 2013 consortium working group to develop a model with contract language reflecting their usual positions, while borrowing the following principles from the 2010 working group:

- introduce an extensive commentary field (the Guidelines) to provide a balanced view and understanding;
- improve language, remove redundant clauses, simplify;
- make the model publicly available through SubOptic.

4. SPECIFICITIES OF CONSORTIA OF PURCHASERS

The 2010 Model assumed a single purchaser and a single supplier. The Consortium model takes into account multiple purchasers forming a consortium, which is very common given the cost of submarine cable projects. The model also takes into account the multi-supplier case which may occur in large multi-segment systems. In such a case, purchasers want a main contractor and they require from him the guarantee of overall system interoperability.

The multiple purchasing parties configuration has important structural and contractual implications.

Structurally, a Central Billing Party (CBP) is created to simplify the financial administration of the consortium: all billing between the supplier and the parties is to take place between the supplier and the CBP. Both sides utilise this mechanism because it centralises bill processing in the hands of a single entity, saves time and reduces the risk of errors.

Contractually, it is necessary to set out the payment obligations of the purchasers with respect to the supplier. The purchasers, who are often competitors in their daily business, will never agree to being jointly and severally liable, which would be the ideal situation for the supplier. And this leads to the first fundamental difficulty in the negotiations. What happens if one purchaser does not meet its payment obligations? [2]

In such a case, consortia require the supplier to take action to recover the debt, including late interest charges, from the defaulting purchaser directly, without impact on other purchasers.

The supplier has various ways to alleviate the risk of not being paid including:

- requesting the right to suspend the work, and also the right to terminate;
- requesting payment guarantees from the purchasers which the supplier rates as financially vulnerable. Typical tools for payment guarantees are bank letters of credit;
- taking a stake in the system, thus becoming a member of the consortium, the ultimate goal being to resell its stake to a new incoming party. This boils down to vendor financing.

5. OTHER IMPORTANT AREAS OF NEGOTIATION

Negotiations are traditionally lengthy. There are a lot of relatively small technicalities that often provide cause for serious negotiation, but in the following, we focus on key areas of negotiation.

Financial guarantees in favour of Purchasers

Transfer of property occurs at the end of the project, at the Provisional Acceptance (PA). However the purchasers make regular payments to the suppliers throughout the project. Moreover, they will have paid most of the contract value before the PA, without any property having transferred yet. It is now the purchasers' turn to want financial protection against the risk of the supplier delivering a faulty system. The tools here again are financial guarantees. The basic contractual mechanism is the Guarantee Against Payment (GAP), meaning that for every Billing Milestone (BM) paid by the consortium, the supplier provides a financial guarantee for the same amount. The purchasers can use this guarantee

where there is evidence the system delivered does not meet the specifications.

In some contracts the GAP mechanism is applied only to the initial down payment, it is then called a Letter of Performance Guarantee, or a “Performance Bond”. A Performance Bond can be extended to cover the warranty period as a “Warranty Bond.”

Thus, the interplay of payment guarantees between suppliers and purchasers may end up with a paradoxical situation: the purchasers provide payment guarantees to the supplier to ensure they will pay the BMs, and the supplier provides financial guarantees the purchasers to ensure they can recover the BMs in case of a total project failure.

Warranty and Final Acceptance

Purchasers are very concerned with the warranty of the system they purchase, more particularly regarding the wet plant. The reliability of wet plant components, especially repeaters, has become a major concern for new projects.

Warranty of submarine systems is also a paradoxical area: the system is typically warranted both for 5 and 25 years. The 5 year warranty is straightforward: if an element fails during that period, the supplier will simply replace it at his own cost. The 25 year lifetime warranty is more subtle. In short, the purchasers want to be protected against abnormal internal degradation of the system, causing the system to fail before its end of life. In the view of the purchasers, one way to obtain such protection is to define a Final Acceptance (FA) milestone and a Warranty Bond associated with the completion of the milestone.

In this respect, the two models (2010 and 2013) diverge regarding the definition of

“Final Acceptance”. On one hand, suppliers see FA as the mere closure of the deficiencies identified at the PA. This should normally happen relatively quickly after PA. On the other hand, purchasers see FA as a major milestone in the lifetime warranty, at the end of the 5 years Warranty period. The key concept of FA is to check whether a pattern of failure that may prevent the system from meeting its lifecycle objectives has developed or not. Repeated failures of repeaters at a faster rate than expected is a typical pattern of failure dreaded by purchasers. In case such a pattern of failure has developed, purchasers will want to withhold the FA certificate, and impose an extension of the Warranty Bond.

Applicable Law

The choice of law is a technical matter which requires legal specialists. The jurisdiction chosen in the contract can have an important impact on the interpretation of the contract in case of disputes. The 2010 model was based on English Law (common law) while the consortium model opted for Swiss law, a regime considered as “neutral” for consortiums which typically include investors from both common law and civil law countries.

Suspension/termination

The right to suspend, let alone the more aggressive right to terminate, are rights purchasers do not want to share with the supplier. Since the supplier will want some level of reciprocity this is traditionally a lively area of negotiation.

Balance of risk, permitting, landing sites and stations

Extensive negotiation may also occur around the balance of risks that could delay the project and raise projects costs. Purchasers’ main obligation is to pay the supplier, but they also have the key obligation to deliver the landing sites

infrastructure (beach manhole, land cable routes and landing station) by certain deadlines. Another critical point is permitting, which may also be the responsibility of purchasers. The permitting process can be unpredictable and lengthy; therefore there is a high level of risk tied to it. The risks must be taken into account in the contract and a mechanism should be integrated to smoothly anticipate and adapt to delays. The nightmare scenario to be avoided is the arrival of the cable ship at the boundary of territorial waters with the permits not delivered yet. This prevents the completion of the cable lay all the way to the beach manhole. Such a situation increases the cost of the project dramatically and neither party wants to pay for that.

6. CONCLUSION

The construction of submarine cable systems is a complex and sophisticated engineering project. Not surprisingly, the underlying contract is also a complex set of interacting clauses. Just as no two cable projects are the same, no two contracts will be the same either. Each project will have specific challenges and issues that will need to be carefully considered and require individually negotiated contract terms. This will especially be so if new technology or new network structures are involved.

Contract models represent starting points for contract negotiations between suppliers and purchasers. In the case of a consortium, the purchasers will usually impose the starting point in the ITT sent to the suppliers.

With the publication of the 2013 Consortium Contract Model three years after the publishing of the 2010 Model Contract, two reference contract models

are now publicly available to embody the views of each set of players. The associated guidelines included with both models provide an understanding of both sides' objectives and what is at stake in the negotiations. Together, both models form an overall "supermodel" with two reference positions. A negotiated contract will represent some intermediate point between both positions. By virtue of these two model contracts, it is hoped that parties are now better able to evaluate their negotiating stance from the position of this "intermediate point".

7. REFERENCES

- [1] "Model Contract with Guidelines for the Construction of a Submarine Cable system", SubOptic 2010, available on the SubOptic website.
- [2] Shota Masuda, "Consortium contracts – Captive techniques for managing the diverse credit risk profiles", SubOptic 2010.