ROUTE 7 - CONTRACT REVIEW

POTENTIAL COST ISSUES FOR MTC IF BEJV RED BOOK CONTRACT AGREED

1. Introduction

1.1 This review considers in summary the potential cost exposure for MTC if the BEJV contract terms are accepted.

1.2 This can only be a summary. The true detail is contained in over 100 pages of complex terms and conditions.

1.3 It provides some suggestions if this form of contract is agreed and executed.

1.4 This review is to be read with our review provided on 24 January 2010.

1.5 Our advice to MTC is that the current BEJV terms and conditions should **NOT** be signed by MTC. There may be other political and commercial issues about which we are not aware which make it necessary to sign this week. However, we are not aware of these.

2. General Position

2.1 Until 25 January 2010, our instructions were not to negotiate on the detail of the form of contract, though we were authorised to consider matters of general principle with in-house counsel to BEJV.

2.2 We did this yesterday, 26 January 2010, although we have received indirect communication that it is intended to sign the contract on Friday 29 January 2010.

2.3 Our view is that the only contract which BEJV will be prepared to sign within that time frame is its own version of the FIDIC Red Book - a traditional form of contract with only an estimated price, with the actual works to be remeasured and charged at unit rates.

2.4 As we have advised previously, there is nothing unreasonable in proposing a traditional and remeasureable contract for this type of work. Equally, the FIDIC Red Book is a reasonable contract.

2.5 However:

2.5.1 a traditional remeasureable contract does not achieve cost certainty;

2.5.2 the FIDIC Red Book has been amended in a completely one-sided way to BEJV's benefit; and

2.5.3 BEJV's tender is not compliant with the Tender Dossier. BEJV have simply ignored the requirement to provide a design and build solution (ie a fixed price lump sum).

2.6 Our view is that a traditional remeasurement contract, together with BEJV's amendments, presents considerable exposure to MTC beyond the estimate of circa 400m euros.

2.7 **<u>The apparent contract price of 400m euros is consequently nothing more than a non-binding estimate</u>**.

2.8 Further, without finance in place, to enter into such a contract presents MTC and the Government with an immediate liability which it would be committed to and would only be able to avoid by making considerable payments to BEJV.

3. Detailed Assessment of the BEJV form of contract

3.1 The BEJV form of contract is based on the FIDIC Red Book. Even unamended, as a unit rate, remeasurable contract, with no design obligations, the FIDIC Red Book imposes a number of risks on MTC. However, this risk profile is generally considered to be reasonable in the international commercial market.

3.2 I is also very usual for the FIDIC Red Book to be amended to move more of the risks to the contractor.

3.3 It is not the purpose of this review to provide details of the standard risk profile of the FIDIC Red Book or to suggest amendments in favour of MTC to the base document.

3.4 The purpose of this review is to identify how BEJV has amended the Red Book to make it more onerous on MTC and the cost implications for MTC. key issues are highlighted in bold and underlined.

Issue	Dealt with by BEJV	Possible Cost Increase (approximate - all figures would vary depending on events during construction)	Suggested amendment to be negotiated
Complete Contract **(Not included in the current draft)**	**MTC will be committed to the whole motorway and not just to those sections it can afford.** **The intention has always been for MTC only to commit to the sections it could afford.** **There is no condition precedent to the effective date of the contract to protect MTC. BEJV has only recognised that MTC may omit work (clause 13.1(d)). This might work, but:** • **MTC could not get the work carried out by another contractor at a later date** • **MTC would be obliged to pay MTC for the**	**Commitment to sums which MTC/Government does not currently have**	**There are two options:** **1. The contract is amended to allow MTC to instruct BEJV to commence work on a particular section in MTC's absolute discretion; or** **2. The contract is amended to allow MTC to omit sections of the Works at any time without (or with limited) financial consequences.** **The amendments need to be**

	lost profit of the omitted work. The other option given by BEJV is that it would be entitled to be paid Cost plus Profit for the period of any delay, which would then constitute an extension of time for the Time for Completion (clause 8.1). Ultimately, BEJV may also be entitled to terminate the contract (clause 16.2).		made to the form of agreement.
Design responsibility (clauses 2.1, 4.5 and 5.1)	BEJV takes no design risk: • MTC to employ and pay design team. Currently no control over terms of the appointment of the design team (to be by BEJV, before appointments novated to MTC) • MTC has risk of defective design re consequences for BEJV • MTC has risk of redesigning to deal with unforeseen circumstances • extra costs to BEJV for dealing with defective design or changes in design - on an indemnity basis	50m- 100m euros.	MTC might prefer to: 1. Appoint and manage the design team itself (i.e. no input from BEJV) so as to avoid paying the Design Management Fee; or 2. Require BEJV to be responsible for design (as per the original tender dossier). In any event, we would recommend that: • the "indemnity" provision is replaced with a "reimbursement"

			provision. • **the design fee is negotiated down from 25,000 per month** • **the terms of any appointment are subject to MTC's approval**
MTC's financial arrangements (clauses 2.4 and 16.2)	MTC must confirm it has the finance. BEJV can choose to terminate if evidence is not provided		MTC might wish to negotiate the ability of BEJV to terminate, so that this is replaced with a suspension provision. In any event, however, termination or suspension is likely to have cost consequences for MTC.
Unexpected Ground Conditions **(clause 4.7, 4.10 and 4.12)**	**BEJV takes no risk through remeasurement and unit rate pricing:** • **MTC to pay for design changes** • **MTC pays for whatever is encountered**	**50m- 100m euros.**	**MTC has two options:** **1. MTC might seek to share the risk of unexpected ground conditions with BEJV (e.g. through a cost sharing mechanism); or** **2. MTC might seek to transfer the risk to BEJV in its entirety (as per the original tender dossier). Of**

			<u>course, this might have significant cost consequences.</u>
Remeasurement and Unit Rates (clause 12)	The only elements which are fixed are the rates themselves (cf escalation below). MTC to pay for work carried out. This may be very different from the work set out and now priced at c. 400m euros. Unit rates are either incomplete or too general. Further work is being undertaken to tighten these rates, but this may not have been completed by Friday 29 January 2010.	Possible 30%	A number of options available to MTC are: 1. Seek to make this contract a lump sum contract (which BEJV has indicated would not be acceptable); 2. Limit the maximum additional cost which would be acceptable to MTC; or 3. Delay entering into the contract until greater certainty of the design is known, so that a more realistic price may be agreed.
Provisional Sums (clause 13.5)	MTC commits to paying all the costs of the subcontractors who carry out this work, plus profit. MTC should not pay where any cost is unreasonable or caused by BEJV		Although BEJV feel that this issue is already covered in the contract, we do not agree - it should be expressly stated, so there can be no doubt that MTC would not be responsible for such costs.
Escalation (clause 12.3D)	After 1 year all prices subject to an increase based on inflation index.	50m euros	The obvious option for MTC is to fix the prices at the current level for the

	We have been informed that this may be conceded by BEJV but it is in the latest draft provided to us.		duration of the contract.
Time of Payment (clause 14)	All payment periods have been reduced so that MTC must pay sooner than the standard FIDIC position. Interest on late payment is 4% so high.		We see no reason why the standard FIDIC payment periods should not be reinstated (or, if MTC prefers to make payment later than that, to include MTC's own preferred payment terms); and interest reduced to a lower level.
Provision of borrow pits, quarries, depots **(clause 2.1)**	**MTC to provide these along the route and within certain distance.** **We understand that an alternative being discussed is that MTC will pay for haulage costs from Albania. However, there is still a cost implication for MTC.**	**25m euros**	**The alternative options are that BEJV pays its own haulage costs (or the costs of establishing the required borrow pits, quarries and depots).**
Contractor's Consents (clause 2.1)	MTC will be obliged to pay BEJV if these take more than 2 months, even though the consents are for BEJV to provide.		It may be that MTC is comfortable that it will be able to provide all necessary assistance to BEJV ensure that this is not an issue. If not, then we might seek to increase this period.
Extensions of	The reasons for extensions of time to the date for		We see no reason to depart from the standard FIDIC Red Book position on

Time and Costs (clauses 8.4, 8.5A and 12)	completion are much more extensive. Also all extensions of time entitle BEJV to cost plus profit		these provisions.
Programme **(clause 8.3)**	**MTC is committed to complying with the programme. If it does not do everything assigned to it, there will be cost and time consequences.**		**A possible solution is to remove the programme from the list of contractual documents. Whilst BEJV will still be committed to complete each section of the Works by the relevant Date for Completion, a failure by MTC to comply with the programme might have different consequences (e.g. BEJV is given additional time but not cost).**
Delay Damages **(clause 8.7)**	**These are a fixed sum of 40,000 euros per day up to a maximum equivalent of 365 days delay.** **This is MTC's only recovery for delay. MTC should confirm it is happy with these figures.** **Also, MTC will only be entitled to these damages if the last section is delayed. If there is delay in completion of earlier sections, the damages will not apply. This is unusual since**		**The amount of delay damages (or the level of the cap) might be increased; and made more generally applicable to the other sections.**

	usually sections are dealt with independently.		
Bonus for Early Completion **(clause 8.7)**	**BEJV is entitled to a bonus of 3.6 million euros for early completion.**		**The amount of the bonus might be reduced or, if the principle of the bonus is unacceptable to MTC, removed altogether.**
Remedying Defects and Defects Notification Period (clauses 11.2 and 11.3)	BEJV's obligations are more limited than the standard FIDIC position.		We see no reason to depart from the standard FIDIC Red Book position.
Target Cost Mechanism **(Schedule 7)**	**BEJV approach is completely one-sided. Maximum contribution is 12.5m euros and then only after significant other additional costs have been paid by MTC alone.** **It is a matter for negotiation, but this current target cost mechanism is of very limited benefit to MTC**		**We suggest that a more balanced target cost mechanism could be included.** **We suggest 50/50 on cost overruns which are not for variations, extensions of time etc.**
Termination and Suspension	The standard FIDIC provisions have been amended to make them more favourable to BEJV - shorter periods of failure to pay before		Again, we see no reason to depart from the standard FIDIC Red Book

(clause 16)	suspension/termination by BEJV and longer periods if MTC wants to use its rights to terminate. Also BEJV entitled to loss of profit.		position.
Indemnities (clause 17)	The MTC indemnities to BEJV have been extended. They also cover Contractor Related parties - an extension from the standard FIDIC position.		There is no reason to extend the standard FIDIC Red Book indemnities - particularly to the Contractor Related Parties. The standard position should be reinstated.
Limits on Liability **(clause 17.6)**	**It is usual to include some limits on liability but BEJV has extended the clause, but also still allowed itself the right to claim loss of profit.** **It has also included a maximum liability to MTC of 10% of the Contract Price (with exceptions for indemnities, IP and delay damages).** **It also terminates liabilities immediately on issue of relevant certificates. This is very unusual.**		**There are a number of obvious amendments here:** **1. The clause should be returned to the standard FIDIC Red Book clause.** **2. MTC might increase the maximum liability of BEJV to MTC to a greater percentage of the Contract Price.** **3. BEJV's liability should survive issue of the relevant certificates - for instance, it is not unusual for this to remain until some time after the end of the defects**

			notification period.
Force Majeure (clause 19)	This has been extended and BEJV is entitled to cost which is significantly different from the standard FIDIC position.		Again, we see no reason to extend the standard position under the FIDIC Red Book.
Cost plus Profit **(clause 12)**	**Some elements of work are additional. Profit is appropriate on some aspects of work. However, not all additional work should be subject to profit.** **Most work to be carried out by BEJV is subject to a profit uplift, whether it is appropriate or not.**		**MTC should ask BEJV to confirm those items of work on which it requires profit to be paid, and then decide whether it is prepared to pay profit on all of these. MTC should try to reduce the profit percentage.**
Standby time, other major additional costs **(clause)**	**Payments all subject to high percentage profit uplift even though unit rates contain profit**	**7-8% profit**	**Once the above exercise has been completed, MTC might consider whether BEJV's required level of profit is acceptable - it might be reduced.**
Custom duties on BEJV equipment, utilities and some other taxes	**To be paid by MTC.**	**10m euros**	**Is MTC prepared to pay such duties etc? If not, then this clause will need to be amended, to make clear that BEJV must pay these.**

(clause)			
Foreign Labour **(clause 6.12)**	**MTC will indemnify BEJV if BEJV cannot find local labour and has to employ foreign labour.**		**The obvious amendment is to reverse this provision, particularly given that it is important to MTC that local labour is used.**
Working Hours **(clause 6.5)**	**BEJV has allowed itself to work 24/7. If MTC restricts this there will be a cost implication.**		**If MTC is not prepared to allow BEJV to work at weekends, or outside of usual working hours, this must be stated.**
Contractor's Establishment Payment **(clause)**	**To be paid by MTC.**	**40m euros (exact)**	**Is MTC prepared to make such a payment and, if so, is the amount of such payment acceptable to MTC?** **If not, then this must be made clear to BEJV.**
Dispute Resolution (clause)	Rather than the Kosovo courts, the process is arbitration in accordance with the ICC rules in Paris, France. There is also a provision relating to a Management Committee which is set up to look to avoid disputes		Is this acceptable to MTC, given the provisions of Kosovar procurement law?

	though these can be used by contractors.		
Choice of Law (clause)	Local Kosovo law is to apply regarding the carrying out of the works. However, English law is to apply to the interpretation of the contract terms. MTC would not be able to use Kosovo law to challenge the limits of liability included in the contract. Most contractors would consider it unreasonable for MTC to use Kosovo law like this, but nevertheless it is a potential disadvantage for MTC.		MTC is currently investigating the acceptability of this proposal.

3.5 We should emphasise that this is not an exhaustive list of the proposed BEJV contract terms and conditions but identifies some of the more significant risk issues.

4. Conclusion

4.1 Our view is that a traditional remeasurement contract, together with BEJV's amendments, presents considerable exposure to MTC beyond the estimate of circa 400m euros.

4.2 The risk of a remeasurement contract may be one worth taking if the priority is to start work sooner on the basis of the currently available documents. Our suggestion if this route is adopted is to enter a contract which is more similar to the standard FIDIC Red Book form. However, there is no possible way that such a contract will be signed by BEJV this week.

4.3 The BEJV amendments are additional risks for MTC. In large part they should be resisted since we cannot advise that they are a reasonable commercial position. However, if MTC wants to sign a contract on Friday 29 January 2010, there is no option in our view but to sign a contract on BEJV's terms.

4.4 There are procurement law implications if this is the decision since it may be necessary to inform other tenderers/potential tenderers. They may also want and be entitled to tender on a remeasurement basis.

4.5 **NB: It is extremely dangerous in our view for MTC to sign a contract in the current form. Specifically, this is because:**

1 the contract is a complete contract for all the motorway

2 there are no condition precedents which make the contract conditional on MTC obtaining funding

3 there are no provisions to allow MTC only to instruct part of the works (eg Sections A1 and A2)

4 BEJV has no obligations to start until it has evidence of financing

5 BEJV can be paid lost profit on works which it is not instructed to carry out

6 BEJV can terminate if the funding evidence is not provided and can then claim profit

4.6 Our specific comments are:

4.6.1 any discussions about finance should not be on the assumption that MTC requires only 400m euros to build the motorway. MTC needs much more, perhaps as much as double;

4.6.2 greater certainty on price could be achieved by spending more time on design and investigation, but this may not be an acceptable option;

4.6.3 some sections (notably Sections A1 and A2) are more advanced than the others. It may be possible to investigate carrying out these sections on a fixed price lump sum basis. Other tenderers may also be interested in this and it may be possible under Kosovo procurement law; and

4.5.4 in any event discussions on the technical aspects should continue in order that MTC has greater knowledge of the potential technical issues and cost implications.

4.8 We remain available to provide further assistance in the negotiations.

Eversheds 27 January 2010