UNCITRAL MODEL LAWS ON PUBLIC PROCUREMENT

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United Nations Commission on International Trade Law

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2003 - Model Legislative Provisions on Privately Financed Infrastructure Projects

Adopted by UNCITRAL on 7 July 2003, the legislative recommendations and the model provisions are intended to assist domestic legislative bodies in the establishment of a legislative framework favourable to privately financed infrastructure projects. They supplement the UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects.

General Assembly resolution

Text

Travaux préparatoires

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Fifty-eighth session
Agenda item 151

Resolution adopted by the General Assembly

[*on the report of the Sixth Committee (A/58/513)*]

58/76. Model Legislative Provisions on Privately Financed Infrastructure Projects of the United Nations Commission on International Trade Law

The General Assembly,

Bearing in mind the role of public-private partnerships to improve the provision and sound management of infrastructure and public services in the interest of sustainable economic and social development,

Recognizing the need to provide an enabling environment that both encourages private investment in infrastructure and takes into account the public interest concerns of the country,

Emphasizing the importance of efficient and transparent procedures for the award of privately financed infrastructure projects,

Stressing the desirability of facilitating project implementation by rules that enhance transparency, fairness and long-term sustainability and remove undesirable restrictions on private sector participation in infrastructure development and operation,

Recalling the valuable guidance that the United Nations Commission on International Trade Law has provided to Member States towards the establishment of a favourable legislative framework for private participation in infrastructure development through the *UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects*,[1]

Believing that the Model Legislative Provisions on Privately Financed Infrastructure Projects of the United Nations Commission on International Trade Law will be of further assistance to States, in particular developing countries, in promoting good governance and establishing an appropriate legislative framework for such projects,

1. *Expresses its appreciation* to the United Nations Commission on International Trade Law for the completion and adoption of the Model Legislative Provisions on Privately Financed Infrastructure Projects, the text of which is

[1] United Nations publication, Sales No. E.01.V.4.

contained in annex I to the report of the United Nations Commission on International Trade Law on its thirty-sixth session;[2]

2. *Requests* the Secretary-General to publish the Model Legislative Provisions and to make all efforts to ensure that the Model Legislative Provisions along with the *UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects*[1] become generally known and available;

3. *Also requests* the Secretary-General, subject to availability of resources, to consolidate in due course the text of the Model Legislative Provisions and the *Legislative Guide* into one single publication and, in doing so, to retain the legislative recommendations contained in the *Legislative Guide* as a basis of the development of the Model Legislative Provisions;

4. *Recommends* that all States give due consideration to the Model Legislative Provisions and the *Legislative Guide* when revising or adopting legislation related to private participation in the development and operation of public infrastructure.

72nd plenary meeting
9 December 2003

[2] *Official Records of the General Assembly, Fifty-eighth Session, Supplement No. 17* (A/58/17).

UNCITRAL

Model Legislative Provisions on Privately Financed Infrastructure Projects

Prepared by the United Nations
Commission on International Trade Law

UNITED NATIONS

UNCITRAL

Model Legislative Provisions on Privately Financed Infrastructure Projects

Prepared by the United Nations
Commission on International Trade Law

UNITED NATIONS
New York, 2004

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Preface

The present *Model Legislative Provisions* were prepared by the United Nations Commission on International Trade Law (UNCITRAL) as an addition to the *UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects*.[a] In addition to representatives of member States of the Commission, representatives of many other States and of a number of international organizations, both intergovernmental and non-governmental, participated actively in the preparatory work.

The Commission considered the additional work to be undertaken in the field of privately financed infrastructure projects after the adoption of the *Legislative Guide* in 2001 and entrusted a working group with the task of preparing model legislative provisions on the basis of the recommendations contained in the *Legislative Guide*.[b] The working group devoted two sessions, held in Vienna from 24 to 28 September 2001 and from 9 to 13 September 2002 to the preparation of the draft model legislative provisions. The Commission finalized and adopted[c] the *Model Legislative Provisions* at its thirty-sixth session, held in Vienna from 30 June to 11 July 2003, and requested the Secretariat to disseminate them among Governments, relevant international intergovernmental and non-governmental organizations, private sector entities and academic institutions.

The Commission further requested the Secretariat to consolidate in due course the text of the *Model Legislative Provisions* and the *Legislative Guide* into one single publication and, in doing so, to retain the legislative recommendations contained in the *Legislative Guide* as a basis of the development of the *Model Legislative Provisions*.[d]

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[a] United Nations publication, Sales No. E.01.V.4.

[b] *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17* (A/56/17), para. 369 (see *Yearbook of the United Nations Commission on International Trade Law 2001*, part one).

[c] Ibid., *Fifty-eighth Session, Supplement No. 17* (A/58/17), paras. 12-171.

[d] Ibid., para. 171.

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Resolution adopted by the General Assembly

[on the report of the Sixth Committee (A/58/513)]

58/76. Model Legislative Provisions on Privately Financed Infrastructure Projects of the United Nations Commission on International Trade Law

The General Assembly,

Bearing in mind the role of public-private partnerships to improve the provision and sound management of infrastructure and public services in the interest of sustainable economic and social development,

Recognizing the need to provide an enabling environment that both encourages private investment in infrastructure and takes into account the public interest concerns of the country,

Emphasizing the importance of efficient and transparent procedures for the award of privately financed infrastructure projects,

Stressing the desirability of facilitating project implementation by rules that enhance transparency, fairness and long-term sustainability and remove undesirable restrictions on private sector participation in infrastructure development and operation,

Recalling the valuable guidance that the United Nations Commission on International Trade Law has provided to Member States towards the establishment of a favourable legislative framework for private participation in infrastructure development through the *UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects*,[1]

Believing that the Model Legislative Provisions on Privately Financed Infrastructure Projects of the United Nations Commission on International Trade Law will be of further assistance to States, in particular developing countries, in promoting good governance and establishing an appropriate legislative framework for such projects,

1. *Expresses its appreciation* to the United Nations Commission on International Trade Law for the completion and adoption of the Model Legislative Provisions on Privately Financed Infrastructure Projects, the text of which is contained in annex I to the report of the United Nations Commission on International Trade Law on its thirty-sixth session;[2]

2. *Requests* the Secretary-General to publish the Model Legislative Provisions and to make all efforts to ensure that the Model Legislative Provisions along with the *UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects*[1] become generally known and available;

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[1]United Nations publication, Sales No. E.01.V.4.

[2]*Official Records of the General Assembly, Fifty-eighth Session, Supplement No. 17* (A/58/17).

3. *Also requests* the Secretary-General, subject to availability of resources, to consolidate in due course the text of the Model Legislative Provisions and the *Legislative Guide* into one single publication and, in doing so, to retain the legislative recommendations contained in the *Legislative Guide* as a basis of the development of the Model Legislative Provisions;

4. *Recommends* that all States give due consideration to the Model Legislative Provisions and the *Legislative Guide* when revising or adopting legislation related to private participation in the development and operation of public infrastructure.

72nd plenary meeting
9 December 2003

Foreword

The following pages contain a set of general recommended legislative principles entitled "legislative recommendations" and model legislative provisions (the "model provisions") on privately financed infrastructure projects. The legislative recommendations and the model provisions are intended to assist domestic legislative bodies in the establishment of a legislative framework favourable to privately financed infrastructure projects. They are followed by notes that offer an analytical explanation of the financial, regulatory, legal, policy and other issues raised in the subject area. The reader is advised to read the legislative recommendations and the model provisions together with the notes, which provide background information to enhance understanding of the legislative recommendations and model provisions.

The legislative recommendations and the model provisions consist of a set of core provisions dealing with matters that deserve attention in legislation specifically concerned with privately financed infrastructure projects.

The model provisions are designed to be implemented and supplemented by the issuance of regulations providing further details. Areas more suitably addressed by regulations rather than statutes are identified accordingly. Moreover, the successful implementation of privately financed infrastructure projects typically requires various measures beyond the establishment of an appropriate legislative framework, such as adequate administrative structures and practices, organizational capability, technical, legal and financial expertise, appropriate human and financial resources and economic stability.

It should be noted that the legislative recommendations and the model provisions do not deal with other areas of law that also have an impact on privately financed infrastructure projects but on which no specific legislative recommendations are made in the UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects.* *Those other areas of law include, for instance, promotion and protection of investments, property law, security interests, rules and procedures on compulsory acquisition of private property, general contract law, rules on government contracts and administrative law, tax law and environmental protection and consumer protection laws. The relationship of such other areas of law to any law enacted specifically with respect to privately financed infrastructure projects should be borne in mind.*

*United Nations publication, Sales No. E.01.V.4.

Part one

Legislative recommendations

I. General legislative and institutional framework

Constitutional, legislative and institutional framework (see the *Legislative Guide,* chap. I, "General legislative and institutional framework", paras. 2-14)

Recommendation 1. The constitutional, legislative and institutional framework for the implementation of privately financed infrastructure projects should ensure transparency, fairness and the long-term sustainability of projects. Undesirable restrictions on private sector participation in infrastructure development and operation should be eliminated.

Scope of authority to award concessions (see the *Legislative Guide*, chap. I, "General legislative and institutional framework", paras. 15-22)

Recommendation 2. The law should identify the public authorities of the host country (including, as appropriate, national, provincial and local authorities) that are empowered to award concessions and enter into agreements for the implementation of privately financed infrastructure projects.

Recommendation 3. Privately financed infrastructure projects may include concessions for the construction and operation of new infrastructure facilities and systems or the maintenance, modernization, expansion and operation of existing infrastructure facilities and systems.

Recommendation 4. The law should identify the sectors or types of infrastructure in respect of which concessions may be granted.

Recommendation 5. The law should specify the extent to which a concession might extend to the entire region under the jurisdiction of the respective contracting authority, to a geographical subdivision thereof or

to a discrete project, and whether it might be awarded with or without exclusivity, as appropriate, in accordance with rules and principles of law, statutory provisions, regulations and policies applying to the sector concerned. Contracting authorities might be jointly empowered to award concessions beyond a single jurisdiction.

Administrative coordination (see the *Legislative Guide*, chap. I, "General legislative and institutional framework", paras. 23-29)

Recommendation 6. Institutional mechanisms should be established to coordinate the activities of the public authorities responsible for issuing approvals, licences, permits or authorizations required for the implementation of privately financed infrastructure projects in accordance with statutory or regulatory provisions on the construction and operation of infrastructure facilities of the type concerned.

Authority to regulate infrastructure services (see the *Legislative Guide*, chap. I, "General legislative and institutional framework", paras. 30-53)

Recommendation 7. The authority to regulate infrastructure services should not be entrusted to entities that directly or indirectly provide infrastructure services.

Recommendation 8. Regulatory competence should be entrusted to functionally independent bodies with a level of autonomy sufficient to ensure that their decisions are taken without political interference or inappropriate pressures from infrastructure operators and public service providers.

Recommendation 9. The rules governing regulatory procedures should be made public. Regulatory decisions should state the reasons on which they are based and should be accessible to interested parties through publication or other means.

Recommendation 10. The law should establish transparent procedures whereby the concessionaire may request a review of regulatory decisions by an independent and impartial body, which may include court review, and should set forth the grounds on which such a review may be based.

Recommendation 11. Where appropriate, special procedures should be established for handling disputes among public service providers concerning alleged violations of laws and regulations governing the relevant sector.

II. Project risks and government support

Project risks and risk allocation (see the *Legislative Guide,* chap. II, "Project risks and government support", paras. 8-29)

Recommendation 12. No unnecessary statutory or regulatory limitations should be placed upon the contracting authority's ability to agree on an allocation of risks that is suited to the needs of the project.

Government support (see the *Legislative Guide*, chap. II, "Project risks and government support", paras. 30-60)

Recommendation 13. The law should clearly state which public authorities of the host country may provide financial or economic support to the implementation of privately financed infrastructure projects and which types of support they are authorized to provide.

Part two

Model legislative provisions

I. General provisions

Model provision 1. Preamble (see the *Legislative Guide*, recommendation 1 and chap. I, paras. 2-14)

WHEREAS the [*Government*] [*Parliament*] of [. . .] considers it desirable to establish a favourable legislative framework to promote and facilitate the implementation of privately financed infrastructure projects by enhancing transparency, fairness and long-term sustainability and removing undesirable restrictions on private sector participation in infrastructure development and operation;

WHEREAS the [*Government*] [*Parliament*] of [. . .] considers it desirable to further develop the general principles of transparency, economy and fairness in the award of contracts by public authorities through the establishment of specific procedures for the award of infrastructure projects;

[*Other objectives that the enacting State might wish to state*];

Be it therefore enacted as follows:

Model provision 2. Definitions (see the *Legislative Guide*, introduction, paras. 9-20)

For the purposes of this law:

(a) "Infrastructure facility" means physical facilities and systems that directly or indirectly provide services to the general public;

(b) "Infrastructure project" means the design, construction, development and operation of new infrastructure facilities or the rehabilitation, modernization, expansion or operation of existing infrastructure facilities;

(c) "Contracting authority" means the public authority that has the power to enter into a concession contract for the implementation of an infrastructure project [*under the provisions of this law*];[1]

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[1]It should be noted that this definition relates only to the power to enter into concession contracts. Depending on the regulatory regime of the enacting State, a separate body, referred to as "regulatory agency" in subpara. *(h),* may have responsibility for issuing rules and regulations governing the provision of the relevant service.

(d) "Concessionaire" means the person that carries out an infrastructure project under a concession contract entered into with a contracting authority;

(e) "Concession contract" means the mutually binding agreement or agreements between the contracting authority and the concessionaire that set forth the terms and conditions for the implementation of an infrastructure project;

(f) "Bidder" or "bidders" means persons, including groups thereof, that participate in selection proceedings concerning an infrastructure project;[2]

(g) "Unsolicited proposal" means any proposal relating to the implementation of an infrastructure project that is not submitted in response to a request or solicitation issued by the contracting authority within the context of a selection procedure;

(h) "Regulatory agency" means a public authority that is entrusted with the power to issue and enforce rules and regulations governing the infrastructure facility or the provision of the relevant services.[3]

Model provision 3. Authority to enter into concession contracts (see the *Legislative Guide,* recommendation 2 and chap. I, paras. 15-18)

The following public authorities have the power to enter into concession contracts[4] for the implementation of infrastructure projects falling within their respective spheres of competence: [*the enacting State lists the relevant public authorities of the host country that may enter into concession contracts by way of an exhaustive or indicative list of public authorities, a list of types or categories of public authority or a combination thereof*].[5]

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[2]The term "bidder" or "bidders" encompasses, according to the context, both persons that have sought an invitation to take part in pre-selection proceedings or persons that have submitted a proposal in response to a contracting authority's request for proposals.

[3]The composition, structure and functions of such a regulatory agency may need to be addressed in special legislation (see the *Legislative Guide,* recommendations 7-11 and chap. I, "General legislative and institutional framework", paras. 30-53).

[4]It is advisable to establish institutional mechanisms to coordinate the activities of the public authorities responsible for issuing the approvals, licences, permits or authorizations required for the implementation of privately financed infrastructure projects in accordance with statutory or regulatory provisions on the construction and operation of infrastructure facilities of the type concerned (see the *Legislative Guide*, recommendation 6 and chap. I, "General legislative and institutional framework", paras. 23-29). In addition, for countries that contemplate providing specific forms of government support to infrastructure projects, it may be useful for the relevant law, such as legislation or a regulation governing the activities of entities authorized to offer government support, to identify clearly which entities have the power to provide such support and what kind of support may be provided (see chap. II, "Project risks and government support").

[5]Enacting States may generally have two options for completing this model provision. One alternative may be to provide a list of authorities empowered to enter into concession contracts, either in the model provision or in a schedule to be attached thereto. Another alternative might be for the enacting State to indicate the levels of government that have the power to enter into those contracts, without naming relevant public authorities. In a federal State, for example, such an enabling clause might refer to "the Union, the states [or provinces] and the municipalities". In any event, it is advisable for enacting States that wish to include an exhaustive list of authorities to consider mechanisms allowing for revisions of such a list as the need arises. One possibility to that end might be to include the list in a schedule to the law or in regulations that may be issued thereunder.

Model provision 4. Eligible infrastructure sectors (see the *Legislative Guide,* recommendation 4 and chap. I, paras. 19-22)

Concession contracts may be entered into by the relevant authorities in the following sectors: [*the enacting State indicates the relevant sectors by way of an exhaustive or indicative list*].[6]

II. Selection of the concessionaire

Model provision 5. Rules governing the selection proceedings (see the *Legislative Guide,* recommendation 14 and chap. III, paras. 1-33)

The selection of the concessionaire shall be conducted in accordance with model provisions 6-27 and, for matters not provided herein, in accordance with [*the enacting State indicates the provisions of its laws that provide for transparent and efficient competitive procedures for the award of government contracts*].[7]

1. Pre-selection of bidders

Model provision 6. Purpose and procedure of pre-selection (see the *Legislative Guide,* chap. III, paras. 34-50)

1. The contracting authority shall engage in pre-selection proceedings with a view to identifying bidders that are suitably qualified to implement the envisaged infrastructure project.

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[6]It is advisable for enacting States that wish to include an exhaustive list of sectors to consider mechanisms allowing for revisions of such a list as the need arises. One possibility to that end might be to include the list in a schedule to the law or in regulations that may be issued thereunder.

[7]The reader's attention is drawn to the relationship between the procedures for the selection of the concessionaire and the general legislative framework for the award of government contracts in the enacting State. While some elements of structured competition that exist in traditional procurement methods may be usefully applied, a number of adaptations are needed to take into account the particular needs of privately financed infrastructure projects, such as a clearly defined pre-selection phase, flexibility in the formulation of requests for proposals, special evaluation criteria and some scope for negotiations with bidders. The selection procedures reflected in this chapter are based largely on the features of the principal method for the procurement of services under the UNCITRAL Model Law on Procurement of Goods, Construction and Services, which was adopted by UNCITRAL at its twenty-seventh session, held in New York from 31 May to 17 June (the "Model Procurement Law"). The model provisions on the selection of the concessionaire are not intended to replace or reproduce the entire rules of the enacting State on government procurement, but rather to assist domestic legislators in developing special rules for the selection of the concessionaire. The model provisions assume that there exists in the enacting State a general framework for the award of government contracts providing for transparent and efficient competitive procedures in a manner that meets the standards of the Model Procurement Law. Thus, the model provisions do not deal with a number of practical procedural steps that would typically be found in an adequate general procurement regime. Examples include the following matters: manner of publication of notices, procedures for issuance of requests for proposals, record-keeping of the procurement process, accessibility of information to the public and review procedures. Where appropriate, the notes to these model provisions refer the reader to provisions of the Model Procurement Law, which may, mutatis mutandis, supplement the practical elements of the selection procedure described herein.

2. The invitation to participate in the pre-selection proceedings shall be published in accordance with [*the enacting State indicates the provisions of its laws governing publication of invitation to participate in proceedings for the pre-qualification of suppliers and contractors*].

3. To the extent not already required by [*the enacting State indicates the provisions of its laws on procurement proceedings that govern the content of invitations to participate in proceedings for the pre-qualification of suppliers and contractors*],[8] the invitation to participate in the pre-selection proceedings shall include at least the following:

(a) A description of the infrastructure facility;

(b) An indication of other essential elements of the project, such as the services to be delivered by the concessionaire, the financial arrangements envisaged by the contracting authority (for example, whether the project will be entirely financed by user fees or tariffs or whether public funds such as direct payments, loans or guarantees may be provided to the concessionaire);

(c) Where already known, a summary of the main required terms of the concession contract to be entered into;

(d) The manner and place for the submission of applications for pre-selection and the deadline for the submission, expressed as a specific date and time, allowing sufficient time for bidders to prepare and submit their applications; and

(e) The manner and place for solicitation of the pre-selection documents.

4. To the extent not already required by [*the enacting State indicates the provisions of its laws on procurement proceedings that govern the content of the pre-selection documents to be provided to suppliers and contractors in proceedings for the pre-qualification of suppliers and contractors*],[9] the pre-selection documents shall include at least the following information:

(a) The pre-selection criteria in accordance with model provision 7;

(b) Whether the contracting authority intends to waive the limitations on the participation of consortia set forth in model provision 8;

(c) Whether the contracting authority intends to request only a limited number[10] of pre-selected bidders to submit proposals upon completion of the pre-selection proceedings in accordance with model provision 9, paragraph 2, and, if applicable, the manner in which this selection will be carried out;

[8]A list of elements typically contained in an invitation to participate in pre-qualification proceedings can be found in art. 25, para. 2, of the Model Procurement Law.

[9]A list of elements typically contained in pre-qualification documents can be found in art. 7, para. 3, of the Model Procurement Law.

[10]In some countries, practical guidance on selection procedures encourages domestic contracting authorities to limit the prospective proposals to the lowest possible number sufficient to ensure meaningful competition (for example, three or four). The manner in which rating systems (in particular quantitative ones) may be used to arrive at such a range of bidders is discussed in the *Legislative Guide* (see chap. III, “Selection of the concessionaire”, paras. 48 and 49). See also footnote 14.

(d) Whether the contracting authority intends to require the successful bidder to establish an independent legal entity established and incorporated under the laws of [*the enacting State*] in accordance with model provision 30.

5. For matters not provided for in this model provision, the pre-selection proceedings shall be conducted in accordance with [*the enacting State indicates the provisions of its laws on government procurement governing the conduct of proceedings for the pre-qualification of suppliers and contractors*].[11]

Model provision 7. Pre-selection criteria (see the *Legislative Guide*, recommendation 15 and chap. III, paras. 34-40, 43 and 44)

In order to qualify for the selection proceedings, interested bidders must meet objectively justifiable criteria[12] that the contracting authority considers appropriate in the particular proceedings, as stated in the pre-selection documents. These criteria shall include at least the following:

(a) Adequate professional and technical qualifications, human resources, equipment and other physical facilities as necessary to carry out all the phases of the project, including design, construction, operation and maintenance;

(b) Sufficient ability to manage the financial aspects of the project and capability to sustain its financing requirements;

(c) Appropriate managerial and organizational capability, reliability and experience, including previous experience in operating similar infrastructure facilities.

Model provision 8. Participation of consortia (see the *Legislative Guide*, recommendation 16 and chap. III, paras. 41 and 42)

1. The contracting authority, when first inviting the participation of bidders in the selection proceedings, shall allow them to form bidding consortia. The information required from members of bidding consortia to demonstrate their qualifications in accordance with model provision 7 shall relate to the consortium as a whole as well as to its individual participants.

[11]Procedural steps on pre-qualification proceedings, including procedures for handling requests for clarifications and disclosure requirements for the contracting authority's decision on the bidders' qualifications, can be found in art. 7 of the Model Procurement Law, paras. 2-7.

[12]The laws of some countries provide for some sort of preferential treatment for domestic entities or afford special treatment to bidders that undertake to use national goods or employ local labour. The various issues raised by domestic preferences are discussed in the *Legislative Guide* (see chap. III, "Selection of the concessionaire", paras. 43 and 44). The *Legislative Guide* suggests that countries that wish to provide some incentive to national suppliers may wish to apply such preferences in the form of special evaluation criteria, rather than by a blanket exclusion of foreign suppliers. In any event, where domestic preferences are envisaged, they should be announced in advance, preferably in the invitation to the pre-selection proceedings.

2. Unless otherwise [authorized by . . . [*the enacting State indicates the relevant authority*] and] stated in the pre-selection documents, each member of a consortium may participate, either directly or indirectly, in only one consortium[13] at the same time. A violation of this rule shall cause the disqualification of the consortium and of the individual members.

3. When considering the qualifications of bidding consortia, the contracting authority shall consider the capabilities of each of the consortium members and assess whether the combined qualifications of the consortium members are adequate to meet the needs of all phases of the project.

Model provision 9. Decision on pre-selection (see the *Legislative Guide*, recommendation 17 (for para. 2) and chap. III, paras. 47-50)

1. The contracting authority shall make a decision with respect to the qualifications of each bidder that has submitted an application for pre-selection. In reaching that decision, the contracting authority shall apply only the criteria that are set forth in the pre-selection documents. All pre-selected bidders shall thereafter be invited by the contracting authority to submit proposals in accordance with model provisions 10-17.

2. Notwithstanding paragraph 1, the contracting authority may, provided that it has made an appropriate statement in the pre-selection documents to that effect, reserve the right to request proposals upon completion of the pre-selection proceedings only from a limited number[14] of bidders that best meet the pre-selection criteria. For this purpose, the contracting authority shall rate the bidders that meet the pre-selection criteria on the basis of the criteria applied to assess their qualifications and draw up the list of bidders that will be invited to submit proposals upon completion of the pre-selection proceedings. In drawing up the list, the contracting authority shall apply only the manner of rating that is set forth in the pre-selection documents.

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[13]The rationale for prohibiting the participation of bidders in more than one consortium to submit proposals for the same project is to reduce the risk of leakage of information or collusion between competing consortia. Nevertheless, the model provision contemplates the possibility of ad hoc exceptions to this rule, for instance, in the event that only one company or only a limited number of companies could be expected to deliver a specific good or service essential for the implementation of the project.

[14]In some countries, practical guidance on selection procedures encourages domestic contracting authorities to limit the prospective proposals to the lowest possible number sufficient to ensure meaningful competition (for example, three or four). The manner in which rating systems (in particular quantitative ones) may be used to arrive at such a range of bidders is discussed in the *Legislative Guide* (see chap. III, “Selection of the concessionaire”, para. 48). It should be noted that the rating system is used solely for the purpose of the pre-selection of bidders. The ratings of the pre-selected bidders should not be taken into account at the stage of evaluation of proposals (see model provision 15), at which all pre-selected bidders should start out on an equal standing.

2. Procedures for requesting proposals

Model provision 10. Single-stage and two-stage procedures for requesting proposals (see the *Legislative Guide*, recommendations 18 (for para. 1) and 19 (for paras. 2 and 3) and chap. III, paras. 51-58)

1. The contracting authority shall provide a set of the request for proposals and related documents issued in accordance with model provision 11 to each pre-selected bidder that pays the price, if any, charged for those documents.

2. Notwithstanding the above, the contracting authority may use a two-stage procedure to request proposals from pre-selected bidders when the contracting authority does not deem it to be feasible to describe in the request for proposals the characteristics of the project such as project specifications, performance indicators, financial arrangements or contractual terms in a manner sufficiently detailed and precise to permit final proposals to be formulated.

3. Where a two-stage procedure is used, the following provisions apply:

(a) The initial request for proposals shall call upon the bidders to submit, in the first stage of the procedure, initial proposals relating to project specifications, performance indicators, financing requirements or other characteristics of the project as well as to the main contractual terms proposed by the contracting authority;[15]

(b) The contracting authority may convene meetings and hold discussions with any of the bidders to clarify questions concerning the initial request for proposals or the initial proposals and accompanying documents submitted by the bidders. The contracting authority shall prepare minutes of any such meeting or discussion containing the questions raised and the clarifications provided by the contracting authority;

(c) Following examination of the proposals received, the contracting authority may review and, as appropriate, revise the initial request for proposals by deleting or modifying any aspect of the initial project specifications, performance indicators, financing requirements or other characteristics of the project, including the main contractual terms, and any criterion for evaluating and comparing proposals and for ascertaining the successful bidder, as set forth in the initial request for proposals, as well as by adding characteristics or

[15]In many cases, in particular for new types of project, the contracting authority may not be in a position, at this stage, to have formulated a detailed draft of the contractual terms envisaged by it. Also, the contracting authority may find it preferable to develop such terms only after an initial round of consultations with the pre-selected bidders. In any event, however, it is important for the contracting authority, at this stage, to provide some indication of the key contractual terms of the concession contract, in particular the way in which the project risks should be allocated between the parties under the concession contract. If this allocation of contractual rights and obligations is left entirely open until after the issuance of the final request for proposals, the bidders may respond by seeking to minimize the risks they accept, which may frustrate the purpose of seeking private investment for developing the project (see chap. III, “Selection of the concessionaire”, paras. 67-70; see also chap. II, “Project risks and government support”, paras. 8-29).

criteria to it. The contracting authority shall indicate in the record of the selection proceedings to be kept pursuant to model provision 26 the justification for any revision to the request for proposals. Any such deletion, modification or addition shall be communicated in the invitation to submit final proposals;

(d) In the second stage of the proceedings, the contracting authority shall invite the bidders to submit final proposals with respect to a single set of project specifications, performance indicators or contractual terms in accordance with model provisions 11-17.

Model provision 11. Content of the request for proposals (see the *Legislative Guide*, recommendation 20 and chap. III, paras. 59-70)

To the extent not already required by [*the enacting State indicates the provisions of its laws on procurement proceedings that govern the content of requests for proposals*],[16] the request for proposals shall include at least the following information:

(a) General information as may be required by the bidders in order to prepare and submit their proposals;[17]

(b) Project specifications and performance indicators, as appropriate, including the contracting authority's requirements regarding safety and security standards and environmental protection;[18]

(c) The contractual terms proposed by the contracting authority, including an indication of which terms are deemed to be non-negotiable;

(d) The criteria for evaluating proposals and the thresholds, if any, set by the contracting authority for identifying non-responsive proposals; the relative weight to be accorded to each evaluation criterion; and the manner in which the criteria and thresholds are to be applied in the evaluation and rejection of proposals.

Model provision 12. Bid securities (see the *Legislative Guide*, chap. III, para. 62)

1. The request for proposals shall set forth the requirements with respect to the issuer and the nature, form, amount and other principal terms and conditions of the required bid security.

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[16]A list of elements typically contained in a request for proposals for services can be found in article 38 of the Model Procurement Law.

[17]A list of the elements that should be provided can be found in the *Legislative Guide*, chapter III, "Selection of the concessionaire", paras. 61 and 62.

[18]See the *Legislative Guide*, chapter III, "Selection of the concessionaire", paras. 64-66.

2. A bidder shall not forfeit any bid security that it may have been required to provide, other than in cases of:[19]

(a) Withdrawal or modification of a proposal after the deadline for submission of proposals and, if so stipulated in the request for proposals, before that deadline;

(b) Failure to enter into final negotiations with the contracting authority pursuant to model provision 17, paragraph 1;

(c) Failure to submit its best and final offer within the time limit prescribed by the contracting authority pursuant to model provision 17, paragraph 2;

(d) Failure to sign the concession contract, if required by the contracting authority to do so, after the proposal has been accepted;

(e) Failure to provide required security for the fulfilment of the concession contract after the proposal has been accepted or to comply with any other condition prior to signing the concession contract specified in the request for proposals.

Model provision 13. Clarifications and modifications (see the *Legislative Guide*, recommendation 21 and chap. III, paras. 71 and 72)

The contracting authority may, whether on its own initiative or as a result of a request for clarification by a bidder, review and, as appropriate, revise any element of the request for proposals as set forth in model provision 11. The contracting authority shall indicate in the record of the selection proceedings to be kept pursuant to model provision 26 the justification for any revision to the request for proposals. Any such deletion, modification or addition shall be communicated to the bidders in the same manner as the request for proposals at a reasonable time prior to the deadline for submission of proposals.

Model provision 14. Evaluation criteria (see the *Legislative Guide*, recommendations 22 (for para. 1) and 23 (for para. 2) and chap. III, paras. 73-77)

1. The criteria for the evaluation and comparison of the technical proposals[20] shall include at least the following:

(a) Technical soundness;

(b) Compliance with environmental standards;

(c) Operational feasibility;

(d) Quality of services and measures to ensure their continuity.

[19]General provisions on bid securities can be found in art. 32 of the Model Procurement Law.

[20]See the *Legislative Guide*, chapter III, “Selection of the concessionaire”, para. 74.

2. The criteria for the evaluation and comparison of the financial and commercial proposals[21] shall include, as appropriate:

(a) The present value of the proposed tolls, unit prices and other charges over the concession period;

(b) The present value of the proposed direct payments by the contracting authority, if any;

(c) The costs for design and construction activities, annual operation and maintenance costs, present value of capital costs and operating and maintenance costs;

(d) The extent of financial support, if any, expected from a public authority of [*the enacting State*];

(e) The soundness of the proposed financial arrangements;

(f) The extent of acceptance of the negotiable contractual terms proposed by the contracting authority in the request for proposals;

(g) The social and economic development potential offered by the proposals.

Model provision 15. Comparison and evaluation of proposals (see the *Legislative Guide*, recommendation 24 and chap. III, paras. 78-82)

1. The contracting authority shall compare and evaluate each proposal in accordance with the evaluation criteria, the relative weight accorded to each such criterion and the evaluation process set forth in the request for proposals.

2. For the purposes of paragraph 1, the contracting authority may establish thresholds with respect to quality, technical, financial and commercial aspects. Proposals that fail to achieve the thresholds shall be regarded as non-responsive and rejected from the selection procedure.[22]

Model provision 16. Further demonstration of fulfilment of qualification criteria (see the *Legislative Guide*, recommendation 25 and chap. III, paras. 78-82)

The contracting authority may require any bidder that has been pre-selected to demonstrate again its qualifications in accordance with the same

[21]See the *Legislative Guide*, chapter III, "Selection of the concessionaire", paras. 75-77.

[22]This model provision offers an example of an evaluation process that a contracting authority may wish to apply to compare and evaluate proposals for privately financed infrastructure projects. Alternative evaluation processes such as a two-step evaluation process or the two-envelope system are described in the *Legislative Guide*, chap. III, "Selection of the concessionaire", paras. 79-82. In contrast to the process set forth in this model provision, the processes described in the *Legislative Guide* are designed to allow the contracting authority to compare and evaluate the non-financial criteria separately from the financial criteria so as to avoid situations where undue weight would be given to certain elements of the financial criteria (such as the unit price) to the detriment of the non-financial criteria. In order to ensure the integrity, transparency and predictability of the evaluation stage of the selection proceedings, it is recommended that the enacting State set forth in its law the evaluation processes that contracting authorities may use to compare and evaluate proposals and the details of the application of this process.

criteria used for pre-selection. The contracting authority shall disqualify any bidder that fails to demonstrate again its qualifications if requested to do so.[23]

Model provision 17. Final negotiations (see the *Legislative Guide*, recommendations 26 (for para. 1) and 27 (for para. 2) and chap. III, paras. 83 and 84)

1. The contracting authority shall rank all responsive proposals on the basis of the evaluation criteria and invite for final negotiation of the concession contract the bidder that has attained the best rating. Final negotiations shall not concern those contractual terms, if any, that were stated as non-negotiable in the final request for proposals.

2. If it becomes apparent to the contracting authority that the negotiations with the bidder invited will not result in a concession contract, the contracting authority shall inform the bidder of its intention to terminate the negotiations and give the bidder reasonable time to formulate its best and final offer. If the contracting authority does not find that proposal acceptable, it shall terminate the negotiations with the bidder concerned. The contracting authority shall then invite for negotiations the other bidders in the order of their ranking until it arrives at a concession contract or rejects all remaining proposals. The contracting authority shall not resume negotiations with a bidder with which negotiations have been terminated pursuant to this paragraph.

3. Negotiation of concession contracts without competitive procedures

Model provision 18. Circumstances authorizing award without competitive procedures (see recommendation 28 and chap. III, para. 89)

Subject to approval by [*the enacting State indicates the relevant authority*],[24] the contracting authority is authorized to negotiate a concession contract without using the procedure set forth in model provisions 6 to 17 in the following cases:

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[23]Where pre-qualification proceedings have been engaged in, the criteria shall be the same as those used in the pre-qualification proceedings.

[24]The rationale for subjecting the award of the concession contract without competitive procedures to the approval of a higher authority is to ensure that the contracting authority engages in direct negotiations with bidders only in the appropriate circumstances (see the *Legislative Guide*, chap. III, "Selection of the concessionaire", paras. 85-96). The model provision therefore suggests that the enacting State indicate a relevant authority that is competent to authorize negotiations in all cases set forth in the model provision. The enacting State may provide, however, for different approval requirements for each subparagraph of the model provision. In some cases, for instance, the enacting State may provide that the authority to engage in such negotiations derives directly from the law. In other cases, the enacting State may make the negotiations subject to the approval of different higher authorities, depending on the nature of the services to be provided or the infrastructure sector concerned. In those cases, the enacting State may need to adapt the model provision to these approval requirements by adding the particular approval requirement to the subparagraph concerned, or by adding a reference to provisions of its law where these approval requirements are set forth.

(a) When there is an urgent need for ensuring continuity in the provision of the service and engaging in the procedures set forth in model provisions 6 to 17 would be impractical, provided that the circumstances giving rise to the urgency were neither foreseeable by the contracting authority nor the result of dilatory conduct on its part;

(b) Where the project is of short duration and the anticipated initial investment value does not exceed the amount [of [*the enacting State specifies a monetary ceiling*]] [set forth in [*the enacting State indicates the provisions of its laws that specify the monetary threshold below which a privately financed infrastructure project may be awarded without competitive procedures*]];[25]

(c) Where the project involves national defence or national security;

(d) Where there is only one source capable of providing the required service, such as when the provision of the service requires the use of intellectual property, trade secrets or other exclusive rights owned or possessed by a certain person or persons;

(e) In cases of unsolicited proposals falling under model provision 23;

(f) When an invitation to the pre-selection proceedings or a request for proposals has been issued but no applications or proposals were submitted or all proposals failed to meet the evaluation criteria set forth in the request for proposals and if, in the judgement of the contracting authority, issuing a new invitation to the pre-selection proceedings and a new request for proposals would be unlikely to result in a project award within a required time frame;[26]

(g) In other cases where the [*the enacting State indicates the relevant authority*] authorizes such an exception for compelling reasons of public interest.[27]

Model provision 19. Procedures for negotiation of a concession contract (see the Legislative Guide, recommendation 29 and chap. III, para. 90)

Where a concession contract is negotiated without using the procedures set forth in model provisions 6-17 the contracting authority shall:[28]

(a) Except for concession contracts negotiated pursuant to model provision 18, subparagraph *(c),* cause a notice of its intention to commence

[25]As an alternative to the exclusion provided for in subparagraph *(b),* the enacting State may consider devising a simplified procedure for request for proposals for projects falling thereunder, for instance by applying the procedures described in art. 48 of the Model Procurement Law.

[26]The enacting State may wish to require that the contracting authority include in the record to be kept pursuant to model provision 26 a summary of the results of the negotiations and indicate the extent to which those results differed from the project specifications and contractual terms of the original request for proposals, and that it state the reasons therefor.

[27]Enacting States that deem it desirable to authorize the use of negotiated procedures on an ad hoc basis may wish to retain subparagraph *(g)* when implementing the model provision. Enacting States wishing to limit exceptions to the competitive selection procedures may prefer not to include the subparagraph. In any event, for purposes of transparency, the enacting State may wish to indicate here or elsewhere in the model provision other exceptions, if any, authorizing the use of negotiated procedures that may be provided for under specific legislation.

[28]A number of elements to enhance transparency in negotiations under this model provision are discussed in the *Legislative Guide*, chap. III, "Selection of the concessionaire", paras. 90-96.

negotiations in respect of a concession contract to be published in accordance with [*the enacting State indicates the provisions of any relevant laws on procurement proceedings that govern the publication of notices*];

(b) Engage in negotiations with as many persons as the contracting authority judges capable[29] of carrying out the project as circumstances permit;

(c) Establish evaluation criteria against which proposals shall be evaluated and ranked.

4. Unsolicited proposals[30]

Model provision 20. Admissibility of unsolicited proposals (see the *Legislative Guide*, recommendation 30 and chap. III, paras. 97-109)

As an exception to model provisions 6 to 17, the contracting authority[31] is authorized to consider unsolicited proposals pursuant to the procedures set forth in model provisions 21 to 23, provided that such proposals do not relate to a project for which selection procedures have been initiated or announced.

Model provision 21. Procedures for determining the admissibility of unsolicited proposals (see the *Legislative Guide*, recommendations 31 (for paras. 1 and 2) and 32 (for para. 3) and chap. III, paras. 110-112)

1. Following receipt and preliminary examination of an unsolicited proposal, the contracting authority shall promptly inform the proponent whether or not the project is considered to be potentially in the public interest.[32]

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[29]Enacting States wishing to enhance transparency in the use of negotiated procedures may establish, by specific regulations, qualification criteria to be met by persons invited to negotiations pursuant to model provisions 18 and 19. An indication of possible qualification criteria is contained in model provision 7.

[30]The policy considerations on the advantages and disadvantages of unsolicited proposals are discussed in the *Legislative Guide*, chap. III, "Selection of the concessionaire", paras. 98-100. States that wish to allow contracting authorities to handle such proposals may wish to use the procedures set forth in model provisions 21-23.

[31]The model provision assumes that the power to entertain unsolicited proposals lies with the contracting authority. However, depending on the regulatory system of the enacting State, a body separate from the contracting authority may have the responsibility for entertaining unsolicited proposals or for considering, for instance, whether an unsolicited proposal is in the public interest. In such a case, the manner in which the functions of such a body may need to be coordinated with those of the contracting authority should be carefully considered by the enacting State (see footnotes 1, 3 and 24 and the references cited therein).

[32]The determination that a proposed project is in the public interest entails a considered judgement regarding the potential benefits to the public that are offered by the project, as well as its relationship to the Government's policy for the infrastructure sector concerned. In order to ensure the integrity, transparency and predictability of the procedures for determining the admissibility of unsolicited proposals, it may be advisable for the enacting State to provide guidance, in regulations or other documents, concerning the criteria that will be used to determine whether an unsolicited proposal is in the public interest, which may include criteria for assessing the appropriateness of the contractual arrangements and the reasonableness of the proposed allocation of project risks.

2. If the project is considered to be potentially in the public interest under paragraph 1, the contracting authority shall invite the proponent to submit as much information on the proposed project as is feasible at this stage to allow the contracting authority to make a proper evaluation of the proponent's qualifications[33] and the technical and economic feasibility of the project and to determine whether the project is likely to be successfully implemented in the manner proposed in terms acceptable to the contracting authority. For this purpose, the proponent shall submit a technical and economic feasibility study, an environmental impact study and satisfactory information regarding the concept or technology contemplated in the proposal.

3. In considering an unsolicited proposal, the contracting authority shall respect the intellectual property, trade secrets or other exclusive rights contained in, arising from or referred to in the proposal. Therefore, the contracting authority shall not make use of information provided by or on behalf of the proponent in connection with its unsolicited proposal other than for the evaluation of that proposal, except with the consent of the proponent. Except as otherwise agreed by the parties, the contracting authority shall, if the proposal is rejected, return to the proponent the original and any copies of documents that the proponent submitted and prepared throughout the procedure.

Model provision 22. Unsolicited proposals that do not involve intellectual property, trade secrets or other exclusive rights (see the *Legislative Guide*, recommendation 33 and chap. III, paras. 113 and 114)

1. Except in the circumstances set forth in model provision 18, the contracting authority shall, if it decides to implement the project, initiate a selection procedure in accordance with model provisions 6 to 17 if the contracting authority considers that:

(a) The envisaged output of the project can be achieved without the use of intellectual property, trade secrets or other exclusive rights owned or possessed by the proponent; and

(b) The proposed concept or technology is not truly unique or new.

2. The proponent shall be invited to participate in the selection proceedings initiated by the contracting authority pursuant to paragraph 1 and may be given an incentive or a similar benefit in a manner described by the contracting authority in the request for proposals in consideration for the development and submission of the proposal.

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[33]The enacting State may wish to provide in regulations the qualification criteria that need to be met by the proponent. Elements to be taken into account for that purpose are indicated in model provision 7.

Model provision 23. Unsolicited proposals involving intellectual property, trade secrets or other exclusive rights (see the *Legislative Guide*, recommendations 34 (for paras. 1 and 2) and 35 (for paras. 3 and 4) and chap. III, paras. 115-117)

1. If the contracting authority determines that the conditions of model provision 22, paragraph 1 *(a)* and *(b),* are not met, it shall not be required to carry out a selection procedure pursuant to model provisions 6 to 17. However, the contracting authority may still seek to obtain elements of comparison for the unsolicited proposal in accordance with the provisions set out in paragraphs 2 to 4 of this model provision.[34]

2. Where the contracting authority intends to obtain elements of comparison for the unsolicited proposal, the contracting authority shall publish a description of the essential output elements of the proposal with an invitation for other interested parties to submit proposals within [a reasonable period] [*the enacting State indicates a certain amount of time*].

3. If no proposals in response to an invitation issued pursuant to paragraph 2 of this model provision are received within [a reasonable period] [the amount of time specified in paragraph 2 above], the contracting authority may engage in negotiations with the original proponent.

4. If the contracting authority receives proposals in response to an invitation issued pursuant to paragraph 2, the contracting authority shall invite the proponents to negotiations in accordance with the provisions set forth in model provision 19. In the event that the contracting authority receives a sufficiently large number of proposals, which appear prima facie to meet its infrastructure needs, the contracting authority shall request the submission of proposals pursuant to model provisions 10 to 17, subject to any incentive or other benefit that may be given to the person who submitted the unsolicited proposal in accordance with model provision 22, paragraph 2.

5. *Miscellaneous provisions*

Model provision 24. Confidentiality (see the *Legislative Guide*, recommendation 36 and chap. III, para. 118)

The contracting authority shall treat proposals in such a manner as to avoid the disclosure of their content to competing bidders. Any discussions, communications and negotiations between the contracting authority and a bidder pursuant to model provisions 10, paragraph 3, 17, 18, 19 or 23, paragraphs 3 and 4, shall be confidential. Unless required by law or by a court

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[34]The enacting State may wish to consider adopting a special procedure for handling unsolicited proposals falling under this model provision, which may be modelled, mutatis mutandis, on the request-for-proposals procedure set forth in article 48 of the Model Procurement Law.

order or permitted by the request for proposals, no party to the negotiations shall disclose to any other person any technical, price or other information in relation to discussions, communications and negotiations pursuant to the aforementioned provisions without the consent of the other party.

Model provision 25. Notice of contract award (see the *Legislative Guide*, recommendation 37 and chap. III, para. 119)

Except for concession contracts awarded pursuant to model provision 18, subparagraph *(c),* the contracting authority shall cause a notice of the contract award to be published in accordance with [*the enacting State indicates the provisions of its laws on procurement proceedings that govern the publication of contract award notices*]. The notice shall identify the concessionaire and include a summary of the essential terms of the concession contract.

Model provision 26. Record of selection and award proceedings (see the *Legislative Guide*, recommendation 38 and chap. III, paras. 120-126)

The contracting authority shall keep an appropriate record of information pertaining to the selection and award proceedings in accordance with [*the enacting State indicates the provisions of its laws on public procurement that govern record of procurement proceedings*].[35]

Model provision 27. Review procedures (see the *Legislative Guide*, recommendation 39 and chap. III, paras. 127-131)

A bidder that claims to have suffered, or that may suffer, loss or injury due to a breach of a duty imposed on the contracting authority by the law may seek review of the contracting authority's acts or failures to act in accordance with [*the enacting State indicates the provisions of its laws governing the review of decisions made in procurement proceedings*].[36]

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[35]The content of such a record for the various types of project award contemplated in the model provisions, as well as the extent to which the information contained therein may be accessible to the public, are discussed in the *Legislative Guide,* chap. III, "Selection of the concessionaire", paras. 120-126. The content of such a record for the various types of project award is further set out in article 11 of the Model Procurement Law. If the laws of the enacting State do not adequately address these matters, the enacting State should adopt legislation or regulations to that effect.

[36]Elements for the establishment of an adequate review system are discussed in the *Legislative Guide,* chap. III, "Selection of the concessionaire", paras. 127-131. They are also contained in chapter VI of the Model Procurement Law. If the laws of the enacting State do not provide such an adequate review system, the enacting State should consider adopting legislation to that effect.

III. Contents and implementation of the concession contract

Model provision 28. Contents and implementation of the concession contract (see the *Legislative Guide*, recommendation 40 and chap. IV, paras. 1-11)

The concession contract shall provide for such matters as the parties deem appropriate,[37] such as:

(a) The nature and scope of works to be performed and services to be provided by the concessionaire (see chap. IV, para. 1);

(b) The conditions for provision of those services and the extent of exclusivity, if any, of the concessionaire's rights under the concession contract (see recommendation 5);

(c) The assistance that the contracting authority may provide to the concessionaire in obtaining licences and permits to the extent necessary for the implementation of the infrastructure project;

(d) Any requirements relating to the establishment and minimum capital of a legal entity incorporated in accordance with model provision 30 (see recommendations 42 and 43 and model provision 30);

(e) The ownership of assets related to the project and the obligations of the parties, as appropriate, concerning the acquisition of the project site and any necessary easements, in accordance with model provisions 31 to 33 (see recommendations 44 and 45 and model provisions 31-33);

(f) The remuneration of the concessionaire, whether consisting of tariffs or fees for the use of the facility or the provision of services; the methods and formulas for the establishment or adjustment of any such tariffs or fees; and payments, if any, that may be made by the contracting authority or other public authority (see recommendations 46 and 48);

(g) Procedures for the review and approval of engineering designs, construction plans and specifications by the contracting authority, and the procedures for testing and final inspection, approval and acceptance of the infrastructure facility (see recommendation 52);

(h) The extent of the concessionaire's obligations to ensure, as appropriate, the modification of the service so as to meet the actual demand for the service, its continuity and its provision under essentially the same conditions for all users (see recommendation 53 and model provision 38);

(i) The contracting authority's or other public authority's right to monitor the works to be performed and services to be provided by the concessionaire and the conditions and extent to which the contracting authority or a regulatory agency may order variations in respect of the works and conditions of service or take such other reasonable actions as they may find appropriate to ensure that the infrastructure facility is properly operated and the

[37]Enacting States may wish to note that the inclusion in the concession contract of provisions dealing with some of the matters listed in this model provision is mandatory pursuant to other model provisions.

services are provided in accordance with the applicable legal and contractual requirements (see recommendations 52 and 54, subpara. *(b)*);

(j) The extent of the concessionaire's obligation to provide the contracting authority or a regulatory agency, as appropriate, with reports and other information on its operations (see recommendation 54, subpara. *(a)*);

(k) Mechanisms to deal with additional costs and other consequences that might result from any order issued by the contracting authority or another public authority in connection with subparagraphs *(h)* and *(i)* above, including any compensation to which the concessionaire might be entitled (see chap. IV, paras. 73-76);

(l) Any rights of the contracting authority to review and approve major contracts to be entered into by the concessionaire, in particular with the concessionaire's own shareholders or other affiliated persons (see recommendation 56);

(m) Guarantees of performance to be provided and insurance policies to be maintained by the concessionaire in connection with the implementation of the infrastructure project (see recommendation 58, subparas. *(a)* and *(b)*);

(n) Remedies available in the event of default of either party (see recommendation 58, subpara. *(e)*);

(o) The extent to which either party may be exempt from liability for failure or delay in complying with any obligation under the concession contract owing to circumstances beyond its reasonable control (see recommendation 58, subpara. *(d)*);

(p) The duration of the concession contract and the rights and obligations of the parties upon its expiry or termination (see recommendation 61);

(q) The manner for calculating compensation pursuant to model provision 47 (see recommendation 67);

(r) The governing law and the mechanisms for the settlement of disputes that may arise between the contracting authority and the concessionaire (see recommendation 69 and model provisions 29 and 49);

(s) The rights and obligations of the parties with respect to confidential information (see model provision 24).

Model provision 29. Governing law (see the *Legislative Guide*, recommendation 41 and chap. IV, paras. 5-8)

The concession contract is governed by the law of [the enacting State] unless otherwise provided in the concession contract.[38]

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[38]Legal systems provide varying answers to the question as to whether the parties to a concession contract may choose as the governing law of the contract a law other than the laws of the host country. Furthermore, as discussed in the *Legislative Guide* (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 5-8), in some countries the concession contract may be subject to administrative law, while in others the concession contract may be governed by private law (see also the *Legislative Guide*, chap. VII, "Other relevant areas of law", paras. 24-27). The governing law also includes legal rules of other fields of law that apply to the various issues that arise during the implementation of an infrastructure project (see generally the *Legislative Guide*, chap. VII, "Other relevant areas of law", sect. B).

Model provision 30. Organization of the concessionaire (see the *Legislative Guide*, recommendations 42 and 43 and chap. IV, paras. 12-18)

The contracting authority may require that the successful bidder establish a legal entity incorporated under the laws of [the enacting State], provided that a statement to that effect was made in the pre-selection documents or in the request for proposals, as appropriate. Any requirement relating to the minimum capital of such a legal entity and the procedures for obtaining the approval of the contracting authority to its statute and by-laws and significant changes therein shall be set forth in the concession contract consistent with the terms of the request for proposals.

Model provision 31. Ownership of assets[39] (see the *Legislative Guide*, recommendation 44 and chap. IV, paras. 20-26)

The concession contract shall specify, as appropriate, which assets are or shall be public property and which assets are or shall be the private property of the concessionaire. The concession contract shall in particular identify which assets belong to the following categories:

(a) Assets, if any, that the concessionaire is required to return or transfer to the contracting authority or to another entity indicated by the contracting authority in accordance with the terms of the concession contract;

(b) Assets, if any, that the contracting authority, at its option, may purchase from the concessionaire; and

(c) Assets, if any, that the concessionaire may retain or dispose of upon expiry or termination of the concession contract.

Model provision 32. Acquisition of rights related to the project site (see the *Legislative Guide*, recommendation 45 and chap. IV, paras. 27-29)

1. The contracting authority or other public authority under the terms of the law and the concession contract shall make available to the concessionaire

[39]Private sector participation in infrastructure projects may be devised in a variety of different forms, ranging from publicly owned and operated infrastructure to fully privatized projects (see the *Legislative Guide*, "Introduction and background information on privately financed infrastructure projects", paras. 47-53). Those general policy options typically determine the legislative approach for ownership of project-related assets (see the *Legislative Guide*, chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 20-26). Irrespective of the host country's general or sectoral policy, the ownership regime of the various assets involved should be clearly defined and based on sufficient legislative authority. Clarity in this respect is important, as it will directly affect the concessionaire's ability to create security interests in project assets for the purpose of raising financing for the project (see the *Legislative Guide*, chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 52-61). Consistent with the flexible approach taken by various legal systems, the model provision does not contemplate an unqualified transfer of all assets to the contracting authority but allows a distinction between assets that must be transferred to the contracting authority, assets that may be purchased by the contracting authority, at its option, and assets that remain the private property of the concessionaire, upon expiry or termination of the concession contract or at any other time.

or, as appropriate, shall assist the concessionaire in obtaining such rights related to the project site, including title thereto, as may be necessary for the implementation of the project.

2. Any compulsory acquisition of land that may be required for the implementation of the project shall be carried out in accordance with [*the enacting State indicates the provisions of its laws that govern compulsory acquisition of private property by public authorities for reasons of public interest*].

Model provision 33. Easements[40] (see the *Legislative Guide*, recommendation 45 and chap. IV, para. 30)

Variant A

1. The contracting authority or other public authority under the terms of the law and the concession contract shall make available to the concessionaire or, as appropriate, shall assist the concessionaire to enjoy the right to enter upon, transit through or do work or fix installations upon property of third parties, as appropriate and required for the implementation of the project in accordance with [*the enacting State indicates the provisions of its laws that govern easements and other similar rights enjoyed by public utility companies and infrastructure operators under its laws*].

Variant B

1. The concessionaire shall have the right to enter upon, transit through or do work or fix installations upon property of third parties, as appropriate and required for the implementation of the project in accordance with [*the enacting State indicates the provisions of its laws that govern easements and other similar rights enjoyed by public utility companies and infrastructure operators under its laws*].

2. Any easements that may be required for the implementation of the project shall be created in accordance with [*the enacting State indicates the provisions of its laws that govern the creation of easements for reasons of public interest*].

[40]The right to transit on or through adjacent property for project-related purposes or to do work on such property may be acquired by the concessionaire directly or may be compulsorily acquired by a public authority simultaneously with the project site. A somewhat different alternative, which is reflected in variant B, might be for the law itself to empower public service providers to enter, pass through or do work or fix installations upon the property of third parties, as required for the construction, operation and maintenance of public infrastructure (see the *Legislative Guide*, chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 30-32).

Model provision 34. Financial arrangements (see the *Legislative Guide*, recommendations 46, 47 and 48 and chap. IV, paras. 33-51)

1. The concessionaire shall have the right to charge, receive or collect tariffs or fees for the use of the facility or its services in accordance with the concession contract, which shall provide for methods and formulas for the establishment and adjustment of those tariffs or fees [*in accordance with the rules established by the competent regulatory agency*].[41]

2. The contracting authority shall have the power to agree to make direct payments to the concessionaire as a substitute for, or in addition to, tariffs or fees for the use of the facility or its services.

Model provision 35. Security interests (see the *Legislative Guide*, recommendation 49 and chap. IV, paras. 52-61)

1. Subject to any restriction that may be contained in the concession contract,[42] the concessionaire has the right to create security interests over any of its assets, rights or interests, including those relating to the infrastructure project, as required to secure any financing needed for the project, including, in particular, the following:

(a) Security over movable or immovable property owned by the concessionaire or its interests in project assets;

(b) A pledge of the proceeds of, and receivables owed to the concessionaire for, the use of the facility or the services it provides.

2. The shareholders of the concessionaire shall have the right to pledge or create any other security interest in their shares in the concessionaire.

3. No security under paragraph 1 may be created over public property or other property, assets or rights needed for the provision of a public service, where the creation of such security is prohibited by the law of [*the enacting State*].

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[41]Tolls, fees, prices or other charges accruing to the concessionaire, which are referred to in the *Legislative Guide* as "tariffs", may be the main (sometimes even the sole) source of revenue to recover the investment made in the project in the absence of subsidies or payments by the contracting authority or other public authorities (see the *Legislative Guide*, chap. II, "Project risks and government support", paras. 30-60). The cost at which public services are provided is typically an element of the Government's infrastructure policy and a matter of immediate concern for large sections of the public. Thus, the regulatory framework for the provision of public services in many countries includes special tariff-control rules. Furthermore, statutory provisions or general rules of law in some legal systems establish parameters for pricing goods or services, for instance by requiring that charges meet certain standards of "reasonableness", "fairness" or "equity" (see the *Legislative Guide*, chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 36-46).

[42]These restrictions may, in particular, concern the enforcement of the rights or interests relating to assets of the infrastructure project.

Model provision 36. Assignment of the concession contract (see the *Legislative Guide*, recommendation 50 and chap. IV, paras. 62 and 63)

Except as otherwise provided in model provision 35, the rights and obligations of the concessionaire under the concession contract may not be assigned to third parties without the consent of the contracting authority. The concession contract shall set forth the conditions under which the contracting authority shall give its consent to an assignment of the rights and obligations of the concessionaire under the concession contract, including the acceptance by the new concessionaire of all obligations thereunder and evidence of the new concessionaire's technical and financial capability as necessary for providing the service.

Model provision 37. Transfer of controlling interest[43] in the concessionaire (see the *Legislative Guide*, recommendation 51 and chap. IV, paras. 64-68)

Except as otherwise provided in the concession contract, a controlling interest in the concessionaire may not be transferred to third parties without the consent of the contracting authority. The concession contract shall set forth the conditions under which consent of the contracting authority shall be given.

Model provision 38. Operation of infrastructure (see the *Legislative Guide*, recommendation 53 and chap. IV, paras. 80-93 (for para. 1) and recommendation 55 and chap. IV, paras. 96 and 97 (for para. 2))

1. The concession contract shall set forth, as appropriate, the extent of the concessionaire's obligations to ensure:

(a) The modification of the service so as to meet the demand for the service;

(b) The continuity of the service;

(c) The provision of the service under essentially the same conditions for all users;

(d) The non-discriminatory access, as appropriate, of other service providers to any public infrastructure network operated by the concessionaire.

[43]The notion of "controlling interest" generally refers to the power to appoint the management of a corporation and influence or determine its business. Different criteria may be used in various legal systems or even in different bodies of law within the same legal system, ranging from formal criteria attributing a controlling interest to the ownership of a certain amount (typically more than 50 per cent) of the total combined voting power of all classes of stock of a corporation to more complex criteria that take into account the actual management structure of a corporation. Enacting States that do not have a statutory definition of "controlling interest" may need to define the term in regulations issued to implement the model provision.

2. The concessionaire shall have the right to issue and enforce rules governing the use of the facility, subject to the approval of the contracting authority or a regulatory body.

Model provision 39. Compensation for specific changes in legislation (see the *Legislative Guide*, recommendation 58, subpara. *(c)*, and chap. IV, paras. 122-125)

The concession contract shall set forth the extent to which the concessionaire is entitled to compensation in the event that the cost of the concessionaire's performance of the concession contract has substantially increased or that the value that the concessionaire receives for such performance has substantially diminished, as compared with the costs and the value of performance originally foreseen, as a result of changes in legislation or regulations specifically applicable to the infrastructure facility or the services it provides.

Model provision 40. Revision of the concession contract (see the *Legislative Guide*, recommendation 58, subpara. *(c)*, and chap. IV, paras. 126-130)

1. Without prejudice to model provision 39, the concession contract shall further set forth the extent to which the concessionaire is entitled to a revision of the concession contract with a view to providing compensation in the event that the cost of the concessionaire's performance of the concession contract has substantially increased or that the value that the concessionaire receives for such performance has substantially diminished, as compared with the costs and the value of performance originally foreseen, as a result of:

(a) Changes in economic or financial conditions; or

(b) Changes in legislation or regulations not specifically applicable to the infrastructure facility or the services it provides;

provided that the economic, financial, legislative or regulatory changes:

(a) Occur after the conclusion of the contract;

(b) Are beyond the control of the concessionaire; and

(c) Are of such a nature that the concessionaire could not reasonably be expected to have taken them into account at the time the concession contract was negotiated or to have avoided or overcome their consequences.

2. The concession contract shall establish procedures for revising the terms of the concession contract following the occurrence of any such changes.

Model provision 41. Takeover of an infrastructure project by the contracting authority (see the *Legislative Guide*, recommendation 59 and chap. IV, paras. 143-146)

Under the circumstances set forth in the concession contract, the contracting authority has the right to temporarily take over the operation of the facility for the purpose of ensuring the effective and uninterrupted delivery of the service in the event of serious failure by the concessionaire to perform its obligations and to rectify the breach within a reasonable period of time after having been given notice by the contracting authority to do so.

Model provision 42. Substitution of the concessionaire (see the *Legislative Guide*, recommendation 60 and chap. IV, paras. 147-150)

The contracting authority may agree with the entities extending financing for an infrastructure project and the concessionaire to provide for the substitution of the concessionaire by a new entity or person appointed to perform under the existing concession contract upon serious breach by the concessionaire or other events that could otherwise justify the termination of the concession contract or other similar circumstances.[44]

IV. Duration, extension and termination of the concession contract

1. *Duration and extension of the concession contract*

Model provision 43. Duration and extension of the concession contract (see the *Legislative Guide*, recommendation 62 and chap. V, paras. 2-8)

The duration of the concession shall be set forth in the concession contract. The contracting authority may not agree to extend its duration except as a result of the following circumstances:

(a) Delay in completion or interruption of operation due to circumstances beyond the reasonable control of either party;

(b) Project suspension brought about by acts of the contracting authority or other public authorities;

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[44]The substitution of the concessionaire by another entity, proposed by the lenders and accepted by the contracting authority under the terms agreed by them, is intended to give the parties an opportunity to avert the disruptive consequences of termination of the concession contract (see the *Legislative Guide*, chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 147-150). The parties may wish first to resort to other practical measures, possibly in a successive fashion, such as temporary takeover of the project by the lenders or by a temporary administrator appointed by them, or enforcement of the lenders' security over the shares of the concessionaire company by selling those shares to a third party acceptable to the contracting authority.

(c) Increase in costs arising from requirements of the contracting authority not originally foreseen in the concession contract, if the concessionaire would not be able to recover such costs without such extension; or

(d) [*Other circumstances, as specified by the enacting State*].[45]

2. *Termination of the concession contract*

Model provision 44. Termination of the concession contract by the contracting authority (see the *Legislative Guide*, recommendation 63 and chap. V, paras. 14-27)

The contracting authority may terminate the concession contract:

(a) In the event that it can no longer be reasonably expected that the concessionaire will be able or willing to perform its obligations, owing to insolvency, serious breach or otherwise;

(b) For compelling[46] reasons of public interest, subject to payment of compensation to the concessionaire, the terms of the compensation to be as agreed in the concession contract;

(c) [*Other circumstances that the enacting State might wish to add*].

Model provision 45. Termination of the concession contract by the concessionaire (see the *Legislative Guide*, recommendation 64 and chap. V, paras. 28-33)

The concessionaire may not terminate the concession contract except under the following circumstances:

(a) In the event of serious breach by the contracting authority or other public authority of its obligations in connection with the concession contract;

(b) If the conditions for a revision of the concession contract under model provision 40, paragraph 1, are met, but the parties have failed to agree on a revision of the concession contract; or

(c) If the cost of the concessionaire's performance of the concession contract has substantially increased or the value that the concessionaire receives for such performance has substantially diminished as a result of acts or omissions of the contracting authority or other public authorities, for instance, pursuant to model provision 28, subparagraphs *(h)* and *(i),* and the parties have failed to agree on a revision of the concession contract.

[45]The enacting State may wish to consider the possibility of having the law authorize a consensual extension of the concession contract pursuant to its terms, for reasons of public interest, as justified in the record to be kept by the contracting authority pursuant to model provision 26.

[46]Possible situations constituting a compelling reason of public interest are discussed in the *Legislative Guide*, chap. V, "Duration, extension and termination of the project agreement", para. 27.

Model provision 46. Termination of the concession contract by either party (see the *Legislative Guide*, recommendation 65 and chap. V, paras. 34 and 35)

Either party shall have the right to terminate the concession contract in the event that the performance of its obligations is rendered impossible by circumstances beyond either party's reasonable control. The parties shall also have the right to terminate the concession contract by mutual consent.

3. Arrangements upon termination or expiry of the concession contract

Model provision 47. Compensation upon termination of the concession contract (see the *Legislative Guide*, recommendation 67 and chap. V, paras. 43-49)

The concession contract shall stipulate how compensation due to either party is calculated in the event of termination of the concession contract, providing, where appropriate, for compensation for the fair value of works performed under the concession contract, costs incurred or losses sustained by either party, including, as appropriate, lost profits.

Model provision 48. Wind-up and transfer measures (see the *Legislative Guide*, recommendation 66 and chap. V, paras. 37-42 (for subpara. *(a)*) and recommendation 68 and chap. V, paras. 50-62 (for subparas. *(b)*-*(d)*)

The concession contract shall provide, as appropriate, for:

(a) Mechanisms and procedures for the transfer of assets to the contracting authority;

(b) The compensation to which the concessionaire may be entitled in respect of assets transferred to the contracting authority or to a new concessionaire or purchased by the contracting authority;

(c) The transfer of technology required for the operation of the facility;

(d) The training of the contracting authority's personnel or of a successor concessionaire in the operation and maintenance of the facility;

(e) The provision, by the concessionaire, of continuing support services and resources, including the supply of spare parts, if required, for a reasonable period after the transfer of the facility to the contracting authority or to a successor concessionaire.

V. Settlement of disputes

Model provision 49. Disputes between the contracting authority and the concessionaire (see the *Legislative Guide*, recommendation 69 and chap. VI, paras. 3-41)

Any disputes between the contracting authority and the concessionaire shall be settled through the dispute settlement mechanisms agreed by the parties in the concession contract.[47]

Model provision 50. Disputes involving customers or users of the infrastructure facility (see the *Legislative Guide*, recommendation 71 and chap. VI, paras. 43-45)

Where the concessionaire provides services to the public or operates infrastructure facilities accessible to the public, the contracting authority may require the concessionaire to establish simplified and efficient mechanisms for handling claims submitted by its customers or users of the infrastructure facility.

Model provision 51. Other disputes (see the *Legislative Guide*, recommendation 70 and chap. VI, para. 42)

1. The concessionaire and its shareholders shall be free to choose the appropriate mechanisms for settling disputes among themselves.

2. The concessionaire shall be free to agree on the appropriate mechanisms for settling disputes between itself and its lenders, contractors, suppliers and other business partners.

[47]The enacting State may provide in its legislation dispute settlement mechanisms that are best suited to the needs of privately financed infrastructure projects.

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United Nations Commission on International Trade Law

Travaux préparatoires

2003 - Model Legislative Provisions on Privately Financed Infrastructure Projects

Related documents are available from:

- the fourth and fifth sessions of Working Group I
- and from the twenty-ninth, thirty, thirty-first, thirty-second, thirty-third, thirty-fourth, thirty-fifth and thirty-sixth sessions of the Commission.

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2000 - UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects

Adopted by UNCITRAL on 29 June 2000, the purpose of the Guide is to assist in the establishment of a legal framework favourable to private investment in public infrastructure. The advice provided in the Guide aims at achieving a balance between the desire to facilitate and encourage private participation in infrastructure projects, on the one hand, and various public interest concerns of the host country, on the other.

General Assembly resolution

Text

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Resolution adopted by the General Assembly

[*on the report of the Sixth Committee (A/56/588 and Corr.1)*]

56/79. Report of the United Nations Commission on International Trade Law on the work of its thirty-fourth session

The General Assembly,

Recalling its resolution 2205 (XXI) of 17 December 1966, by which it established the United Nations Commission on International Trade Law with a mandate to further the progressive harmonization and unification of the law of international trade and in that respect to bear in mind the interests of all peoples, in particular those of developing countries, in the extensive development of international trade,

Reaffirming its conviction that the progressive harmonization and unification of international trade law, in reducing or removing legal obstacles to the flow of international trade, especially those affecting the developing countries, would contribute significantly to universal economic cooperation among all States on a basis of equality, equity and common interest and to the elimination of discrimination in international trade and, thereby, to the well-being of all peoples,

Emphasizing the need for higher priority to be given to the work of the Commission in view of the increasing value of the modernization of international trade law for global economic development and thus for the maintenance of friendly relations among States,

Stressing the value of the participation by States at all levels of economic development and from different legal systems in the process of harmonizing and unifying international trade law,

Having considered the report of the Commission on the work of its thirty-fourth session,[1]

Concerned that activities undertaken by other bodies of the United Nations system in the field of international trade law without coordination with the Commission might lead to undesirable duplication of efforts and would not be in

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[1] *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17* and corrigenda (A/56/17 and Corr. 1 and.3).

keeping with the aim of promoting efficiency, consistency and coherence in the unification and harmonization of international trade law, as stated in its resolution 37/106 of 16 December 1982,

Stressing the importance of the further development of case law on United Nations Commission on International Trade Law texts in promoting the uniform application of the legal texts of the Commission and its value for government officials, practitioners and academics,

1. *Takes note with appreciation* of the report of the United Nations Commission on International Trade Law on the work of its thirty-fourth session;[1]

2. *Takes note with satisfaction* of the completion and adoption by the Commission of the draft Convention on the Assignment of Receivables in International Trade[2] and of the United Nations Commission on International Trade Law Model Law on Electronic Signatures;[3]

3. *Takes note* of the progress made in the work of the Commission on arbitration and insolvency law and of its decision to commence work on electronic contracting, privately financed infrastructure projects, security interests and transport law, and expresses its appreciation to the Commission for its decision to adjust its working methods in order to accommodate its increased workload without endangering the high quality of its work;

4. *Expresses its appreciation* to the secretariat of the Commission for the publication and distribution of the *Legislative Guide on Privately Financed Infrastructure Projects*,[4] calls upon the secretariat to ensure, in a joint effort with intergovernmental organizations such as the regional commissions of the United Nations, the United Nations Development Programme, the United Nations Industrial Development Organization, organizations of the World Bank Group and regional development banks, wide dissemination of the *Legislative Guide*, and invites States to give favourable consideration to its provisions when revising or adopting legislation in that area;

5. *Appeals* to Governments that have not yet done so to reply to the questionnaire circulated by the Secretariat in relation to the legal regime governing the recognition and enforcement of foreign arbitral awards and, in particular, to the legislative implementation of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, done at New York on 10 June 1958;[5]

6. *Invites* States to nominate persons to work with the private foundation established to encourage assistance to the Commission from the private sector;

7. *Reaffirms* the mandate of the Commission, as the core legal body within the United Nations system in the field of international trade law, to coordinate legal activities in this field and, in this connection:

(*a*) Calls upon all bodies of the United Nations system and invites other international organizations to bear in mind the mandate of the Commission and the need to avoid duplication of effort and to promote efficiency, consistency and coherence in the unification and harmonization of international trade law;

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[2] Ibid., annex I.

[3] Ibid., annex II.

[4] United Nations publication, Sales No. E.01.V.4.

[5] United Nations, *Treaty Series*, vol. 330, No. 4739.

(*b*) Recommends that the Commission, through its secretariat, continue to maintain close cooperation with the other international organs and organizations, including regional organizations, active in the field of international trade law;

8. *Also reaffirms* the importance, in particular for developing countries, of the work of the Commission concerned with training and technical assistance in the field of international trade law, such as assistance in the preparation of national legislation based on legal texts of the Commission;

9. *Expresses the desirability* of increased efforts by the Commission, in sponsoring seminars and symposia, to provide such training and technical assistance, and in this connection:

(*a*) Expresses its appreciation to the Commission for organizing seminars and briefing missions in Belarus, Burkina Faso, China, Colombia, Croatia, Cuba, the Dominican Republic, Egypt, Kenya, Lithuania, Peru, the Republic of Korea, Tunisia, Ukraine and Uzbekistan;

(*b*) Expresses its appreciation to the Governments whose contributions enabled the seminars and briefing missions to take place, and appeals to Governments, the relevant bodies of the United Nations system, organizations, institutions and individuals to make voluntary contributions to the United Nations Commission on International Trade Law Trust Fund for Symposia and, where appropriate, to the financing of special projects, and otherwise to assist the secretariat of the Commission in financing and organizing seminars and symposia, in particular in developing countries, and in the award of fellowships to candidates from developing countries to enable them to participate in such seminars and symposia;

10. *Appeals* to the United Nations Development Programme and other bodies responsible for development assistance, such as the International Bank for Reconstruction and Development and the European Bank for Reconstruction and Development, as well as to Governments in their bilateral aid programmes, to support the training and technical assistance programme of the Commission and to cooperate and coordinate their activities with those of the Commission;

11. *Appeals* to Governments, the relevant bodies of the United Nations system, organizations, institutions and individuals, in order to ensure full participation by all Member States in the sessions of the Commission and its working groups, to make voluntary contributions to the trust fund established to provide travel assistance to developing countries that are members of the Commission, at their request and in consultation with the Secretary-General;

12. *Decides*, in order to ensure full participation by all Member States in the sessions of the Commission and its working groups, to continue, in the competent Main Committee during the fifty-sixth session of the General Assembly, its consideration of granting travel assistance to the least developed countries that are members of the Commission, at their request and in consultation with the Secretary-General;

13. *Reiterates*, in view of the increased work programme of the Commission, its request to the Secretary-General to strengthen the secretariat of the Commission within the bounds of the resources available in the Organization so as to ensure and enhance the effective implementation of the programme of the Commission;

14. *Requests* the Secretary-General to adjust the terms of reference of the United Nations Commission on International Trade Law Trust Fund for Symposia so

as to make it possible for the resources in the Trust Fund to be used also for the financing of training and technical assistance activities undertaken by the Secretariat;

15. *Stresses* the importance of bringing into effect the conventions emanating from the work of the Commission for the global unification and harmonization of international trade law, and to this end urges States that have not yet done so to consider signing, ratifying or acceding to those conventions.

85th plenary meeting
12 December 2001

UNCITRAL

Legislative Guide on Privately Financed Infrastructure Projects

Prepared by the United Nations Commission on International Trade Law

United Nations
New York, 2001

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Preface

The present *Legislative Guide* was prepared by the United Nations Commission on International Trade Law (UNCITRAL). In addition to representatives of member States of the Commission, representatives of many other States and of a number of international organizations, both intergovernmental and non-governmental, participated actively in the preparatory work.

The Commission considered possible work to be undertaken in the field of privately financed infrastructure projects in 1996, in the light of a note by the Secretariat on build-operate-transfer (BOT) projects.[1] The Commission decided to prepare a legislative guide and requested the Secretariat to prepare draft chapters of such a guide.[2] The Commission reviewed the drafts chapters from its thirtieth to its thirty-third sessions.[3] The Commission adopted the *Legislative Guide* at its thirty-third session, held in New York from 12 June to 7 July 2000, subject to editorial modifications left to the Secretariat, and requested the Secretariat to ensure its widest possible dissemination.[4]

[1] "Build-operate-transfer projects: note by the Secretariat" (A/CN.9/424) (*Yearbook of the United Nations Commission on International Trade Law 1996* (hereinafter referred to as the "*UNCITRAL Yearbook")* (United Nations publication, Sales No. E.98.V.7, vol. XXVII), part two, chap. V).

[2] See *Official Records of the General Assembly, Fifty-first Session, Supplement No. 17* (A/51/17), paras. 225-230 (*UNCITRAL Yearbook 1996,* part one).

[3] See ibid., *Fifty-second Session, Supplement No. 17* (A/52/17), paras. 231-247 (*UNCITRAL Yearbook 1997,* vol. XXVIII (United Nations publication, Sales No. E.99.V.6), part one); ibid., *Fifty-third Session, Supplement No. 17* (A/53/17), paras. 12-206 (*UNCITRAL Yearbook 1998,* vol. XXIX (United Nations publication, Sales No. E.99.V.12), part one); and ibid., *Fifty-fourth Session, Supplement No. 17* (A/54/17), paras. 12-307).

[4] See *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17* (A/55/17), para. 372.

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Consolidated legislative recommendations

Foreword

The following pages contain a set of recommended legislative principles entitled "legislative recommendations". The legislative recommendations are intended to assist in the establishment of a legislative framework favourable to privately financed infrastructure projects. The legislative recommendations are followed by notes that offer an analytical introduction with references to financial, regulatory, legal, policy and other issues raised in the subject area. The user is advised to read the legislative recommendations together with the notes, which provide background information to enhance understanding of the legislative recommendations.

The legislative recommendations deal with matters that it is important to address in legislation specifically concerned with privately financed infrastructure projects. They do not deal with other areas of law that, as discussed in the notes to the legislative recommendations, also have an impact on privately financed infrastructure projects. Moreover, the successful implementation of privately financed infrastructure projects typically requires various measures beyond the establishment of an appropriate legislative framework, such as adequate administrative structures and practices, organizational capability, technical expertise, appropriate human and financial resources and economic stability.

For host countries wishing to promote privately financed infrastructure projects it is recommended that the following principles be implemented by the law:

I. General legislative and institutional framework

Constitutional, legislative and institutional framework (see chap. I, "General legislative and institutional framework", paras. 2-14)

Recommendation 1. The constitutional, legislative and institutional framework for the implementation of privately financed infrastructure projects should ensure transparency, fairness, and the long-term sustainability of projects. Undesirable restrictions on private sector participation in infrastructure development and operation should be eliminated.

Scope of authority to award concessions (see chap. I, "General legislative and institutional framework", paras. 15-22)

Recommendation 2. The law should identify the public authorities of the host country (including, as appropriate, national, provincial and local authorities) that are empowered to award concessions and enter into agreements for the implementation of privately financed infrastructure projects.

Recommendation 3. Privately financed infrastructure projects may include concessions for the construction and operation of new infrastructure facilities and systems or the maintenance, modernization, expansion and operation of existing infrastructure facilities and systems.

Recommendation 4. The law should identify the sectors or types of infrastructure in respect of which concessions may be granted.

Recommendation 5. The law should specify the extent to which a concession might extend to the entire region under the jurisdiction of the respective contracting authority, to a geographical subdivision thereof or to a discrete project, and whether it might be awarded with or without exclusivity, as appropriate, in accordance with rules and principles of law, statutory provisions, regulations and policies applying to the sector concerned. Contracting authorities might be jointly empowered to award concessions beyond a single jurisdiction.

Administrative coordination (see chap. I, "General legislative and institutional framework", paras. 23-29)

Recommendation 6. Institutional mechanisms should be established to coordinate the activities of the public authorities responsible for issuing approvals, licences, permits or authorizations required for the implementation of privately financed infrastructure projects in accordance with statutory or regulatory provisions on the construction and operation of infrastructure facilities of the type concerned.

Authority to regulate infrastructure services (see chap. I, "General legislative and institutional framework", paras. 30-53)

Recommendation 7. The authority to regulate infrastructure services should not be entrusted to entities that directly or indirectly provide infrastructure services.

Recommendation 8. Regulatory competence should be entrusted to functionally independent bodies with a level of autonomy sufficient to ensure that their decisions are taken without political interference or inappropriate pressures from infrastructure operators and public service providers.

Recommendation 9. The rules governing regulatory procedures should be made public. Regulatory decisions should state the reasons on which they are based and should be accessible to interested parties through publication or other means.

Recommendation 10. The law should establish transparent procedures whereby the concessionaire may request a review of regulatory decisions by an independent and impartial body, which may include court review, and should set forth the grounds on which such a review may be based.

Recommendation 11. Where appropriate, special procedures should be established for handling disputes among public service providers concerning alleged violations of laws and regulations governing the relevant sector.

II. Project risks and government support

Project risks and risk allocation (see chap. II, "Project risks and government support", paras. 8-29)

Recommendation 12. No unnecessary statutory or regulatory limitations should be placed upon the contracting authority's ability to agree on an allocation of risks that is suited to the needs of the project.

Government support (see chap. II, "Project risks and government support", paras. 30-60)

Recommendation 13. The law should clearly state which public authorities of the host country may provide financial or economic support to the implementation of privately financed infrastructure projects and which types of support they are authorized to provide.

III. Selection of the concessionaire

General considerations (see chap. III, "Selection of the concessionaire", paras. 1-33)

Recommendation 14. The law should provide for the selection of the concessionaire through transparent and efficient competitive procedures adapted to the particular needs of privately financed infrastructure projects.

Pre-selection of bidders (see chap. III, "Selection of the concessionaire", paras. 34-50)

Recommendation 15. The bidders should demonstrate that they meet the pre-selection criteria that the contracting authority considers appropriate for the particular project, including:

(a) Adequate professional and technical qualifications, human resources, equipment and other physical facilities as necessary to carry out all the phases of the project, namely, engineering, construction, operation and maintenance;

(b) Sufficient ability to manage the financial aspects of the project and capability to sustain the financing requirements for the engineering, construction and operational phases of the project;

(c) Appropriate managerial and organizational capability, reliability and experience, including previous experience in operating public infrastructure.

Recommendation 16. The bidders should be allowed to form consortia to submit proposals, provided that each member of a pre-selected consortium may participate, either directly or through subsidiary companies, in only one bidding consortium.

Recommendation 17. The contracting authority should draw up a short list of the pre-selected bidders that will subsequently be invited to submit proposals upon completion of the pre-selection phase.

Procedures for requesting proposals (see chap. III, "Selection of the concessionaire", paras. 51-84)

Single-stage and two-stage procedures for requesting proposals

Recommendation 18. Upon completion of the pre-selection proceedings, the contracting authority should request the pre-selected bidders to submit final proposals.

Recommendation 19. Notwithstanding the above, the contracting authority may use a two-stage procedure to request proposals from pre-selected bidders when it is not feasible for it to formulate project specifications or performance indicators and contractual terms in a manner sufficiently detailed and precise to permit final proposals to be formulated. Where a two-stage procedure is used, the following provisions should apply:

(a) The contracting authority should first call upon the pre-selected bidders to submit proposals relating to output specifications and other characteristics of the project as well as to the proposed contractual terms;

(b) The contracting authority may convene a meeting of bidders to clarify questions concerning the initial request for proposals;

(c) Following examination of the proposals received, the contracting authority may review and, as appropriate, revise the initial project specifications and contractual terms prior to issuing a final request for proposals.

Content of the final request for proposals

Recommendation 20. The final request for proposals should include at least the following:

(a) General information as may be required by the bidders in order to prepare and submit their proposals;

(b) Project specifications and performance indicators, as appropriate, including the contracting authority's requirements regarding safety and security standards and environmental protection;

(c) The contractual terms proposed by the contracting authority;

(d) The criteria for evaluating the proposals, the relative weight to be accorded to each such criterion and the manner in which the criteria are to be applied in the evaluation of proposals.

Clarifications and modifications

Recommendation 21. The contracting authority may, whether on its own initiative or as a result of a request for clarification by a bidder, modify the final request for proposals by issuing addenda at a reasonable time prior to the deadline for submission of proposals.

Evaluation criteria

Recommendation 22. The criteria for the evaluation and comparison of the technical proposals should concern the effectiveness of the proposal submitted by the bidder in meeting the needs of the contracting authority, including the following:

(a) Technical soundness;

(b) Operational feasibility;

(c) Quality of services and measures to ensure their continuity;

(d) Social and economic development potential offered by the proposals.

Recommendation 23. The criteria for the evaluation and comparison of the financial and commercial proposals may include, as appropriate:

(a) The present value of the proposed tolls, fees, unit prices and other charges over the concession period;

(b) The present value of the proposed direct payments by the contracting authority, if any;

(c) The costs for design and construction activities, annual operation and maintenance costs, present value of capital costs and operating and maintenance costs;

(d) The extent of financial support, if any, expected from the Government;

(e) Soundness of the proposed financial arrangements;

(f) The extent of acceptance of the proposed contractual terms.

Submission, opening, comparison and evaluation of proposals

Recommendation 24. The contracting authority may establish thresholds with respect to quality, technical, financial and commercial aspects to be reflected in the proposals in accordance with the criteria set out in the request for proposals. Proposals that fail to achieve the thresholds should be regarded as non-responsive.

Recommendation 25. Whether or not it has followed a pre-selection process, the contracting authority may retain the right to require the bidders to

demonstrate their qualifications again in accordance with criteria and procedures set forth in the request for proposals or the pre-selection documents, as appropriate. Where a pre-selection process has been followed, the criteria should be the same as those used in the pre-selection proceedings.

Final negotiations and project award

Recommendation 26. The contracting authority should rank all responsive proposals on the basis of the evaluation criteria set forth in the request for proposals and invite for final negotiation of the project agreement the bidder that has attained the best rating. Final negotiations may not concern those terms of the contract which were stated as non-negotiable in the final request for proposals.

Recommendation 27. If it becomes apparent to the contracting authority that the negotiations with the bidder invited will not result in a project agreement, the contracting authority should inform that bidder that it is terminating the negotiations and then invite for negotiations the other bidders on the basis of their ranking until it arrives at a project agreement or rejects all remaining proposals.

Concession award without competitive procedures (see chap. III, "Selection of the concessionaire", paras. 85-96)

Recommendation 28. The law should set forth the exceptional circumstances under which the contracting authority may be authorized to award a concession without using competitive procedures, such as:

(a) When there is an urgent need for ensuring continuity in the provision of the service and engaging in a competitive selection procedure would therefore be impractical;

(b) In case of projects of short duration and with an anticipated initial investment value not exceeding a specified low amount;

(c) Reasons of national defence or national security;

(d) Cases where there is only one source capable of providing the required service (for example, because it requires the use of patented technology or unique know-how);

(e) In case of unsolicited proposals of the type referred to in legislative recommendations 34 and 35;

(f) When an invitation to the pre-selection proceedings or a request for proposals has been issued but no applications or proposals were submitted or all proposals failed to meet the evaluation criteria set forth in the request for proposals, and if, in the judgement of the contracting authority, issuing a new request for proposals would be unlikely to result in a project award;

(g) Other cases where the higher authority authorizes such an exception for compelling reasons of public interest.

Recommendation 29. The law may require that the following procedures be observed for the award of a concession without competitive procedures:

(a) The contracting authority should publish a notice of its intention to award a concession for the implementation for the proposed project and should engage in negotiations with as many companies judged capable of carrying out the project as circumstances permit;

(b) Offers should be evaluated and ranked according to the evaluation criteria established by the contracting authority;

(c) Except for the situation referred to in recommendation 28 (c), the contracting authority should cause a notice of the concession award to be published, disclosing the specific circumstances and reasons for the award of the concession without competitive procedures.

Unsolicited proposals (see chap. III, "Selection of the concessionaire", paras. 97-117)

Recommendation 30. By way of exception to the selection procedures described in legislative recommendations 14–27, the contracting authority may be authorized to handle unsolicited proposals pursuant to specific procedures established by the law for handling unsolicited proposals, provided that such proposals do not relate to a project for which selection procedures have been initiated or announced by the contracting authority.

Procedures for determining the admissibility of unsolicited proposals

Recommendation 31. Following receipt and preliminary examination of an unsolicited proposal, the contracting authority should inform the proponent, within a reasonably short period, whether or not there is a potential public interest in the project. If the project is found to be in the public interest, the contracting authority should invite the proponent to submit a formal proposal in sufficient detail to allow the contracting authority to make a proper evaluation of the concept or technology and determine whether the proposal meets the conditions set forth in the law and is likely to be successfully implemented at the scale of the proposed project.

Recommendation 32. The proponent should retain title to all documents submitted throughout the procedure and those documents should be returned to it in the event that the proposal is rejected.

Procedures for handling unsolicited proposals that do not involve proprietary concepts or technology

Recommendation 33. The contracting authority should initiate competitive selection procedures under recommendations 14–27 above if it is found that the envisaged output of the project can be achieved without the use of a process, design, methodology or engineering concept for which the author of the unsolicited proposal possesses exclusive rights or if the proposed concept or technology is not truly unique or new. The author of the unsolicited proposal should be invited to participate in such proceedings and may be given a premium for submitting the proposal.

Procedures for handling unsolicited proposals involving proprietary concepts or technology

Recommendation 34. If it appears that the envisaged output of the project cannot be achieved without using a process, design, methodology or engineering concept for which the author of the unsolicited proposal possesses exclusive rights, the contracting authority should seek to obtain elements of comparison for the unsolicited proposal. For that purpose, the contracting authority should publish a description of the essential output elements of the proposal with an invitation for other interested parties to submit alternative or comparable proposals within a certain reasonable period.

Recommendation 35. The contracting authority may engage in negotiations with the author of the unsolicited proposal if no alternative proposals are received, subject to approval by a higher authority. If alternative proposals are submitted, the contracting authority should invite all the proponents to negotiations in accordance with the provisions of legislative recommendation 29 (a)–(c).

Confidentiality (see chap. III, "Selection of the concessionaire", para. 118)

Recommendation 36. Negotiations between the contracting authority and bidders should be confidential and one party to the negotiations should not reveal to any other person any technical, price or other commercial information relating to the negotiations without the consent of the other party.

Notice of project award (see chap. III, "Selection of the concessionaire", para. 119)

Recommendation 37. The contracting authority should cause a notice of the award of the project to be published. The notice should identify the concessionaire and include a summary of the essential terms of the project agreement.

Record of selection and award proceedings (see chap. III, "Selection of the concessionaire", paras. 120-126)

Recommendation 38. The contracting authority should keep an appropriate record of key information pertaining to the selection and award proceedings. The law should set forth the requirements for public access.

Review procedures (see chap. III, "Selection of the concessionaire", paras. 127-131)

Recommendation 39. Bidders who claim to have suffered, or who may suffer, loss or injury owing to a breach of a duty imposed on the contracting authority by the law may seek review of the contracting authority's acts in accordance with the laws of the host country.

IV. Construction and operation of infrastructure: legislative framework and project agreement

General provisions on the project agreement (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 1-11)

Recommendation 40. The law might identify the core terms to be provided in the project agreement, which may include those terms referred to in recommendations 41-68 below.

Recommendation 41. Unless otherwise provided, the project agreement should be governed by the law of the host country.

Organization of the concessionaire (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 12-18)

Recommendation 42. The contracting authority should have the option to require that the selected bidders establish an independent legal entity with a seat in the country.

Recommendation 43. The project agreement should specify the minimum capital of the project company and the procedures for obtaining the approval by the contracting authority of the statutes and by-laws of the project company and fundamental changes therein.

The project site, assets and easements (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 19-32)

Recommendation 44. The project agreement should specify, as appropriate, which assets will be public property and which assets will be the private property of the concessionaire. The project agreement should identify which assets the concessionaire is required to transfer to the contracting authority or to a new concessionaire upon expiry or termination of the project agreement; which assets the contracting authority, at its option, may purchase from the concessionaire; and which assets the concessionaire may freely remove or dispose of upon expiry or termination of the project agreement.

Recommendation 45. The contracting authority should assist the concessionaire in obtaining such rights related to the project site as necessary for the operation, construction and maintenance of the facility. The law might empower the concessionaire to enter upon, transit through, do work or fix installations upon property of third parties, as required for the construction, operation and maintenance of the facility.

Financial arrangements (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 33-51)

Recommendation 46. The law should enable the concessionaire to collect tariffs or user fees for the use of the facility or the services it provides. The project agreement should provide for methods and formulas for the adjustment of those tariffs or user fees.

Recommendation 47. Where the tariffs or fees charged by the concessionaire are subject to external control by a regulatory body, the law should set forth the mechanisms for periodic and extraordinary revisions of the tariff adjustment formulas.

Recommendation 48. The contracting authority should have the power, where appropriate, to agree to make direct payments to the concessionaire as a substitute for, or in addition to, service charges to be paid by the users or to enter into commitments for the purchase of fixed quantities of goods or services.

Security interests (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 52-61)

Recommendation 49. The concessionaire should be responsible for raising the funds required to construct and operate the infrastructure facility and, for that purpose, should have the right to secure any financing required for the project with a security interest in any of its property, with a pledge of shares of the project company, with a pledge of the proceeds and receivables arising out of the concession, or with other suitable security, without prejudice to any rule of law that might prohibit the creation of security interests in public property.

Assignment of the concession (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 62 and 63)

Recommendation 50. The concession should not be assigned to third parties without the consent of the contracting authority. The project agreement should set forth the conditions under which the contracting authority might give its consent to an assignment of the concession, including the acceptance by the new concessionaire of all obligations under the project agreement and evidence of the new concessionaire's technical and financial capability as necessary for providing the service.

Transfer of controlling interest in the project company (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 64-68)

Recommendation 51. The transfer of a controlling interest in a concessionaire company may require the consent of the contracting authority, unless otherwise provided.

Construction works (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 69-79)

Recommendation 52. The project agreement should set forth the procedures for the review and approval of construction plans and specifications by the contracting authority, the contracting authority's right to monitor the construction of, or improvements to, the infrastructure facility, the conditions under which the contracting authority may order variations in respect of construction specifications and the procedures for testing and final inspection, approval and acceptance of the facility, its equipment and appurtenances.

Operation of infrastructure (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 80-97)

Recommendation 53. The project agreement should set forth, as appropriate, the extent of the concessionaire's obligations to ensure:

(a) The adaptation of the service so as to meet the actual demand for the service;

(b) The continuity of the service;

(c) The availability of the service under essentially the same conditions to all users;

(d) The non-discriminatory access, as appropriate, of other service providers to any public infrastructure network operated by the concessionaire.

Recommendation 54. The project agreement should set forth:

(a) The extent of the concessionaire's obligation to provide the contracting authority or a regulatory body, as appropriate, with reports and other information on its operations;

(b) The procedures for monitoring the concessionaire's performance and for taking such reasonable actions as the contracting authority or a regulatory body may find appropriate, to ensure that the infrastructure facility is properly operated and the services are provided in accordance with the applicable legal and contractual requirements.

Recommendation 55. The concessionaire should have the right to issue and enforce rules governing the use of the facility, subject to the approval of the contracting authority or a regulatory body.

General contractual arrangements (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 98-150)

Recommendation 56. The contracting authority may reserve the right to review and approve major contracts to be entered into by the concessionaire, in particular contracts with the concessionaire's own shareholders or related persons. The contracting authority's approval should not normally be withheld except where the contracts contain provisions inconsistent with the

project agreement or manifestly contrary to the public interest or to mandatory rules of a public law nature.

Recommendation 57. The concessionaire and its lenders, insurers and other contracting partners should be free to choose the applicable law to govern their contractual relations, except where such a choice would violate the host country's public policy.

Recommendation 58. The project agreement should set forth:

(a) The forms, duration and amounts of the guarantees of performance that the concessionaire may be required to provide in connection with the construction and the operation of the facility;

(b) The insurance policies that the concessionaire may be required to maintain;

(c) The compensation to which the concessionaire may be entitled following the occurrence of legislative changes or other changes in the economic or financial conditions that render the performance of the obligation substantially more onerous than originally foreseen. The project agreement should further provide mechanisms for revising the terms of the project agreement following the occurrence of any such changes;

(d) The extent to which either party may be exempt from liability for failure or delay in complying with any obligation under the project agreement owing to circumstances beyond their reasonable control;

(e) Remedies available to the contracting authority and the concessionaire in the event of default by the other party.

Recommendation 59. The project agreement should set forth the circumstances under which the contracting authority may temporarily take over the operation of the facility for the purpose of ensuring the effective and uninterrupted delivery of the service in the event of serious failure by the concessionaire to perform its obligations.

Recommendation 60. The contracting authority should be authorized to enter into agreements with the lenders providing for the appointment, with the consent of the contracting authority, of a new concessionaire to perform under the existing project agreement if the concessionaire seriously fails to deliver the service required or if other specified events occur that could justify the termination of the project agreement.

V. Duration, extension and termination of the project agreement

Duration and extension of the project agreement (see chap. V, "Duration, extension and termination of the project agreement", paras. 2-8)

Recommendation 61. The duration of the concession should be specified in the project agreement.

Recommendation 62. The term of the concession should not be extended, except for those circumstances specified in the law, such as:

(a) Completion delay or interruption of operation due to the occurrence of circumstances beyond either party's reasonable control;

(b) Project suspension brought about by acts of the contracting authority or other public authorities;

(c) To allow the concessionaire to recover additional costs arising from requirements of the contracting authority not originally foreseen in the project agreement that the concessionaire would not be able to recover during the normal term of the project agreement.

Termination of the project agreement (see chap. V, "Duration, extension and termination of the project agreement", paras. 9-35)

Termination by the contracting authority

Recommendation 63. The contracting authority should have the right to terminate the project agreement:

(a) In the event that it can no longer be reasonably expected that the concessionaire will be able or willing to perform its obligations, owing to insolvency, serious breach or otherwise;

(b) For reasons of public interest, subject to payment of compensation to the concessionaire.

Termination by the concessionaire

Recommendation 64. The concessionaire should have the right to terminate the project agreement under exceptional circumstances specified in the law, such as:

(a) In the event of serious breach by the contracting authority or other public authority of their obligations under the project agreement;

(b) In the event that the concessionaire's performance is rendered substantially more onerous as a result of variation orders or other acts of the contracting authority, unforeseen changes in conditions or acts of other public authorities and that the parties have failed to agree on an appropriate revision of the project agreement.

Termination by either party

Recommendation 65. Either party should have the right to terminate the project agreement in the event that the performance of its obligations is rendered impossible by the occurrence of circumstances beyond either party's reasonable control. The parties should also have the right to terminate the project agreement by mutual consent.

Consequences of expiry or termination of the project agreement (see chap. V, "Duration, extension and termination of the project agreement", paras. 36-62)

Transfer of assets to the contracting authority or to a new concessionaire

Recommendation 66. The project agreement should lay down the criteria for establishing, as appropriate, the compensation to which the concessionaire may be entitled in respect of assets transferred to the contracting authority or to a new concessionaire or purchased by the contracting authority upon expiry or termination of the project agreement.

Financial arrangements upon termination

Recommendation 67. The project agreement should stipulate how compensation due to either party in the event of termination of the project agreement is to be calculated, providing, where appropriate, for compensation for the fair value of works performed under the project agreement, and for losses, including lost profits.

Wind-up and transitional measures

Recommendation 68. The project agreement should set out, as appropriate, the rights and obligations of the parties with respect to:

(a) The transfer of technology required for the operation of the facility;

(b) The training of the contracting authority's personnel or of a successor concessionaire in the operation and maintenance of the facility;

(c) The provision, by the concessionaire, of operation and maintenance services and the supply of spare parts, if required, for a reasonable period after the transfer of the facility to the contracting authority or to a successor concessionaire.

VI. Settlement of disputes

Disputes between the contracting authority and the concessionaire (see chap. VI, "Settlement of disputes", paras. 3-41)

Recommendation 69. The contracting authority should be free to agree to dispute settlement mechanisms regarded by the parties as best suited to the needs of the project.

Disputes between project promoters and between the concessionaire and its lenders, contractors and suppliers (see chap. VI, "Settlement of disputes", para. 42)

Recommendation 70. The concessionaire and the project promoters should be free to choose the appropriate mechanisms for settling commercial disputes among the project promoters, or disputes between the concessionaire and its lenders, contractors, suppliers and other business partners.

Disputes involving customers or users of the infrastructure facility (see chap. VI, "Settlement of disputes", paras. 43-45)

Recommendation 71. The concessionaire may be required to make available simplified and efficient mechanisms for handling claims submitted by its customers or users of the infrastructure facility.

Introduction and background information on privately financed infrastructure projects*

A. Introduction

1. The roles of the public and the private sectors in the development of infrastructure have evolved considerably in history. Public services such as gas street lighting, power distribution, telegraphy and telephony, steam railways and electrical tramways were launched in the nineteenth century and in many countries they were provided by private companies that had obtained a licence or concession from the Government. Numerous privately funded road or canal projects were carried out at that time and there was a rapid development of international project financing, including international bond offerings to finance railways or other major infrastructure.

2. However, during most of the twentieth century the international trend was, in turn, towards public provision of infrastructure and other services. Infrastructure operators were often nationalized and competition was reduced by mergers and acquisitions. The degree of openness of the world economy also receded during this period. Infrastructure sectors remained privately operated only in a relatively small number of countries, often with little or no competition. In many countries the pre-eminence of the public sector in infrastructure service provision became enshrined in the constitution.

3. The current reverse trend towards private sector participation and competition in infrastructure sectors started in the early 1980s and has been driven by general as well as country-specific factors. Among the general factors are significant technological innovations; high indebtedness and stringent budget constraints limiting the public sector's ability to meet increasing infrastructure needs; the expansion of international and local capital markets, with a consequent improvement in access to private funding; and an increasing number of successful international experiences with private participation and competition in infrastructure. In many countries, new legislation was adopted, not only to govern such transactions, but also to modify the market structure and the rules of competition governing the sectors in which they were taking place.

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*Section B of the present chapter is conceived as general background information on matters that are examined from a legislative perspective in the subsequent chapters of the *Guide*. For additional information, the reader is particularly advised to consult publications by other international organizations, such as the *Guidelines for Infrastructure Development through Build-Operate-Transfer (BOT) Projects*, prepared by the United Nations Industrial Development Organization (UNIDO publication, Sales No. UNIDO.95.6.E), the *World Development Report 1994: Infrastructure for Development* (New York, Oxford University Press, 1994) and the *World Development Report 1996: From Plan to Market* (New York, Oxford University Press, 1996), both published by the World Bank, or *Financing Private Infrastructure* (Washington, D.C., 1996), published by the International Finance Corporation.

4. The purpose of the present *Guide* is to assist in the establishment of a legal framework favourable to private investment in public infrastructure. The advice provided in the *Guide* aims at achieving a balance between the desire to facilitate and encourage private participation in infrastructure projects, on the one hand, and various public interest concerns of the host country, on the other. The *Guide* discusses a number of concerns of fundamental public interest, which, despite numerous differences of policy and legislative treatment, are recognized in most legal systems. Points of public concern include matters such as continuity in the provision of public services; adherence to environmental protection, health, safety and quality standards set by the host country; fairness of prices charged to the public; non-discriminatory treatment of customers or users, full disclosure of information pertaining to the operation of infrastructure facilities and the flexibility needed to meet changed conditions, including expansion of the service to meet additional demand. Fundamental concerns of the private sector, in turn, usually include issues such as stability of the legal and economic environment in the host country; transparency of laws and regulations and predictability and impartiality in their application; enforceability of property rights against violations by third parties; assurances that private property is respected by the host country and not interfered with other than for reasons of public interest and only if compensation is paid; and freedom of the parties to agree on commercial terms that ensure a reasonable return on invested capital commensurate with the risks taken by private investors. The *Guide* does not provide a single set of model solutions to address these concerns, but it helps the reader to evaluate different approaches available and to choose the one most suitable in the national or local context.

1. Organization and scope of the Guide

5. The *Guide* contains a set of recommended legislative principles entitled "legislative recommendations". The legislative recommendations are intended to assist in the establishment of a legislative framework favourable to privately financed infrastructure projects. The legislative recommendations are followed by notes offering an analytical introduction with references to financial, regulatory, legal, policy and other issues raised in the subject area. The user is advised to read the legislative recommendations together with the notes, which provide background information to enhance understanding of the legislative recommendations.

6. The legislative recommendations deal with matters that it is important to address in legislation specifically concerned with privately financed infrastructure projects. They do not deal with other areas of law, which, as discussed in notes to the legislative recommendations, also have an impact on privately financed infrastructure projects. Moreover, the successful implementation of privately financed infrastructure projects typically requires various measures beyond the establishment of an appropriate legislative framework, such as adequate administrative structures and practices, organizational capability, technical expertise, appropriate human and financial resources and economic stability. Although some of these matters are mentioned in the notes, they are not addressed in the legislative recommendations.

7. The *Guide* is intended to be used as a reference by national authorities and legislative bodies when preparing new laws or reviewing the adequacy of existing laws and regulations. For that purpose, the *Guide* helps identify areas of law that are typically most relevant to private capital investment in public infrastructure projects and discusses the content of those laws which would be conducive to attracting private capital, national and foreign. The *Guide* is not intended to provide advice on drafting agreements for the execution of privately financed infrastructure projects. However, the *Guide* does discuss some contractual issues (for instance, in chaps. IV, "Construction and operation of infrastructure: legislative framework and project agreement" and V, "Duration, extension and termination of the project agreement") to the extent that they relate to matters that might usefully be addressed in the legislation.

8. The *Guide* pays special attention to infrastructure projects that involve an obligation, on the part of the selected investors, to undertake physical construction, repair or expansion works in exchange for the right to charge a price, either to the public or to a public authority, for the use of the infrastructure facility or for the services it generates. Although such projects are sometimes grouped with other transactions for the "privatization" of governmental functions or property, the *Guide* is not concerned with "privatization" transactions that do not relate to the development and operation of public infrastructure. In addition, the *Guide* does not address projects for the exploitation of natural resources, such as mining, oil or gas exploitation projects under some "concession", "licence" or "permission" issued by the public authorities of the host country.

2. Terminology used in the Guide

9. The following paragraphs explain the meaning and use of certain expressions that appear frequently in the *Guide*. For terms not mentioned below, such as technical terms used in financial and business management writings, the reader is advised to consult other sources of information on the subject, such as the *Guide*lines *for Infrastructure Development through Build-Operate-Transfer (BOT) Projects* prepared by the United Nations Industrial Development Organization (UNIDO).[1]

(a) "Public infrastructure" and "public services"

10. As used in the *Guide*, the expression public infrastructure refers to physical facilities that provide services essential to the general public. Examples of public infrastructure in this sense may be found in various sectors and include various types of facility, equipment or system: power generation plants and power distribution networks (electricity sector); systems for local and long-distance telephone communications and data transmission networks (telecommunications sector); desalination plants, waste water treatment plants, water

[1]UNIDO publication, Sales No. UNIDO.95.6.E, hereafter referred to as the *UNIDO BOT Guidelines.*

distribution facilities (water sector); facilities and equipment for waste collection and disposal (sanitation sector); and physical installations and systems used for public transportation, such as urban and inter-urban railways, underground trains, bus lines, roads, bridges, tunnels, ports, airlines and airports (transportation sector).

11. The line between publicly and privately owned infrastructure must be drawn by each country as a matter of public policy. In some countries, airports are owned by the Government; in others they are privately owned but subject to regulation or to the terms of an agreement with the competent public authority. Hospital and medical facilities, as well as prison and correctional facilities may be in public or private hands, depending on the country's preferences. Often, but not always, power and telecommunication facilities are in the public sector. No view is expressed in the *Guide* as to where the line should be drawn in a particular country.

12. The notions of public infrastructure and public services are well established in the legal tradition of some countries, being sometimes governed by a specific body of law, which is typically referred to as administrative law (see chap. VII, "Other relevant areas of law", paras. 24-27). However, in a number of other countries, apart from being subject to special regulations, public services are not regarded as being intrinsically distinct from other types of business. As used in the *Guide*, the expressions public services and public service providers should not be understood in a technical sense that may be attached to them under any particular legal system.

(b) "Concession", "project agreement" and related expressions

13. In many countries, public services constitute government monopolies or are otherwise subject to special regulation. Where that is the case, the provision of a public service by an entity other than a public authority typically requires an act of authorization by the appropriate governmental body. Different expressions are used to define such acts of authorization under national laws and in some legal systems various expressions may be used to denote different types of authorization. Commonly used expressions include terms such as "concession", "franchise", "licence" or "lease" ("*affermage*"). In some legal systems, in particular those belonging to the civil law tradition, certain forms of infrastructure projects are referred to by well-defined legal concepts such as public works concession or public service concession. As used in the *Guide*, the word "concession" is not to be understood in a technical sense that may be attached to it under any particular legal system or domestic law.

14. As used in the *Guide*, the term "project agreement" means an agreement between a public authority and the entity or entities selected to carry out the project that sets forth the terms and conditions for the construction or modernization, operation and maintenance of the infrastructure. Other expressions that may be used in some legal systems to refer to such an agreement, such as "concession agreement" or "concession contract", are not used in the *Guide*.

15. The *Guide* uses the word "concessionaire" to refer generally to an entity that carries out an infrastructure project under a concession issued by a public authority of the host country. The term "project company" is sometimes used in the *Guide* to refer specifically to an independent legal entity established for the purpose of carrying out a particular project.

(c) References to national authorities

16. As used in the *Guide*, the word "Government" encompasses the various public authorities of the host country entrusted with executive or policy-making functions, at the national, provincial or local level. The expression "public authorities" is used to refer, in particular, to entities of, or related to, the executive branch of the Government. The expressions "legislature" and "legislator" are used specifically with reference to the organs that exercise legislative functions in the host country.

17. The expression "contracting authority" is generally used in the *Guide* to refer to the public authority of the host country that has the overall responsibility for the project and on behalf of which the project is awarded. Such authority may be national, provincial or local (see below, paras. 69 and 70).

18. The expression "regulatory agency" is used in the *Guide* to refer to the public authority that is entrusted with the power to issue and enforce rules and regulations governing the operation of the infrastructure. The regulatory agency may be established by statute with the specific purpose of regulating a particular infrastructure sector.

(d) "Build-operate-transfer" and related expressions

19. The various types of project referred to in this *Guide* as privately financed infrastructure projects are sometimes divided into several categories, according to the type of private participation or the ownership of the relevant infrastructure, as indicated below:

(a) *Build-operate-transfer (BOT).* An infrastructure project is said to be a BOT project when the contracting authority selects a concessionaire to finance and construct an infrastructure facility or system and gives the entity the right to operate it commercially for a certain period, at the end of which the facility is transferred to the contracting authority;

(b) *Build-transfer-operate (BTO).* This expression is sometimes used to emphasize that the infrastructure facility becomes the property of the contracting authority immediately upon its completion, the concessionaire being awarded the right to operate the facility for a certain period;

(c) *Build-rent-operate-transfer (BROT) or "build-lease-operate-transfer" (BLOT).* These are variations of BOT or BTO projects where, in addition to the obligations and other terms usual to BOT projects, the concessionaire rents the physical assets on which the facility is located for the duration of the agreement;

(d) *Build-own-operate-transfer (BOOT).* These are projects in which a concessionaire is engaged for the financing, construction, operation and maintenance of a given infrastructure facility in exchange for the right to collect fees and other charges from its users. Under this arrangement the private entity owns the facility and its assets until it is transferred to the contracting authority;

(e) *Build-own-operate (BOO).* This expression refers to projects where the concessionaire owns the facility permanently and is not under an obligation to transfer it back to the contracting authority.

20. Besides acronyms used to highlight the particular ownership regime, other acronyms may be used to emphasize one or more of the obligations of the concessionaire. In some projects, existing infrastructure facilities are turned over to private entities to be modernized or refurbished, operated and maintained, permanently or for a given period of time. Depending on whether the private sector will own such an infrastructure facility, those arrangements may be called either "refurbish-operate-transfer" (ROT) or "modernize-operate-transfer" (MOT), in the first case, or "refurbish-own-operate" (ROO) or "modernize-own-operate" (MOO), in the latter. The expression "design-build-finance-operate" (DBFO) is sometimes used to emphasize the concessionaire's additional responsibility for designing the facility and financing its construction.

B. Background information on privately financed infrastructure projects

21. In most of the countries that have recently built new infrastructure through private investment, privately financed infrastructure projects are an important tool in meeting national infrastructure needs. Essential elements of national policies include the level of competition sought for each infrastructure sector, the way in which the sector is structured and the mechanisms used to ensure adequate functioning of infrastructure markets. National policies to promote private investment in infrastructure are often accompanied by measures destined to introduce competition between public service providers or to prevent abuse of monopolistic conditions where competition is not feasible.

22. In devising programmes to promote private sector investment in the development and operation of public infrastructure, a number of countries have found it useful to review the assumptions under which public sector monopolies were established, including the historical circumstances and political conditions that had led to their creation, with a view to

(a) identifying those activities which still maintain the characteristics of natural monopoly; and

(b) assessing the feasibility and desirability of introducing competition in certain infrastructure sectors.

1. *Private investment and infrastructure policy*

23. The measures that may be required to implement a governmental policy to promote competition in various infrastructure sectors will depend essentially on the prevailing market structure. The main elements that characterize a particular market structure include barriers to the entry of competitors of an economic, legal, technical or other nature, the degree of vertical or horizontal integration, the number of companies operating in the market as well as the availability of substitute products or services.

(a) Competition policy and monopolies

24. The term "monopoly" in the strict sense refers to a market with only one supplier. However, pure monopoly and perfect competition mark two ends of a spectrum. Most markets for commodities or services are characterized by a degree of competition that lies between those two extremes. Generally, monopolies can be classified as natural monopolies, legal monopolies and de facto monopolies; each of them may require different policy approaches;

(a) *Natural monopolies.* These are economic activities that allow a single provider to supply the whole market at a lower cost than two or more providers. This situation is typical for economic activities that entail large investment and high fixed costs, but decreasing costs of producing an additional unit of services (e.g. an additional cubic metre of water) to attend an increase of demand. Natural monopolies tend to exhibit large upfront fixed investment requirements that make it difficult for a new company, lacking comparable economies of scale, to enter the market and undercut the incumbent;

(b) *Legal monopolies.* Legal monopolies are established by law and may cover sectors or activities that are or are not natural monopolies. In the latter category, monopolies exist solely because competition is prohibited. The developments that had led many countries to the establishment of legal monopolies were often based on the consideration that national infrastructure needs, in terms of both quality and quantity, could not be adequately met by leaving infrastructure to the free market;

(c) *De facto monopolies.* These monopolies may not necessarily be the result of economic fundamentals or of legal provisions, but simply of the absence of competition, resulting, for example, from the integrated nature of the infrastructure company and its ability to control essential facilities to the exclusion of other suppliers.

25. Although monopolies are sometimes justified on legal, political or social grounds, they may produce negative economic effects. A service provider operating under monopolistic conditions is typically able to fix prices above those which would be charged in competitive conditions. The surplus profit that results from insufficient competition implies a transfer of wealth from consumers to producers. Monopolies have also been found to cause a net loss of welfare to the economy as a result of inflated prices generated by artificially low production; a reduced rate of innovation; and insufficient efforts to reduce

production costs. Furthermore, in particular in infrastructure sectors, there may be secondary effects on other markets. (For example, lack of competition and efficiency in telecommunications has negative repercussions through increases in cost for the economy at large.)

26. Despite their negative economic effects, monopolies and other regulatory barriers to competition have sometimes been maintained in the absence of natural monopoly conditions. One of the reasons cited for retaining monopolies is that they may be used to foster certain policy objectives, such as ensuring the provision of services in certain regions or to certain categories of consumer at low prices or even below cost. Examples of services for which the price may not cover costs include lifeline telephone, water or power service, discounted transport for certain categories of traveller (e.g. schoolchildren or senior citizens), as well as other services for low-income or rural users. A monopolistic service provider is able to finance the provision of such services through internal "cross-subsidies" from other profitable services provided in other regions or to other categories of consumer.

27. Another reason sometimes cited for retaining legal monopolies in the absence of natural monopoly conditions is to make the sector more attractive to private investors. Private operators may insist on being granted exclusivity rights to provide a certain service so as to reduce the commercial risk of their investment. However, that objective has to be balanced against the interests of consumers and the economy as a whole. For those countries where the granting of exclusivity rights is found to be needed as an incentive to private investment, it may be advisable to consider restricting competition, though on a temporary basis only (see chap. I, "General legislative and institutional framework", paras. 20-22).

(b) Scope for competition in different sectors

28. Until recently, monopolistic conditions prevailed in most infrastructure sectors either because the sector was a natural monopoly or because regulatory barriers or other factors (e.g. vertically integrated structure of public service providers) prevented effective competition. However, rapid technological progress has broadened the potential scope for competition in infrastructure sectors, as discussed briefly below:

(a) *Telecommunication sector.* New wireless technology not only makes mobile telecommunication services possible, but it is also increasingly competing with fixed (wireline) services. Fibre optic networks, cable television networks, data transmission over power lines, global satellite systems, increasing computing power, improved data compression techniques, convergence between communications, broadcasting and data processing are further contributing to the breakdown of traditional monopolies and modes of service provision. As a result of these and other changes, telecommunication services have become competitive and countries are increasingly opening up the sector to free entry, while limiting access only to services that require the use of scarce public resources, such as radio frequency;

(b) *Energy sector*. In the energy sector, combined-cycle gas turbines and other technologies allowing for efficient power production on smaller scales and standardization in manufacturing of power generation equipment have led several countries to change the monopolistic and vertically integrated structure of domestic electricity markets. Increasing computing power and improved data-processing software make it easier to dispatch electricity across a grid and to organize power pools and other mechanisms to access the network and trade in electricity;

(c) *Transport sector*. Technology is in many cases also at the origin of changing patterns in the transport sector: the introduction of containers and other innovations, such as satellite communications, making it possible to track shipments across the globe, have had profound consequences on shipping, port management and rail and truck transport, while fostering the development of intermodal transport.

29. Technological changes such as these have prompted the legislatures in a number of countries to extend competition to infrastructure sectors by adopting legislation that abolishes monopolies and other barriers to entry, changes the way infrastructure sectors are organized and establishes a regulatory framework that fosters effective competition. The extent to which this can be done depends on the sector, the size of the market and other factors.

2. Restructuring of infrastructure sectors

30. In many countries, private participation in infrastructure development has followed the introduction of measures to restructure infrastructure sectors. Legislative action typically begins with the abolition of rules that prohibit private participation in infrastructure and the removal of all other legal impediments to competition that cannot be justified by reasons of public interest. It should be noted, however, that the extent to which a particular sector may be opened to competition is a decision that is taken in the light of the country's overall economic policy. Some countries, in particular developing countries, might have a legitimate interest in promoting the development of certain sectors of local industry and might thus choose not to open certain infrastructure sectors to competition.

31. For monopolistic situations resulting from legal prohibitions rather than economic and technological fundamentals, the main legislative action needed to introduce competition is the removal of the existing legal barriers. This may need to be reinforced by rules of competition (such as the prohibition of collusion, cartels, predatory pricing or other unfair trading practices) and regulatory oversight (see chap. I, "General legislative and institutional framework", paras. 30-53). For a number of activities, however, effective competition may not be obtained through the mere removal of legislative barriers without legislative measures to restructure the sector concerned. In some countries, monopolies have been temporarily maintained only for the time needed to facilitate a gradual, more orderly and socially acceptable transition from a monopolistic to a competitive market structure.

(a) Unbundling of infrastructure sectors

32. In the experience of some countries it has been found that vertically or horizontally integrated infrastructure companies may be able to prevent effective competition. Integrated companies may try to extend their monopolistic powers in one market or market segment to other markets or market segments in order to extract monopoly rents in those activities as well. Therefore, some countries have found it necessary to separate the monopoly element (such as the grid in many networks) from competitive elements in given infrastructure sectors. By and large, infrastructure services tend to be competitive, whereas the underlying physical infrastructure often has monopolistic characteristics.

33. The separation of competitive activities from monopolistic ones may in turn require the unbundling of vertically or horizontally integrated activities. Vertical unbundling occurs when upstream activities are separated from downstream ones, for example, by separating production, transmission, distribution and supply activities in the power sector. The objective is typically to separate key network components or essential facilities from the competitive segments of the business. Horizontal unbundling occurs when one or more parallel activities of a monopolist public service provider are divided among separate companies, which may either compete directly with each other in the market (as is increasingly the case with power production) or retain a monopoly over a smaller territory (as may be the case with power distribution). Horizontal unbundling refers both to a single activity or segment being broken up (as in the power sector examples) and to substitutes being organized separately in one or more markets (as in the case of separation of cellular services from fixed-line telephony, for example).

34. However, the costs and benefits of such changes need to be considered carefully. Costs may include those associated with the change itself (e.g. transaction and transition costs, including the loss incurred by companies that lose benefits or protected positions as a result of the new scheme) and those resulting from the operation of the new scheme, in particular higher coordination costs resulting, for example, from more complicated network planning, technical standardization or regulation. Benefits, on the other hand, may include new investments, better or new services, more choice and lower economic costs.

(b) Recent experience in major infrastructure sectors

(i) Telecommunications

35. Unbundling has not been too common in the telecommunication sector. In some countries, long-distance and international services were separated from local services; competition was introduced in the former, while the latter remained largely monopolistic. In some of those countries that trend is now being reversed, with local telephone companies being allowed to provide long-distance services and long-distance companies being allowed to provide local services, all in a competitive context. Mandatory open access rules are common in the telecommunication sector of those countries where the historical public service provider offers services in competition with other providers while controlling essential parts of the network.

(ii) Electricity

36. Electricity laws recently enacted in various countries call for the unbundling of the power sector by separating generation, transmission and distribution. In some cases, supply is further distinguished from distribution in order to leave only the monopolistic activity (i.e. the transport of electricity for public use over wires) under a monopoly. In those countries, the transmission and distribution companies do not buy or sell electricity but only transport it against a regulated fee. Trade in electricity occurs between producers or brokers on the one hand and users on the other. In some of the countries concerned, competition is limited to large users only or is being phased in gradually.

37. Where countries have opted for the introduction of competition in the power and gas sectors, new legislation has organized the new market structure, stipulating to what extent the market had to be unbundled (sometimes including the number of public service providers to be created out of the incumbent monopoly), or removed barriers to new entry. The same energy laws have also established specific competition rules, whether structural (e.g. prohibition of cross-ownership between companies in different segments of the market, such as production, transmission and distribution, or gas and electricity sale and distribution) or behavioural (e.g. third-party access rules, prohibition of alliances or other collusive arrangements). New institutions and regulatory mechanisms, such as power pools, dispatch mechanisms or energy regulatory agencies, have been established to make the new energy markets work. Finally, other aspects of energy law and policy have had to be amended in conjunction with these changes, including the rules governing the markets for oil, gas, coal and other energy sources.

(iii) Water and sanitation

38. The most common market structure reform introduced in the water and sanitation sector is horizontal unbundling. Some countries have created several water utilities where a single one existed before. This is particularly common in, but is not limited to, countries with separate networks that are not or only slightly interconnected. In practice, it has been found that horizontal unbundling facilitates comparison of the performance of service providers.

39. Some countries have invited private investors to provide bulk water to a utility or to build and operate water treatment or desalination plants, for example. In such vertical unbundling, the private services (and the discrete investments they require) are usually rendered under contract to a utility and do not fundamentally modify the monopolistic nature of the market structure: the plants usually do not compete with each other and are usually not allowed to bypass the utility to supply customers. A number of countries have introduced competition in bulk water supply and transportation; in some cases, there are active water markets. Elsewhere, competition is limited to expensive bottled or trucked water and private wells.

(iv) Transport

40. In the restructuring measures taken in various countries, a distinction is made between transport infrastructure and transport services. The former may often have natural monopoly characteristics, whereas services are generally competitive. Competition in transport services should be considered not only within a single mode but also across modes, since trains, trucks, buses, airlines and ships tend to compete for passengers and freight.

41. With respect to railways, some countries have opted for a separation between the ownership and operation of infrastructure (e.g. tracks, signalling systems and train stations) on the one hand and of rail transport services (e.g. passenger and freight) on the other. In such schemes, the law does not allow the track operator also to operate transport services, which are operated by other companies often in competition with each other. Other countries have let integrated companies operate infrastructure as well as services, but have enforced third-party access rights to the infrastructure, sometimes called "trackage rights". In those cases, transport companies, whether another rail line or a transport service company, have right of access to the track on certain terms and the company controlling the track has the obligation to grant such access.

42. In many countries, ports were until recently managed as public sector monopolies. When opening the sector to private participation, legislators have considered different models. Under the landlord-port system, the port authority is responsible for the infrastructure as well as overall coordination of port activities; it does not, however, provide services to ships or merchandise. In service ports, the same entity is responsible for infrastructure and services. Competition between service providers (e.g. tugboats, stevedoring and warehousing) may be easier to establish and maintain under the landlord system.

43. Legislation governing airports may also require changes, whether to allow private investment or competition between or within airports. Links between airport operation and air traffic control may also need to be considered carefully. Within airports, many countries have introduced competition in handling services, catering and other services to planes, as well as in passenger services such as retail shops, restaurants, parking and the like. In some countries, the construction and operation of a new terminal at an existing airport has been entrusted to a new operator, thus creating competition between terminals. In others, new airports have been built on a BOT basis and existing ones transferred to private ownership.

(c) Transitional measures

44. The transition from monopoly to market needs to be carefully managed. Political, social or other factors have led some countries to pursue a gradual or phased approach to implementation. As technology and other outside forces are constantly changing, some countries have adopted sector reforms that could be accelerated or adjusted to take those changing circumstances into account.

45. Some countries have felt that competition should not be introduced at once. In such cases, legislation has provided for temporary exclusivity rights, limitation in the number of public service providers or other restrictions on competition. Those measures are designed to give the incumbent adequate time to prepare for competition and to adjust prices, while giving the public service provider adequate incentives for investment and service expansion. Other countries have included provisions calling for the periodic revision (at the time of price reviews, for example) of such restrictions with a view to ascertaining whether the conditions that justified them at the time when they were introduced still prevail.

46. Another transitional measure, at least in some countries with government-owned public service providers, has been the restructuring or privatization of the incumbent service provider. In most countries where government-owned providers of public services have been privatized, liberalization has by and large either accompanied or preceded privatization. Some countries have proceeded otherwise and have privatized companies with significant exclusivity rights, often to increase privatization proceeds. They have, however, found it difficult and sometimes very expensive to remove, restrict or shorten at a later stage the exclusive rights or monopolies protecting private or privatized public service providers.

3. *Forms of private sector participation in infrastructure projects*

47. Private sector participation in infrastructure projects may be devised in a variety of different forms, ranging from publicly owned and operated infrastructure to fully privatized projects. The appropriateness of a particular variant for a given type of infrastructure is a matter to be considered by the Government in view of the national needs for infrastructure development and an assessment of the most efficient ways in which particular types of infrastructure facility may be developed and operated. In a particular sector more than one option may be used.

(a) Public ownership and public operation

48. In cases where public ownership and control is desired, direct private financing as well as infrastructure operation under commercial principles may be achieved by establishing a separate legal entity controlled by the Government to own and operate the project. Such an entity may be managed as an independent private commercial enterprise that is subject to the same rules and business principles that apply to private companies. Some countries have a well established tradition in operating infrastructure facilities through these types of company. Opening the capital of such companies to private investment or making use of such a company's ability to issue bonds or other securities may create an opportunity for attracting private investment in infrastructure.

49. Another form of involving private participation in publicly owned and operated infrastructure may be the negotiation of "service contracts" whereby

the public operator contracts out specific operation and maintenance activities to the private sector. The Government may also entrust a broad range of operation and maintenance activities to a private entity acting on behalf of the contracting authority. Under such an arrangement, which is sometimes referred to as a "management contract", the private operator's compensation may be linked to its performance, often through a profit-sharing mechanism, although compensation on the basis of a fixed fee may also be used, in particular where the parties find it difficult to establish mutually acceptable mechanisms to assess the operator's performance.

(b) Public ownership and private operation

50. Alternatively, the whole operation of public infrastructure facilities may be transferred to private entities. One possibility is to give the private entity, usually for a certain period, the right to use a given facility, to supply the relevant services and to collect the revenue generated by that activity. Such a facility may already be in existence or may have been specially built by the private entity concerned. This combination of public ownership and private operation has the essential features of arrangements that in some legal systems may be referred to as "public works concessions" or "public service concessions".

51. Another form of private participation in infrastructure is where a private entity is selected by the contracting authority to operate a facility that has been built by or on behalf of the Government, or whose construction has been financed with public funds. Under such an arrangement, the operator assumes the obligation to operate and maintain the infrastructure and is granted the right to charge for the services it provides. In such a case, the operator assumes the obligation to pay to the contracting authority a portion of the revenue generated by the infrastructure that is used by the contracting authority to amortize the construction cost. Such arrangements are referred to in some legal systems as "lease" or "*affermage*".

(c) Private ownership and operation

52. Under the third approach, the private entity not only operates the facility, but also owns the assets related to it. Here, too, there may be substantial differences in the treatment of such projects under domestic laws, for instance as to whether the contracting authority retains the right to reclaim title to the facility or to assume responsibility for its operation (see also chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 23-29).

53. Where the facility is operated pursuant to a governmental licence, private ownership of physical assets (e.g. a telecommunication network) is often separable from the licence to provide the service to the public (e.g. long-distance telephone services), in that the licence can be withdrawn by the competent public authority under certain circumstances. Thus, private ownership of the facility may not necessarily entail an indefinite right to provide the service.

4. *Financing structures and sources of finance for infrastructure*

(a) Notion of project finance

54. Large-scale projects involving the construction of new infrastructure facilities are often carried out by new corporate entities specially established for that purpose by the project promoters. Such a new entity, often called a "project company", becomes the vehicle for raising funds for the project. Because the project company lacks an established credit or an established balance sheet on which the lenders can rely, the preferred financing modality for the development of new infrastructure is called "project finance". In a project finance transaction, credit will be made available to the extent that the lenders can be satisfied to look primarily to the project's cash flow and earnings as the source of funds for the repayment of loans taken out by the project company. Other guarantees either are absent or cover only certain limited risks. To that end, the project's assets and revenue, and the rights and obligations relating to the project, are independently estimated and are strictly separated from the assets of the project company's shareholders.

55. Project finance is also said to be "non-recourse" financing owing to the absence of recourse to the project company's shareholders. In practice, however, lenders are seldom ready to commit the large amounts needed for infrastructure projects solely on the basis of a project's expected cash flow or assets. The lenders may reduce their exposure by incorporating into the project documents a number of back-up or secondary security arrangements and other means of credit support provided by the project company's shareholders, the Government, purchasers or other interested third parties. This modality is commonly called "limited recourse" financing.

(b) Financing sources for infrastructure projects

56. Alternatives to traditional public financing are playing an increasing role in the development of infrastructure. In recent years, new infrastructure investment in various countries has included projects with exclusively or predominantly private funding sources. The two main types of fund are debt finance, usually in the form of loans obtained on commercial markets, and equity investment. However, financing sources are not limited to those. Public and private investment have often been combined in arrangements sometimes called "public-private partnerships".

(i) Equity capital

57. The first type of capital for infrastructure projects is provided in the form of equity investment. Equity capital is obtained in the first place from the project promoters or other individual investors interested in taking stock in the concessionaire. However, such equity capital normally represents only a portion of the total cost of an infrastructure project. In order to obtain commercial loans or to have access to other sources of funds to meet the capital requirements of the project, the project promoters and other individual investors have

to offer priority payment to the lenders and other capital providers, thus accepting that their own investment will only be paid after payment of those other capital providers. Therefore, the project promoters typically assume the highest financial risk. At the same time, they will hold the largest share in the project's profit once the initial investment is paid. Substantial equity investment by the project promoters is typically welcomed by the lenders and the Government, as it helps reduce the burden of debt service on the concessionaire's cash flow and serves as an assurance of those companies' commitment to the project.

(ii) Commercial loans

58. Debt capital often represents the main source of funding for infrastructure projects. It is obtained on the financial market primarily by means of loans extended to the project company by national or foreign commercial banks, typically using funds that originate from short- to medium-term deposits remunerated by those banks at floating interest rates. Consequently, loans extended by commercial banks are often subject to floating interest rates and normally have a maturity term shorter than the project period. However, where feasible and economic, given financial market conditions, banks may prefer to raise and lend medium- to long-term funds at fixed rates, so as to avoid exposing themselves and the concessionaire over a long period to interest rate fluctuations, while also reducing the need for hedging operations. Commercial loans are usually provided by lenders on condition that their payment takes precedence over the payment of any other of the borrower's liabilities. Therefore, commercial loans are said to be "unsubordinated'' or "senior" loans.

(iii) "Subordinated" debt

59. The third type of fund typically used in these projects are "subordinated" loans, sometimes also called "mezzanine" capital. Such loans rank higher than equity capital in order of payment, but are subordinate to senior loans. This subordination may be general (i.e. ranking generally lower than any senior debt) or specific, in which case the loan agreements specifically identify the type of debt to which it is subordinated. Subordinated loans are often provided at fixed rates, usually higher than those of senior debt. As an additional tool to attract such capital, or sometimes as an alternative to higher interest rates, providers of subordinated loans may be offered the prospect of direct participation in capital gains, by means of the issue of preferred or convertible shares or debentures, sometimes providing an option to subscribe for shares of the concessionaire at preferential prices.

(iv) Institutional investors

60. In addition to subordinated loans provided by the project promoters or by public financial institutions, subordinated debt may be obtained from financing companies, investment funds, insurance companies, collective investment schemes (e.g. mutual funds), pension funds and other so-called "institutional investors". These institutions normally have large sums available for long-term investment and may represent an important source of additional capital for

infrastructure projects. Their main reasons for accepting the risk of providing capital to infrastructure projects are the prospect of remuneration and interest in diversifying investment.

(v) Capital market funding

61. As more experience is gained with privately financed infrastructure projects, increased use is being made of capital market funding. Funds may be raised by the placement of preferred shares, bonds and other negotiable instruments on a recognized stock exchange. Typically, the public offer of negotiable instruments requires regulatory approval and compliance with requirements of the relevant jurisdiction, such as requirements concerning the information to be provided in the prospectus of issuance and, in some jurisdictions, the need for prior registration. Bonds and other negotiable instruments may have no other security than the general credit of the issuer or may be secured by a mortgage or other lien on specific property.

62. The possibility of gaining access to capital markets is usually greater for existing public utilities with an established commercial record than for companies specially established to build and operate a new infrastructure and lacking the required credit rating. Indeed, a number of stock exchanges require that the issuing company have some established record over a certain minimum period before being permitted to issue negotiable instruments.

(vi) Financing by Islamic financial institutions

63. One additional group of potential capital providers are Islamic financial institutions. Those institutions operate under rules and practices derived from the Islamic legal tradition. One of the most prominent features of banking activities under their rules is the absence of interest payments or strict limits to the right to charge interest and consequently the establishment of other forms of consideration for the borrowed money, such as profit-sharing or direct participation of the financial institutions in the results of the transactions of their clients. As a consequence of their operating methods, Islamic financial institutions may be more inclined than other commercial banks to consider direct or indirect equity participation in a project.

(vii) Financing by international financial institutions

64. International financial institutions may also play a significant role as providers of loans, guarantees or equity to privately financed infrastructure projects. A number of projects have been co-financed by the World Bank, the International Finance Corporation or by regional development banks.

65. International financial institutions may also play an instrumental role in the formation of "syndications" for the provision of loans to the project. Some of those institutions have special loan programmes under which they become the sole "lender of record" to a project, acting on its own behalf and on behalf

of participating banks and assuming responsibility for processing disbursements by participants and for subsequent collection and distribution of loan payments received from the borrower, either pursuant to specific agreements or based on other rights that are available under their status of preferred creditor. Some international financial institutions may also provide equity or mezzanine capital, by investing in capital market funds specialized in securities issued by infrastructure operators. Lastly, international financial institutions may provide guarantees against a variety of political risks, which may facilitate the project company's task of raising funds in the international financial market (see chap. II, "Project risks and government support", paras. 61-71).

(viii) Support by export credit and investment promotion agencies

66. Export credit and investment promotion agencies may provide support to the project in the form of loans, guarantees or a combination of both. The participation of export credit and investment promotion agencies may provide a number of advantages, such as lower interest rates than those applied by commercial banks and longer-term loans, sometimes at a fixed interest rate (see chap. II, "Project risks and government support", paras. 72-74).

(ix) Combined public and private finance

67. In addition to loans and guarantees extended by commercial banks and national or multilateral public financial institutions, in a number of cases public funds have been combined with private capital for financing new projects. Such public funds may originate from government income or sovereign borrowing. They may be combined with private funds as initial investment or as long-term payments, or may take the form of governmental grants or guarantees. Infrastructure projects may be co-sponsored by the Government through equity participation in the concessionaire, thus reducing the amount of equity and debt capital needed from private sources (see chap. II, "Project risks and government support", paras. 40 and 41).

5. *Main parties involved in implementing infrastructure projects*

68. The parties to a privately financed infrastructure project may vary greatly, depending on the infrastructure sector, the modality of private sector participation and the arrangements used for financing the project. The following paragraphs identify the main parties in the implementation of a typical privately financed infrastructure project involving the construction of a new infrastructure facility and carried out under the "project finance" modality.

(a) The contracting authority and other public authorities

69. The execution of a privately financed infrastructure project frequently involves a number of public authorities in the host country at the national, provincial or local level. The contracting authority is the main body responsible for the project within the Government. Furthermore, the execution of the

project may necessitate the active participation (e.g. for the issuance of licences or permits) of other public authorities in addition to the contracting authority, at the same or at a different level of Government. Those authorities play a crucial role in the execution of privately financed infrastructure projects.

70. The contracting authority or another public authority normally identifies the project pursuant to its own policies for infrastructure development in the sector concerned and determines the type of private sector participation that would allow the most efficient operation of the infrastructure facility. Thereafter, the contracting authority conducts the process that leads to the selection of the concessionaire. Furthermore, throughout the life of the project, the Government may need to provide various forms of support—legislative, administrative, regulatory and sometimes financial—so as to ensure that the facility is successfully built and adequately operated. Finally, in some projects the Government may become the ultimate owner of the facility.

(b) The project company and the project promoters

71. Privately financed infrastructure projects are usually carried out by a joint venture of companies including construction and engineering companies and suppliers of heavy equipment interested in becoming the main contractors or suppliers of the project. The companies that participate in such a joint venture are referred to in the *Guide* as the "promoters" of the project. Those companies will be intensively involved in the development of the project during its initial phase and their ability to cooperate with each other and to engage other reliable partners will be essential for timely and successful completion of the work. Furthermore, the participation of a company with experience in operating the type of facility being built is an important factor to ensure the long-term viability of the project. Where an independent legal entity is established by the project promoters, other equity investors not otherwise engaged in the project (usually institutional investors, investment banks, bilateral or multilateral lending institutions, sometimes also the Government or a government-owned corporation) may also participate. The participation of local investors, where the project company is required to be established under the laws of the host country (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 12-18), is sometimes encouraged by the Government.

(c) Lenders

72. The risks to which the lenders are exposed in project finance, be it non-recourse or limited recourse, are considerably higher than in conventional transactions. This is even more the case where the security value of the physical assets involved (e.g. a road, bridge or tunnel) is difficult to realize, given the lack of a "market" where such assets could easily be sold, or act as obstacles to recovery or repossession. This circumstance affects not only the terms under which the loans are provided (e.g. the usually higher cost of project finance and extensive conditions to funding), but also, as a practical matter, the availability of funds.

73. Owing to the magnitude of the investment required for a privately financed infrastructure project, loans are often organized in the form of "syndicated" loans with one or more banks taking the lead role in negotiating the finance documents on behalf of the other participating financial institutions, mainly commercial banks. Commercial banks that specialize in lending for certain industries are typically not ready to assume risks with which they are not familiar (for a discussion of project risks and risk allocation, see chap. II, "Project risks and government support", paras. 8-29). For example, long-term lenders may not be interested in providing short-term loans to finance infrastructure construction. Therefore, in large-scale projects, different lenders are often involved at different phases of the project. With a view to avoiding disputes that might arise from conflicting actions taken by individual lenders or disputes between lenders over payment of their loans, lenders extending funds to large projects sometimes do so under a common loan agreement. Where various credit facilities are provided under separate loan agreements, the lenders will typically negotiate a so-called "inter-creditor agreement". An inter-creditor agreement usually contains provisions dealing with matters such as provisions for disbursement of payments, pro rata or in a certain order of priority; conditions for declaring events of default and accelerating the maturity of credits; and coordination of foreclosure on security provided by the project company.

(d) International financial institutions and export credit and investment promotion agencies

74. International financial institutions and export credit and investment promotion agencies will have concerns of generally the same order as other lenders to the project. In addition to this, they will be particularly interested in ensuring that the project execution and its operation are not in conflict with particular policy objectives of those institutions and agencies. Increasing emphasis is being given by international financial institutions to the environmental impact of infrastructure projects and their long-term sustainability. The methods and procedures applied to select the concessionaire will also be carefully considered by international financial institutions providing loans to the project. Many global and regional financial institutions and national development funding agencies have established guidelines or other requirements governing procurement with funds provided by them, which is typically reflected in their standard loan agreements (see also chap. III, "Selection of the concessionaire", para. 18).

(e) Insurers

75. Typically, an infrastructure project will involve casualty insurance covering its plant and equipment, third-party liability insurance and worker's compensation insurance. Other possible types of insurance include insurance for business interruption, interruption in cash flows and cost overrun (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 119 and 120). Those types of insurance are usually available on the commercial insurance markets, although the availabil-

ity of commercial insurance may be limited for certain extraordinary events outside the control of the parties (e.g. war, riots, vandalism, earthquakes or hurricanes). The private insurance market is playing an increasing role in coverage against certain types of political risk, such as contract repudiation, failure by a public authority to perform its contractual obligations or unfair calls for independent guarantees. In some countries, insurance underwriters structure comprehensive insurance packages aimed at avoiding certain risks being left uncovered owing to gaps between individual insurance policies. In addition to private insurance, guarantees against political risks may be provided by international financial institutions, such as the World Bank, the Multilateral Investment Guarantee Agency and the International Finance Corporation, by regional development banks or by export credit and investment promotion agencies (see chap. II, "Project risks and government support", paras. 61-74).

(f) Independent experts and advisers

76. Independent experts and advisers play an important role at various stages of privately financed infrastructure projects. Experienced companies typically supplement their own technical expertise by retaining the services of outside experts and advisers, such as financial experts, international legal counsel or consulting engineers. Merchant and investment banks often act as advisers to project promoters in arranging the finance and in formulating the project to be implemented, an activity that, while essential to project finance, is quite distinct from the financing itself. Independent experts may advise the lenders to the project, for example, on the assessment of project risks in a specific host country. They may also assist public authorities in devising sector-specific strategies for infrastructure development and in formulating an adequate legal and regulatory framework. Furthermore, independent experts and advisers may assist the contracting authority in the preparation of feasibility and other preliminary studies, in the formulation of requests for proposals or standard contractual terms and specifications, in the evaluation and comparison of proposals or in the negotiation of the project agreement.

77. In addition to private entities, a number of intergovernmental organizations (e.g. UNIDO and the regional commissions of the Economic and Social Council) and international financial institutions (e.g. the World Bank and the regional development banks) have special programmes whereby they may either provide this type of technical assistance directly to the Government or assist the latter in identifying qualified advisers.

I. General legislative and institutional framework

A. General remarks

1. The establishment of an appropriate and effective legal framework is a prerequisite to creating an environment that fosters private investment in infrastructure. For countries where such a legal framework already exists, it is important to ensure that the law is sufficiently flexible and responsive to keep pace with the developments in various infrastructure sectors. This chapter deals with some general issues that domestic legislators are advised to consider when setting up or reviewing the legal framework for privately financed infrastructure projects in order to achieve the above objectives. Section B (paras. 2-14) sets out general considerations on the constitutional and legislative framework; section C (paras. 15-22) deals with the scope of authority to award infrastructure and public services concessions; section D (paras. 23-29) discusses possible measures to enhance administrative coordination; and section E (paras. 30-53) deals with institutional and procedural arrangements for the regulation of infrastructure sectors.

B. Constitutional, legislative and institutional framework

2. This section considers general guiding principles that may inspire the legal framework for privately financed infrastructure projects. It further points out the possible implications that the constitutional law of the host country may have for the implementation of these projects. Lastly, this section deals briefly with possible choices to be made regarding the level and type of instrument that might need to be enacted and their scope of application.

1. General guiding principles for a favourable constitutional and legislative framework

3. In considering the establishment of an enabling legal framework or in reviewing the adequacy of the existing framework, domestic legislators may wish to take into account some general principles that have inspired recent legislative actions in various countries, which are discussed briefly in the following paragraphs.

(a) Transparency

4. A transparent legal framework is characterized by clear and readily accessible rules and by efficient procedures for their application. Transparent laws

and administrative procedures create predictability, enabling potential investors to estimate the costs and risks of their investment and thus to offer their most advantageous terms. Transparent laws and administrative procedures may also foster openness through provisions requiring the publication of administrative decisions, including, when appropriate, an obligation to state the grounds on which they are based and to disclose other information of public relevance. They also help to guard against arbitrary or improper actions or decisions by the contracting authority or its officials and thus help to promote confidence in a country's infrastructure development programme. Transparency of laws and administrative procedures is of particular importance where foreign investment is sought, since foreign companies may be unfamiliar with the country's practices for the award of infrastructure projects.

(b) Fairness

5. The legal framework is both the means by which Governments regulate and ensure the provision of public services to their citizens and the means by which public service providers and their customers may protect their rights. A fair legal framework takes into account the various (and sometimes possibly conflicting) interests of the Government, the public service providers and their customers and seeks to achieve an equitable balance between them. The private sector's business considerations, the users' right to adequate services, both in terms of quality and price, the Government's responsibility for ensuring the continuous provision of essential services and its role in promoting national infrastructure development are but a few of the interests that deserve appropriate recognition in the law.

(c) Long-term sustainability

6. An important objective of domestic legislation on infrastructure development is to ensure the long-term provision of public services, with increasing attention being paid to environmental sustainability. Inadequate arrangements for the operation and maintenance of public infrastructure severely limit efficiency in all sectors of infrastructure and result directly in reduced service quality and increased costs for users. From a legislative perspective, it is important to ensure that the host country has the institutional capacity to undertake the various tasks entrusted to public authorities involved in infrastructure projects throughout their phases of implementation. Another measure to enhance the long-term sustainability of a national infrastructure policy is to achieve a correct balance between competitive and monopolistic provision of public services. Competition may reduce overall costs and provide more back-up facilities for essential services. In certain sectors, competition has also helped to increase the productivity of infrastructure investment, to enhance responsiveness to the needs of the customers and to obtain better quality for public services, thus improving the business environment in all sectors of the economy.

2. Constitutional law and privately financed infrastructure projects

7. The constitutional law of a number of countries refers generally to the duty of the State to ensure the provision of public services. Some of them list

the infrastructure and service sectors that come under the responsibility of the State, while in others the task of identifying those sectors is delegated to the legislator. Under some national constitutions, the provision of certain public services is reserved exclusively to the State or to specially created public entities. Other constitutions, however, authorize the State to award concessions to private entities for the development and operation of infrastructure and the provision of public services. In some countries, there are limitations to the participation of foreigners in certain sectors or requirements that the State should participate in the capital of the companies providing public services.

8. For countries wishing to promote private investment in infrastructure it is important to review existing constitutional rules so as to identify possible restrictions to the implementation of privately financed infrastructure projects. In some countries, privately financed infrastructure projects have been delayed by uncertainties regarding the extent of the State's authority to award them. Sometimes, concerns that those projects might contravene constitutional rules on State monopolies or on the provision of public services have led to judicial disputes, with a consequent negative impact on the implementation of the projects.

9. It is further important to take into account constitutional rules relating to the ownership of land or infrastructure facilities. The constitutional law of some countries contains limitations to private ownership of land and certain means of production. In other countries, private property is recognized, but the constitution declares all or certain types of infrastructure to be State property. Prohibitions and restrictions of this nature can be an obstacle to the execution of projects that entail private operation, or private operation and ownership, of the relevant infrastructure (see further chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 23-29).

3. General and sector-specific legislation

10. Legislation frequently plays a central role in promoting private investment in public infrastructure projects. The law typically embodies a political commitment, provides specific legal rights and may represent an important guarantee of stability of the legal and regulatory regime. In most countries, the implementation of privately financed infrastructure projects was in fact preceded by legislative measures setting forth the general rules under which those projects were awarded and executed.

11. As a matter of constitutional law or legislative practice, some countries may need to adopt specific legislation in respect of individual projects. In other countries with a well-established tradition of awarding concessions to the private sector for the provision of public services, the Government is authorized by general legislation to award to the private sector any activity carried out by the public sector having an economic value that makes such activity capable of being exploited by private entities. General legislation of this type creates a framework for providing a uniform treatment to issues that are common to privately financed projects in different infrastructure sectors.

12. However, by its very nature, general legislation is normally not suitable to address all the particular requirements of different sectors. Even in countries that have adopted general legislation addressing cross-sectoral issues, it has been found that supplementary sector-specific legislation allows the legislator to formulate rules that take into account the market structure in each sector (see above, "Introduction and background information on privately financed infrastructure projects", paras. 21-46). It should be noted that in many countries sector-specific legislation was adopted at a time when a significant portion or even the entirety of the national infrastructure consisted of State monopolies. For countries interested in promoting private sector investment in infrastructure it is advisable to review existing sector-specific legislation so as to ascertain its suitability for privately financed infrastructure projects.

13. Sector-specific legislation may further play an important role in establishing a framework for the regulation of individual infrastructure sectors (see below, paras. 30-53). Legislative guidance is particularly useful in countries at the initial stages of setting up or developing national regulatory capacities. Such legislation represents a useful assurance that the regulators do not have unlimited discretion in the exercise of their functions, but are bound by the parameters provided by the law. However, it is generally advisable to avoid rigid or excessively detailed legislative provisions dealing with contractual aspects of the implementation of privately financed infrastructure projects, which in most cases would not be adequate to their long-term nature (see further chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", and chap. V, "Duration, extension and termination of the project agreement").

14. Many countries have used legislation to establish the general principles for the organization of infrastructure sectors and the basic policy, institutional and regulatory framework. However, the law may not be the best instrument to set detailed technical and financial requirements. Many countries have preferred to enact regulations setting forth more detailed rules to implement the general provisions of domestic laws on privately financed infrastructure projects. Regulations are found to be easier to adapt to a change in environment, whether the change results from the transition to market-based rules or from external developments, such as new technologies or changing economic or market conditions. Whatever the instrument used, clarity and predictability are of the essence.

C. Scope of authority to award concessions

15. The implementation of privately financed infrastructure projects may require the enactment of special legislation or regulations authorizing the State to entrust the provision of public services to private entities. The enactment of express legislative authorization may be an important measure to foster the confidence of potential investors, national or foreign, in a national policy to promote private sector investment in infrastructure. Central elements to the authority to award concessions for infrastructure projects are discussed in the following paragraphs.

1. Authorized agencies and relevant fields of activity

16. In some legal systems the Government's responsibility for the provision of public services may not be delegated without prior legislative authorization. For those countries which wish to attract private investment in infrastructure, it is particularly important to state clearly in the law the authority to entrust entities other than public authorities of the host country with the right to provide certain public services. Such a general provision may be particularly important in those countries where public services are governmental monopolies or where it is envisaged to engage private entities to provide certain services that used to be available to the public free of charge (see further chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 37 and 38).

17. Where general legislation is adopted, it is also advisable to identify clearly the public authorities or levels of government competent to award infrastructure projects and to act as contracting authorities. In order to avoid unnecessary delay, it is particularly advisable to have rules in place that make it possible to ascertain the persons or offices that have the authority to enter into commitments on behalf of the contracting authority (and, as appropriate, of other public authorities) at different stages of negotiation and to sign the project agreement. It is useful to consider the extent of powers that may be needed by authorities other than the central Government to carry out projects falling within their purview. For projects involving offices or agencies at different levels of government (for example, national, provincial or local), where it is not possible to identify in advance all the relevant offices and agencies involved, other measures may be needed to ensure appropriate coordination among them (see below, paras. 23-29).

18. For purposes of clarity, it is advisable to identify in such general legislation those sectors in which concessions may be awarded. Alternatively, where this is not deemed feasible or desirable, the law might identify those activities which may not be the object of a concession (for example, activities related to national defence or security).

2. Purpose and scope of concessions

19. It may be useful for the law to define the nature and purpose of privately financed infrastructure projects for which concessions may be awarded in the host country. One possible approach may be to define the various categories of projects according to the extent of the rights and obligations assumed by the concessionaire (for example, "build-operate-transfer", "build-own-operate", "built-transfer-operate" and "build-transfer"). However, given the wide variety of schemes that may come into play in connection with private investment in infrastructure, it may be difficult to provide exhaustive definitions of all of them. As an alternative, the law could generally provide that concessions may be awarded for the purpose of entrusting an entity, private or public, with the obligation to carry out infrastructure works and deliver certain public services, in exchange for the right to charge a price for the use of the facility or premises

or for the service or goods it generates, or for other payment or remuneration agreed to by the parties. The law could further clarify that concessions may be awarded for the construction and operation of a new infrastructure facility or system or for maintenance, repair, refurbishment, modernization, expansion and operation of existing infrastructure facilities and systems, or only for the management and delivery of a public service.

20. Another important issue concerns the nature of the rights vested in the concessionaire, in particular whether the right to provide the service is exclusive or whether the concessionaire will face competition from other infrastructure facilities or service providers. Exclusivity may concern the right to provide a service in a particular geographical region (for example, a communal water distribution company) or embrace the whole territory of the country (for example, a national railway company); it may relate to the right to supply one particular type of goods or services to one particular customer (for example, a power generator being the exclusive regional supplier to a power transmitter and distributor) or to a limited group of customers (for example, a national long-distance telephone carrier providing connections to local telephone companies).

21. The decision whether or not to grant exclusivity rights to a certain project or category of projects should be taken in the light of the host country's policy for the sector concerned. As discussed earlier, the scope for competition varies considerably in different infrastructure sectors. While certain sectors, or segments thereof, have the characteristics of natural monopolies, in which case open competition is usually not an economically viable alternative, other infrastructure sectors have been successfully opened to free competition (see "Introduction and background information on privately financed infrastructure projects", paras. 28 and 29).

22. It is desirable therefore to deal with the issue of exclusivity in a flexible manner. Rather than excluding or prescribing exclusive concessions, it may be preferable for the law to authorize the grant of exclusive concessions when it is deemed to be in the public interest, such as in cases where the exclusivity is justified for the purpose of ensuring the technical or economical viability of the project. The contracting authority may be required to state the reasons for envisaging an exclusive concession prior to starting the procedure to select the concessionaire. Such general legislation may be supplemented by sector-specific laws regulating the issue of exclusivity in a manner suitable for each particular sector.

D. Administrative coordination

23. Depending on the administrative structure of the host country, privately financed infrastructure projects may require the involvement of several public authorities, at various levels of government. For instance, the competence to lay down regulations and rules for the activity concerned may rest in whole or in part with a public authority at a level different from the one that is responsible for providing the relevant service. It may also be that both the regulatory

and the operational functions are combined in one entity, but that the authority to award government contracts is centralized in a different public authority. For projects involving foreign investment, it may also happen that certain specific competences fall within the mandate of an agency responsible for approving foreign investment proposals.

24. Recent international experience has demonstrated the usefulness of entrusting a central unit within the host country's administration with the overall responsibility for formulating policy and providing practical guidance on privately financed infrastructure projects. Such a central unit may also be responsible for coordinating the input of the main public authorities that interface with the project company. It is recognized, however, that such an arrangement may not be possible in some countries, owing to their particular administrative organization. Where it is not feasible to establish such a central unit, other measures may be considered to ensure an adequate level of coordination among the various public authorities involved, as discussed in the following paragraphs.

1. Coordination of preparatory measures

25. One important measure to ensure the successful implementation of privately financed infrastructure projects is the requirement that the relevant public authority conduct a preliminary assessment of the project's feasibility, including economic and financial aspects such as expected economic advantages of the project, estimated cost and potential revenue anticipated from the operation of the infrastructure facility and the environmental impact of the project. The studies prepared by the contracting authority should, in particular, identify clearly the expected output of the project, provide sufficient justification for the investment, propose a modality for private sector participation and describe a particular solution to the output requirement.

26. Following the identification of the future project, it is for the Government to establish its relative priority and to assign human and other resources for its implementation. At that point, it is desirable that the contracting authority review existing statutory or regulatory requirements relating to the operation of infrastructure facilities of the type proposed with a view to identifying the main public authorities whose input will be required for the implementation of the project. It is also important at this stage to consider the measures that may be required in order for the contracting authority and the other public authorities involved to perform the obligations they may reasonably anticipate in connection with the project. For instance, the Government may need to make advance budgeting arrangements to enable the contracting authority or other public authorities to meet financial commitments that extend over several budgetary cycles, such as long-term commitments to purchase the project's output (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 50 and 51). Furthermore, a series of administrative measures may be needed to implement certain forms of support provided to the project, such as tax exemptions and customs facilitation (see chap. II, "Project risks and government support", paras. 51-54), which may require considerable time.

2. *Arrangements for facilitating the issuance of licences and permits*

27. Legislation may play a useful role in facilitating the issuance of licences and permits that may be needed in the course of a project (such as licences under foreign exchange regulations; licences for the incorporation of the concessionaire; authorizations for the employment of foreigners; registration and stamp duties for the use or ownership of land; import licences for equipment and supplies; construction licences; licences for the installation of cables or pipelines; licences for bringing the facility into operation; and spectrum allocation for mobile communication). The required licences or permits may fall within the competence of various organs at different levels of the administration and the time required for their issuance may be significant, in particular when the approving organs or offices were not originally involved in conceiving the project or negotiating its terms. Delay in bringing an infrastructure project into operation as a result of missing licences or permits for reasons not attributable to the concessionaire is likely to result in an increase in the cost of the project and in the price paid by the users.

28. Thus, it is advisable to conduct an early assessment of licences and permits needed for a particular project in order to avoid delay in the implementation phase. A possible measure to enhance the coordination in the issuance of licences and permits might be to entrust one organ with the authority to receive the applications for licences and permits, to transmit them to the appropriate agencies and to monitor the issuance of all licences and permits listed in the request for proposals and other licences that might be introduced by subsequent regulations. The law may also authorize the relevant agencies to issue provisional licences and permits and provide a time period beyond which those licences and permits are deemed to be granted unless they are rejected in writing.

29. However, it should be noted that the distribution of administrative authority among various levels of government (for example, local, regional and central) often reflects fundamental principles of a country's political organization. Therefore, there are instances where the central Government would not be in a position to assume responsibility for the issuance of all licences and permits or to entrust one single body with such a coordinating function. In those cases, it is important to introduce measures to counter the possibility of delay that might result from such distribution of administrative authority, such as, for instance, agreements between the contracting authority and the other public authorities concerned to facilitate the procedures for a given project or other measures intended to ensure an adequate level of coordination among the various public authorities involved and to make the process of obtaining licences more transparent and efficient. Furthermore, the Government might consider providing some assurance that it will assist the concessionaire as much as possible in obtaining licences required by domestic law, for instance by providing information and assistance to bidders regarding the required licences, as well as the relevant procedures and conditions. From a practical point of view, in addition to coordination among various levels of government and various public authorities, there is a need to ensure consistency in the application of criteria for the issuance of licences and for the transparency of the administrative process.

E. Authority to regulate infrastructure services

30. The provision of certain public services is generally subject to a special regulatory regime that may consist of substantive rules, procedures, instruments and institutions. That framework represents an important instrument to implement the governmental policy for the sector concerned (see "Introduction and background information on privately financed infrastructure projects", paras. 21-46). Depending on the institutional structure of the country concerned and on the allocation of powers between different levels of government, provincial or local legislation may govern some infrastructure sectors, in full or concurrently with national legislation.

31. Regulation of infrastructure services involves a wide range of general and sector-specific issues, which may vary considerably according to the social, political, legal and economic reality of each host country. While occasionally discussing some of the main regulatory issues that are encountered in a similar context in different sectors (see, for instance, chapter IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 39-46 and 82-95), the *Guide* is not intended to exhaust the legal or policy issues arising out of the regulation of various infrastructure sectors. The term "regulatory agencies" refers to the institutional mechanisms required to implement and monitor the rules governing the activities of infrastructure operators. Because the rules applicable to infrastructure operation often allow for a degree of discretion, a body is required to interpret and apply them, monitor compliance, impose sanctions and settle disputes arising out of the implementation of the rules. The specific regulatory tasks and the amount of discretion they involve will be determined by the rules in question, which can vary widely.

32. The *Guide* assumes that the host country has in place the proper institutional and bureaucratic structures and human resources necessary for the implementation of privately financed infrastructure projects. Nevertheless, as a contribution to domestic legislatures considering the need for, and desirability of, establishing regulatory agencies for monitoring the provision of public services, this section discusses some of the main institutional and procedural issues that may arise in that connection. The discussion contained in this section is illustrative of different options that have been used in domestic legislative measures to set up a regulatory framework for privately financed infrastructure projects, but the *Guide* does not thereby advocate the establishment of any particular model or administrative structure. Practical information and technical advice may be obtained from international financial institutions that carry out programmes to assist their member countries in setting up an adequate regulatory framework (such as the World Bank and the regional development banks).

1. Sectoral competence and mandate of regulatory agencies

33. Regulatory responsibilities may be organized on a sectoral or cross-sectoral basis. Countries that have opted for a sectoral approach have in many cases decided to place closely linked sectors or segments thereof under the same regulatory structure (for example, a common regulatory agency for power and

gas or for airports and airlines). Other countries have organized regulation on a cross-sectoral basis, in some cases with one regulatory entity for all infrastructure sectors and in others with one entity for utilities (water, power, gas, telecommunications) and one for transport. In some countries the competence of regulatory agencies might also extend to several sectors within a given region.

34. Regulatory agencies whose competence is limited to a particular sector usually foster the development of technical, sector-specific expertise. Sector-specific regulation may facilitate the development of rules and practices that are tailored to the needs of the sector concerned. However, the decision between sector-specific and cross-sectoral regulation depends in part on the country's regulatory capacity. Countries with limited expertise and experience in infrastructure regulation may find it preferable to reduce the number of independent structures and try to achieve economies of scale.

35. The law setting up a regulatory mechanism often stipulates a number of general objectives that should guide the actions of regulatory agencies, such as the promotion of competition, the protection of users' interests, the satisfaction of demand, the efficiency of the sector or the public service providers, their financial viability, the safeguarding of the public interest or of public service obligations and the protection of investors' rights. Having one or two overriding objectives helps clarify the mandate of regulatory agencies and establish priorities among sometimes conflicting objectives. A clear mandate may also increase a regulatory agency's autonomy and credibility.

2. *Institutional mechanisms*

36. The range of institutional mechanisms for the regulation of infrastructure sectors varies greatly. While there are countries that entrust regulatory functions to organs of the Government (for example, the concerned ministries or departments), other countries have preferred to establish autonomous regulatory agencies, separate from the Government. Some countries have decided to subject certain infrastructure sectors to autonomous and independent regulation while leaving others under ministerial regulation. Sometimes, powers may also be shared between an autonomous regulatory agency and the Government, as is often the case with respect to licensing. From a legislative perspective, it is important to devise institutional arrangements for the regulatory functions that ensure to the regulatory agency an adequate level of efficiency, taking into account the political, legal and administrative tradition of the country.

37. The efficiency of the regulatory regime is in most cases a function of the objectiveness with which regulatory decisions are taken. This, in turn, requires that regulatory agencies should be able to take decisions without interference or inappropriate pressures from infrastructure operators and public service providers. To that effect, legislative provisions in several countries require the independence of the regulatory decision-making process. In order to achieve the desired level of independence it is advisable to separate the regulatory functions from operational ones by removing any regulatory functions that may still be vested with the public service providers and entrust them to a

legally and functionally independent entity. Regulatory independence is supplemented by provisions to prevent conflicts of interest, such as prohibitions for staff of the regulatory agency to hold mandates, accept gifts, enter into contracts or have any other relationship (directly or through family members or other intermediaries) with regulated companies, their parents or affiliates.

38. This leads to a related issue, namely, the need to minimize the risk of decisions being made or influenced by a body that is also the owner of enterprises operating in the regulated sector or a body acting on political rather than technical grounds. In some countries it was felt necessary to provide the regulatory agency with a certain degree of autonomy vis-à-vis the political organs of government. Independence and autonomy should not be considered solely on the basis of the institutional position of the regulatory function, but also on the basis of its functional autonomy (i.e. the availability of sufficient financial and human resources to discharge their responsibilities adequately).

3. Powers of regulatory agencies

39. Regulatory agencies may have decision-making powers, advisory powers or purely consultative powers or a combination of these different levels of powers depending on the subject matter. In some countries, regulatory agencies were initially given limited powers, which were expanded later as the agencies established a track record of independence and professionalism. The legislation often specifies which powers are vested with the Government and which with a regulatory agency. Clarity in this respect is important to avoid unnecessary conflicts and confusion. Investors, as well as consumers and other interested parties, should know to whom to turn with various requests, applications or complaints.

40. Selection of public service providers, for example, is in many countries a process involving the Government as well as the regulatory agency. If the decision to award a project involves broad judgement of a political rather than technical nature, which may often be the case in the context of infrastructure privatization, final responsibility often rests with the Government. If, however, the award criteria are more technical, as may be the case with a liberal licensing regime for power generation or telecommunication services, many countries entrust the decision to an independent regulatory agency. In other cases, the Government may have to ask the regulatory agency's opinion prior to awarding a concession. On the other hand, some countries exclude direct involvement of regulatory agencies in the award process on the basis that it could affect the way they later regulate the provision of the service concerned.

41. The jurisdiction of regulatory agencies normally extends to all enterprises operating in the sectors they regulate, with no distinction between private and public enterprises. The use of some regulatory powers or instruments may be limited by law to the dominant public service providers in the sector. A regulatory agency may, for example, have price policing powers only vis-à-vis the incumbent or dominant public service provider, while new entrants may be allowed to set prices freely.

42. The matters on which regulatory agencies have to arbitrate range from normative responsibilities (for example, rules on the award of concessions and conditions for certification of equipment) to the actual award of concessions; the approval of contracts or decisions proposed by the regulated entities (for example, a schedule or contract on network access); the definition and monitoring of an obligation to provide certain services; the oversight over public service providers (in particular compliance with licence conditions, norms and performance targets); price setting or adjustments; vetting of subsidies, exemptions or other advantages that could distort competition in the sector; sanctions; and dispute settlement.

4. Composition, staff and budget of regulatory agencies

43. When setting up a regulatory agency, a few countries have opted for an agency comprised of a single officer, whereas most others have preferred a regulatory commission. A commission may provide greater safeguards against undue influence or lobbying and may limit the risk of rash regulatory decisions. A one-person regulatory agency, on the other hand, may be able to reach decisions faster and may be held more accountable. To improve the management of the decision-making process in a regulatory commission, the number of members is often kept small (typically three or five members). Even numbers are often avoided to prevent a deadlock, though the chairman could have a casting vote.

44. To increase the regulatory agency's autonomy, different institutions may be involved in the nomination process. In some countries regulatory agencies are appointed by the head of State based on a list submitted by parliament; in others the executive branch of the Government appoints the regulatory agency but subject to confirmation by parliament or upon nominations submitted by parliament, user associations or other bodies. Minimum professional qualifications are often required of the officials of the regulatory agencies, as well as the absence of conflicts of interest that might disqualify them from the function. Terms of office of members of regulatory boards may be staggered in order to prevent total turnover and appointment of all members by the same administration; staggering also promotes continuity in regulatory decision-making. Terms of office are often for a fixed term, may be non-renewable and may be terminated before the expiry of the term for limited reasons only (such as criminal conviction, mental incapacitation, gross negligence or dereliction of duty). Regulatory agencies are often faced with experienced lawyers, accountants and other experts working for the regulated industry and need to be able to acquire the same level of expertise, skills and professionalism, either in-house or by hiring outside advisers as needed.

45. Stable funding sources are critical in order for the regulatory agency to function adequately. In many countries, the budget of the regulatory agency is funded by fees and other levies on the regulated industry. Fees may be set as a percentage of the turnover of the public service providers or be levied for the award of licences, concessions or other authorizations. In some countries, the agency's budget is complemented as needed by budget transfers provided in

the annual finance law. However, this may create an element of uncertainty that may reduce the agency's autonomy.

5. Regulatory process and procedures

46. The regulatory framework typically includes procedural rules governing the way the institutions in charge of the various regulatory functions have to exercise their powers. The credibility of the regulatory process requires transparency and objectivity, irrespective of whether regulatory authority is exercised by a government department or minister or by an autonomous regulatory agency. Rules and procedures should be objective and clear so as to ensure fairness, impartiality and timely action by the regulatory agency. For purposes of transparency, the law should require that they be made public. Regulatory decisions should state the reasons on which they are based and should be made accessible to interested parties, through publication or other appropriate means.

47. Transparency may be further enhanced, as required by some laws, by the publication by the regulatory agency of an annual report on the sector, including, for example, the decisions taken during the exercise, the disputes that have arisen and the way they were settled. Such an annual report may also include the accounts of the regulatory agency and an audit thereof by an independent auditor. Legislation in many countries further requires that this annual report be submitted to a committee of parliament.

48. Regulatory decisions may have an impact on the interests of diverse groups, including the concerned public service provider, its current or potential competitors and business or non-business users. In many countries, the regulatory process includes consultation procedures for major decisions or recommendations. In some countries, that consultation takes the form of public hearings, in others of consultation papers on which comments from interested groups are solicited. Some countries have also established consultative bodies comprised of users and other concerned parties and require that their opinion be sought before major decisions and recommendations are made. To enhance transparency, comments, recommendations or opinions resulting from the consultation process may have to be published or made publicly available.

6. Recourse against decisions of the regulatory agency

49. Another important element of the host country's regulatory regime are the mechanisms whereby public service providers may request a review of regulatory decisions. As with the whole regulatory process, a high degree of transparency and credibility is essential. To be credible, the review should be entrusted to an entity that is independent from the regulatory agency taking the original decision, from the political authorities of the host country and from the public service providers.

50. Review of decisions of regulatory agencies is often in the jurisdiction of courts, but in some legal systems recourse against decisions by regulatory

agencies is in the exclusive jurisdiction of special tribunals dealing solely with administrative matters, which in some countries are separate from the judicial system. If there are concerns over the review process (for example, as regards possible delays or the capacity of courts to make evaluations of the complex economic issues involved in regulatory decisions) review functions may be entrusted to another body, at least in the first instance, before a final recourse to courts or administrative tribunals. In some countries, requests for review are considered by a high-level cross-sectoral independent oversight body. There are also countries where requests for review are heard by a panel composed of persons holding specified judicial and academic functions. As to the grounds on which a request for review may be based, in many cases there are limits, in particular as to the right of the appellate body to substitute its own discretionary assessment of facts for the assessment of the body whose decision is being reviewed.

7. Settlement of disputes between public service providers

51. Disputes may arise between competing concessionaires (for example, two operators of cellular telephony systems) or between concessionaires providing services in different segments of the same infrastructure sector. Such disputes may involve allegations of unfair trade practices (for example, price dumping), uncompetitive practices inconsistent with the country's infrastructure policy (see "Introduction and background information on privately financed infrastructure projects", paras. 23-29) or violation of specific duties of public service providers (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 82-93). In many countries, legislative provisions have been found necessary in order to establish an appropriate framework for the settlement of these disputes.

52. Firstly, the various parties may not have contractual arrangements with one another that could provide for an appropriate dispute settlement mechanism. Even where it would be possible to establish a contractual mechanism, the host country may have an interest that disputes involving certain issues (for example, conditions of access to a given infrastructure network) be settled by a specific body in order to ensure consistency in the application of the relevant rules. Furthermore, certain disputes between public service providers may involve issues that, under the laws of the host country, are not considered able to be settled through arbitration.

53. Domestic laws often establish administrative procedures for handling disputes between public service providers. Typically, public service providers may file complaints with the regulatory agency or with another governmental agency responsible for the application of the rules alleged to have been violated (for example, a governmental body in charge of enforcing competition laws and regulations), which in some countries has the authority to issue a binding decision on the matter. Such mechanisms, even where mandatory, do not necessarily preclude resort by the aggrieved persons to courts, although in some legal systems the courts may only have the power to control the legality of the decision (for example, observance of due process) but not its merits.

II. Project risks and government support

A. General remarks

1. Privately financed infrastructure projects create opportunities for reducing the commitment of public funds and other resources for infrastructure development and operation. They also make it possible to transfer to the private sector a number of risks that would otherwise be borne by the Government. The precise allocation of risks among the various parties involved is typically defined after consideration of a number of factors, including the public interest in the development of the infrastructure in question and the level of risk faced by the project company, other investors and lenders (and the extent of their ability and readiness to absorb those risks at an acceptable cost). Adequate risk allocation is essential to reducing project costs and to ensuring the successful implementation of the project. Conversely, an inappropriate allocation of project risks may compromise the project's financial viability or hinder its efficient management, thus increasing the cost at which the service is provided.

2. In the past, debt financing for infrastructure projects was obtained on the basis of credit support from project sponsors, multilateral and national export credit agencies, Governments and other third parties. In recent years, these traditional sources have not been able to meet the growing needs for infrastructure capital and financing has been increasingly obtained on a project finance basis.

3. Project finance, as a method of financing, seeks to establish the creditworthiness of the project company on a "stand alone" basis, even before construction has begun or any revenues have been generated, and to borrow on the basis of that credit. Commentators have observed that project finance may hold the key to unlocking the vast pools of capital theoretically available in the capital markets for investment in infrastructure. However, project finance has distinctive and demanding characteristics from a financial point of view. Principal among these is that, in a project finance structure, financing parties must rely mainly upon the project company's assets and cash flows for repayment. If the project fails they will have no recourse, or only limited recourse, to the financial resources of a sponsor company or other third party for repayment (see also "Introduction and background information on privately financed infrastructure projects", paras. 54 and 55).

4. The financial methodology of project financing requires a precise projection of the capital costs, revenues and projected costs, expenses, taxes and liabilities of the project. In order to predict these numbers precisely and with certainty and to create a financial model for the project, it is typically necessary to project the "base case" amounts of revenues, costs and expenses of the project company over a long period—often 20 years or more—in order to

determine the amounts of debt and equity the project can support. Central to this analysis is the identification and quantification of risks. For this reason, the identification, assessment, allocation and mitigation of risks is at the heart of project financing from a financial point of view.

5. Among the most important, yet difficult, risks to assess and to mitigate are "political risks" (risks associated with adverse actions of the host Government, its agencies and its courts, in particular in granting licences and permits, adopting regulations applicable to the project company and its markets, taxation and the performance and enforcement of contractual obligations) and "currency risks" (risks related to the value, transferability and convertibility of the local currency). In order to guard against such risks, in particular, project finance structures have often incorporated insurance or guarantees of international financial institutions and export credit agencies as well as guarantees of the host Government.

6. Section B of the present chapter (paras. 8-29) gives an overview of the main risks encountered in privately financed infrastructure projects and contains a brief discussion of common contractual solutions for risk allocation, which emphasizes the need to provide the parties with the necessary flexibility for negotiating a balanced allocation of project risks. Section C (paras. 30-60) sets out policy considerations that the Government may wish to take into account when designing the level of direct governmental support that may be provided to infrastructure projects, such as the degree of public interest in the execution of any given project and the need to avoid the assumption by the Government of open-ended or excessive contingent liabilities. Section C considers some additional support measures that have been used in governmental programmes to promote private investment in infrastructure development, without advocating the use of any of them in particular. Lastly, sections D (paras. 61-71) and E (paras. 72-74) outline guarantees and support measures that may be provided by export credit agencies and investment promotion agencies.

7. Other chapters of this *Guide* deal with related aspects of the host Government's legal regime that are of relevance to the credit and risk analysis of a project. Depending upon the sector and type of project the emphasis will, of course, vary. The reader is referred in particular to chapters IV, "Construction and operation of infrastructure: legislative framework and project agreement"; V, "Duration, extension and termination of the project agreement"; VI, "Settlement of disputes"; and VII, "Other relevant areas of law".

B. Project risks and risk allocation

8. As used in this chapter, the notion of "project risks" refers to those circumstances which, in the assessment of the parties, may have a negative effect on the benefit they expect to achieve with the project. While there may be events that would represent a serious risk for most parties (for example, the physical destruction of the facility by a natural disaster), each party's risk exposure will vary according to its role in the project.

9. The expression "risk allocation" refers to the determination of which party or parties should bear the consequences of the occurrence of events identified as project risks. For example, if the project company is obliged to deliver the infrastructure facility to the contracting authority with certain equipment in functioning condition, the project company is bearing the risk that the equipment may fail to function at the agreed performance levels. The occurrence of that project risk, in turn, may have a series of consequences for the project company, including its liability for failure to perform a contractual obligation under the project agreement or the applicable law (for example, payment of damages to the contracting authority for delay in bringing the facility into operation); certain losses (for example, loss of revenue as a result of delay in beginning operating the facility); or additional cost (for example, cost of repair of faulty equipment or of securing replacement equipment).

10. The party bearing a given risk may take preventive measures with a view to limiting the likelihood of the risk, as well as specific measures to protect itself, in whole or in part, against the consequences of the risk. Such measures are often referred to as "risk mitigation". In the previous example, the project company will carefully review the reliability of the equipment suppliers and the technology proposed. The project company may require its equipment suppliers to provide independent guarantees concerning the performance of their equipment. The supplier may also be liable to pay penalties or liquidated damages to the project company for the consequences of failure of its equipment. In some cases, a more or less complex chain of contractual arrangements may be made to mitigate the consequences of a project risk. For instance, the project company may combine the guarantees provided by the equipment supplier with commercial insurance covering some consequences of the interruption of its business as a result of equipment failure.

1. Overview of main categories of project risk

11. For purposes of illustration, the following paragraphs provide an overview of the main categories of project risks and give examples of certain contractual arrangements used for risk allocation and mitigation. For further discussion on this subject, the reader is advised to consult other sources of information, such as the *UNIDO BOT Guidelines*.[1]

(a) Project disruption caused by events outside the control of the parties

12. The parties face the risk that the project may be disrupted by unforeseen or extraordinary events outside their control, which may be of a physical nature, such as natural disasters—floods, storms or earthquakes—or the result of human action, such as war, riots or terrorist attacks. Such unforeseen or extraordinary events may cause a temporary interruption of the project execution or the operation of the facility, resulting in construction delay, loss of revenue and other losses. Severe events may cause physical damage to the facility or even destruc-

[1]See "Introduction and background information on privately financed infrastructure projects", footnote 1.

tion beyond repair (for a discussion of the legal consequences of the occurrence of such events, see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 131-139).

(b) Project disruption caused by adverse acts of Government ("political risk")

13. The project company and the lenders face the risk that the project execution may be negatively affected by acts of the contracting authority, another agency of the Government or the host country's legislature. Such risks are often referred to as "political risks" and may be divided into three broad categories: "traditional" political risks (for example, nationalization of the project company's assets or imposition of new taxes that jeopardize the project company's prospects of debt repayment and investment recovery); "regulatory" risks (for example, introduction of more stringent standards for service delivery or opening of a sector to competition) and "quasi-commercial" risks (for example, breaches by the contracting authority or project interruptions due to changes in the contracting authority's priorities and plans) (for a discussion of the legal consequences of the occurrence of such events, see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 122-125). In addition to political risks originating from the host country, some political risks may result from acts of a foreign Government, such as blockades, embargoes or boycotts imposed by the Governments of the investors' home countries.

(c) Construction and operation risks

14. The main risks that the parties may face during the construction phase are the risks that the facility cannot be completed at all or cannot be delivered according to the agreed schedule (completion risk); that the construction cost exceeds the original estimates (construction cost overrun risk); or that the facility fails to meet performance criteria at completion (performance risk). Similarly, during the operational phase the parties may face the risk that the completed facility cannot be effectively operated or maintained to produce the expected capacity, output or efficiency (performance risk); or that the operating costs exceed the original estimates (operation cost overrun). It should be noted that construction and operation risks do not affect only the private sector. The contracting authority and the users in the host country may be severely affected by an interruption in the provision of needed services. The Government, as representative of the public interest, will be generally concerned about safety risks or environmental damage caused by improper operation of the facility.

15. Some of these risks may be brought about by the project company or its contractors or suppliers. For instance, construction cost overrun and delay in completion may be the result of inefficient construction practices, waste, insufficient budgeting or lack of coordination among contractors. Failure of the facility to meet performance criteria may also be the result of defective design, inadequacy of the technology used or faulty equipment delivered by the project company's suppliers. During the operational phase, performance failures may

be the consequence, for example, of faulty maintenance of the facility or negligent operation of mechanical equipment. Operation cost overruns may also derive from inadequate management.

16. However, some of these risks may also result from specific actions taken by the contracting authority, by other public authorities or even the host country's legislature. Performance failures or cost overruns may be the consequence of the inadequacy of the technical specifications provided by the contracting authority during the selection of the concessionaire. Delays and cost overruns may also be brought about by actions of the contracting authority subsequent to the award of the project (delays in obtaining approvals and permits, additional costs caused by changes in requirements due to inadequate planning, interruptions caused by inspecting agencies or delays in delivering the land on which the facility is to be built). General legislative or regulatory measures, such as more stringent safety or labour standards, may also result in higher construction or operating costs. Shortfalls in production may be caused by the non-delivery of the necessary supplies (for example, power or gas) on the part of public authorities.

(d) Commercial risks

17. "Commercial risks" relate to the possibility that the project cannot generate the expected revenue because of changes in market prices or demand for the goods or services it generates. Both of these forms of commercial risk may seriously impair the project company's capacity to service its debt and may compromise the financial viability of the project.

18. Commercial risks vary greatly according to the sector and type of project. The risk may be regarded as minimal or moderate where the project company has a monopoly over the service concerned or when it supplies a single client through a standing off-take agreement. However, commercial risks may be considerable in projects that depend on market-based revenues, in particular where the existence of alternative facilities or supply sources makes it difficult to establish a reliable forecast of usage or demand. This may be a serious concern, for instance, in tollroad projects, since tollroads face competition from toll-free roads. Depending on the ease with which drivers may have access to toll-free roads, the toll revenues may be difficult to forecast, especially in urban areas where there may be many alternative routes and roads may be built or improved continuously. Furthermore, traffic usage has been found to be even more difficult to forecast in the case of new tollroads, especially those which are not an addition to an existing toll facility system, because there is no existing traffic to use as an actuarial basis.

(e) Exchange rate and other financial risks

19. Exchange rate risk relates to the possibility that changes in foreign exchange rates alter the exchange value of cash flows from the project. Prices and user fees charged to local users or customers will most likely be paid for in local currency, while the loan facilities and sometimes also equipment or

fuel costs may be denominated in foreign currency. This risk may be considerable, since exchange rates are particularly unstable in many developing countries or countries whose economies are in transition. In addition to exchange rate fluctuations, the project company may face the risk that foreign exchange control or lowering reserves of foreign exchange may limit the availability in the local market of foreign currency needed by the project company to service its debt or repay the original investment.

20. Another risk faced by the project company concerns the possibility that interest rates may rise, forcing the project to bear additional financing costs. This risk may be significant in infrastructure projects given the usually large sums borrowed and the long duration of projects, with some loans extending over a period of several years. Loans are often given at a fixed rate of interest (for example, fixed-rate bonds) to reduce the interest rate risk. In addition, the finance package may include hedging facilities against interest rate risks, for example, by way of interest rate swaps or interest rate caps.

2. *Contractual arrangements for risk allocation and mitigation*

21. It follows from the above that the parties need to take into account a wide range of factors to allocate project risks effectively. For this reason, it is generally not advisable to have in place statutory provisions that limit unnecessarily the negotiators' ability to achieve a balanced allocation of project risks, as appropriate to the needs of individual projects. Nevertheless, it may be useful for the Government to provide some general guidance to officials acting on behalf of domestic contracting authorities, for instance, by formulating advisory principles on risk allocation.

22. Practical guidance provided to contracting authorities in a number of countries often refers to general principles for the allocation of project risks. One such principle is that specific risks should normally be allocated to the party best able to assess, control and manage the risk. Additional guiding principles envisage the allocation of project risks to the party with the best access to hedging instruments (that is, investment schemes to offset losses in one transaction by realizing a simultaneous gain on another) or the greatest ability to diversify the risks or to mitigate them at the lowest cost. In practice, however, risk allocation is often a factor of both policy considerations (for example, the public interest in the project or the overall exposure of the contracting authority under various projects) and the negotiating strength of the parties. Furthermore, in allocating project risks it is important to consider the financial strength of the parties to which a specific risk is allocated and their ability to bear the consequences of the risk, should it occur.

23. It is usually for the project company and its contractors to assume ordinary risks related to the development and operation of the infrastructure. For instance, completion, cost overrun and other risks typical of the construction phase are usually allocated to the construction contractor or contractors through a turnkey construction contract, whereby the contractor assumes full

responsibility for the design and construction of the facility at a fixed price, within a specified completion date and according to particular performance specifications (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 70). The construction contractor is typically liable to pay liquidated damages or penalties for any late completion. In addition, the contractor is also usually required to provide a guarantee of performance, such as a bank guarantee or a surety bond. Separate equipment suppliers are also usually required to provide guarantees in respect of the performance of their equipment. Guarantees of performance provided by contractors and equipment suppliers are often complemented by similar guarantees provided by the concessionaire to the benefit of the contracting authority. Similarly, the project company typically mitigates its exposure to operation risks by entering into an operation and maintenance contract in which the operating company undertakes to achieve the required output and assumes the liability for the consequences of operational failures. In most cases, arrangements of this type will be an essential requirement for a successful project. The lenders, for their part, will seek protection against the consequences of those risks, by requiring the assignment of the proceeds of any bonds issued to guarantee the contractor's performance, for instance. Loan agreements typically require that the proceeds from contract bonds be deposited in an account pledged to the lenders (that is, an "escrow account"), as a safeguard against misappropriation by the project company or against seizure by third parties (for example, other creditors). Nevertheless, the funds paid under the bonds are regularly released to the project company as needed to cover repair costs or operating and other expenses.

24. The contracting authority, on the other hand, will be expected to assume those risks which relate to events attributable to its own actions, such as inadequacy of technical specifications provided during the selection process or delay caused by failure to provide agreed supplies on time. The contracting authority may also be expected to bear the consequences of disruptions caused by acts of Government, for instance by agreeing to compensate the project company for loss of revenue due to price control measures (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 124). While some political risks may be mitigated by procuring insurance, such insurance, if at all available for projects in the country concerned, may not be obtainable at an acceptable cost. Thus, prospective investors and lenders may turn to the Government, for instance, to obtain assurances against expropriation or nationalization and guarantees that proper compensation will be payable in the event of such action (see para. 50). Depending on their assessment of the level of risk faced in the host country, prospective investors and lenders may not be ready to pursue a project in the absence of those assurances or guarantees.

25. Most of the project risks referred to in the preceding paragraphs can, to a greater or lesser extent, be regarded as falling within the control of one party or the other. However, a wide variety of project risks result from events outside the control of the parties or are attributable to the acts of third parties and other principles of risk allocation may thus need to be considered.

26. For example, the project company could expect that the interest rate risk, together with the inflation risk, would be passed on to the end-users or customers of the facility through price increases, although this may not always be possible because of market-related circumstances or price control measures. The price structure negotiated between the project company and the contracting authority will determine the extent to which the project company will avoid those risks or whether it will be expected to absorb some of them (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 36-46).

27. Another category of risk that may be allocated under varying schemes concerns extraneous events such as war, civil disturbance, natural disasters or other events wholly outside the control of the parties. In traditional infrastructure projects carried out by the public sector, the public entity concerned usually bears the risk, for example, of destruction of the facility by natural disasters or similar events, to the extent that those risks may not be insurable. In privately financed infrastructure projects the Government may prefer this type of risk to be borne by the project company. However, depending on their assessment of the particular risks faced in the host country, the private sector may not be ready to bear those risks. Therefore, in practice there is not a single solution to cover this entire category of risk and special arrangements are often made to deal with each of them. For example, the parties may agree that the occurrence of some of those events may exempt the affected party from the consequences of failure to perform under the project agreement and there will be contractual arrangements providing solutions for some of their adverse consequences, such as contract extensions to compensate for delay resulting from events or even some form of direct payment under special circumstances (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 131-139). Those arrangements will be supplemented by commercial insurance purchased by the project company, where available at an acceptable cost (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 119 and 120).

28. Special arrangements may also need to be negotiated for the allocation of commercial risks. Projects such as mobile telecommunication projects usually have a relatively high direct cost recovery potential and in most cases the project company is expected to carry out the project without sharing those risks with the contracting authority and without recourse to support from the Government. In other infrastructure projects, such as power-generation projects, the project company may revert to contractual arrangements with the contracting authority or other public authority in order to reduce its exposure to commercial risks, for example, by negotiating long-term off-take agreements that guarantee a market for the product at an agreed price. Payments may take the form of actual consumption or availability charges or combine elements of both; the applicable rates are usually subject to escalation or indexation clauses in order to protect the real value of revenues from the increased costs of operating an ageing facility (see also chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 50 and 51). Lastly,

there are relatively capital-intensive projects with more slowly developing cost recovery potential, such as water supply and some tollroad projects, which the private sector may be reluctant to carry out without some form of risk-sharing with the contracting authority, for example, through fixed revenue assurances or agreed capacity payments regardless of actual usage (see also chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 48 and 49).

29. The risk allocation eventually agreed to by the contracting authority and the project company will be reflected in their mutual rights and obligations, as set forth in the project agreement. The possible legislative implications of certain provisions commonly found in project agreements are discussed in other chapters of the *Guide* (see chaps. IV, "Construction and operation of infrastructure: legislative framework and project agreement", and V, "Duration, extension and termination of the project agreement"). Various other agreements will also be negotiated by the parties to mitigate or reallocate the risks they assume (for example, loan agreements; construction, equipment supply, operation and maintenance contracts; direct agreement between the contracting authority and the lenders; and off-take and long-term supply agreements, where applicable).

C. Government support

30. The discussion in the preceding section shows that the parties may use various contractual arrangements to allocate and mitigate project risks. Nevertheless, those arrangements may not always be sufficient to ensure the level of comfort required by private investors to participate in privately financed infrastructure projects. It may also be found that certain additional government support is needed to enhance the attractiveness of private investment in infrastructure projects in the host country.

31. Government support may take various forms. Generally, any measure taken by the Government to enhance the investment climate for infrastructure projects may be regarded as governmental support. From that perspective, the existence of legislation enabling the Government to award privately financed infrastructure projects or the establishment of clear lines of authority for the negotiation and follow-up of infrastructure projects (see chap. I, "General legislative and institutional framework", paras. 23-29) may represent important measures to support the execution of infrastructure projects. As used in the *Guide*, however, the expression "government support" has a narrower connotation and refers in particular to special measures, in most cases of a financial or economic nature, that may be taken by the Government to enhance the conditions for the execution of a given project or to assist the project company in meeting some of the project risks, above and beyond the ordinary scope of the contractual arrangements agreed to between the contracting authority and the project company to allocate project risks. Government support measures, where available, are typically an integral part of governmental programmes to attract private investment for infrastructure projects.

1. Policy considerations relating to government support

32. In practice, a decision to support the implementation of a project is based on an assessment by the Government of the economic or social value of the project and whether that justifies additional governmental support. The Government may estimate that the private sector alone may not be able to finance certain projects at an acceptable cost. The Government may also consider that particular projects may not materialize without certain support measures that mitigate some of the project risks. Indeed, the readiness of private investors and lenders to carry out large projects in a given country is not only based on their assessment of specific project risks, but is also influenced by their comfort with the investment climate in the host country, in particular in the infrastructure sector. Factors to which private investors may attach special importance include the host country's economic system and the degree of development of market structures and the degree to which the country has already succeeded with privately financed infrastructure projects over a period of years.

33. For the above reasons, a number of countries have adopted a flexible approach for dealing with the issue of governmental support. In some countries, this has been done by legislative provisions that tailor the level and type of support to the specific needs of individual infrastructure sectors. In other countries, this has been achieved by providing the host Government with sufficient legislative authority to extend certain types of assurance or guarantee while preserving its discretion not to make them available in all cases. However, the host Government will be interested in ensuring that the level and type of support provided to the project does not result in the assumption of open-ended liabilities. Indeed, over-commitment of public authorities through guarantees given to a specific project may prevent them from extending guarantees in other projects of perhaps even greater public interest.

34. The efficiency of governmental support programmes for private investment in infrastructure may be enhanced by the introduction of appropriate techniques for budgeting for governmental support measures or for assessing the total cost of other forms of governmental support. For example, loan guarantees provided by public authorities usually have a cost lower than the cost of loan guarantees provided by commercial lenders. The difference (less the value of fees and interests payable by the project company) represents a cost for the Government and a subsidy for the project company. However, loan guarantees are often not recorded as expenses until such time as a claim is made. Thus, the actual amount of the subsidy granted by the Government is not recorded, which may create the incorrect impression that loan guarantees entail a lesser liability than direct subsidy payments. Similarly, the financial and economic cost of tax exemptions granted by the Government may not be apparent, which makes them less transparent than other forms of direct governmental support. For these reasons, countries that are contemplating establishing support programmes for privately financed infrastructure projects may need to devise special methods for estimating the budgetary cost of support measures such as tax exemptions, loans and loan guarantees provided by public authorities that take into account the expected present value of future costs or loss of revenue.

2. *Forms of government support*

35. The availability of direct governmental support, be it in the form of financial guarantees, public loans or revenue assurances, may be an important element in the financial structuring of the project. The following paragraphs briefly describe forms of governmental support that are sometimes authorized under domestic laws and discuss possible legislative implications they may have for the host country, without advocating the use of any of them in particular.

36. Generally, besides the administrative and budgetary measures that may be needed to ensure the fulfilment of governmental commitments throughout the duration of the project, it is advisable for the legislature to consider the possible need for an explicit legislative authorization to provide certain forms of support. Where government support is found advisable, it is important for the legislature to bear in mind the host country's obligations under international agreements on regional economic integration or trade liberalization, which may limit the ability of public authorities of the contracting States to provide support, financial or otherwise, to companies operating in their territories. Furthermore, where a Government is contemplating support for the execution of an infrastructure project, that circumstance should be made clear to all prospective bidders at an appropriate time during the selection proceedings (see chap. III, "Selection of the concessionaire", para. 67).

(a) Public loans and loan guarantees

37. In some cases, the law authorizes the Government to extend interest-free or low-interest loans to the project company to lower the project's financing cost. Depending on the accounting rules to be followed, some interest-free loans provided by public agencies can be recorded as revenue in the project company's accounts, with loan payments being treated as deductible costs for tax and accounting purposes. Moreover, subordinate loans provided by the Government may enhance the financial terms of the project by supplementing senior loans provided by commercial banks without competing with senior loans for repayment. Governmental loans may be generally available to all project companies in a given sector or they may be limited to providing temporary assistance to the project company in the event that certain project risks materialize. The total amount of any such loan may be further limited to a fixed sum or to a percentage of the total project cost.

38. In addition to public loans, some national laws authorize the contracting authority or other agency of the host Government to provide loan guarantees for the repayment of loans taken by the project company. Loan guarantees are intended to protect the lenders (and, in some cases, investors providing funds to the project as well) against default by the project company. Loan guarantees do not entail an immediate disbursement of public funds and they may appear more attractive to the Government than direct loans. However, loan guarantees may represent a substantial contingent liability and the Government's exposure may be significant, especially in the event of total failure by the project company. Indeed, the Government would in most cases

find little comfort in a possible subrogation in the rights of the lenders against an insolvent project company.

39. Thus, in addition to introducing general measures to enhance the efficiency of governmental support programmes (see para. 34), it may be advisable to consider concrete provisions to limit the Government's exposure under loan guarantees. Rules governing the provision of loan guarantees may provide a maximum ceiling, which could be expressed as a fixed sum or, if more flexibility is needed, a certain percentage of the total investment in any given project. Another measure to circumscribe the contingent liabilities of the guaranteeing agency may be to define the circumstances under which such guarantees may be extended, taking into account the types of project risk the Government may be ready to share. For instance, if the Government considers sharing only the risks of temporary disruption caused by events outside the control of the parties, the guarantees could be limited to the event that the project company is rendered temporarily unable to service its loans owing to the occurrence of specially designated unforeseeable events outside the project company's control. If the Government wishes to extend a greater degree of protection to the lenders, the guarantees may cover the project company's permanent failure to repay its loans for the same reasons. In such a case, however, it is advisable not to remove the incentives for the lenders to arrange for the continuation of the project, for instance by identifying another suitable concessionaire or by stepping in through an agent appointed to remedy the project company's default (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 147-150). The call on the governmental guarantees could thus be conditional upon the prior exhaustion of other remedies available to the lenders under the project agreement, the loan agreements or their direct agreements with the contracting authority, if any. In any event, full loan guarantees by the Government amounting to a total protection of the lenders against the risk of default by the project company are not a common feature of infrastructure projects carried out under the project finance modality.

(b) Equity participation

40. Another form of additional support by the Government may consist of direct or indirect equity participation in the project company. Equity participation by the Government may help achieve a more favourable ratio between equity and debt by supplementing the equity provided by the project sponsors, in particular where other sources of equity capital, such as investment funds, cannot be tapped by the project company. Equity investment by the Government may also be useful to satisfy legal requirements of the host country concerning the composition of locally established companies. The company laws of some jurisdictions, or special legislation on infrastructure projects, require a certain amount of participation of local investors in locally established companies. However, it may not always be possible to secure the required level of local participation on acceptable terms. Local investors may lack the interest or financial resources to invest in large infrastructure projects; they may also be averse to or lack experience in dealing with specific project risks.

41. Governmental participation may involve certain risks that the Government may wish to consider. In particular, there is a risk that such participation may be understood as an implied guarantee by the Government, so that the parties, or even third parties, may expect the Government to back the project fully or eventually even take it over at its own cost if the project company fails. Where such an implied guarantee is not intended, appropriate provisions should be made to clarify the limits of governmental involvement in the project.

(c) Subsidies

42. Tariff subsidies are used in some countries to supplement the project company's revenue when the actual income of the project falls below a certain minimum level. The provision of the services in some areas where the project company is required to operate may not be a profitable undertaking, because of low demand or high operational costs or because the project company is required to provide the service to a certain segment of the population at low cost. Thus, the law in some countries authorizes the Government to undertake to extend subsidies to the project company in order to make it possible to provide the services at a lower price.

43. Subsidies usually take the form of direct payments to the project company, either lump-sum payments or payments calculated specifically to supplement the project company's revenue. In the latter case, the Government should ensure that it has in place adequate mechanisms for verifying the accuracy of subsidy payments made to the project company, by means, for example, of audit and financial disclosure provisions in the project agreement. An alternative to direct subsidies may be to allow the project company to cross-subsidize less profitable activities with revenue earned in more profitable ones. This may be done by combining in the same concession both profitable and less profitable activities or areas of operation, or by granting to the project company the commercial exploitation of a separate and more profitable ancillary activity (see paras. 48-60).

44. However, it is important for the legislature to consider practical implications and possible legal obstacles to the provision of subsidies to the project company. For example, subsidies are found to distort free competition and the competition laws of many countries prohibit the provision of subsidies or other forms of direct financial aid that are not expressly authorized by legislation. Subsidies may also be inconsistent with the host country's international obligations under international agreements on regional economic integration or trade liberalization.

(d) Sovereign guarantees

45. In connection with privately financed infrastructure projects, the term "sovereign guarantees" is sometimes used to refer to any of two types of guarantee provided by the host Government. The first type includes guarantees issued by the host Government to cover the breach of obligations assumed by the contracting authority under the project agreement. A second category in-

cludes guarantees that the project company will not be prevented by the Government from exercising certain rights that are granted to it under the project agreement or that derive from the laws of the country, for example, the right to repatriate profits at the end of the project. Whatever form such guarantees may take, it is important for the Government and the legislature to consider the Government's ability to assess and manage efficiently its own exposure to project risks and to determine the acceptable level of direct or contingent liabilities it can assume.

(i) Guarantees of performance by the contracting authority

46. Performance guarantees may be used where the contracting authority is a separate or autonomous legal entity that does not engage the responsibility of the Government itself. Such guarantees may be issued in the name of the Government or of a public financial institution of the host country. They may also take the form of a guarantee issued by international financial institutions that are backed by a counter-guarantee by the Government (see paras. 61-71). Guarantees given by the Government may be useful instruments to protect the project company from the consequences of default by the contracting authority or other public authority assuming specific obligations under the project agreement. The most common situations in which such guarantees are used include the following:

(a) *Off-take guarantees.* Under these arrangements, the Government guarantees payment of goods and services supplied by the project company to public entities. Payment guarantees are often used in connection with payment obligations under off-take agreements in the power-generation sector (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 50). Such guarantees may be of particular importance where the main or sole customer of the project company is a government monopoly. Additional comfort is provided to the project company and lenders when the guarantee is subscribed by an international financial institution;

(b) *Supply guarantees.* Supply guarantees may also be provided to protect the project company from the consequences of default by public sector entities providing goods and supplies required for the operation of the facility—fuel, electricity or water, for example—or to secure payment of indemnities for which the contracting authority may become liable under the supply agreement;

(c) *General guarantees.* These are guarantees intended to protect the project company against any form of default by the contracting authority, rather than default on specifically designated obligations. Although general performance guarantees may not be very frequent, there are cases in which the project company and the lenders may regard them as a condition necessary for executing the project. This may be the case, for example, where the obligations undertaken by the contracting authority are not commensurate with its creditworthiness, as may happen in connection with large concessions granted by municipalities or other autonomous entities. Guarantees by the Government may be useful to ensure specific performance, for example, when the host Government undertakes to substitute for the contracting entity in the perform-

ance of certain acts (for example, delivery of an appropriate site for disposal of by-products).

47. Generally, it is important not to overestimate the adequacy of sovereign guarantees alone to protect the project company against the consequences of default by the contracting authority. Except when their purpose is to ensure specific performance, sovereign guarantees usually have a compensatory function. Thus, they may not substitute for appropriate contractual remedies in the event of default by the contracting authority (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 140-150). Different types of contractual remedies, or combinations thereof, may be used to deal with various events of default, for example, liquidated damages in the event of default and price increases or contract extensions in the event of additional delay in project execution caused by acts of the contracting authority. Furthermore, in order to limit the Government's exposure and to reduce the risk of calls on the guarantee, it is advisable to consider measures to encourage the contracting authority to live up to its obligations under the project agreement or to make efforts to control the causes of default. Such measures may include express subrogation rights of the guarantor against the contracting authority or internal control mechanisms to ensure the accountability of the contracting authority or its agents in the event, for instance, of wanton or reckless breach of its obligations under the project agreement resulting in a call on the sovereign guarantee.

(ii) Guarantees against adverse acts of Government

48. Unlike performance guarantees, which protect the project company against the consequences of default by the contracting authority, the guarantees considered here relate to acts of other authorities of the host country that are detrimental to the rights of the project company or otherwise substantially affect the implementation of the project agreement. Such guarantees are often referred to as "political risk guarantees".

49. One type of guarantee contemplated in national laws consists of foreign exchange guarantees, which usually fulfil three functions: to guarantee the convertibility of the local earnings into foreign currency, to guarantee the availability of the required foreign currency and to guarantee the transferability abroad of the converted sums. Foreign exchange guarantees are common in privately financed infrastructure projects involving a substantial amount of debt denominated in currencies other than the local currency, in particular in those countries which do not have freely convertible currencies. Some laws also provide that such a guarantee may be backed by a bank guarantee issued in favour of the project company. A foreign exchange guarantee is not normally intended to protect the project company and the lenders against the risks of exchange rate fluctuation or market-induced devaluation, which are considered to be ordinary commercial risks. However, in practice, Governments have sometimes agreed to assist the project company in cases where the project company is unable to repay its debts in foreign currency owing to extreme devaluation of the local currency.

50. Another important type of guarantee may be to assure the company and its shareholders that they will not be expropriated without adequate compensation. Such a guarantee would typically extend both to confiscation of property owned by the project company in the host country and to the nationalization of the project company itself, that is, confiscation of shares of the project company's capital. This type of guarantee is usually provided for in laws dealing with direct foreign investment and in bilateral investment protection treaties (see chap. VII, "Other relevant areas of law", paras. 4-6).

(e) Tax and customs benefits

51. Another method for the host Government to support the execution of privately financed projects could be to grant some form of tax and customs exemption, reduction or benefit. Domestic legislation on foreign direct investment often provides special tax regimes to encourage foreign investment and in some countries it has been found useful expressly to extend such a taxation regime to foreign companies participating in privately financed infrastructure projects (see also chap. VII, "Other relevant areas of law", paras. 34-39).

52. Typical tax exemptions or benefits include exemption from income or profit tax or from property tax on the facility, or exemptions from income tax on interest due on loans and other financial obligations assumed by the project company. Some laws provide that all transactions related to a privately financed infrastructure project will be exempted from stamp duties or similar charges. In some cases, the law establishes some preferential tax treatment or provides that the project company will benefit from the same favourable tax treatment generally given to foreign investments. Sometimes the tax benefit takes the form of a more favourable income tax rate, combined with a decreasing level of exemption during the initial years of the project. Such exemptions and benefits are sometimes extended to the contractors engaged by the project company, in particular foreign contractors.

53. Further taxation measures sometimes used to promote privately financed infrastructure projects are exemptions from withholding tax to foreign lenders providing loans to the project. Under many legal systems, any interest, commission or fee in connection with a loan or indebtedness that is borne directly or indirectly by locally established companies or is deductible against income earned locally is deemed to be local income for taxation purposes. Therefore, both local and foreign lenders to infrastructure projects may be liable to the payment of income tax in the host country, which the project company may be required to withhold from payments to foreign lenders, as non-residents of the host country. Income tax due by the lenders in the host country is typically taken into account in the negotiations between the project company and the lenders and may result in a higher financial cost for the project. In some countries, the competent organs are authorized to grant exemptions from withholding tax in connection with payments to non-residents that are found to be made for a purpose that promotes or enhances the economic or technological development of the host country or are otherwise deemed to be related to a purpose of public relevance.

54. Besides tax benefits or exemptions, national laws sometimes facilitate the import of equipment for the use of the project company by means of exemption from customs duties. Such exemption typically applies to the payment of import duties on equipment, machinery, accessories, raw materials and materials imported into the country for purposes of conducting preliminary studies, designing, constructing and operating infrastructure projects. In the event that the project company wishes to transfer or sell the imported equipment on the domestic market, the approval of the contracting authority usually needs to be obtained and the relevant import duties, turnover tax or other taxes need to be paid in accordance with the laws of the country. Sometimes the law authorizes the Government either to grant an exemption from customs duty or to guarantee that the level of duty will not be raised to the detriment of the project.

(f) Protection from competition

55. An additional form of governmental support may consist of assurances that no competing infrastructure project will be developed for a certain period or that no agency of the Government will compete with the project company, directly or through another concessionaire. Assurances of this sort serve as a guarantee that the exclusivity rights that may be granted to the concessionaire (see chap. I, "General legislative and institutional framework", paras. 20-22) will not be nullified during the life of the project. Protection from competition may be regarded by the project company and the lenders as an essential condition for participating in the development of infrastructure in the host country. Some national laws contain provisions whereby the Government undertakes not to facilitate or support the execution of a parallel project that might generate competition to the project company. In some cases, the law contains an undertaking by the Government that it will not alter the terms of such exclusivity to the detriment of the project company without the project company's consent.

56. Provisions of this type may be intended to foster the confidence of the project sponsors and the lenders that the basic assumptions under which the project was awarded will be respected. However, they may be inconsistent with the host country's international obligations under agreements on regional economic integration and trade liberalization. Furthermore, they may limit the ability of the Government to deal with an increase in the demand for the service concerned as the public interest may require or to ensure the availability of the services to various categories of user. It is therefore important to consider carefully the interests of the various parties involved. For instance, the required price level to allow profitable exploitation of a tollroad may exceed the paying capacity of low-income segments of the public. Thus, the contracting authority may have an interest in maintaining open to the public a toll-free road as an alternative to a new tollroad. At the same time, however, if the contracting authority decides to improve or upgrade the alternative road, the traffic flow may be diverted from the tollroad built by the project company, thus affecting its flow of income. Similarly, the Government may wish to introduce free competition for the provision of long-distance telephone services in order to expand the availability and reduce the cost of telecommunication services (for a brief overview of issues relating to competition, see "Intro-

duction and background information on privately financed infrastructure projects", paras. 24-29). The consequence of such a measure, however, may be a significant erosion of the income anticipated by the project company.

57. Generally, it may be useful to authorize the Government, where appropriate, to give assurances that the project company's exclusive rights will not be unduly affected by subsequent changes in governmental policies without appropriate compensation. However, it may not be advisable to adopt statutory provisions that rule out the possibility of subsequent changes in the Government's policy for the sector concerned, including a decision to promote competition or to build parallel infrastructure. The possible consequences of such future changes for the project company should be dealt with by the parties in contractual provisions dealing with changes in circumstances (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 121-130). It is particularly advisable to provide the contracting authority with the necessary power to negotiate with the project company the compensation that may be due for loss or damage that may result from a competing infrastructure project subsequently launched by the contracting authority or from any equivalent measure of the Government that adversely affects the project company's exclusive rights.

(g) Ancillary revenue sources

58. One additional form of support to the execution of privately financed infrastructure projects may be to allow the project company to diversify its investment through additional concessions for the provision of ancillary services or the exploitation of other activities. In some cases, alternative sources of revenue may also be used as a subsidy to the project company for the purpose of pursuing a policy of low or controlled prices for the main service. Provided that the ancillary activities are sufficiently profitable, they may enhance the financial feasibility of a project: the right to collect tolls on an existing bridge, for example, may be an incentive for the execution of a new toll-bridge project. However, the relative importance of ancillary revenue sources should not be overemphasized.

59. In order to allow the project company to pursue ancillary activities, it may be necessary for the Government to receive legislative authorization to grant the project company the right to use property belonging to the contracting authority for the purposes of such activities (for example, land adjacent to a highway for construction of service areas) or the right to charge fees for the use of a facility built by the contracting authority. Where it is felt necessary to control the development and possibly the expansion of such ancillary activities, the approval of the contracting authority might be required in order for the project company to undertake significant expansion of facilities used for ancillary activities.

60. Under some legal systems, certain types of ancillary source of revenue offered by the Government may be regarded as a concession separate from the main concession and it is therefore advisable to review possible limitations to

the project company's freedom to enter into contracts for the operation of ancillary facilities (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 100 and 101).

D. Guarantees provided by international financial institutions

61. Besides guarantees given directly by the host Government, there may be guarantees issued by international financial institutions, such as the World Bank, the Multilateral Investment Guarantee Agency and the regional development banks. Such guarantees usually protect the project company against certain political risks, but under some circumstances they may also cover breach of the project agreement, for instance, where the project company defaults on its loans as a result of the breach of an obligation by the contracting authority.

1. Guarantees provided by multilateral lending institutions

62. In addition to lending to Governments and public authorities, multilateral lending institutions, such as the World Bank and the regional development banks, have developed programmes to extend loans to the private sector. Sometimes they can also provide guarantees to commercial lenders for public and private sector projects. In most cases, guarantees provided by those institutions require a counter-guarantee from the host Government.

63. Guarantees by multilateral lending institutions are designed to mitigate the risks of default on sovereign contractual obligations or long-maturity loans that private lenders are not prepared to bear and are not equipped to evaluate. For instance, guarantees provided by the World Bank may typically cover specified risks (the partial risk guarantee) or all credit risks during a specified part of the financing term (the partial credit guarantee), as summarized below. Most regional development banks provide guarantees under terms similar to those of the World Bank.

(a) Partial risk guarantees

64. A partial risk guarantee covers specified risks arising from non-performance of sovereign contractual obligations or certain political force majeure events. Such guarantees ensure payment in the case of debt service default resulting from the non-performance of contractual obligations undertaken by Governments or their agencies. They may cover various types of non-performance, such as failure to maintain the agreed regulatory framework, including price formulas; failure to deliver inputs, such as fuel supplied to a private power company; failure to pay for outputs, such as power purchased by a government utility from a power company or bulk water purchased by a local public distribution company; failure to compensate for project delays or interruptions caused by government actions or political events; procedural delays; and adverse changes in exchange control laws or regulations.

65. When multilateral lending institutions participate in financing a project, they sometimes provide support in the form of a waiver of recourse that they would otherwise have to the project company in the event that default is caused by events such as political risks. For example, a multilateral lending institution taking a completion guarantee from the project company may accept that it cannot enforce that guarantee if the reason for failure to complete was a political risk reason.

(b) Partial credit guarantees

66. Partial credit guarantees are provided to private sector borrowers with a government counter-guarantee. They are designed to cover the portion of financing that falls due beyond the normal tenure of loans provided by private lenders. These guarantees are generally used for projects involving private sector participation that need long-term funds to be financially viable. A partial credit guarantee typically extends maturities of loans and covers all events of non-payment for a designated part of the debt service.

2. Guarantees provided by the Multilateral Investment Guarantee Agency

67. The Multilateral Investment Guarantee Agency (MIGA) offers long-term political risk insurance coverage to new investments originating in any member country and destined for any developing member country other than the country from which the investment originates. New investment contributions associated with the expansion, modernization or financial restructuring of existing projects are also eligible, as are acquisitions that involve the privatization of State enterprises. Eligible forms of foreign investment include equity, shareholder loans and loan guarantees issued by equity holders, provided the loans and loan guarantees have terms of at least three years. Loans to unrelated borrowers can also be insured, as long as a shareholder investment in the project is concurrently insured. Other eligible forms of investment are technical assistance, management contracts and franchising and licensing agreements, provided they have terms of at least three years and the remuneration of the investor is tied to the operating results of the project. MIGA insures against the following risks: foreign currency transfer restrictions, expropriation, breach of contract, war and civil disturbance.

(a) Transfer restrictions

68. The purpose of guarantees of foreign currency transfer extended by MIGA is similar to that of sovereign foreign exchange guarantees that may be provided by the host Government (see para. 49). This guarantee protects against losses arising from an investor's inability to convert local currency (capital, interest, principal, profits, royalties and other remittances) into foreign exchange for transfer outside the host country. The coverage insures against

excessive delays in acquiring foreign exchange caused by action or failure to act by the host Government, by adverse changes in exchange control laws or regulations and by deterioration in conditions governing the conversion and transfer of local currency. Currency devaluation is not covered. On receipt of the blocked local currency from an investor, MIGA pays compensation in the currency of its contract of guarantee.

(b) Expropriation

69. This guarantee protects against loss of the insured investment as a result of acts by the host Government that may reduce or eliminate ownership of, control over or rights to the insured investment. In addition to outright nationalization and confiscation, "creeping" expropriation—a series of acts that, over time, have an expropriatory effect—is also covered. Coverage is provided on a limited basis for partial expropriation (for example, confiscation of funds or tangible assets). Bona fide, non-discriminatory measures taken by the host Government in the exercise of legitimate regulatory authority are not covered. For total expropriation of equity investments, MIGA pays the net book value of the insured investment. For expropriation of funds, MIGA pays the insured portion of the blocked funds. For loans and loan guarantees, the Agency insures the outstanding principal and any accrued and unpaid interest. Compensation is paid upon assignment of the investor's interest in the expropriated investment (for example, equity shares or interest in a loan agreement) to MIGA.

(c) Breach of contract

70. This guarantee protects against losses arising from the host Government's breach or repudiation of a contract with the investor. In the event of an alleged breach or repudiation, the investor must be able to invoke a dispute resolution mechanism (for example, arbitration) under the underlying contract and obtain an award for damages. If, after a specified period of time, the investor has not received payment or if the dispute resolution mechanism fails to function because of actions taken by the host Government, MIGA will pay compensation.

(d) War and civil disturbance

71. This guarantee protects against loss from damage to, or the destruction or disappearance of, tangible assets caused by politically motivated acts of war or civil disturbance in the host country, including revolution, insurrection, coup d'état, sabotage and terrorism. For equity investments, MIGA will pay the investor's share of the least of the book value of the assets, their replacement cost or the cost of repair of damaged assets. For loans and loan guarantees, MIGA will pay the insured portion of the principal and interest payments in default as a direct result of damage to the assets of the project caused by war and civil disturbance. War and civil disturbance coverage also extends to events that, for a period of one year, result in an interruption of project operations essential to overall financial viability. This type of business interruption is effective when the investment is considered a total loss; at that point, MIGA will pay the book value of the total insured equity investment.

E. Guarantees provided by export credit agencies and investment promotion agencies

72. Insurance against certain political, commercial and financial risks, as well as direct lending, may be obtained from export credit agencies and investment promotion agencies. Export credit agencies and investment promotion agencies have typically been established in a number of countries to assist in the export of goods or services originating from that country. Export credit agencies act on behalf of the Governments of the countries supplying goods and services for the project. Most export credit agencies are members of the International Union of Credit and Investment Insurers (Berne Union), whose main objectives include promoting international cooperation and fostering a favourable investment climate; developing and maintaining sound principles of export credit insurance; and establishing and sustaining discipline in the terms of credit for international trade.

73. While the support available differs from country to country, export credit agencies typically offer two lines of coverage:

(a) *Export credit insurance*. In the context of the financing of privately financed infrastructure projects, the essential purpose of export credit insurance is to guarantee payment to the seller whenever a foreign buyer of exported goods or services is allowed to defer payment. Export credit insurance may take the form of "supplier credit" or "buyer credit" insurance arrangements. Under the supplier credit arrangements the exporter and the importer agree on commercial terms that call for deferred payment evidenced by negotiable instruments (for example, bills of exchange or promissory notes) issued by the buyer. Subject to proof of creditworthiness, the exporter obtains insurance from an export credit agency in its home country. Under the buyer credit modality, the buyer's payment obligation is financed by the exporter's bank, which in turn obtains insurance coverage from an export credit agency. Export credits are generally classified as short-term (repayment terms of usually under two years), medium-term (usually two to five years) and long-term (over five years). Official support by export credit agencies may take the form of "pure cover", by which is meant insurance or guarantees given to exporters or lending institutions without financing support. Official support may also be given in the form of "financing support", which is defined as including direct credits to the overseas buyer, refinancing and all forms of interest rate support;

(b) *Investment insurance*. Export credit agencies may offer insurance coverage either directly to a borrower or to the exporter for certain political and commercial risks. Typical political and commercial risks include war, insurrection or revolution; expropriation, nationalization or requisition of assets; non-conversion of currency; and lack of availability of foreign exchange. Investment insurance provided by export credit agencies typically protects the investors in a project company established abroad against the insured risks, but not the project company itself. Investment insurance cover tends to be extended to a wide range of political risks. Export credit agencies prepared to cover such risks will typically require sufficient information on the legal system of the host country.

74. The conditions under which export credit agencies of member countries of the Organisation for Economic Cooperation and Development (OECD) offer support to both supplier and buyer credit transactions have to be in accordance with the OECD Arrangement on Guidelines for Officially Supported Export Credits (also referred to as the “OECD consensus“). The main purpose of the arrangement is to provide a suitable institutional framework to prevent unfair competition by means of official support for export credits. In order to avoid market-distorting subsidies, the Arrangement regulates the conditions of terms of insurances, guarantees or direct lending supported by Governments.

III. Selection of the concessionaire

A. General remarks

1. The present chapter deals with methods and procedures recommended for use in the award of privately financed infrastructure projects. In line with the advice of international organizations, such as UNIDO[1] and the World Bank,[2] the *Guide* expresses a preference for the use of competitive selection procedures, while recognizing that sometimes concessions may be awarded without competitive procedures according to the legal tradition of the country concerned (see also paras. 85-88).

2. The selection procedures recommended in this chapter present some of the features of the principal method for the procurement of services under the UNCITRAL Model Law on Procurement of Goods, Construction and Services (the "UNCITRAL Model Procurement Law").[3] A number of adaptations have been introduced to take into account the particular needs of privately financed infrastructure projects, such as a clearly defined pre-selection phase. Where appropriate, this chapter refers the reader to provisions of the UNCITRAL Model Procurement Law, which may, mutatis mutandis, supplement the selection procedure described herein.

1. Selection procedures covered by the Guide

3. Private investment in infrastructure may take various forms, each requiring special methods for selecting the concessionaire. For the purpose of discussing possible selection methods for the infrastructure projects dealt with in the *Guide*, a distinction may be made between three main forms of private investment in infrastructure:

(a) *Purchase of public utility enterprises*. Private capital may be invested in public infrastructure through the purchase of physical assets or the shares of public utility enterprises. Such transactions are often carried out in accordance with rules governing the award of contracts for the disposition of state property. In many countries, the sale of shares of public utility enterprises requires prior legislative authorization. Disposition methods often include offering of shares on stock markets or competitive proceedings such as auctions or invitations to bid whereby the property is awarded to the qualified party offering the highest price;

[1]*UNIDO BOT Guidelines*, p. 96.

[2]International Bank for Reconstruction and Development, *Procurement under IBRD and IDA Loans*, Washington, D.C., 1996, para. 3.13 (a).

[3]The UNCITRAL Model Law on Procurement of Goods, Construction and Services and its accompanying Guide to Enactment were adopted by the United Nations Commission on International Trade Law at its twenty-seventh session, held in New York from 31 May to 17 June 1994.

(b) *Provision of public services without development of infrastructure*. In other types of project, the service providers own and operate all the equipment necessary and sometimes compete with other suppliers for the provision of the relevant service. Some national laws establish special procedures whereby the State may authorize a private entity to supply public services by means of exclusive or non-exclusive "licences". Licences may be publicly offered to interested parties who satisfy the qualification requirements set forth by the law or established by the licensing authority. Sometimes licensing procedures involve public auctions to interested qualified parties;

(c) *Construction and operation of public infrastructure*. In projects for the construction and operation of public infrastructure, a private entity is engaged to provide both works and services to the public. The procedures governing the award of those contracts are in some aspects similar to those which govern public procurement of construction and services. National laws provide a variety of methods for public procurement, ranging from structured competitive methods, such as tendering proceedings, to less structured negotiations with prospective suppliers.

4. This chapter deals primarily with selection procedures suitable for use in relation to infrastructure projects that involve an obligation, on the part of the selected private entity, to undertake physical construction, repair or expansion works in the infrastructure concerned with a view to subsequent private operation (that is, those referred to in para. 3 (c)). It does not deal specifically with other methods of selecting providers of public services through licensing or similar procedures, or of merely disposing of State property through capital increases or offerings of shares.

2. *General objectives of selection procedures*

5. For the award of contracts for infrastructure projects, the contracting authority may either apply methods and procedures already provided in the laws of the host country or establish procedures specifically designed for that purpose. In either situation, it is important to ensure that such procedures are generally conducive to attaining the fundamental objectives of rules governing the award of public contracts. Those objectives are discussed briefly below.

(a) Economy and efficiency

6. In connection with infrastructure projects, "economy" refers to the selection of a concessionaire that is capable of performing works and delivering services of the desired quality at the most advantageous price or that offers the best commercial proposal. In most cases, economy is best achieved by means of procedures that promote competition among bidders. Competition provides them with incentives to offer their most advantageous terms and it can encourage them to adopt efficient or innovative technologies or production methods in order to do so.

7. It should be noted, however, that competition does not necessarily require the participation of a large number of bidders in a given selection process. For large projects, in particular, there may be reasons for the contracting authority to wish to limit the number of bidders to a manageable number (see para. 20). Provided that appropriate procedures are in place, the contracting authority can take advantage of effective competition even where the competitive base is limited.

8. Economy can often be promoted through participation by foreign companies in selection proceedings. Not only can foreign participation expand the competitive base, it can also lead to the acquisition by the contracting authority and its country of technologies that are not available locally. Foreign participation in selection proceedings may be necessary where there exists no domestic expertise of the type required by the contracting authority. A country wishing to achieve the benefits of foreign participation should ensure that its relevant laws and procedures are conducive to such participation.

9. "Efficiency" refers to selection of a concessionaire within a reasonable amount of time, with minimal administrative burdens and at reasonable cost both to the contracting authority and to participating bidders. In addition to the losses that can accrue directly to the contracting authority from inefficient selection procedures (owing, for example, to delayed selection or high administrative costs), excessively costly and burdensome procedures can lead to increases in the overall project costs or even discourage competent companies from participating in the selection proceedings altogether.

(b) Promotion of the integrity of and confidence in the selection process

10. Another important objective of rules governing the selection of the concessionaire is to promote the integrity of and confidence in the process. Thus, an adequate selection system will usually contain provisions designed to ensure fair treatment of bidders, to reduce or discourage unintentional or intentional abuses of the selection process by persons administering it or by companies participating in it and to ensure that selection decisions are taken on a proper basis.

11. Promoting the integrity of the selection process will help to promote public confidence in the process and in the public sector in general. Bidders will often refrain from spending the time and sometimes substantial sums of money to participate in selection proceedings unless they are confident that they will be treated fairly and that their proposals or offers have a reasonable chance of being accepted. Those which do participate in selection proceedings in which they do not have that confidence would probably increase the project cost to cover the higher risks and costs of participation. Ensuring that selection proceedings are run on a proper basis could reduce or eliminate that tendency and result in more favourable terms to the contracting authority.

12. To guard against corruption by government officials, including employees of the contracting authorities, the host country should have in place an effec-

tive system of sanctions. These could include sanctions of a criminal nature that would apply to unlawful acts of officials conducting the selection process and of participating bidders. Conflicts of interest should also be avoided, for instance by requiring that officials of the contracting authority, their spouses, relatives and associates abstain from owning a debt or equity interest in a company participating in a selection process or accepting to serve as a director or employee of such a company. Furthermore, the law governing the selection proceedings should obligate the contracting authority to reject offers or proposals submitted by a party who gives or agrees to give, directly or indirectly, to any current or former officer or employee of the contracting authority or other public authority a gratuity in any form, an offer of employment or any other thing or service of value, as an inducement with respect to an act or decision of or procedure followed by the contracting authority in connection with the selection proceedings. These provisions may be supplemented by other measures, such as the requirement that all companies invited to participate in the selection process undertake neither to seek to influence unduly the decisions of the public officials involved in the selection process nor otherwise to distort the competition by means of collusive or other illicit practices (that is, the so-called "integrity agreement"). Also, in the procurement practices adopted by some countries, bidders are required to guarantee that no official of the procuring entity has been or shall be admitted by the bidder to any direct or indirect benefit arising from the contract or the award thereof. Breach of such a provision typically constitutes a breach of an essential term of the contract.

13. The confidence of investors may be further fostered by adequate provisions to protect the confidentiality of proprietary information submitted by them during the selection proceedings. This should include sufficient assurances that the contracting authority will treat proposals in such a manner as to avoid the disclosure of their contents to competing bidders; that any discussions or negotiations will be confidential; and that trade or other information that bidders might include in their proposals will not be made known to their competitors.

(c) Transparency of laws and procedures

14. Transparency of laws and procedures governing the selection of the concessionaire will help to achieve a number of the policy objectives already mentioned. Transparent laws are those in which the rules and procedures to be followed by the contracting authority and by bidders are fully disclosed, are not unduly complex and are presented in a systematic and understandable way. Transparent procedures are those which enable the bidders to ascertain what procedures have been followed by the contracting authority and the basis of decisions taken by it.

15. One of the most important ways to promote transparency and accountability is to include provisions requiring that the contracting authority maintain a record of the selection proceedings (see paras. 120-126). A record summariz-

ing key information concerning those proceedings facilitates the exercise of the right of aggrieved bidders to seek review. That in turn will help to ensure that the rules governing the selection proceedings are, to the extent possible, self-policing and self-enforcing. Furthermore, adequate record requirements in the law will facilitate the work of public authorities exercising an audit or control function and promote the accountability of contracting authorities to the public at large as regards the award of infrastructure projects.

16. An important corollary of the objectives of economy, efficiency, integrity and transparency is the availability of administrative and judicial procedures for the review of decisions made by the authorities involved in the selection proceedings (see paras. 127-131).

3. *Special features of selection procedures for privately financed infrastructure projects*

17. Generally, economy in the award of public contracts is best achieved through methods that promote competition among a range of bidders within structured, formal procedures. Competitive selection procedures, such as tendering, are usually prescribed by national laws as the rule for normal circumstances in procurement of goods or construction.

18. The formal procedures and the objectivity and predictability that characterize the competitive selection procedures generally provide optimal conditions for competition, transparency and efficiency. Thus, the use of competitive selection procedures in privately financed infrastructure projects has been recommended by UNIDO, which has formulated detailed practical guidance on how to structure those procedures.[1] The rules for procurement under loans provided by the World Bank also advocate the use of competitive selection procedures and provide that a concessionaire selected pursuant to bidding procedures acceptable to the World Bank is generally free to adopt its own procedures for the award of contracts required to implement the project. However, where the concessionaire was not itself selected pursuant to those competitive procedures, the award of subcontracts has to be done pursuant to competitive procedures acceptable to the World Bank.[2]

19. It should be noted, however, that no international legislative model has thus far been specifically devised for competitive selection procedures in privately financed infrastructure projects. On the other hand, domestic laws on competitive procedures for the procurement of goods, construction or services may not be entirely suitable for privately financed infrastructure projects. International experience in the award of privately financed infrastructure projects has in fact revealed some limitations of traditional forms of competitive selection procedures, such as the tendering method. In view of the particular issues raised by privately financed infrastructure projects, which are briefly discussed below, it is advisable for the Government to consider adapting such procedures for the selection of the concessionaire.

(a) Range of bidders to be invited

20. The award of privately financed infrastructure projects typically involves complex, time-consuming and expensive proceedings, and the sheer scale of most infrastructure projects reduces the likelihood of obtaining proposals from a large number of suitably qualified bidders. In fact, competent bidders may be reluctant to participate in procurement proceedings for high-value projects if the competitive field is too large and where they run the risk of having to compete with unrealistic proposals or proposals submitted by unqualified bidders. Open tendering without a pre-selection phase is therefore usually not advisable for the award of infrastructure projects.

(b) Definition of project requirements

21. In traditional public procurement of construction works the procuring authority usually assumes the position of a *maître d'ouvrage* or employer, while the selected contractor carries out the function of the performer of the works. The procurement procedures emphasize the inputs to be provided by the contractor, that is, the contracting authority establishes clearly what is to be built, how and by what means. It is therefore common for invitations to tender for construction works to be accompanied by extensive and very detailed technical specifications of the type of works and services being procured. In those cases, the contracting authority will be responsible for ensuring that the specifications are adequate to the type of infrastructure to be built and that such infrastructure will be capable of being operated efficiently.

22. However, for many privately financed infrastructure projects, the contracting authority may envisage a different allocation of responsibilities between the public and the private sector. In those cases, after having established a particular infrastructure need, the contracting authority may prefer to leave to the private sector the responsibility for proposing the best solution for meeting such a need, subject to certain requirements that may be established by the contracting authority (for example, regulatory performance or safety requirements, sufficient evidence that the technical solutions proposed have been previously tested and have met internationally acceptable safety and other standards). The selection procedure used by the contracting authority may thus give more emphasis to the output expected from the project (that is, the services or goods to be provided) than to technical details of the works to be performed or means to be used to provide those services.

(c) Evaluation criteria

23. For projects to be financed, owned and operated by public authorities, goods, construction works or services are typically purchased with funds available under approved budgetary allocations. With the funding sources usually secured, the main objective of the procuring entity is to obtain the best value for the funds it spends. Therefore, in those types of procurement the decisive factor in establishing the winner among the responsive and technically accept-

able proposals (that is, those which have passed the threshold with respect to quality and technical aspects) is often the global price offered for the construction works, which is calculated on the basis of the cost of the works and other costs incurred by the contractor, plus a certain margin of profit.

24. Privately financed infrastructure projects, in turn, are typically expected to be financially self-sustainable, with the development and operational costs being recovered from the project's own revenue. Therefore, a number of other factors will need to be considered in addition to the construction and operation cost and the price to be paid by the users. For instance, the contracting authority will need to consider carefully the financial and commercial feasibility of the project, the soundness of the financial arrangements proposed by the bidders and the reliability of the technical solutions used. Such interest exists even where no governmental guarantees or payments are involved, because unfinished projects or projects with large cost overruns or higher than expected maintenance costs often have a negative impact on the overall availability of needed services and on the public opinion in the host country. Also, the contracting authority will aim at formulating qualification and evaluation criteria that give adequate weight to the need to ensure the continuous provision of and, as appropriate, universal access to the public service concerned. Furthermore, given the usually long duration of infrastructure concessions, the contracting authority will need to satisfy itself as to the soundness and acceptability of the arrangements proposed for the operational phase and will weigh carefully the service elements of the proposals (see para. 74).

(d) Negotiations with bidders

25. Laws and regulations governing tendering proceedings often prohibit negotiations between the contracting authority and the contractors concerning a proposal submitted by them. The rationale for such a strict prohibition, which is also contained in article 35 of the UNCITRAL Model Procurement Law, is that negotiations might result in an "auction", in which a proposal offered by one contractor is used to apply pressure on another contractor to offer a lower price or an otherwise more favourable proposal. As a result of that strict prohibition, contractors selected to provide goods or services pursuant to traditional procurement procedures are typically required to sign standard contract documents provided to them during the procurement proceedings.

26. The situation is different in the award of privately financed infrastructure projects. The complexity and long duration of such projects makes it unlikely that the contracting authority and the selected bidder could agree on the terms of a draft project agreement without negotiation and adjustments to adapt those terms to the particular needs of the project. This is particularly true for projects involving the development of new infrastructure where the final negotiation of the financial and security arrangements takes place only after the selection of the concessionaire. It is important, however, to ensure that these negotiations are carried out in a transparent manner and do not lead to changes to the basis on which the competition was carried out (see paras. 83 and 84).

4. *Preparations for the selection proceedings*

27. The award of privately financed infrastructure projects is in most cases a complex exercise requiring careful planning and coordination among the offices involved. By ensuring that adequate administrative and personnel support is available to conduct the type of selection proceeding that it has chosen, the Government plays an essential role in promoting confidence in the selection process.

(a) Appointment of the award committee

28. One important preparatory measure is the appointment of the committee that will be responsible for evaluating the proposals and making an award recommendation to the contracting authority. The appointment of qualified and impartial members to the selection committee is not only a requirement for an efficient evaluation of the proposals, but may further foster the confidence of bidders in the selection process.

29. Another important preparatory measure is the appointment of the independent advisers who will assist the contracting authority in the selection procedures. The contracting authority may need, at this early stage, to retain the services of independent experts or advisers to assist in establishing appropriate qualification and evaluation criteria, defining performance indicators (and, if necessary, project specifications) and preparing the documentation to be issued to bidders. Consultant services and advisers may also be retained to assist the contracting authority in the evaluation of proposals, drafting and negotiation of the project agreement. Consultants and advisers can be particularly helpful by bringing a range of technical expertise that may not always be available in the host country's civil service, such as technical or engineering advice (for example, on technical assessment of the project or installations and technical requirements of contract); environmental advice (for example, environmental assessment and operation requirements); or financial advice (for example, on financial projections, review of financing sources, assessing the adequate ratio between debt and equity and drafting of financial information documents).

(b) Feasibility and other studies

30. As indicated earlier (see chap. I, "General legislative and institutional framework", para. 25), one of the initial steps that should be taken by the Government in relation to a proposed infrastructure project is to conduct a preliminary assessment of its feasibility, including economic and financial aspects such as expected economic advantages of the project, estimated cost and potential revenue anticipated from the operation of the infrastructure facility. The option to develop infrastructure as a privately financed project requires a positive conclusion on the feasibility and financial viability of the project. An assessment of the project's environmental impact should also ordinarily be carried out by the contracting authority as part of its feasibility studies. In some countries, it has been found useful to provide for some public participation in the preliminary assessment of the project's environmental impact and the various options available to minimize it.

31. Prior to starting the proceedings leading to the selection of a prospective concessionaire, it is advisable for the contracting authority to review and, as required, expand those initial studies. In some countries contracting authorities are advised to formulate model projects for reference purposes (typically including a combination of estimated capital investment, operation and maintenance costs) prior to inviting proposals from the private sector. The purpose of such model projects is to demonstrate the viability of the commercial operation of the infrastructure and the affordability of the project in terms of total investment cost and cost to the public. They will also provide the contracting authority with a useful tool for comparison and evaluation of proposals. The confidence of bidders will be promoted by evidence that the technical, economical and financial assumptions of the project, as well as the proposed role of the private sector, have been carefully considered by the contracting authority.

(c) Preparation of documentation

32. Selection proceedings for the award of privately financed infrastructure projects typically require the preparation of extensive documentation, including a project outline, pre-selection documents, the request for proposals, instructions for preparing proposals and a draft of the project agreement. The quality and clarity of the documents issued by the contracting authority plays a significant role in ensuring an efficient and transparent selection procedure.

33. Standard documentation prepared in sufficiently precise terms may be an important element to facilitate the negotiations between bidders and prospective lenders and investors. It may also be useful for ensuring consistency in the treatment of issues common to most projects in a given sector. However, in using standard contract terms it is advisable to bear in mind the possibility that a specific project may raise issues that had not been anticipated when the standard document was prepared or that the project may necessitate particular solutions that might be at variance with the standard terms. Careful consideration should be given to the need to achieve an appropriate balance between the level of uniformity desired for project agreements of a particular type and the flexibility that might be needed for finding project-specific solutions.

B. Pre-selection of bidders

34. Given the complexity of privately financed infrastructure projects the contracting authority may wish to limit the number of bidders from whom proposals will subsequently be requested only to those who satisfy certain qualification criteria. In traditional government procurement, the pre-selection proceedings may consist of the verification of certain formal requirements, such as adequate proof of technical capability or prior experience in the type of procurement, so that all bidders who meet the pre-selection criteria are automatically admitted to the tendering phase. The pre-selection proceedings for privately financed infrastructure projects may, in turn, involve elements of evaluation and selection. This may be the case, for example, where the contracting authority establishes a ranking of pre-selected bidders (see para. 48).

1. Invitation to the pre-selection proceedings

35. In order to promote transparency and competition, it is advisable that the invitation to the pre-selection proceedings be made public in a manner that reaches an audience wide enough to provide an effective level of competition. The laws of many countries identify publications, usually the official gazette or other official publication, in which the invitation to the pre-selection proceedings is to be published. With a view to fostering participation of foreign companies and maximizing competition, the contracting authority may wish to have the invitations to the pre-selection proceedings made public also in a language customarily used in international trade, in a newspaper of wide international circulation or in a relevant trade publication or technical or professional journal of wide international circulation. One possible medium for such publication is *Development Business*, published by the Department of Public Information of the United Nations Secretariat.

36. Pre-selection documents should contain sufficient information for bidders to be able to ascertain whether the works and services entailed by the project are of a type that they can provide and, if so, how they can participate in the selection proceedings. The invitation to the pre-selection proceedings should, in addition to identifying the infrastructure to be built or renovated, contain information on other essential elements of the project, such as the services to be delivered by the concessionaire, the financial arrangements envisaged by the contracting authority (for example, whether the project will be entirely financed by user fees or tolls or whether public funds may be provided as direct payments, loans or guarantees) and, where already known, a summary of the main required terms of the project agreement to be entered into as a result of the selection proceedings.

37. In addition, the invitation to the pre-selection proceedings should include general information similar to the information typically provided in pre-selection documents under general rules on public procurement.[4]

2. Pre-selection criteria

38. Generally, bidders should be required to demonstrate that they possess the professional and technical qualifications, financial and human resources, equipment and other physical facilities, managerial capability, reliability and experience necessary to carry out the project. Additional criteria that might be particularly relevant for privately financed infrastructure projects may include the ability to manage the financial aspects of the project and previous experience in operating public infrastructure or in providing services under regulatory oversight (for example, quality indicators of their past performance, size

[4]For example, instructions for preparing and submitting pre-selection applications; any documentary evidence or other information that must be submitted by bidders to demonstrate their qualifications; and the manner, place and deadline for the submission of applications (see UNCITRAL Model Procurement Law, art. 7, para. 3).

and type of previous projects carried out by the bidders); the level of experience of the key personnel to be engaged in the project; sufficient organizational ability (including minimum levels of construction, operation and maintenance equipment); ability to sustain the financing requirements for the engineering, construction and operational phases of the project (demonstrated, for instance, by evidence of the bidders' ability to provide an adequate amount of equity to the project and sufficient evidence from reputable banks attesting the bidder's good financial standing). Qualification requirements should cover all phases of an infrastructure project, including financing management, engineering, construction, operation and maintenance, where appropriate. In addition, the bidders should be required to demonstrate that they meet such other qualification criteria as would typically apply under the general procurement laws of the host country.[5]

39. One important aspect to be considered by the contracting authority relates to the relationship between the award of one particular project and the governmental policy pursued for the sector concerned (see "Introduction and background information on privately financed infrastructure projects", paras. 21-46). Where competition is sought, the Government may be interested in ensuring that the relevant market or sector is not dominated by one enterprise (for example, that the same company does not operate more than a certain limited number of local telephone companies within a given territory). To implement such a policy and to avoid market domination by bidders who may have already been awarded a concession within a given sector of the economy, the contracting authority may wish to include in the pre-selection documents for new concessions provisions that limit the participation of or prevent another award to such bidders. For purposes of transparency, it is desirable for the law to provide that, where the contracting authority reserves the right to reject a proposal on those or similar grounds, adequate notice of that circumstance must be included in the invitation to the pre-selection proceedings.

40. Qualification requirements should apply equally to all bidders. A contracting authority should not impose any criterion, requirement or procedure with respect to the qualifications of bidders that has not been set forth in the pre-selection documents. When considering the professional and technical qualifications of bidding consortia, the contracting authority should consider the individual specialization of the consortium members and assess whether the combined qualifications of the consortium members are adequate to meet the needs of all phases of the project.

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[5]For example, that they have legal capacity to enter into the project agreement; that they are not insolvent, in receivership, bankrupt or being wound up, their affairs are not being administered by a court or a judicial officer, their business activities have not been suspended and they are not the subject of legal proceedings for any of the foregoing; that they have fulfilled their obligations to pay taxes and social security contributions in the State; that they have not, and their directors or officers have not, been convicted of any criminal offence related to their professional conduct or the making of false statements or misrepresentations as to their qualifications to enter into a procurement contract within a certain period of years preceding the commencement of the selection proceedings or have not been otherwise disqualified pursuant to administrative suspension or disbarment proceedings (see UNCITRAL Model Procurement Law, art. 6, para. 1 (b)).

3. Issues relating to the participation of bidding consortia

41. Given the large scale of most infrastructure projects, the interested companies typically participate in the selection proceedings through consortia especially formed for that purpose. Therefore, information required from members of bidding consortia should relate to the consortium as a whole as well as to its individual participants. For the purpose of facilitating the liaison with the contracting authority, it may be useful to require in the pre-selection documents that each consortium designate one of its members as a focal point for all communications with the contracting authority. It is generally advisable for the contracting authority to require that the members of bidding consortia submit a sworn statement undertaking that, if awarded the contract, they shall bind themselves jointly and severally for the obligations assumed in the name of the consortium under the project agreement. Alternatively, the contracting authority may reserve itself the right to require at a later stage that the members of the selected consortium establish an independent legal entity to carry out the project (see also chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 12-18).

42. It is also advisable for the contracting authority to review carefully the composition of consortia and their parent companies. It may happen that one company, directly or through subsidiary companies, joins more than one consortium to submit proposals for the same project. Such a situation should not be allowed, since it raises the risk of leakage of information or collusion between competing consortia, thus undermining the credibility of the selection proceedings. It is therefore advisable to provide in the invitation to the pre-selection proceedings that each of the members of a qualified consortium may participate, either directly or through subsidiary companies, in only one bid for the project. A violation of this rule should cause the disqualification of the consortium and of the individual member companies.

4. Pre-selection and domestic preferences

43. The laws of some countries provide for some sort of preferential treatment for domestic entities or afford special treatment to bidders that undertake to use national goods or employ local labour. Such preferential or special treatment is sometimes provided as a material qualification requirement (for example, a minimum percentage of national participation in the consortium) or as a condition for participating in the selection procedure (for example, to appoint a local partner as a leader of the bidding consortium).

44. Domestic preferences may give rise to a variety of issues. Firstly, their use is not permitted under the guidelines of some international financial institutions and might be inconsistent with international obligations entered into by many States pursuant to agreements on regional economic integration or trade facilitation. Furthermore, from the perspective of the host country it is important to weigh the expected advantages against the disadvantage of depriving the contracting authority of the possibility of obtaining better options to meet the national infrastructure needs. It is also important not to allow total insulation

from foreign competition so as not to perpetuate lower levels of economy, efficiency and competitiveness of the concerned sectors of national industry. This is the reason why many countries that wish to provide some incentive to national suppliers, while at the same time taking advantage of international competition, do not contemplate a blanket exclusion of foreign participation or restrictive qualification requirements. Domestic preferences may take the form of special evaluation criteria establishing margins of preference for national bidders or bidders who offer to procure supplies, services and products in the local market. The margin of preference technique, which is provided in article 34, paragraph 4 *(d)*, of the UNCITRAL Model Procurement Law, is more transparent than subjective qualification or evaluation criteria. Furthermore, it allows the contracting authority to favour local bidders that are capable of approaching internationally competitive standards, and it does so without simply excluding foreign competition. Where domestic preferences are envisaged, they should be announced in advance, preferably in the invitation to the pre-selection proceedings.

5. *Contribution towards costs of participation in the selection proceedings*

45. The price charged for the pre-selection documents should only reflect the cost of printing such documents and providing them to the bidders. It should not be used as an additional tool to limit the number of bidders. Such a practice is both ineffective and adds to the already considerable cost of participation in the pre-selection proceedings. The high costs of preparing proposals for infrastructure projects and the relatively high risks that a selection procedure may not lead to a contract award may function as a deterrent for some companies to join in a consortium to submit a proposal, in particular when they are not familiar with the selection procedures applied in the host country.

46. Therefore, some countries authorize the contracting authority to consider arrangements for compensating pre-selected bidders if the project cannot proceed for reasons outside their control or for contributing to the costs incurred by them after the pre-selection phase, when justified in a particular case by the complexity involved and the prospect of significantly improving the quality of the competition. When such contribution or compensation is envisaged, appropriate notice should be given to potential bidders at an early stage, preferably in the invitation to the pre-selection proceedings.

6. *Pre-selection proceedings*

47. The contracting authority should respond to any request by a bidding consortium for clarification of the pre-selection documents that is received by the contracting authority within a reasonable time prior to the deadline for the submission of applications so as to enable the bidders to make a timely submission of their application. The response to any request that might reasonably be expected to be of interest to other bidders should, without identifying the source of the request, be communicated to all bidders to which the contracting authority provided the pre-selection documents.

48. In some countries, practical guidance on selection procedures encourages domestic contracting authorities to limit the prospective proposals to the lowest possible number sufficient to ensure meaningful competition (for example, three or four). For that purpose, those countries apply a quantitative rating system for technical, managerial and financial criteria, taking into account the nature of the project. Quantitative pre-selection criteria are found to be more easily applicable and transparent than qualitative criteria involving the use of merit points. However, in devising a quantitative rating system, it is important to avoid unnecessary limitation of the contracting authority's discretion in assessing the qualifications of bidders. The contracting authority may also need to take into account the fact that the procurement guidelines of some multilateral financial institutions prohibit the use of pre-selection proceedings for the purpose of limiting the number of bidders to a predetermined number. In any event, where such a rating system is to be used, that circumstance should be clearly stated in the pre-selection documents.

49. Upon completion of the pre-selection phase, the contracting authority usually draws up a short list of the pre-selected bidders that will subsequently be invited to submit proposals. One practical problem sometimes faced by contracting authorities concerns proposals for changes in the composition of bidding consortia during the selection proceedings. From the perspective of the contracting authority, it is generally advisable to exercise caution in respect of proposed substitutions of individual members of bidding consortia after the closing of the pre-selection phase. Changes in the composition of consortia may substantially alter the basis on which the pre-selected bidding consortia were short-listed by the contracting authority and may give rise to questions about the integrity of the selection proceedings. As a general rule, only pre-selected bidders should be allowed to participate in the selection phase, unless the contracting authority can satisfy itself that a new consortium member meets the pre-selection criteria to substantially the same extent as the retiring member of the consortium.

50. While the criteria used for pre-selecting bidders should not be weighted again at the evaluation phase, the contracting authority may wish to reserve itself the right to require, at any stage of the selection process, that the bidders again demonstrate their qualifications in accordance with the same criteria used to pre-select them.

C. Procedures for requesting proposals

51. This section discusses the procedures for requesting proposals from the pre-selected bidders. The procedures described herein are in a number of respects similar to the procedures for the solicitation of proposals under the preferred method for the procurement of services provided in the UNCITRAL Model Procurement Law, with some adaptations needed to fit the needs of contracting authorities awarding infrastructure projects.

1. *Phases of the procedure*

52. Following the pre-selection of bidders, it is advisable for the contracting authority to review its original feasibility study and the definition of the output and performance requirements and to consider whether a revision of those requirements is needed in the light of the information obtained during the pre-selection proceedings. At this stage, the contracting authority should already have determined whether a single or a two-stage procedure will be used to request proposals.

(a) Single-stage procedure

53. The decision between having a single or a two-stage procedure for requesting proposals will depend on the nature of the contract, on how precisely the technical requirements can be defined and whether output results (or performance indicators) are used for selection of the concessionaire. If it is deemed both feasible and desirable for the contracting authority to formulate performance indicators or project specifications to the necessary degree of precision or finality, the selection process may be structured as a single-stage procedure. In that case, after having concluded the pre-selection of bidders, the contracting authority would proceed directly to issuing a final request for proposals (see paras. 59-72).

(b) Two-stage procedure

54. There are cases, however, in which it may not be feasible for the contracting authority to formulate its requirement in sufficiently detailed and precise project specifications or performance indicators to permit proposals to be formulated, evaluated and compared uniformly on the basis of those specifications and indicators. This may be the case, for instance, when the contracting authority has not determined the type of technical and material input that would be suitable for the project in question (for example, the type of construction material to be used in a bridge). In such cases, it might be considered undesirable, from the standpoint of obtaining the best value, for the contracting authority to proceed on the basis of specifications or indicators it has drawn up in the absence of discussions with bidders as to the exact capabilities and possible variations of what is being offered. For that purpose, the contracting authority may wish to divide the selection proceedings into two stages and allow a certain degree of flexibility for discussions with bidders.

55. Where the selection procedure is divided into two stages, the initial request for proposals typically calls upon the bidders to submit proposals relating to output specifications and other characteristics of the project as well as to the proposed contractual terms. The invitation for bids would allow bidders to offer their own solutions for meeting the particular infrastructure need in accordance with defined standards of service. The proposals submitted at this stage would typically consist of solutions on the basis of a conceptual design or performance indicators without indication of financial elements, such as the expected price or level of remuneration.

56. To the extent the terms of the contractual arrangements are already known by the contracting authority, they should be included in the request for proposals, possibly in the form of a draft of the project agreement. Knowledge of certain contractual terms, such as the risk allocation envisaged by the contracting authority, is important in order for the bidders to formulate their proposals and discuss the "bankability" of the project with potential lenders. The initial response to those contractual terms, in particular the risk allocation envisaged by the contracting authority, may help the contracting authority assess the feasibility of the project as originally conceived. However, it is important to distinguish between the procedure to request proposals and the negotiation of the final contract, after the project has been awarded. The purpose of this initial stage is to enable the contracting authority to formulate its requirement subsequently in a manner that enables a final competition to be carried out on the basis of a single set of parameters. The invitation of initial proposals at this stage should not lead to a negotiation of the terms of the contract prior to its final award.

57. The contracting authority may then convene a meeting of bidders to clarify questions concerning the request for proposals and accompanying documentation. The contracting authority may, at the first stage, engage in discussions with any bidder concerning any aspect of its proposal. The contracting authority should treat proposals in such a manner as to avoid the disclosure of their contents to competing bidders. Any discussions need to be confidential and one party to the discussions should not reveal to any other person any technical, financial or other information relating to the discussions without the consent of the other party.

58. Following those discussions, the contracting authority should review and, as appropriate, revise the initial project specifications. In formulating those revised specifications, the contracting authority should be allowed to delete or modify any aspect of the technical or quality characteristics of the project originally set forth in the request for proposals and any criterion originally set forth in those documents for evaluating and comparing proposals. Any such deletion, modification or addition should be communicated to bidders in the invitation to submit final proposals. Bidders not wishing to submit a final proposal should be allowed to withdraw from the selection proceedings without forfeiting any security that they may have been required to provide.

2. *Content of the final request for proposals*

59. At the final stage, the contracting authority should invite the bidders to submit final proposals with respect to the revised project specifications, performance indicators and contractual terms. The request for proposals should generally include all information necessary to provide a basis to enable the bidders to submit proposals that meet the needs of the contracting authority and that the contracting authority can compare in an objective and fair manner.

(a) General information to bidders

60. General information to bidders should cover, as appropriate, those items which are ordinarily included in solicitation documents or requests for proposals for the procurement of goods, construction and services.[6] Particularly important is the disclosure of the criteria to be used by the contracting authority in determining the successful proposal and the relative weight of such criteria (see paras. 73-77).

(i) Information on feasibility studies

61. It is advisable to include in the general information provided to bidders instructions for the preparation of feasibility studies they may be required to submit with their final proposals. Such feasibility studies typically cover, for instance, the following aspects:

(a) *Commercial viability*. In particular in projects financed on a non-recourse or limited recourse basis, it is essential to establish the need for the project outputs and to evaluate and project such needs over the proposed operational life of the project, including expected demand (for example, traffic forecasts for roads) and pricing (for example, tolls);

(b) *Engineering design and operational feasibility*. Bidders should be requested to demonstrate the suitability of the technology they propose, including equipment and processes, to national, local and environmental conditions, the likelihood of achieving the planned performance level and the adequacy of the construction methods and schedules. This study should also define the proposed organization, methods and procedures for operating and maintaining the completed facility;

(c) *Financial viability*. Bidders should be requested to indicate the proposed sources of financing for the construction and operation phases, including debt capital and equity investment. While the loan and other financing agreements in most cases are not executed until after the signing of the project agreement, the bidders should be required to submit sufficient evidence of the lenders' intention to provide the specified financing. In some countries, bidders are also required to indicate the expected financial internal rate of return in relation to the effective cost of capital corresponding to the financing arrangements proposed. Such information is intended to allow the contracting authority to consider the reasonableness and affordability of the proposed prices or fees to be charged by the concessionaire and the potential for subsequent increases therein;

(d) *Environmental impact*. This study should identify possible negative or adverse effects on the environment as a consequence of the project and

[6]For example, instructions for preparing and submitting proposals, including the manner, place and deadline for the submission of proposals and the period of time during which proposals shall be in effect and any requirements concerning tender securities; the means by which bidders may seek clarifications of the request for proposals, and a statement as to whether the contracting authority intends, at this stage, to convene a meeting of bidders; the place, date and time for the opening of proposals and the procedures to be followed for opening and examining proposals; and the manner in which the proposals will be evaluated (see UNCITRAL Model Procurement Law, arts. 27 and 38).

indicate corrective measures that need to be taken to ensure compliance with the applicable environmental standards. Such a study should take into account, as appropriate, the relevant environmental standards of international financial institutions and of national, provincial and local authorities.

(ii) Information on bid securities

62. It is advisable for the request for proposals to indicate any requirements of the contracting authority with respect to the issuer and the nature, form, amount and other principal terms of any bid security that the bidders may be required to provide so as to cover those losses which may result from withdrawal of proposals or failure by the selected bidder to conclude a project agreement. In order to ensure fair treatment of all bidders, requirements that refer directly or indirectly to the conduct by the bidder submitting the proposal should not relate to conduct other than withdrawal or modification of the proposal after the deadline for submission of proposals or before the deadline if so stipulated in the request for proposals; failure to achieve financial closing; failure to sign the project agreement if required by the contracting authority to do so; and failure to provide required security for the fulfilment of the project agreement after the proposal has been accepted or to comply with any other condition prior to signing the project agreement specified in the request for proposals. Safeguards should be included to ensure that a bid security requirement is only imposed fairly and for the purpose intended.[7]

(iii) Qualification of bidders

63. Where no pre-selection of bidders was carried out prior to the issuance of the request for proposals or when the contracting authority retains the right to require the bidders to demonstrate again their qualifications, the request for proposals should set out the information that needs to be provided by the bidders to substantiate their qualifications (see paras. 38-40).

(b) Project specifications and performance indicators

64. The level of detail provided in the specifications, as well as the appropriate balance between the input and output elements, will be influenced by considerations of issues such as the type and ownership of the infrastructure and the allocation of responsibilities between the public and the private sectors (see paras. 21 and 22). It is generally advisable for the contracting authority to bear in mind the long-term needs of the project and to formulate its specifications in a manner that allows it to obtain sufficient information to select the

[7]Article 32 of the UNCITRAL Model Procurement Law provides certain important safeguards, including, *inter alia*, the requirement that the contracting authority should make no claim to the amount of the tender security and should promptly return, or procure the return of, the tender security document, after whichever of the following that occurs earliest: (a) the expiry of the tender security; (b) the entry into force of the project agreement and the provision of a security for the performance of the contract, if such a security is required by the request for proposals; (c) the termination of the selection process without the entry into force of a project agreement; or (d) the withdrawal of the proposal prior to the deadline for the submission of proposals, unless the request for proposals stipulates that no such withdrawal is permitted.

bidder that offers the highest quality of services the best economic terms. The contracting authority may find it useful to formulate the project specifications in a way that defines adequately the output and performance required without being overly prescriptive in how that is to be achieved. Project specifications and performance indicators typically cover items such as the following:

(a) *Description of project and expected output*. If the services require specific buildings, such as a transport terminal or an airport, the contracting authority may wish to provide no more than outline planning concepts for the division of the site into usage zones on an illustrative basis, instead of plans indicating the location and size of individual buildings, as would normally be the case in traditional procurement of construction services. However, where in the judgement of the contracting authority it is essential for the bidders to provide detailed technical specifications, the request for proposals should include, at least, the following information: description of the works and services to be performed, including technical specifications, plans, drawings and designs; time schedule for the execution of works and provision of services; and the technical requirements for the operation and maintenance of the facility;

(b) *Minimum applicable design and performance standards, including appropriate environmental standards*. Performance standards are typically formulated in terms of the desired quantity and quality of the outputs of the facility. Proposals that deviate from the relevant performance standards should be regarded as non-responsive;

(c) *Quality of services*. For projects involving the provision of public services, the performance indicators should include a description of the services to be provided and the relevant standards of quality to be used by the contracting authority in the evaluation of the proposals. Where appropriate, reference should be made to any general obligations of public service providers as regards expansion and continuity of the service so as to meet the demand of the community or territory served, ensuring non-discriminatory availability of services to the users and granting non-discriminatory access of other service providers to any public infrastructure network operated by the concessionaire, under the terms and conditions established in the project agreement (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 82-93).

65. Bidders should be instructed to provide the information necessary in order for the contracting authority to evaluate the technical soundness of proposals, their operational feasibility and responsiveness to standards of quality and technical requirements, including the following information:

(a) Preliminary engineering design, including proposed schedule of works;

(b) Project cost, including operating and maintenance cost requirements and proposed financing plan (for example, proposed equity contribution or debt);

(c) The proposed organization, methods and procedures for the operation and maintenance of the project under bidding;

(d) Description of quality of services.

66. Each of the above-mentioned performance indicators may require the submission of additional information by the bidders, according to the project being awarded. For the award of a concession for distribution of electricity in a specific region, for example, indicators may include minimum technical standards such as: (a) specified voltage (and frequency) fluctuation at the consumer level; (b) duration of outages (expressed in hours per year); (c) frequency of outages (expressed in a number per year); (d) losses; (e) number of days to connect a new customer; and (f) commercial standards for customer relationship (for example, number of days to pay bills, to reconnect installations or to respond to customers' complaints).

(c) Contractual terms

67. It is advisable for the bidding documents to provide some indication of how the contracting authority expects to allocate the project risks (see also chaps. II, "Project risks and government support", and IV, "Construction and operation of infrastructure: legislative framework and project agreement"). This is important in order to set the terms of debate for negotiations on certain details of the project agreement (see paras. 83 and 84). If risk allocation is left entirely open, the bidders may respond by seeking to minimize the risks they accept, which may frustrate the purpose of seeking private investment for developing the project. Furthermore, the request of proposals should contain information on essential elements of the contractual arrangements envisaged by the contracting authority, such as:

(a) The duration of the concession or invitations to bidders to submit proposals for the duration of the concession;

(b) Formulas and indices to be used in adjustments to prices;

(c) Government support and investment incentives, if any;

(d) Bonding requirements;

(e) Requirements of regulatory agencies, if any;

(f) Monetary rules and regulations governing foreign exchange remittances;

(g) Revenue-sharing arrangements, if any;

(h) Indication, as appropriate, of the categories of assets that the concessionaire would be required to transfer to the contracting authority or make available to a successor concessionaire at the end of the project period;

(i) Where a new concessionaire is being selected to operate an existing infrastructure, a description of the assets and property that will be made available to the concessionaire;

(j) The possible alternative, supplementary or ancillary revenue sources (for example, concessions for exploitation of existing infrastructure), if any, that may be offered to the successful bidder.

68. Bidders should be instructed to provide the information necessary in order for the contracting authority to evaluate the financial and commercial elements

of the proposals and their responsiveness to the proposed contractual terms. The financial proposals should normally include the following information:

(a) For projects in which the concessionaire's income is expected to consist primarily of tolls, fees or charges paid by the customers or users of the infrastructure facility, the financial proposal should indicate the proposed price structure. For projects in which the concessionaire's income is expected to consist primarily of payments made by the contracting authority or another public authority to amortize the concessionaire's investment, the financial proposal should indicate the proposed amortization payments and repayment period;

(b) The present value of the proposed prices or direct payments based on the discounting rate and foreign exchange rate prescribed in the bidding documents;

(c) If it is estimated that the project would require financial support by the Government, the level of such support, including, as appropriate, any subsidy or guarantee expected from the Government or the contracting authority;

(d) The extent of risks assumed by the bidders during the construction and operation phase, including unforeseen events, insurance, equity investment and other guarantees against those risks.

69. In order to limit and establish clearly the scope of the negotiations that will take place following the evaluation of proposals (see paras. 83 and 84), the final request for proposals should indicate which are the terms of the project agreement that are deemed not negotiable.

70. It is useful for the contracting authority to require that the final proposals submitted by the bidders contain evidence showing the comfort of the bidder's main lenders with the proposed commercial terms and allocation of risks, as outlined in the request for proposals. Such a requirement might play a useful role in resisting pressures to reopen commercial terms at the stage of final negotiations. In some countries, bidders are required to initial and return to the contracting authority the draft project agreement together with their final proposals as a confirmation of their acceptance of all terms in respect of which they did not propose specific amendments.

3. *Clarifications and modifications*

71. The right of the contracting authority to modify the request for proposals is important in order to enable it to obtain what is required to meet its needs. It is therefore advisable to authorize the contracting authority, whether on its own initiative or as a result of a request for clarification by a bidder, to modify the request for proposals by issuing an addendum at any time prior to the deadline for submission of proposals. However, when amendments are made that would reasonably require bidders to spend additional time preparing their proposals, such additional time should be granted by extending the deadline for submission of proposals accordingly.

72. Generally, clarifications, together with the questions that gave rise to the clarifications, and modifications must be communicated promptly by the contracting authority to all bidders to whom the contracting authority provided the request for proposals. If the contracting authority convenes a meeting of bidders, it should prepare minutes of the meeting containing the requests submitted at the meeting for clarification of the request for proposals and its responses to those requests and should send copies of the minutes to the bidders.

4. Evaluation criteria

73. The award committee should rate the technical and financial elements of each proposal in accordance with the predisclosed rating systems for the technical evaluation criteria and should specify in writing the reasons for its rating. Generally, it is important for the contracting authority to achieve an appropriate balance between evaluation criteria relating to the physical investment (for example, the construction works) and evaluation criteria relating to the operation and maintenance of the infrastructure and the quality of services to be provided by the concessionaire. Adequate emphasis should be given to the long-term needs of the contracting authority, in particular the need to ensure the continuous delivery of the service at the required level of quality and safety.

(a) Evaluation of technical aspects of the proposals

74. Technical evaluation criteria are designed to facilitate the assessment of the technical, operational, environmental and financing viability of the proposal vis-à-vis the prescribed specifications, indicators and requirements prescribed in the bidding documents. To the extent practicable, the technical criteria applied by the contracting authority should be objective and quantifiable, so as to enable proposals to be evaluated objectively and compared on a common basis. This reduces the scope for discretionary or arbitrary decisions. Regulations governing the selection process might spell out how such factors are to be formulated and applied. Technical proposals for privately financed infrastructure projects are usually evaluated in accordance with the following criteria:

(a) *Technical soundness*. Where the contracting authority has established minimum engineering design and performance specifications or standards, the basic design of the project should conform to those specifications or standards. Bidders should be required to demonstrate the soundness of the proposed construction methods and schedules;

(b) *Operational feasibility*. The proposed organization, methods and procedures for operating and maintaining the completed facility must be well defined, should conform to the prescribed performance standards and should be shown to be workable;

(c) *Quality of services*. Evaluation criteria used by the contracting authority should include an analysis of the manner in which the bidders undertake to maintain and expand the service, including the guarantees offered for ensuring its continuity;

(d) *Environmental standards*. The proposed design and the technology of the project to be used should be in accordance with the environmental standards set forth in the request for proposals. Any negative or adverse effects on the environment as a consequence of the project as proposed by the bidders should be properly identified, including the corresponding corrective or mitigating measures;

(e) *Enhancements*. These may include other terms the author of the project may offer to make the proposals more attractive, such as revenue-sharing with the contracting authority, fewer governmental guarantees or reduction in the level of government support;

(f) *Potential for social and economic development*. Under this criterion, the contracting authority may take into account the potential for social and economic development offered by the bidders, including benefits to underprivileged groups of persons and businesses, domestic investment or other business activity, the encouragement of employment, the reservation of certain production for domestic suppliers, the transfer of technology and the development of managerial, scientific and operational skills;

(g) *Qualification of bidders*. When no pre-selection was made by the contracting authority prior to the issuance of the request for proposals, the contracting authority should not accept a proposal if the bidders that submitted the proposals are not qualified.

(b) Evaluation of financial and commercial aspects of the proposals

75. In addition to criteria for the technical evaluation of proposals, the contracting authority needs to define criteria for assessing and comparing the financial proposals. Criteria typically used for the evaluation and comparison of the financial and commercial proposals include, as appropriate, the following:

(a) *The present value of the proposed tolls, fees, unit prices and other charges over the concession period.* For projects in which the concessionaire's income is expected to consist primarily of tolls, fees or charges paid by the customers or users of the infrastructure facility, the assessment and comparison of the financial elements of the final proposals is typically based on the present value of the proposed tolls, fees, rentals and other charges over the concession period according to the prescribed minimum design and performance standards;

(b) *The present value of the proposed direct payments by the contracting authority, if any.* For projects in which the concessionaire's income is expected to consist primarily of payments made by the contracting authority to amortize the concessionaire's investment, the assessment and comparison of the financial elements of the final proposals is typically based on the present value of the proposed schedule of amortization payments for the facility to be constructed according to the prescribed minimum design and performance standards, plans and specifications;

(c) *The costs for design and construction activities, annual operation and maintenance costs, present value of capital costs and operating and main-*

tenance costs. It is advisable for the contracting authority to include these items among the evaluation criteria so as to permit an assessment of the financial feasibility of the proposals;

(d) *The extent of financial support, if any, expected from the Government.* Government support measures expected or required by the bidders should be included among the evaluation criteria as they may entail significant immediate or contingent financial liability for the Government (see chap. II, "Project risks and government support", paras. 30-60);

(e) *Soundness of the proposed financial arrangements.* The contracting authority should assess whether the proposed financing plan, including the proposed ratio between equity investment and debt, is adequate to meet the construction, operating and maintenance costs of the project;

(f) *The extent of acceptance of the proposed contractual terms.* Proposals for changes or modifications in the contractual terms circulated with the request for proposals (such as in those dealing with risk allocation or compensation payments) may have substantial financial implications for the contracting authority and should be carefully examined.

76. A comparison of the proposed tolls, fees, unit prices or other charges is an important factor for ensuring objectiveness and transparency in the choice between equally responsive proposals. However, it is important for the contracting authority to consider carefully the relative weight of this criterion in the evaluation process. The notion of "price" usually does not have the same value for the award of privately financed infrastructure projects as it has in the procurement of goods and services. Indeed, the remuneration of the concessionaire is often the combined result of charges paid by the users, ancillary revenue sources and direct subsidies or payments made by the public entity awarding the contract.

77. It flows from the above that, while the unit price for the expected output retains its role as an important element of comparison of proposals, it may not always be regarded as the most important factor. Of particular importance is the overall assessment of the financial feasibility of the proposals since it allows the contracting authority to consider the bidders' ability to carry out the project and the likelihood of subsequent increases in the proposed prices. This is important with a view to avoiding project awards to bidders that offer attractive but unrealistically low prices in the expectation of being able to raise such prices once a concession is obtained.

5. *Submission, opening, comparison and evaluation of proposals*

78. Proposals should be required to be submitted in writing, signed and placed in sealed envelopes. A proposal received by the contracting authority after the deadline for the submission of proposals should not be opened and should be returned to the bidder that submitted it. For the purpose of ensuring transparency, national laws often prescribe formal procedures for the opening of pro-

posals, usually at a time previously specified in the request for proposals, and require that the bidders that have submitted proposals, or their representatives, be permitted by the contracting authority to be present at the opening of the proposals. Such a requirement helps to minimize the risk that the proposals might be altered or otherwise tampered with and represents an important guarantee of the integrity of the proceedings.

79. In view of the complexity of privately financed infrastructure projects and the variety of evaluation criteria usually applied in the award of the project, it may be advisable for the contracting authority to apply a two-step evaluation process whereby non-financial criteria would be taken into consideration separately from, and perhaps before, financial criteria so as to avoid situations where undue weight would be given to certain elements of the financial criteria (such as the unit price) to the detriment of the non-financial criteria.

80. To that end, in some countries bidders are required to formulate and submit their technical and financial proposals in two separate envelopes. The two-envelope system is sometimes used because it permits the contracting authority to evaluate the technical quality of proposals without being influenced by their financial components. However, the method has been criticized as being contrary to the objective of economy in the award of public contracts. In particular, there is said to be a danger that, by selecting proposals initially on the basis of technical merit alone and without reference to price, a contracting authority might be tempted to select, upon the opening of the first envelope, proposals offering technically superior works and to reject proposals offering less sophisticated solutions that nevertheless meet the contracting authority's needs at an overall lower cost. International financial institutions, such as the World Bank, do not accept the two-envelope system for projects financed by them because of concerns that the system gives margin to a higher degree of discretion in the evaluation of proposals and makes it more difficult to compare them in an objective manner.

81. As an alternative to the use of a two-envelope system, the contracting authorities may require both technical and financial proposals to be contained in one single proposal, but structure their evaluation in two stages, as in the evaluation procedure provided in article 42 of the UNCITRAL Model Procurement Law. At an initial stage, the contracting authority typically establishes a threshold with respect to quality and technical aspects to be reflected in the technical proposals in accordance with the criteria as set out in the request for proposals, and rates each technical proposal in accordance with such criteria and the relative weight and manner of application of those criteria as set forth in the request for proposals. The contracting authority then compares the financial and commercial proposals that have attained a rating at or above the threshold. When the technical and financial proposals are to be evaluated consecutively, the contracting authority should initially ascertain whether the technical proposals are prima facie responsive to the request for proposals (that is, whether they cover all items required to be addressed in the technical proposals). Incomplete proposals, as well as proposals that deviate from the request for proposals, should be rejected at this stage. While the contracting

authority may ask bidders for clarifications of their proposals, no change in a matter of substance in the proposal, including changes aimed at making a non-responsive proposal responsive, should be sought, offered or permitted at this stage.

82. In addition to deciding whether to use a two-envelope system or a two-stage evaluation procedure, it is important for the contracting authority to disclose the relative weight to be accorded to each evaluation criterion and the manner in which criteria are to be applied in the evaluation of proposals. Two possible approaches might be used to reach an appropriate balance between financial and technical aspects of the proposals. One possible approach is to consider as most advantageous the proposal that obtains the highest combined rating in respect of both price and non-price evaluation criteria. Alternatively, the price proposed for the output (for example, the water or electricity price or the level of tolls) might be the deciding factor in establishing the winning proposal among the responsive proposals. In any event, in order to promote the transparency of the selection process and to avoid improper use of non-price evaluation criteria, it is advisable to require the awarding committee to provide written reasons for selecting a proposal other than the one offering the lowest unit price for the output.

6. *Final negotiations and project award*

83. The contracting authority should rank all responsive proposals on the basis of the evaluation criteria set forth in the request for proposals and invite the best-rated bidder for final negotiation of certain elements of the project agreement. If two or more proposals obtain the highest rating, or if there is only an insignificant difference in the rating of two or more proposals, the contracting authority should invite for negotiations all the bidders that have obtained essentially the same rating. The final negotiations should be limited to fixing the final details of the transaction documentation and satisfying the reasonable requirements of the selected bidder's lenders. One particular problem faced by contracting authorities is the danger that the negotiations with the selected bidder might lead to pressures to amend, to the detriment of the Government or the consumers, the price or risk allocation originally contained in the proposal. Changes in essential elements of the proposal should not be permitted, as they may distort the assumptions on the basis of which the proposals were submitted and rated. Therefore, the negotiations at this stage may not concern those terms of the contract which were deemed not negotiable in the final request for proposals (see para. 69). The risk of reopening commercial terms at this late stage could be further minimized by insisting that the selected bidder's lenders indicate their comfort with the risk allocation embodied in their bid at a stage where there is competition among bidders (see para. 70). The contracting authority's financial advisers might contribute to this process by advising whether bidders' proposals are realistic and what levels of financial commitment are appropriate at each stage. The process of reaching financial close can itself be quite lengthy.

84. The contracting authority should inform the remaining responsive bidders that they may be considered for negotiation if the negotiations with the bidder with better ratings do not result in a project agreement. If it becomes apparent to the contracting authority that the negotiations with the invited bidder will not result in a project agreement, the contracting authority should inform that bidder that it is terminating the negotiations and then invite for negotiations the next bidder on the basis of its ranking until it arrives at a project agreement or rejects all remaining proposals. To avoid the possibility of abuse and unnecessary delay, the contracting authority should not reopen negotiations with any bidder with whom they have already been terminated.

D. Concession award without competitive procedures

85. In the legal tradition of certain countries, privately financed infrastructure projects involve the delegation by the contracting authority of the right and duty to provide a public service. As such, they are subject to a special legal regime that differs in many respects from the regime that applies generally to the award of public contracts for the purchase of goods, construction or services.

86. Given the very particular nature of the services required (including their complexity, amount of investment involved and completion time), the procedures used in those countries place the accent on the contracting authority's freedom to choose the operator who best suits its need, in terms of professional qualifications, financial strength, ability to ensure the continuity of the service, equal treatment of the users and quality of the proposal. In contrast to the competitive selection procedures usually followed for the award of other public contracts, which sometimes may appear to be excessively rigid, preference is given to a procedure that is characterized by a high degree of flexibility and discretion on the part of the contracting authority. However, freedom of negotiation does not mean arbitrary choice and the laws of those countries provide procedures to ensure transparency and fairness in the conduct of the selection process.

87. In some countries where tendering is under normal circumstances the rule for public procurement of goods, construction and services, guidelines issued to contracting authorities advise the use of negotiations whenever possible for the award of privately financed infrastructure projects. The rationale for encouraging negotiations in those countries is that in negotiating with bidders the Government is not bound by predetermined requirements or rigid specifications and has more flexibility for taking advantage of innovative or alternative proposals that may be submitted by the bidders in the selection proceedings, as well as for changing and adjusting its own requirements in the event that more attractive options for meeting the infrastructure needs are formulated during the negotiations.

88. Negotiations outside structured competitive procedures generally afford a high degree of flexibility that some countries have found beneficial to the

selection of the concessionaire. Coupled with appropriate measures to ensure transparency, integrity and fairness, such negotiations carried out in those countries have led to satisfactory results. However, such negotiations may have a number of disadvantages that make them less suitable to be used as a principal selection method in a number of countries. Because of the high level of flexibility and discretion afforded to the contracting authority, negotiations outside structured competitive procedures require highly skilled personnel with sufficient experience in negotiating complex projects. They also require a well structured negotiating team, clear lines of authority and a high level of coordination and cooperation among all the offices involved. The use of negotiations for the award of privately financed infrastructure projects may therefore not represent a viable alternative for countries that do not have the tradition of using such methods for the award of large government contracts. Another disadvantage of those negotiations is that they may not ensure the level of transparency and objectivity that can be achieved by more structured competitive procedures. In some countries there might be concerns that the higher level of discretion in those negotiations might carry with it a higher risk of abusive or corrupt practices. In view of the above, the host country may wish to prescribe the use of competitive selection procedures as a rule for the award of privately financed infrastructure projects and to reserve concession awards without competitive procedures only for exceptional cases.

1. Authorizing circumstances

89. For purposes of transparency as well as for ensuring discipline in the award of projects, it might be generally desirable for the law to identify the exceptional circumstances under which the contracting authority may be authorized to select the concessionaire without using competitive selection procedures. They may include, for example, the following:

(a) When there is an urgent need for ensuring immediate provision of the service and engaging in a competitive selection procedure would therefore be impractical, provided that the circumstances giving rise to the urgency were neither foreseeable by the contracting authority nor the result of dilatory conduct on its part. Such an exceptional authorization may be needed, for instance, in cases of interruption in the provision of a given service or where an incumbent concessionaire fails to provide the service at acceptable standards or if the project agreement is rescinded by the contracting authority, when engaging in a competitive selection procedure would be impractical in view of the urgent need to ensure the continuity of the service;

(b) In the case of projects of short duration and with an anticipated initial investment value not exceeding a specified low amount;

(c) Reasons of national defence or security;

(d) Cases where there is only one source capable of providing the required service (for example, because it can be provided only by the use of patented technology or unique know-how) including certain cases of unsolicited proposals (see paras. 115-117);

(e) When an invitation to the pre-selection proceedings or a request for proposals has been issued, but no applications or proposals were submitted or all proposals were rejected and, in the judgement of the contracting authority, issuing a new request for proposals would be unlikely to result in a project award. However, in order to reduce the risk of abuse in changing the selection method, the contracting authority should only be authorized to award a concession without using competitive selection procedures when such a possibility was expressly provided for in the original request for proposals.

2. *Measures to enhance transparency in the award of concessions without competitive procedures*

90. Procedures to be followed in procurement through negotiation outside structured competitive procedures are typically characterized by a higher degree of flexibility than the procedures applied to other methods of procurement. Few rules and procedures are established to govern the process by which the parties negotiate and conclude their contract. In some countries, procurement laws allow contracting authorities virtually unrestricted freedom to conduct negotiations as they see fit. The laws of other countries establish a procedural framework for negotiation designed to maintain fairness and objectivity and to bolster competition by encouraging participation of bidders. Provisions on procedures for selection through negotiation address a variety of issues discussed below, in particular, requirements for approval of the contracting authority's decision to select the concessionaire through negotiation, selection of negotiating partners, criteria for comparison and evaluation of offers, and recording of the selection proceedings.

(a) Approval

91. A threshold requirement found in many countries is that a contracting authority must obtain the approval of a higher authority prior to engaging in selection through negotiations outside structured competitive procedures. Such provisions generally require the application for approval to be in writing and to set forth the grounds necessitating the use of negotiation. Approval requirements are intended, in particular, to ensure that the concession award without competitive procedures is used only in appropriate circumstances.

(b) Selection of negotiating partners

92. In order to make the award proceedings as competitive as possible, it is advisable to require the contracting authority to engage in negotiations with as many companies judged susceptible of meeting the need as circumstances permit. Beyond such a general provision, there is no specific provision in the laws of some countries on the minimum number of contractors or suppliers with whom the contracting authority is to negotiate. The laws of some other countries, however, require the contracting authority, where practicable, to negotiate with, or to solicit proposals from, a minimum number of bidders (three, for example). The contracting authority is permitted to negotiate with a smaller number in certain circumstances, in particular, when fewer than the minimum number of potential bidders were available.

93. For the purpose of enhancing transparency, it is also advisable to require a notice of the negotiation proceedings to be given to bidders in a specified manner. For example, the contracting authority may be required to publish the notice in a particular publication normally used for that purpose. Such notice requirements are intended to bring the procurement proceedings to the attention of a wider range of bidders than might otherwise be the case, thereby promoting competition. Given the magnitude of most infrastructure projects, the notice should normally contain certain minimum information (a description of the project, for example, or qualification requirements) and should be issued in sufficient time to allow bidders to prepare offers. Generally the formal eligibility requirements applicable to bidders in competitive selection proceedings should also apply in negotiation proceedings.

94. In some countries, notice requirements are waived when the contracting authority resorts to negotiation following unsuccessful bidding proceedings (see para. 89 (e)), if all qualified bidders are permitted to participate in the negotiations or if no bids at all were received.

(c) Criteria for comparison and evaluation of offers

95. Another useful measure to enhance the transparency and effectiveness of negotiations outside structured competitive procedures consists of establishing general criteria that proposals are requested to meet (for example, general performance objectives or output specifications), as well as criteria for evaluating offers made during the negotiations and for selecting the winning concessionaire (for example, the technical merit of an offer, prices, operating and maintenance costs and the profitability and development potential of the project agreement). Where more than one proposal is received, some elements of competition may be usefully introduced in the negotiations. The contracting authority should identify the proposals that appear to meet those criteria and engage in discussions with the author of each such proposal in order to refine and improve upon the proposal to the point where it is satisfactory to the contracting authority. The price of each proposal does not enter into those discussions. When the proposals have been finalized, it may be advisable for the contracting authority to seek a best and final offer on the basis of the clarified proposals. It is recommendable that bidders should include with their final offer evidence that the risk allocation that the offer embodies would be acceptable to their proposed lenders. From the best and final offers received, the preferred bidder can then be chosen. The project would then be awarded to the party offering the “most economical” or “most advantageous” proposal in accordance with the criteria for selecting the winning concessionaire set forth in the invitation to negotiate.

(d) Notice of concession award

96. The contracting authority should be required to establish a record of the selection proceedings (see paras. 120-126) and should publish a notice of the concession award, which, except in cases involving national defence or national security interests, should disclose, in particular, the specific circum-

stances and reasons for the award of the concession without competitive procedures (see para. 122). In some countries, transparency is further enhanced by requiring that the project agreement be opened to public inspection.

E. Unsolicited proposals

97. Public authorities are sometimes approached directly by private companies who submit proposals for the development of projects in respect of which no selection procedures have been opened. These proposals are usually referred to as "unsolicited proposals". Unsolicited proposals may result from the identification by the private sector of an infrastructure need that may be met by a privately financed project. They may also involve innovative proposals for infrastructure management and offer the potential for transfer of new technology to the host country.

1. Policy considerations

98. One possible reason sometimes cited for waiving the requirement of competitive selection procedures is to provide an incentive for the private sector to submit proposals involving the use of new concepts or technologies to meet the contracting authority's needs. By the very nature of competitive selection procedures, no bidder has an assurance of being awarded the project, unless it wins the competition. The cost of formulating proposals for large infrastructure projects may be a deterrent for companies concerned about their ability to match proposals submitted by competing bidders. In contrast, the private sector may see an incentive for the submission of unsolicited proposals in rules that allow a contracting authority to negotiate such proposals directly with their authors. The contracting authority, too, may have an interest in the possibility of engaging in direct negotiations in order to stimulate the private sector to formulate innovative proposals for infrastructure development.

99. At the same time, however, the award of projects pursuant to unsolicited proposals and without competition from other bidders may expose the Government to serious criticism, in particular in cases involving exclusive concessions. In addition, prospective lenders, including multilateral and bilateral financial institutions, may have difficulty in lending or providing guarantees for projects that have not been the subject of competitive selection proceedings. They may fear the possibility of challenge and cancellation by future Governments (for example, because the project award may be deemed subsequently to have been the result of favouritism or because the procedure did not provide objective parameters for comparing prices, technical elements and the overall effectiveness of the project) or legal or political challenge by other interested parties, such as customers dissatisfied with increased prices or competing companies alleging unjust exclusion from a competitive selection procedure.

100. In view of the above considerations, it is important for the host country to consider the need for, and the desirability of, devising special procedures for

handling unsolicited proposals that differ from the procedures usually followed for the award of privately financed infrastructure projects. For that purpose, it may be useful to analyse two situations most commonly mentioned in connection with unsolicited proposals, namely, unsolicited proposals claiming to involve the use of new concepts or technologies to address the contracting authority's infrastructure needs and unsolicited proposals claiming to address an infrastructure need not already identified by the contracting authority.

(a) Unsolicited proposals claiming to involve the use of new concepts or technologies to address the contracting authority's infrastructure needs

101. Generally, for infrastructure projects that require the use of some kind of industrial process or method, the contracting authority would have an interest in stimulating the submission of proposals incorporating the most advanced processes, designs, methodologies or engineering concepts with demonstrated ability to enhance the project's outputs (by significantly reducing construction costs, for example, accelerating project execution, improving safety, enhancing project performance, extending economic life, reducing costs of facility maintenance and operations or reducing negative environmental impact or disruptions during either the construction or the operational phase of the project).

102. The contracting authority's legitimate interests might also be achieved through appropriately modified competitive selection procedures instead of a special set of rules for handling unsolicited proposals. For instance, if the contracting authority is using selection procedures that emphasize the expected output of the project, without being prescriptive about the manner in which that output is to be achieved (see paras. 64-66), the bidders would have sufficient flexibility to offer their own proprietary processes or methods. In such a situation, the fact that each of the bidders has its own proprietary processes or methods would not pose an obstacle to competition, provided that all the proposed methods are technically capable of generating the output expected by the contracting authority.

103. Adding the necessary flexibility to the competitive selection procedures may in these cases be a more satisfactory solution than devising special non-competitive procedures for dealing with proposals claiming to involve new concepts or technologies. With the possible exception of proprietary concepts or technologies whose uniqueness may be ascertained on the basis of the existing intellectual property rights, a contracting authority may face considerable difficulties in defining what constitutes a new concept or technology. Such a determination may require the services of costly independent experts, possibly from outside the host country, to avoid allegations of bias. A determination that a project involves a novel concept or technology might also be met by claims from other interested companies also claiming to have appropriate new technologies.

104. However, a somewhat different situation may arise if the uniqueness of the proposal or its innovative aspects are such that it would not be possible to implement the project without using a process, design, methodology or engi-

neering concept for which the proponent or its partners possess exclusive rights, either worldwide or regionally. The existence of intellectual property rights in relation to a method or technology may indeed reduce or eliminate the scope for meaningful competition. This is why the procurement laws of most countries authorize procuring entities to engage in single-source procurement if the goods, construction or services are available only from a particular supplier or contractor or if the particular supplier or contractor has exclusive rights over the goods, construction or services and no reasonable alternative or substitute exists (see the UNCITRAL Model Procurement Law, art. 22).

105. In such a case, it would be appropriate to authorize the contracting authority to negotiate the execution of the project directly with the proponent of the unsolicited proposal. The difficulty, of course, would be how to establish, with the necessary degree of objectivity and transparency, that there exists no reasonable alternative or substitute to the method or technology contemplated in the unsolicited proposal. For that purpose, it is advisable for the contracting authority to establish procedures for obtaining elements of comparison for the unsolicited proposal.

(b) Unsolicited proposals claiming to address an infrastructure need not already identified by the contracting authority

106. The merit of unsolicited proposals of this type consists of the identification of a potential for infrastructure development that has not been considered by the authorities of the host country. However, in and of itself this circumstance should not normally provide sufficient justification for a directly negotiated project award in which the contracting authority has no objective assurance that it has obtained the most advantageous solution for meeting its needs.

2. *Procedures for handling unsolicited proposals*

107. In the light of the above considerations, it is advisable for the contracting authority to establish transparent procedures for determining whether an unsolicited proposal meets the required conditions and whether it is in the contracting authority's interest to pursue it.

(a) Restrictions to the receivability of unsolicited proposals

108. In the interest of ensuring proper accountability for public expenditures, some domestic laws provide that no unsolicited proposal may be considered if the execution of the project would require significant financial commitments from the contracting authority or other public authority such as guarantees, subsidies or equity participation. The reason for such a limitation is that the procedures for handling unsolicited proposals are typically less elaborate than ordinary selection procedures and may not ensure the same level of transpar-

ency and competition that would otherwise be achieved. However, there may be reasons for allowing some flexibility in the application of this condition. In some countries, the presence of government support other than direct government guarantees, subsidy or equity participation (for example, the sale or lease of public property to authors of project proposals) does not necessarily disqualify a proposal from being treated and accepted as an unsolicited proposal.

109. Another condition for consideration of an unsolicited proposal is that it should relate to a project for which no selection procedures have been initiated or announced by the contracting authority. The rationale for handling an unsolicited proposal without using a competitive selection procedure is to provide an incentive for the private sector to identify new or unanticipated infrastructure needs or to formulate innovative proposals for meeting those needs. This justification may no longer be valid if the project has already been identified by the authorities of the host country and the private sector is merely proposing a technical solution different from the one envisaged by the contracting authority. In such a case, the contracting authority could still take advantage of innovative solutions by applying a two-stage selection procedure (see paras. 54-58). However, it would not be consistent with the principle of fairness in the award of public contracts to entertain unsolicited proposals outside selection proceedings already started or announced.

(b) Procedures for determining the admissibility of unsolicited proposals

110. A company or group of companies that approaches the Government with a suggestion for private infrastructure development should be requested to submit an initial proposal containing sufficient information to allow the contracting authority to make a prima facie assessment of whether the conditions for handling unsolicited proposals are met, in particular whether the proposed project is in the public interest. The initial proposal should include, for instance, the following information: a statement of the author's previous project experience and financial standing; a description of the project (type of project, location, regional impact, proposed investment, operational costs, financial assessment and resources needed from the Government or third parties); details about the site (ownership and whether land or other property will have to be expropriated); and a description of the service and the works.

111. Following a preliminary examination, the contracting authority should inform the company, within a reasonably short period, whether or not there is a potential public interest in the project. If the contracting authority reacts positively to the project, the company should be invited to submit a formal proposal, which, in addition to the items covered in the initial proposal, should contain a technical and economic feasibility study (including characteristics, costs and benefits) and an environmental impact study. Furthermore, the author of the proposal should be required to submit satisfactory information regarding the concept or technology contemplated in the proposal. The information disclosed should be in sufficient detail to allow the contracting authority to evaluate the concept or technology properly and to determine whether it meets the required conditions and is likely to be successfully implemented on the scale

of the proposed project. The company submitting the unsolicited proposal should retain title to all documents submitted throughout the procedure and those documents should be returned to it in the event the proposal is rejected.

112. Once all the required information is provided by the author of the proposal, the contracting authority should decide, within a reasonably short period, whether it intends to pursue the project and, if so, what procedure will be used. Choice of the appropriate procedure should be made on the basis of the contracting authority's preliminary determination as to whether or not the implementation of the project would be possible without the use of a process, design, methodology or engineering concept for which the proposing company or its partners possess exclusive rights.

(c) Procedures for handling unsolicited proposals that do not involve proprietary concepts or technology

113. If the contracting authority, upon examination of an unsolicited proposal, decides that there is public interest in pursuing the project, but the implementation of the project is possible without the use of a process, design, methodology or engineering concept for which the proponent or its partners possess exclusive rights, the contracting authority should be required to award the project by using the procedures that would normally be required for the award of privately financed infrastructure projects, such as, for instance, the competitive selection procedures described in this *Guide* (see paras. 34-84). However, the selection procedures may include certain special features so as to provide an incentive to the submission of unsolicited proposals. These incentives may consist of the following measures:

(a) The contracting authority could undertake not to initiate selection proceedings regarding a project in respect of which an unsolicited proposal was received without inviting the company that submitted the original proposal;

(b) The original bidder might be given some form of premium for submitting the proposal. In some countries that use a merit-point system for the evaluation of financial and technical proposals the premium takes the form of a margin of preference over the final rating (that is, a certain percentage over and above the final combined rating obtained by that company in respect of both financial and non-financial evaluation criteria). One possible difficulty of such a system is the risk of setting the margin of preference so high as to discourage competing meritorious bids, thus resulting in the receipt of a project of lesser value in exchange for the preference given to the innovative bidder. Alternative forms of incentives may include the reimbursement, in whole or in part, of the costs incurred by the original author in the preparation of the unsolicited proposal. For purposes of transparency, any such incentives should be announced in the request for proposals.

114. Notwithstanding the incentives that may be provided, the author of the unsolicited proposal should generally be required to meet essentially the same qualification criteria as would be required of the bidders participating in a competitive selection proceedings (see paras. 38-40).

(d) Procedures for handling unsolicited proposals involving proprietary concepts or technology

115. If it appears that the innovative aspects of the proposal are such that it would not be possible to implement the project without using a process, design, methodology or engineering concept for which the author or its partners possess exclusive rights, either worldwide or regionally, it may be useful for the contracting authority to confirm that preliminary assessment by applying a procedure for obtaining elements of comparison for the unsolicited proposal. One such procedure may consist of the publication of a description of the essential output elements of the proposal (for example, the capacity of the infrastructure facility, quality of the product or the service or price per unit) with an invitation to other interested parties to submit alternative or comparable proposals within a certain period. Such a description should not include input elements of the unsolicited proposal (the design of the facility, for example, or the technology and equipment to be used), in order to avoid disclosing to potential competitors proprietary information of the person who had submitted the unsolicited proposal. The period for submitting proposals should be commensurate with the complexity of the project and should afford the prospective competitors sufficient time to formulate their proposals. This may be a crucial factor for obtaining alternative proposals, for example, if the bidders would have to carry out detailed subsurface geological investigations that might have been carried out over many months by the original bidder, who would want the geological findings to remain secret.

116. The invitation for comparative or competitive proposals should be published with a minimum frequency (for example, once every week for three weeks) in at least one newspaper of general circulation. It should indicate the time and place where bidding documents may be obtained and should specify the time during which proposals may be received. It is important for the contracting authority to protect the intellectual property rights of the original author and to ensure the confidentiality of proprietary information received with the unsolicited proposal. Any such information should not form part of the bidding documents. Both the original bidder and any other company that wishes to submit an alternative proposal should be required to submit a bid security (see para. 62). Two possible avenues may then be pursued, according to the reactions received to the invitation:

(a) If no alternative proposals are received, the contracting authority may reasonably conclude that there is no reasonable alternative or substitute to the method or technology contemplated in the unsolicited proposal. This finding of the contracting authority should be appropriately recorded and the contracting authority could be authorized to engage in direct negotiations with the original proponent. It may be advisable to require that the decision of the contracting authority be reviewed and approved by the same authority whose approval would normally be required in order for the contracting authority to select a concessionaire through direct negotiation (see para. 89). Some countries whose laws mandate the use of competitive procedures have used these procedures in order to establish the necessary transparency required to avoid future challenges to the award of a concession following an unsolicited proposal. In those

countries, the mere publication of an invitation to bid would permit an award to the bidder who originally submitted the unsolicited proposal, even if its bid were the only one received. This is so because compliance with competitive procedures typically requires that the possibility of competition should have been present and not necessarily that competition actually occurred. Publicity creates such a possibility and adds a desirable degree of transparency;

(b) If alternative proposals are submitted, the contracting authority should invite all the bidders to negotiations with a view to identifying the most advantageous proposal for carrying out the project (see paras. 90-96). In the event that the contracting authority receives a sufficiently large number of alternative proposals, which appear prima facie to meet its infrastructure needs, there may be scope for engaging in full-fledged competitive selection procedures (see paras. 34-84), subject to any incentives that may be given to the author of the original proposal (see para. 113 (b)).

117. The contracting authority should be required to establish a record of the selection proceedings (paras. 120-126) and to publish a notice of the award of the project (see para. 119).

F. Confidentiality

118. In order to prevent abuse of the selection procedures and to promote confidence in the process, it is important that confidentiality be observed by all parties, especially where negotiations are involved. Such confidentiality is important in particular to protect any trade or other information that bidders might include in their proposals and that they would not wish to be made known to their competitors. Confidentiality should be kept regardless of the selection method used by the contracting authority.

G. Notice of project award

119. Project agreements frequently include provisions that are of direct interest for parties other than the contracting authority and the concessionaire and who might have a legitimate interest in being informed about certain essential elements of the project. This is the case in particular for projects involving the provision of a service directly to the general public. For purposes of transparency, it may be advisable to establish procedures for publicizing those terms of the project agreement which may be of public interest. Such a requirement should apply regardless of the method used by the contracting authority to select the concessionaire (for example, whether through competitive selection procedures, direct negotiations or as a result of an unsolicited proposal). One possible procedure may be to require the contracting authority to publish a notice of the award of the project, indicating the essential elements of the proposed agreements, such as: (a) the name of the concessionaire; (b) a description of the works and services to be performed by the concessionaire; (c) the duration of the concession; (d) the price structure; (e) a summary of the

essential rights and obligations of the concessionaire and the guarantees to be provided by it; (f) a summary of the monitoring rights of the contracting authority and remedies for breach of the project agreement; (g) a summary of the essential obligations of the Government, including any payment, subsidy or compensation offered by it; and (h) any other essential term of the project agreement, as provided in the request for proposals.

H. Record of selection and award proceedings

120. In order to ensure transparency and accountability and to facilitate the exercise of the right of aggrieved bidders to seek review of decisions made by the contracting authority, the contracting authority should be required to keep an appropriate record of key information pertaining to the selection proceedings.

121. The record to be kept by the contracting authority should contain, as appropriate, such general information concerning the selection proceedings as is usually required to be recorded for public procurement (such as the information listed in article 11 of the UNCITRAL Model Procurement Law), as well as information of particular relevance for privately financed infrastructure projects. Such information may include the following:

(a) A description of the project for which the contracting authority requested proposals;

(b) The names and addresses of the companies participating in bidding consortia and the name and address of the members of the bidders with whom the project agreement has been entered into; and a description of the publicity requirements, including copies of the publicity used or of the invitations sent;

(c) If changes to the composition of the pre-selected bidders are subsequently permitted, a statement of the reasons for authorizing such changes and a finding as to the qualifications of any substitute or additional consortia concerned;

(d) Information relative to the qualifications, or lack thereof, of bidders and a summary of the evaluation and comparison of proposals, including the application of any margin of preference;

(e) A summary of the conclusions of the preliminary feasibility studies commissioned by the contracting authority and a summary of the conclusions of the feasibility studies submitted by the qualified bidders;

(f) A summary of any requests for clarification of the pre-selection documents or the request for proposals, the responses thereto, as well as a summary of any modification of those documents;

(g) A summary of the principal terms of the proposals and of the project agreement;

(h) If the contracting authority has found most advantageous a proposal other than the proposal offering the lowest unit price for the expected output, a justification of the reasons for that finding by the awarding committee;

(i) If all proposals were rejected, a statement to that effect and the grounds for rejection;

(j) If the negotiations with the consortium that submitted the most advantageous proposal and any subsequent negotiations with remaining responsive consortia did not result in a project agreement, a statement to that effect and of the grounds therefor.

122. For concession awards without competitive procedures (see para. 89), it may be useful to include in the record of those proceedings, in addition to requirements referred to in paragraph 121 that may be applicable, the following additional information:

(a) A statement of the grounds and circumstances on which the contracting authority relied to justify the direct negotiation;

(b) The type of publicity used or the name and address of the company or companies directly invited to the negotiations;

(c) The name and address of the company or companies that requested to participate and those which were excluded from participating, if any, and the grounds for their exclusion;

(d) If the negotiations did not result in a project agreement, a statement to that effect and of the grounds therefor;

(e) The justification given for the selection of the final concessionaire.

123. For selection proceedings engaged in as a result of unsolicited proposals (see paras. 107-117), it may be useful to include in the record of those proceedings, in addition to requirements referred to in paragraph 121 that may be applicable, the following additional information:

(a) The name and address of the company or companies submitting the unsolicited proposal and a brief description of it;

(b) A certification by the contracting authority that the unsolicited proposal was found to be of public interest and to involve new concepts or technologies, as appropriate;

(c) The type of publicity used or the name and address of the company or companies directly invited to the negotiations;

(d) The name and address of the company or companies that requested to participate and those which were excluded from participating, if any, and the grounds for their exclusion;

(e) If the negotiations did not result in a project agreement, a statement to that effect and of the grounds therefor;

(f) The justification given for the selection of the final concessionaire.

124. It is advisable for the rules on record requirements to specify the extent and the recipients of the disclosure. Setting the parameters of disclosure involves balancing factors such as the general desirability, from the standpoint

of the accountability of contracting authorities, of broad disclosure; the need to provide bidders with information necessary to enable them to assess their performance in the proceedings and to detect instances in which there are legitimate grounds for seeking review; and the need to protect the bidders' confidential trade information. In view of these considerations, it may be advisable to provide two levels of disclosure, as envisaged in article 11 of the UNCITRAL Model Procurement Law. The information to be provided to any member of the general public may be limited to basic information geared to the accountability of the contracting authority to the general public. However, it is advisable to provide for the disclosure for the benefit of bidders of more detailed information concerning the conduct of the selection, since that information is necessary to enable the bidders to monitor their relative performance in the selection proceedings and to monitor the conduct of the contracting authority in implementing the requirements of the applicable laws and regulations.

125. Moreover, appropriate measures should be taken to avoid the disclosure of confidential trade information of suppliers and contractors. This is true in particular with respect to what is disclosed concerning the evaluation and comparison of proposals, as excessive disclosure of such information may be prejudicial to the legitimate commercial interests of bidders. As a general rule, the contracting authority should not disclose more detailed information relating to the examination, evaluation and comparison of proposals and proposal prices, except when ordered to do so by a competent court.

126. Provisions on limited disclosure of information relating to the selection process would not preclude the applicability to certain parts of the record of other statutes in the enacting State that confer on the public at large a general right to obtain access to government records. Disclosure of the information in the record to legislative or parliamentary oversight bodies may be mandated pursuant to the law applicable in the host country.

I. Review procedures

127. The existence of fair and efficient review procedures is one of the basic requirements for attracting serious and competent bidders and for reducing the cost and the length of award proceedings. An important safeguard of proper adherence to the rules governing the selection procedure is that bidders have the right to seek review of actions by the contracting authority in violation of those rules or of the rights of bidders. Various remedies and procedures are available in different legal systems and systems of administration, which are closely linked to the question of review of governmental actions. Whatever the exact form of review procedures, it is important to ensure that an adequate opportunity and effective procedures for review are provided. It is particularly useful to establish a workable "pre-contract" recourse system (that is, procedures for reviewing the contracting authority's acts as early in the selection proceedings as feasible). Such a system increases the possibility of taking corrective actions by the contracting authority before loss is caused and helps

to reduce cases where monetary compensation is the only option left to redress the consequences of an improper action by the contracting authority. Elements for the establishment of an adequate review system are contained in chapter VI of the UNCITRAL Model Procurement Law.

128. Appropriate review procedures should establish in the first place that bidders have a right to seek review of decisions affecting their rights. In the first instance, that review may be sought from the contracting authority itself, in particular where the project is yet to be awarded. This may facilitate economy and efficiency, since in many cases, in particular prior to the awarding of the project, the contracting authority may be quite willing to correct procedural errors, of which it may even not have been aware. It may also be useful to provide for a review by higher administrative organs of the Government, where such a procedure would be consistent with constitutional, judicial and administrative structures. Finally, most domestic procurement regimes affirm the right to judicial review, which should generally also be available in connection with the award of infrastructure projects.

129. In order to strike a workable balance between, on the one hand, the need to preserve the rights of bidders and the integrity of the selection process and, on the other, the need to limit disruption of the selection process, domestic laws often include a number of restrictions on review procedures. These include restricting the right to review to bidders; establishing time limits for filing of applications for review and for disposition of cases, including time limits for any suspension of the selection proceedings that may apply at the level of administrative review; and excluding from the review procedures a number of decisions that are left to the discretion of the contracting authority and that do not directly involve questions of the fairness of treatment accorded to bidders. In most legal systems, administrative review procedures are available to bidders to challenge decisions by contracting authorities, although judicial review procedures may not be universally available.

130. There exist in most States mechanisms and procedures for review of acts of administrative organs and other public entities. In some States, review mechanisms and procedures have been established specifically for disputes arising in the context of procurement by those organs and entities. In other States, those disputes are dealt with by means of the general mechanisms and procedures for review of administrative acts. Certain important aspects of proceedings for review, such as the forum where review may be sought and the remedies that may be granted, are related to fundamental conceptual and structural aspects of the legal system and the system of State administration in every country. Many legal systems provide for review of acts of administrative organs and other public entities before an administrative body that exercises hierarchical authority or control over the organ or entity. In legal systems that provide for such hierarchical administrative review, the question of which body or bodies are to exercise that function in respect of acts of particular organs or entities depends largely on the structure of the State administration. In the context of general procurement laws, for example, some States provide for review by a body that exercises overall supervision and control over pro-

curement in the State (such as a central procurement board); in other States the review function is performed by the body that exercises financial control and oversight over operations of the Government and of the public administration. In some States, the review function in relation to particular types of cases involving administrative organs or other public entities is performed by specialized independent administrative bodies whose competence is sometimes referred to as "quasi-judicial". Those bodies are not, however, considered in those States to be courts within the judicial system.

131. Many national legal systems provide for judicial review of acts of administrative organs and public entities. In several of those legal systems judicial review is provided in addition to administrative review, while in other systems only judicial review is provided. Some legal systems provide only administrative review, and not judicial review. In some legal systems where both administrative and judicial review are provided, judicial review may be sought only after opportunities for administrative review have been exhausted; in other systems the two means of review are available as options. The main issue raised concerning judicial review is the effect that a judgement that annuls a public bidding would have on the awarded contract, especially when public works have already been initiated. Procurement laws tend to attempt to strike a balance between the conflicting interests of the public sector, that is, the need to uphold the integrity of the procurement procedure and not to delay the rendering of a public service, and the interest of the bidders to preserve their rights. Except where a project agreement was the result of unlawful acts, a good solution is that a judgement should not render the project agreement void, but award damages to the injured party. It is usually agreed that such damages should not include loss of profits, but be limited to the cost incurred by the bidder in preparing the bid.

IV. Construction and operation of infrastructure: legislative framework and project agreement

A. General provisions of the project agreement

1. The "project agreement" between the contracting authority and the concessionaire is the central contractual document in an infrastructure project. The project agreement defines the scope and purpose of the project as well as the rights and obligations of the parties; it provides details on the execution of the project and sets forth the conditions for the operation of the infrastructure or the delivery of the relevant services. Project agreements may be contained in a single document or may consist of more than one separate agreement between the contracting authority and the concessionaire. This section discusses the relation between the project agreement and the host country's legislation on privately financed infrastructure projects. It also discusses procedures and formalities for the conclusion and entry into force of the project agreement.

1. Legislative approaches

2. Domestic legislation often contains provisions dealing with the content of the project agreement. In some countries, the law merely refers to the need for an agreement between the concessionaire and the contracting authority, while the laws of other countries contain extensive mandatory provisions concerning the content of clauses to be included in the agreement. An intermediate approach is taken by those laws which list a number of issues that need to be addressed in the project agreement without regulating in detail the content of its clauses.

3. General legislative provisions on certain essential elements of the project agreement may serve the purpose of establishing a general framework for the allocation of rights and obligations between the parties. They may be intended to ensure consistency in the treatment of certain contractual issues and to provide guidance to the public authorities involved in the negotiation of project agreements at different levels of government (national, provincial or local). Such guidance may be found particularly useful by contracting authorities lacking experience in the negotiation of project agreements. Lastly, legislation may sometimes be required so as to provide the contracting authority with the power to agree on certain types of provisions.

4. However, general legislative provisions dealing in detail with the rights and obligations of the parties might deprive the contracting authority and the concessionaire of the necessary flexibility to negotiate an agreement that takes

into account the needs and particularities of a specific project. Therefore, it is advisable to limit the scope of general legislative provisions concerning the project agreement to those strictly necessary, such as, for instance, provisions on matters for which prior legislative authorization might be needed or those which might affect the interests of third parties or provisions relating to essential policy matters on which variation by agreement is not admitted.

2. *The law governing the project agreement*

5. Statutory provisions on the law applicable to the project agreement are not frequently found in domestic legislation on privately financed infrastructure projects. Where they do appear, they usually provide for the application of the laws of the host country by a general reference to domestic law or by mentioning special statutory or regulatory texts that apply to the project agreement. In some legal systems there may be an implied submission to the laws of the host country, even in the absence of a statutory provision to that effect.

6. The law governing the project agreement includes the rules contained in laws and regulations of the host country related directly to privately financed infrastructure projects, where specific legislation on the matter exists. In some countries the project agreement may be subject to administrative law, while in others the project agreement may be governed by private law (see chap. VII, "Other relevant areas of law", paras. 24-27). The governing law also includes legal rules of other fields of law that apply to the various issues that arise during the execution of an infrastructure project (see generally chap. VII, "Other relevant areas of law", sect. B). Some of those rules may be of an administrative or other public law nature and their application in the host country may be mandatory, such as those dealing with environmental protection measures and health and labour conditions. Some domestic laws expressly identify the matters that are subject to rules of mandatory application. However, a number of issues arising out of the project agreement or the operation of the facility may not be the subject of mandatory rules of a public law nature. This is typically the case of most contractual issues arising under the project agreement (for example, formation, validity and breach of contract, including liability and compensation for breach of contract and wrongful termination).

7. Host countries wishing to adopt legislation on privately financed infrastructure projects where no such legislation exists may need to address the various issues raised by such projects in more than one statutory instrument. Other countries may wish to introduce legislation dealing only with certain issues that have not already been addressed in a satisfactory manner in existing laws and regulations. For instance, specific legislation on privately financed infrastructure projects could establish the particular features of the procedures to select the concessionaire and refer, as appropriate, to existing legislation on the award of government contracts for details on the administration of the process. By the same token, when adopting legislation on privately financed infrastructure projects, host countries may need to repeal the application of certain laws and regulations that, in the view of the legislature, constitute obstacles to their implementation.

8. For purposes of clarity, it may be useful to provide information to potential investors concerning those statutory and regulatory texts which are directly applicable to the execution of privately financed infrastructure projects and, as appropriate, those whose application has been repealed by the legislature. However, as it would not be possible to list exhaustively in the law all the statutes or regulations of direct or subsidiary relevance for privately financed infrastructure projects, such a list might best be provided in a non-legislative document, such as a promotional brochure or general information provided to bidders with the request for proposals (see chap. III, "Selection of the concessionaire", para. 60).

3. Conclusion of the project agreement

9. For projects as complex as infrastructure projects, it is not unusual for several months to elapse in the final negotiations (see chap. III, "Selection of the concessionaire", paras. 83 and 84) before the parties are ready to sign the project agreement. Additional time may also be needed in order to accomplish certain formalities that are often prescribed by law, such as approval of the project agreement by a higher authority. The entry into force of the project agreement or of certain categories of project agreement is in some countries subject to an act of parliament or even the adoption of special legislation. Given the cost entailed by delay in the implementation of the project agreement, it is advisable to find ways of expediting the final negotiations in order to avoid unnecessary delay in the conclusion of the project agreement.

10. A number of factors have been found to cause delay in negotiations, such as inexperience of the parties, poor coordination between different public authorities, uncertainty as to the extent of governmental support and difficulties in establishing security arrangements acceptable to the lenders. The Government may make a significant contribution by providing adequate guidance to negotiators acting on behalf of the contracting authority in the country. The clearer the understanding of the parties as to the provisions to be made in the project agreement, the greater the chances that the negotiation of the project agreement will be conducted successfully. Conversely, where important issues remain open after the selection process and little guidance is provided to the negotiators as to the substance of the project agreement, there may be considerable risk of costly and protracted negotiations as well as of justified complaints that the selection process was not sufficiently transparent and competitive.

11. The procedures for conclusion and entry into force of the project agreement should also be reviewed with a view to expediting matters and avoiding the adverse consequences of delays in the project's timetable. In some countries the power to bind the contracting authority or the Government, as appropriate, is delegated in the relevant legislation to designated officials, so that the entry into force of the project agreement occurs upon signature or upon the completion of certain formalities, such as publication in the official gazette. In countries where such a procedure would not be feasible or where final approvals by another entity may still be required, it would be desirable to consider

streamlining the approval procedures. Where such procedures are perceived as arbitrary or cumbersome, the Government may be requested to provide sufficient guarantees to the concessionaire and the lenders against such risk (see chap. II, "Project risks and government support", paras. 45-50). In some countries where approval requirements exist, contracting authorities have sometimes been authorized to compensate the selected bidder for costs incurred during the selection process and in preparations for the project, should final approval be withheld for reasons not attributable to the selected bidder.

B. Organization of the concessionaire

12. Certain requirements concerning the organization of the concessionaire are often found in domestic legislation and are elaborated upon by detailed provisions in project agreements. They typically deal with issues such as the establishment of the concessionaire as a legal entity, its capital, scope of activities, statutes and by-laws. In most cases, the selected bidders establish a project company as an independent legal entity with its own juridical personality, which then becomes the concessionaire under the project agreement. A project company established as an independent legal entity is the vehicle typically used for raising financing under the project finance modality (see "Introduction and background information on privately financed infrastructure projects", para. 54). Its establishment facilitates coordination in the execution of the project and provides a mechanism for protecting the interests of the project, which may not necessarily coincide with the individual interests of all of the project promoters. This aspect may be of particular importance where significant portions of the services or supplies required by the project are to be provided by members of the project consortium.

13. The project company is usually required to be established within a reasonably short period after the award of the project. Since a substantial part of the liabilities and obligations of the concessionaire, including long-term ones (project agreement, loan and security agreements and construction contracts), are usually agreed upon at an early stage, the project may benefit from being independently represented at the time those instruments are negotiated. However, firm and final commitments by the lenders and other capital providers cannot reasonably be expected to be available prior to the final award of the concession.

14. Entities providing public services are often required to be established as legal entities under the laws of the host country. This requirement reflects the legislature's interest to ensure, *inter alia,* that public service providers comply with domestic accounting and publicity provisions (such as publication of financial statements or requirements to make public certain corporate acts). However, this emphasizes the need for the host country to have adequate company laws in place (see chap. VII, "Other relevant areas of law", paras. 30-33). The ease with which the project company can be established, with due regard to reasonable requirements deemed to be of public interest, may help to avoid unnecessary delay in the implementation of the project.

15. Another important issue concerns the equity investment required for the establishment of the project company. The contracting authority has a legitimate interest in seeking an equity level that ensures a sound financial basis for the project company and guarantees its capability to meet its obligations. However, as the total investment needed as well as the ideal proportion of debt and equity capital vary from project to project, it may be undesirable to provide a legislative requirement of a fixed sum as minimum capital for all companies carrying out infrastructure projects in the country. The contracting authority might instead be given more flexibility to arrive at a desirable amount of equity investment commensurate with the project's financial needs. For instance, the expected equity investment might be expressed as a desirable ratio between debt and equity in the request for proposals and might be included among the evaluation criteria for financial and commercial proposals, so as to stimulate competition among the bidders (see chap. III, "Selection of the concessionaire", paras. 75 and 77).

16. In any event, it is advisable to review legislative provisions or regulatory requirements relating to the organization of the concessionaire so as to ensure their consistency with international obligations assumed by the host country. Provisions that restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service and limitations on the participation of foreign capital in terms of a maximum percentage limit on foreign share-holding or the total value of individual or aggregate foreign investment may be inconsistent with specific obligations undertaken by the signatory States of certain international agreements on economic integration or the liberalization of trade in services.

17. Domestic laws sometimes contain provisions concerning the scope of activities of the project company, requiring, for instance, that they be limited to the development and operation of a particular project. Such restrictions may serve the purpose of ensuring the transparency of the project's accounts and preserving the integrity of its assets, by segregating the assets, proceeds and liabilities of this project from those of other projects or other activities not related to the project. Also, such a requirement may facilitate the assessment of the performance of each project since deficits or profits could not be covered with, or set off against, debts or proceeds from other projects or activities.

18. The contracting authority might also wish to be assured that the statutes and by-laws of the project company will adequately reflect the obligations assumed by the company in the project agreement. For this reason, project agreements sometimes provide that the entry into force of changes in the statutes and by-laws of the project company is effective upon approval by the contracting authority. Where the contracting authority or another public authority participates in the project company, provisions are sometimes made to the effect that certain decisions necessitate the positive vote of the contracting authority in the meeting of the shareholders or board. In any event, it is important to weigh the public interests represented through the contracting authority against the need to afford the project company the flexibility necessary

for the conduct of its business. Where it is deemed necessary to require the contracting authority's approval to proposed amendments to the statutes and by-laws of the project company, it is advisable to limit such a requirement to cases concerning provisions deemed to be of fundamental importance (for example, amount of capital, classes of shares and their privileges or liquidation procedures), which should be identified in the project agreement.

C. The project site, assets and easements

19. Provisions relating to the site of the project are an essential part of most project agreements. They typically deal with issues such as title to land and project assets, acquisition of land, and easements required by the concessionaire to carry out works or to operate the infrastructure. To the extent that the project agreement contemplates transfer of public property to the concessionaire or the creation of a right of use regarding public property, prior legislative authority may be required. Legislation may also be needed to facilitate the acquisition of the required property or easements when the project site is not located on public property.

1. Ownership of project assets

20. As indicated earlier, private sector participation in infrastructure projects may be devised in a variety of different forms, ranging from publicly owned and operated infrastructure to fully privatized projects (see "Introduction and background information on privately financed infrastructure projects", paras. 47-53). Irrespective of the host country's general or sectoral policy, it is important that the ownership regime of the various assets involved be clearly defined and based on sufficient legislative authority. However, there may be no compelling need for detailed legislative provisions on this matter. In various countries it was found sufficient to provide legislative guidance as to matters that need to be addressed in the project agreement.

21. In some legal systems, physical infrastructure required for the provision of public services is generally regarded as public property, even where it was originally acquired or created with private funds. This would typically include any property especially acquired for the construction of the facility in addition to any property that might have been made available to the concessionaire by the contracting authority. However, during the life of the project the concessionaire may make extensive improvements or additions to the facility. It may not always be easily ascertainable under the applicable law whether or not such improvements or additions become an integral part of the public assets held in possession by the concessionaire or whether some of them may be separable from the public property held by the concessionaire and become the concessionaire's private property. It is therefore advisable for the project agreement to specify, as appropriate, which assets will be public property and which will become the private property of the concessionaire.

22. The need for clarity in respect of ownership of project assets is not limited to legal systems where physical infrastructure required for the provision of public services is regarded as public property. Generally, where the contracting authority provides the land or facility required to execute the project, it is advisable for the project agreement to specify, as appropriate, which assets will remain public property and which will become the private property of the concessionaire. The concessionaire may either receive title to such land or facilities or be granted only a leasehold interest or the right to use the land or facilities and build upon it, in particular where the land remains public property. In either case, the nature of the concessionaire's rights should be clearly established, as this will directly affect the concessionaire's ability to create security interests in project assets for the purpose of raising financing for the project (see paras. 54 and 55).

23. In addition to the ownership of assets during the duration of the concession period, it is important to consider the ownership regime upon expiry or termination of the project agreement. In some countries the law places particular emphasis on the contracting authority's interest in the physical assets related to the project and generally require the handover to the contracting authority of all of them, whereas in other countries privately financed infrastructure projects are regarded primarily as a means of procuring services over a specified period, rather than of constructing assets. Thus, the laws of the latter countries limit the concessionaire's handover obligations to public assets and property originally made available to the concessionaire or certain other assets deemed to be necessary to ensure provision of the service. Sometimes, such property is transferred directly from the concessionaire to another concessionaire who succeeds it in the provision of the service.

24. Differences in legislative approaches often reflect the varying role of the public and private sectors under different legal and economic systems, but may also be the result of practical considerations on the part of the contracting authority. One practical reason for the contracting authority to allow the concessionaire to retain certain assets at the end of the project period may be the desire to lower the cost at which the service will be provided. If the project assets are likely to have a residual value for the concessionaire and that value can be taken into account during the selection process, the contracting authority may expect the tariffs charged for the service to be lower. Indeed, if the concessionaire does not expect to have to cover the entire cost of the assets in the life of the project, but can cover part of it by selling them, or using them for other purposes, after the project agreement expires, there is a possibility that the service may be provided at a lower cost than if the concessionaire had to cover all its costs in the life of the project. Moreover, certain assets may require such extensive refurbishing or technological upgrading at the end of the project period that it might not be cost-effective for the contracting authority to claim them. There may also be residual liabilities or consequential costs, for instance, because of liability for environmental damage or demolition costs.

25. For these reasons, the laws of some countries do not contemplate an unqualified transfer of all assets to the contracting authority, but allow a distinction between three main categories of assets:

(a) Assets that must be transferred to the contracting authority. This category typically includes public property that was used by the concessionaire to provide the service concerned. Assets may include both facilities made available to the concessionaire by the contracting authority and new facilities built by the concessionaire pursuant to the project agreement. Some laws also require the transfer of assets, goods and property subsequently acquired by the concessionaire for the purpose of operating the facility, in particular where they become part of, or are permanently affixed to, the infrastructure facility to be handed over to the contracting authority;

(b) Assets that may be purchased by the contracting authority, at its option. This category usually includes assets originally owned by the concessionaire, or subsequently acquired by it, which, without being indispensable or strictly necessary for the provision of the service, may enhance the convenience or efficiency of operating the facility or the quality of the service;

(c) Assets that remain the private property of the concessionaire. These are assets owned by the concessionaire that do not fall under (b) above. Typically the contracting authority is not entitled to such assets, which may be freely removed or disposed of by the concessionaire.

26. In the light of the above, it is useful to require in the law that the project agreement specify, as appropriate, which assets will be public property and which will be the private property of the concessionaire. The project agreement should identify which assets the concessionaire is required to transfer to the contracting authority or to a new concessionaire upon expiry or termination of the project agreement; which assets the contracting authority, at its option, may purchase from the concessionaire; and which assets the concessionaire may freely remove or dispose of upon expiry or termination of the project agreement. These provisions should be complemented by contractual criteria for establishing, as appropriate, the compensation to which the concessionaire may be entitled in respect of assets transferred to the contracting authority or to a new concessionaire or purchased by the contracting authority upon expiry or termination of the project agreement (see chap. V, "Duration, extension and termination of the project agreement", paras. 37-40).

2. *Acquisition of land required for execution of the project*

27. Where a new infrastructure facility is to be built on public land (that is, land owned by the contracting authority or another public authority) or an existing infrastructure facility is to be modernized or rehabilitated, it will normally be for the owner of such land or facility to make it available to the concessionaire. The situation is more complex when the land is not already owned by the contracting authority and needs to be purchased from its owners. In most cases, the concessionaire would not be in the best position to assume responsibility for purchasing the land needed for the project, in view of the

potential delay and expense involved in negotiations with a possibly large number of individual owners, nor, as may be necessary in some jurisdictions, to undertake complex searches of title deeds and review of chains of previous property transfers so as to establish the regularity of the title of individual owners. It is therefore typical for the contracting authority to assume responsibility for providing the land required for the implementation of the project, so as to avoid unnecessary delay or increase in project cost as a result of the acquisition of land. The contracting authority may purchase the required land from its owners or, if necessary, acquire it compulsorily.

28. The procedure whereby private property is compulsorily acquired by the Government against the payment of appropriate compensation to the owners, which is referred to in domestic legal systems by various technical expressions, such as "expropriation", is referred to in the present *Guide* as "compulsory acquisition". In countries where the law contemplates more than one type of procedure for compulsory acquisition, it may be desirable to authorize the competent public authorities to carry out all acquisitions required for privately financed infrastructure projects pursuant to the most efficient of those procedures, such as the special procedures that in some countries apply for reasons of compelling public need (see chap. VII, "Other relevant areas of law", paras. 22 and 23).

29. The power to acquire property compulsorily is usually vested in the Government, but the laws of a number of countries also authorize infrastructure operators or public service providers (such as railway companies, electricity authorities or telephone companies) to perform certain actions for the compulsory acquisition of private property required for providing or expanding their services to the public. In those countries in particular where the award of compensation to the owners of the property compulsorily acquired is adjudicated in court proceedings, it has been found useful to delegate to the concessionaire the authority to carry out certain acts relating to the compulsory acquisition, while the Government remains responsible for accomplishing those acts which, under the relevant legislation, are preconditions to the initiation of the acquisition proceedings. Upon acquisition, the land often becomes public property, although in some cases the law may authorize the contracting authority and the concessionaire to agree on a different arrangement, taking into account their respective shares in the cost of acquiring the property.

3. Easements

30. Special arrangements may be required, in cases where the concessionaire needs to transit on or through the property of third parties to access the project site or to perform or maintain any works required for the provision of the service (for example, to place traffic signs on adjacent lands; to install poles or electric transmission lines above third parties' property; to install and maintain transforming and switching equipment; to trim trees that interfere with telephone lines placed on abutting property; or to lay oil, gas or water pipes).

31. The right to use another person's property for a specific purpose or to do work on it is often referred to by the word "easement". Easements usually require the consent of the owner of the property to which they pertain, unless such rights are provided by the law. Usually it is not an expeditious or cost-effective solution to leave it to the concessionaire to acquire easements directly from the owners of the properties concerned. Instead it is more frequent for those easements to be compulsorily acquired by the contracting authority simultaneously with the project site.

32. A somewhat different alternative might be for the law itself to empower public service providers to enter, pass through or do work or affix installations upon the property of third parties, as required for the construction, operation and maintenance of public infrastructure. Such an approach, which may obviate the need to acquire easements in respect of individual properties, may be used in sector-specific legislation where it is deemed possible to determine, in advance, certain minimum easements that may be needed by the concessionaire. For instance, a law specific to the power generation sector may lay down the conditions under which the concessionaire obtains a right of cabling for the purpose of placing and operating basic and distribution networks on property belonging to third parties. Such a right may be needed for a number of measures, such as establishing or placing underground and overhead cables, as well as establishing supporting structures and transforming and switching equipment; maintaining, repairing and removing any of those installations; establishing a safety zone along underground or overhead cables; or removing obstacles along the wires or encroaching on the safety zone. Under some legal systems, the owners may be entitled to compensation should the extent of the rights granted to the concessionaire be such that the use of the properties by their owners is substantially hindered.

D. Financial arrangements

33. Financial arrangements typically include provisions concerning the concessionaire's obligations to raise funds for the project, outline the mechanisms for disbursing and accounting for funds, establish methods for calculating and adjusting the tariffs charged by the concessionaire and deal with the types of security interests that may be established in favour of the concessionaire's creditors. It is important to ensure that the laws of the host country facilitate or at least do not pose obstacles to the financial management of the project.

1. Financial obligations of the concessionaire

34. In privately financed infrastructure projects the concessionaire is typically responsible for raising the funds required to construct and operate the infrastructure facility. The concessionaire's obligations in this regard are typically set forth in detailed provisions in the project agreement. In most cases, the contracting authority or other public authorities would be interested in limiting their financial obligations to those specifically expressed in the project agreement or those forms of direct support that the Government has agreed to extend to the project.

35. The amount of private capital contributed directly by the project company's shareholders typically represents only a portion of the total proposed investment. A far greater portion derives from loans extended to the concessionaire by commercial banks and international financial institutions and from the proceeds of the placement of bonds and other negotiable instruments on the capital market (see "Introduction and background information on privately financed infrastructure projects", paras. 54-67). It is therefore important to ensure that the law does not unnecessarily restrict the concessionaire's ability to enter into the financial arrangements it sees fit for the purpose of financing the infrastructure.

2. *Tariff setting and tariff control*

36. Tariffs or usage fees charged by the concessionaire may be the main (sometimes even the sole) source of revenue to recover the investment made in the project in the absence of subsidies or payments by the contracting authority (see paras. 47-51) or the Government (see chap. II, "Project risks and government support," paras. 30-60). The concessionaire will therefore seek to be able to set and maintain tariffs and fees at a level that ensures sufficient cash flow for the project. However, in some legal systems there may be limits to the concessionaire's freedom to establish tariffs and fees. The cost at which public services are provided is typically an element of the Governments's infrastructure policy and a matter of immediate concern for large sections of the public. Thus, the regulatory framework in many countries includes special rules to control tariffs and fees for the provision of public services. Furthermore, statutory provisions or general rules of law in some legal systems establish parameters for pricing goods or services, for instance by requiring that tariffs meet certain standards of "reasonableness", "fairness" or "equity".

(a) The concessionaire's authority to collect tariffs

37. In a number of countries prior legislative authorization may be necessary in order for a concessionaire to collect tariffs for the provision of public services or to demand a fee for the use of public infrastructure facilities. The absence of such a general provision in legislation has in some countries given rise to judicial disputes challenging the concessionaire's authority to charge a tariff for the service.

38. Where it is deemed necessary to include in general legislation provisions concerning the level of tariffs and user fees, they should seek to achieve a balance between the interests of investors and current and future users. It is advisable that statutory criteria for determining tariffs and fees take into account, in addition to social factors the Government regards as relevant, the concessionaire's interest in achieving a level of cash flow that ensures the economic viability and commercial profitability of the project. Furthermore, it is advisable to provide the parties with the necessary authority to negotiate appropriate arrangements, including compensation provisions, in order to address situations where the application of tariff control rules directly or indirectly related to the provision of public services may result in fixing tariffs or fees below the level required for the profitable operation of the project (see para. 124).

(b) Tariff control methods

39. Domestic laws often subject tariffs or user fees to some control mechanism. Many countries have chosen to set only the broad tariff principles in legislation while leaving their actual implementation to the regulatory agency concerned and to the terms and conditions of licences or concessions. This approach is advisable because formulas are sector-specific and may require adaptation during the life of a project. Where tariff control measures are used, the law typically requires that the tariff formula be advertised with the request for proposals and be incorporated into the project agreement. Tariff control systems typically consist of formulas for the adjustment of tariffs and monitoring provisions to ensure compliance with the parameters for tariff adjustment. The most common tariff control methods used in domestic laws are based on rate-of-return and price-cap principles. There are also hybrid regimes that have elements of both. It should be noted that a well-functioning tariff control mechanism requires detailed commercial and economic analysis and that the brief discussion that follows offers only an overview of selected issues and possible solutions.

(i) Rate-of-return method

40. Under the rate-of-return method, the tariff adjustment mechanism is devised so as to allow the concessionaire an agreed rate of return on its investment. The tariffs for any given period are established on the basis of the concessionaire's overall revenue requirement to operate the facility, which involves determining its expenses, the investments undertaken to provide the services and the allowed rate of return. Reviews of the tariffs are undertaken periodically, sometimes whenever the contracting authority or other interested parties consider that the actual revenue is higher or lower than the revenue requirement of the facility. For that purpose, the contracting authority verifies the expenses of the facility, determines to what extent investments undertaken by the concessionaire are eligible for inclusion in the rate base and calculates the revenues that need to be generated to cover the allowable expenses and the return on investment agreed upon. The rate-of-return method is typically used in connection with the supply of public services for which a constant demand can be forecast, such as power, gas or water supply. For facilities or services exposed to greater elasticity of demand, such as tollroads, it might not be possible to keep the concessionaire's rate of return constant by regular tariff adjustments.

41. The rate-of-return method has been found to provide a high degree of security for infrastructure operators, since the concessionaire is assured that the tariffs charged will be sufficient to cover its operating expenses and allow the agreed rate of return. Because tariffs are adjusted regularly, thus keeping the concessionaire's rate of return essentially constant, investment in companies providing public services is exposed to little market risk. The result is typically lower costs of capital. The possible disadvantage of the rate-of-return method is that it provides little incentive for infrastructure operators to minimize their costs because of the assurance that those costs will be recovered through tariff adjustments. However, some level of incentive may exist if the tariffs are not adjusted instantaneously or if the adjustment does not apply retroactively. It should be noted that the implementation of the rate-of-return method requires

a substantial amount of information, as well as extensive negotiations (for example, on eligible expenditures and cost allocation).

(ii) Price-cap method

42. Under the price-cap method, a tariff formula is set for a given period (such as four or five years) taking into account future inflation and future efficiency gains expected from the facility. Tariffs are allowed to fluctuate within the limits set by the formula. In some countries, the formula is a weighted average of various indices, in others it is a consumer price index minus a productivity factor. Where substantial new investments are required, the formula may include an additional component to cover these extra costs. The formula can apply to all services of the company or to selected groups of services only, and different formulas may be used for different groups. The periodic readjustment of the formula is, however, based on the rate-of-return type of calculations, requiring the same type of detailed information as indicated above, though on a less frequent basis.

43. The implementation of the price-cap method may be less complex than the rate-of-return method. The price-cap method has been found to provide greater incentives for public service providers, since the concessionaire retains the benefits of lower than expected costs until the next adjustment period. At the same time, however, public service providers are typically exposed to more risk under the price-cap method than under the rate-of-return method. In particular, the concessionaire faces the risk of loss when the costs turn out to be higher than expected, since the concessionaire cannot raise the tariffs until the next tariff adjustment. The greater risk exposure increases the costs of capital. If the project company's returns are not allowed to rise, there may be difficulties in attracting new investment. Also, the company may be tempted to lower the quality of the service in order to reduce costs.

(iii) Hybrid methods

44. Many tariff adjustment methods currently being used combine elements of both the rate-of-return and the price-cap methods with a view to both reducing the risk borne by the service providers and providing sufficient incentives for efficiency in the operation of the infrastructure. One such hybrid method employs sliding scales for adjusting the tariffs that ensure upward adjustment when the rate of return falls below a certain threshold and downward adjustment when the rate of return exceeds a certain maximum, with no adjustment for rates of return falling between those levels. Other possible approaches to balancing the rate-of-return and price-cap methods include a review by the contracting authority of the investments made by the concessionaire to ensure that they meet the criteria of usefulness in order to be taken into account when calculating the concessionaire's revenue requirement. Another tariff adjustment technique that may be used to set tariffs, or more generally to monitor tariff levels, is benchmark or yardstick pricing. By comparing the various cost components of one public service provider with those of another and with international norms, the contracting authority may be able to judge whether tariff adjustments requested by the public service provider are reasonable.

(c) Policy considerations on tariff control

45. Each of the main tariff adjustment methods discussed above has its own advantages and disadvantages and varying impact on private sector investment decisions (see paras. 41 and 43). This should be taken into account by the legislature when considering the appropriateness of tariff control methods to domestic circumstances. Different methods may also be used for different infrastructure sectors. Some laws indeed authorize the contracting authority to apply either a price-cap or rate-of-return method in the selection of concessionaires, according to the scope and nature of investments and services. In choosing a tariff control method, it is important to take into account the impact of the various policy options on private sector investment decisions. Whatever mechanism is chosen, the capacity of the contracting authority or the regulatory agency to monitor adequately the performance of the concessionaire and to implement the adjustment method satisfactorily should be carefully considered (see also chap. I, "General legislative and institutional framework", paras. 30-53).

46. It is important to bear in mind that tariff adjustment formulas cannot be set once and for all, as technology, exchange rates, wage levels, productivity and other factors are bound to change significantly, sometimes even unpredictably, over the concession period. Furthermore, tariff adjustment formulas are typically drawn up assuming a certain level of output or demand and may lead to unsatisfactory results if the volume of output or demand changes considerably. Therefore, many countries have established mechanisms for revision of tariff formulas, including periodic revisions (every four or five years, say) of the formula or ad hoc revisions whenever it is demonstrated that the formula has failed to ensure adequate compensation to the concessionaire (see also paras. 59-68). The tariff regime will also require adequate stability and predictability to enable public service providers and users to plan accordingly and to allow financing based on a predictable revenue. Investors and lenders may be particularly concerned about regulatory changes affecting the tariff adjustment method. Thus, they typically require the tariff adjustment formula to be incorporated into the project agreement.

3. Financial obligations of the contracting authority

47. Where the concessionaire offers services directly to the general public, the contracting authority or other public authority may undertake to make direct payments to the concessionaire as a substitute for, or in addition to, service charges to be paid by the users. Where the concessionaire produces a commodity for further transmission or distribution by another service provider, the contracting authority may undertake to purchase that commodity wholesale at an agreed price and on agreed conditions. The main examples of such arrangements are discussed briefly below.

(a) Direct payments

48. Direct payments by the contracting authority have been used in some countries as a substitute for, or as a supplement to, payments by the end users,

in particular in tollroad projects, through a mechanism known as "shadow tolling". Shadow tolls are arrangements whereby the concessionaire assumes the obligation to develop, build, finance and operate a road or another transportation facility for a set number of years in exchange for periodic payments in place of, or in addition to, real or explicit tolls paid by users. Shadow toll schemes may be used to address risks that are specific to transportation projects, in particular the risk of lower-than-expected traffic levels (see chap. II, "Project risks and government support", para. 18). Furthermore, shadow toll schemes may be politically more acceptable than direct tolls, for example, where it is feared that the introduction of toll payments on public roads may give rise to protests by road users. However, where such arrangements involve some form of subsidy to the project company, their conformity with certain obligations of the host country under international agreements on regional economic integration or trade liberalization should be carefully considered.

49. Shadow tolls may involve a substantial expenditure for the contracting authority and require close and extensive monitoring by it. In countries that have used shadow tolls for the development of new road projects, payments by the contracting authority to the concessionaire are based primarily on actual traffic levels, as measured in vehicle-miles. It is considered advisable to provide that payments are not made until traffic begins, so that the concessionaire has an incentive to open the road as quickly as possible. At the same time, it has been found useful to calculate payments on the basis of actual traffic for the duration of the concession. This system gives the concessionaire a reason to ensure that usage of the road will be disrupted as little as possible by repair works. Alternatively, the project agreement could contain a penalty or liquidated damages clause for lack of lane availability resulting from repair works. The concessionaire is typically required to perform continuous traffic counts to calculate annual vehicle-miles, which are verified periodically by the contracting authority. A somewhat modified system may combine both shadow tolls and direct tolls paid by the users. In such a system, shadow tolls are only paid by the contracting authority in the event that the traffic level over a certain period falls below the agreed minimum level necessary for the concessionaire to operate the road profitably.

(b) Purchase commitments

50. In the case of independent power plants or other facilities that generate goods or services capable of being delivered on a long-term basis to an identified purchaser, the contracting authority or other public authority often assume an obligation to purchase such goods and services, at an agreed rate, as they are offered by the concessionaire. Contracts of this type are usually referred to as "off-take agreements". Off-take agreements often include two types of payments: payments for the availability of the production capacity and payments for units of actual consumption. In a power generation project, for example, the power purchase agreement may contemplate the following charges:

(a) *Capacity charges.* These are charges payable regardless of actual output in a billing period and are calculated to be sufficient to pay all of the

concessionaire's fixed costs incurred to finance and maintain the project, including debt service and other ongoing financing expenses, fixed operation and maintenance expenses and a certain rate of return. The payment of capacity charges is often subject to the observance of certain performance or availability standards;

(b) *Consumption charges.* These charges are not intended to cover all of the concessionaire's fixed costs, but rather to pay the variable or marginal costs that the concessionaire has to bear to generate and deliver a given unit of the relevant service or good (such as a kilowatt-hour of electricity). Consumption charges are usually calculated to cover the concessionaire's variable operating costs, such as that of fuel consumed when the facility is operating, water treatment expenses and costs of consumables. Variable payments are often tied to the concessionaire's own variable operating costs or to an index that reasonably reflects changes in operating costs.

51. From the perspective of the concessionaire, a combined scheme of capacity and consumption charges is particularly useful to ensure cost recovery where the transmission or distribution function for the goods or services generated by the concessionaire is subject to a monopoly. However, the capacity charges provided in the off-take agreement should be commensurate with the other sources of generating capacity available to, or actually used by, the contracting authority. In order to ensure the availability of funds for payments by the contracting authority under the off-take agreement, it is advisable to consider whether advance budgeting arrangements are required. Payments under an off-take agreement may be backed by a guarantee issued by the host Government or by a national or international guarantee agency (see chap. II, "Project risks and government support", paras. 46 and 47).

E. Security interests

52. Generally, security interests in personal property provide the secured creditor with essentially two kinds of rights: a property right allowing the secured creditor, in principle, to repossess the property or have a third party repossess and sell it, and a priority right to receive payment with the proceeds from the sale of the property in the event of default by the debtor. Security arrangements in project finance generally play a defensive or preventive role by ensuring that, in the event a third party acquires the debtor's operations (for example, by foreclosure, in bankruptcy or directly from the debtor) all of the proceeds resulting from the sale of those assets will go first to repayment of outstanding loans. Nevertheless, lenders would generally aim at obtaining security interests that allow them to foreclose and take possession of a project they can take over and operate either to restore its economical viability with a view to reselling at an appropriate time or to retaining the project indefinitely and collecting an ongoing revenue.

53. Security arrangements are crucial for financing infrastructure projects, in particular where the financing is structured under the "project finance" modality. The financing documents for privately financed infrastructure projects typi-

cally include both security over physical assets related to the project and security over intangible assets held by the concessionaire. A few of the main requirements for the successful closure of the security arrangements are discussed below. It should be noted, however, that, in some legal systems, any security given to lenders that makes it possible for them to take over the project is only allowed under exceptional circumstances and under certain specific conditions, namely, that the creation of such security requires the agreement of the contracting authority; that the security should be granted for the specific purpose of facilitating the financing or operation of the project; and that the security interests should not affect the obligations undertaken by the concessionaire. Those conditions often derive from general principles of law or from statutory provisions and cannot be waived by the contracting authority through contractual arrangements.

1. Security interests in physical assets

54. The negotiation of security arrangements required in order to obtain financing for the project may face legal obstacles where project assets are public property. If the concessionaire lacks title to the property it will in many legal systems have no (or only limited) power to encumber such property. Where limitations of this type exist, the law may still facilitate the negotiation of security arrangements for instance by indicating the types of asset in respect of which such security interests may be created or the type of security interest that is permissible. In some legal systems, a concessionaire that is granted a leasehold interest or right to use certain property may create a security interest over the leasehold interest or right to use.

55. Furthermore, security interests may also be created where the concession encompasses different types of public property, such as when title to adjacent land (and not only the right to use it) is granted to a railway company in addition to the right to use the public infrastructure. Where it is possible to create any form of security interests in respect of assets owned by, or required to be handed over to, the contracting authority or assets in relation to which the contracting authority has a contractual option of purchase (see para. 28), the law may require the approval of the contracting authority in order for the concessionaire to create such security interests.

2. Security interests in intangible assets

56. The main intangible asset in an infrastructure project is the concession itself, that is the concessionaire's right to operate the infrastructure or to provide the relevant service. In most legal systems, the concession provides its holder with the authority to control the entire project and entitles the concessionaire to earn the revenue generated by the project. Thus, the value of the concession well exceeds the combined value of all of the physical assets involved in a project. Because the concession holder would usually have the right to possess and dispose of all project assets (with the possible exception of those which are owned by other parties, such as public property in the possession of the conces-

sionaire), the concession would typically encompass both present and future assets of a tangible or intangible nature. The lenders may therefore regard the concession as an essential component of the security arrangements negotiated with the concessionaire. A pledge of the concession itself may have various practical advantages for the concessionaire and the lenders, in particular in legal systems that would not otherwise allow the creation of security over all of a company's assets or which do not generally recognize non-possessory security interests (see chap. VII, "Other relevant areas of law", paras. 10-16). These advantages may include avoiding the need to create separate security interests for each project asset, allowing the concessionaire to continue to deal with those assets in the ordinary course of business and making it possible to pledge certain assets without transferring actual possession of the assets to the creditors. Furthermore, a pledge of the concession may entitle the lenders, in case of breach by the concessionaire, to avert termination of the project by taking over the concession and making arrangements for continuation of the project under another concessionaire. A pledge of the concession may, therefore, represent a useful complement to or, under certain circumstances, a substitute for a direct agreement between the lenders and the contracting authority concerning the lenders' step-in rights (see paras. 147-150).

57. However, in some legal systems there may be obstacles to a pledge of the concession in the absence of express legislative authorization. Under various legal systems, security interests may only be created in respect of assets that can be freely transferable by the grantor of the security. Since the right to operate the infrastructure is in most cases not transferable without the consent of the contracting authority (see paras. 62 and 63), in some legal systems it may not be possible for the concessionaire to create security interests over the concession itself. Recent legislation in some civil law jurisdictions has removed that obstacle by creating a special category of security interest, sometimes referred to by expressions such as "*hipoteca de concesión de obra pública*" or "*prenda de concesión de obra pública*" ("public works concession mortgage" or "pledge of public works concession"), which generally provides the lenders with an enforceable security interest covering all of the rights granted to the concessionaire under the project agreement. However, in order to protect the public interest, the law requires the consent of the contracting authority for any measure by the lenders to enforce such a right, under conditions to be provided in an agreement between the contracting authority and the lenders. A somewhat more limited solution has been achieved in some common law jurisdictions in which a distinction has been made between the non-transferable right to carry out a certain activity under a governmental licence (that is, the "public rights" arising under the licence) and the right to claim proceeds received by the licensee (the latter's "private rights" under the licence).

3. *Security interests in trade receivables*

58. Another form of security typically given in connection with most privately financed infrastructure projects is an assignment to lenders of proceeds from contracts with customers of the concessionaire. Those proceeds may consist of the proceeds of a single contract (such as a power purchase commitment by a

power distribution entity) or of a large number of individual transactions (such as monthly payment of gas or water bills). Those proceeds typically include the tariffs charged to the public for the use of the infrastructure (for example, tolls on a tollroad) or the price paid by the customers for the goods or services provided by the concessionaire (electricity charges, for example). They may also include the revenue of ancillary concessions. Security of this type is a typical element of the financing arrangements negotiated with the lenders and the loan agreements often require that the proceeds of infrastructure projects be deposited in an escrow account managed by a trustee appointed by the lenders. Such a mechanism may also play an essential role in the issuance of bonds and other negotiable instruments by the concessionaire.

59. Security over trade receivables plays a central role in financing arrangements that involve the placement of bonds and other negotiable instruments. Those instruments may be issued by the concessionaire itself, in which case the investors purchasing the security will become its creditors, or they may be issued by a third party to whom the project receivables have been assigned through a mechanism known as "securitization". Securitization involves the creation of financial securities backed by the project's revenue stream, which is pledged to pay the principal and interest of that security. Securitization transactions usually involve the establishment of a legal entity separate from the concessionaire and especially dedicated to the business of securitizing assets or receivables. This legal entity is often referred to as a "special-purpose vehicle". The concessionaire assigns project receivables to the special-purpose vehicle, which, in turn, issues to investors interest-bearing instruments that are backed by the project receivables. The securitized bondholders thereby acquire the right to the proceeds of the concessionaire's transactions with its customers. The concessionaire collects the tariffs from the customers and transfers the funds to the special-purpose vehicle, which then transfers it to the securitized bondholders. In some countries, recent legislation has expressly recognized the concessionaire's authority to assign project receivables to a special-purpose vehicle, which holds and manages the receivables for the benefit of the project's creditors. With a view to protecting the bondholders against the risk of insolvency of the concessionaire, it may be advisable to adopt the necessary legislative measures to enable the legal separation between the concessionaire and the special-purpose vehicle.

60. In most cases it would not be practical for the concessionaire to specify individually the receivables being assigned to the creditors. Assignment of receivables in project finance therefore typically takes the form of a bulk assignment of future receivables. Statutory provisions recognizing the concessionaire's authority to pledge the proceeds of infrastructure projects have been included in recent domestic legislation in various legal systems. However, there may be considerable uncertainty in various legal systems with regard to the validity of the wholesale assignment of receivables and of future receivables. It is therefore important to ensure that domestic laws on security interests do not hinder the ability of the parties effectively to assign trade receivables in order to obtain financing for the project (see chap. VII, "Other relevant areas of law", paras. 10-16).

4. *Security interests in the project company*

61. Where the concession may not be assigned or transferred without the consent of the contracting authority (see paras. 62 and 63), the law sometimes prohibits the establishment of security over the shares of the project company. It should be noted, however, that security over the shares of the project company is commonly required by lenders in project finance transactions and that general prohibitions on the establishment of such security may limit the project company's ability to raise funding for the project. As with other forms of security, it may therefore be useful for the law to authorize the concessionaire's shareholders to create such security, subject to the contracting authority's prior approval, where an approval would be required for the transfer of equity participation in the project company (see paras. 64-68).

F. Assignment of the concession

62. Concessions are granted in view of the particular qualifications and reliability of the concessionaire and in most legal systems they are not freely transferable. Indeed, domestic laws often prohibit the assignment of the concession without the consent of the contracting authority. The purpose of these restrictions is typically to ensure the contracting authority's control over the qualifications of infrastructure operators or public service providers.

63. Some countries have found it useful to mention in the legislation the conditions under which approval for the transfer of a concession prior to its expiry may be granted, such as, for example, acceptance by the new concessionaire of all obligations under the project agreement and evidence of the new concessionaire's technical and financial capability to provide the service. General legislative provisions of this type may be supplemented by specific provisions in the project agreement setting forth the scope of those restrictions, as well as the conditions under which the consent of the contracting authority may be granted. However, it should be noted that restrictions typically apply to the voluntary transfer of its rights by the concessionaire; they do not preclude the compulsory transfer of the concession to an entity appointed by the lenders, with the consent of the contracting authority, for the purpose of averting termination due to serious breach by the concessionaire (see also paras. 147-150).

G. Transfer of controlling interest in the project company

64. The contracting authority may be concerned that the original members of the bidding consortium maintain their commitment to the project throughout its duration and that effective control over the project company will not be transferred to entities unknown to the contracting authority. Concessionaires are selected to carry out infrastructure projects at least partly on the basis of their experience and capabilities for that sort of project (see chap. III, "Selection of the concessionaire", paras. 38-40). Contracting authorities are therefore concerned that, if the concessionaire's shareholders are entirely free to transfer

their investment in a given project, there will be no assurance as to who will actually be delivering the relevant services.

65. Contracting authorities may draw reassurance from the experience that the selected bidding consortium demonstrated in the pre-selection phase and from the performance guarantees provided by the parent organizations of the original consortium and its subcontractors. In practice, however, the reassurance that may result from the apparent expertise of the shareholders in the concessionaire should not be overemphasized. Where a separate legal entity is established to carry out the project, which is often the case (see para. 12), the backing of the concessionaire's shareholders, should the project run into difficulties, may be limited to their maximum liability. Thus, restrictions on the transferability of investment, in and of themselves, may not represent sufficient protection against the risk of performance failure by the concessionaire. In particular, these restrictions are not a substitute for appropriate contractual remedies under the project agreement, such as monitoring of the level of service provided (see paras. 147-150) or termination without full compensation in case of unsatisfactory performance (see chap. V, "Duration, extension and termination of the project agreement", paras. 44 and 45).

66. In addition to the above, restrictions on the transferability of shares in companies providing public services may also present some disadvantages for the contracting authority. As noted earlier (see "Introduction and background information on privately financed infrastructure projects", paras. 54-67), there are numerous types of funding available from different investors for different risk and reward profiles. The initial investors, such as construction companies and equipment suppliers, will seek to be rewarded for the higher risks they take on, while subsequent investors may require a lesser return commensurate with the reduced risks they bear. Most of the initial investors have finite resources and need to recycle capital in order to be able to participate in new projects. Therefore, those investors might not be willing to tie up capital in long-term projects. At the end of the construction period, the initial investors might prefer to sell their interest on to a secondary equity provider whose required rate of return is less. Once usage is more certain, another refinancing could take place. However, if the investors' ability to invest and re-invest capital for project development is restricted by constraints on the transferability of shares in infrastructure projects, there is a risk of a higher cost of funding. In some circumstances it may not be possible to fund a project at all, as some investors whose involvement may be crucial for the implementation of the project may not be willing to participate. From a long-term perspective, the development of a market place for investment in public infrastructure may be hindered if investors are unnecessarily constrained in the freedom to transfer their interest in privately financed infrastructure projects.

67. For the above reasons, it may be advisable to limit the restrictions on the transfer of a controlling interest in the project company to a certain period of time (for example, a certain number of years after the entry into force of the project agreement) or to situations where such restrictions are justified by reasons of public interest. One such situation may be where the concessionaire

is in possession of public property or where the concessionaire receives loans, subsidies, equity or other forms of direct governmental support. In these cases, the contracting authority's accountability for the proper use of public funds requires assurances that the funds and assets are entrusted to a solid company, to which the original investors remain committed during a reasonable period. Another situation that may justify imposing limitations on the transfer of shares of concessionaire companies may be where the contracting authority has an interest in preventing transfer of shares to particular investors. For example, the contracting authority may wish to control acquisition of controlling shares of public service providers to avoid the formation of oligopolies or monopolies in liberalized sectors. Or it may not be thought appropriate for a company that had defrauded one part of Government to be employed by another through a newly acquired subsidiary.

68. In these exceptional cases it may be advisable to require that the initial investors seek the prior consent of the contracting authority before transferring their equity participation. It should be made clear in the project agreement that any such consent should not be unreasonably withheld or unduly delayed. For transparency purposes, it may also be advisable to establish the grounds for withholding approval and to require the contracting authority to specify in each instance the reasons for any refusal. The appropriate duration of such limitations—whether for a particular phase of the project or for the entire concession term—may need to be considered on a case-by-case basis. In some projects, it may be possible to relax such restrictions after the facility has been completed. It is also advisable to clarify in the project agreement whether these limitations, if any, should apply to the transfer of any participation in the concessionaire, or whether the concerns of the contracting authority will focus on one particular investor (such as a construction company or the facility designer) while the construction phase lasts or for a significant time beyond.

H. Construction works

69. Contracting authorities purchasing construction works typically act as the employer under a construction contract and retain extensive monitoring and inspection rights, including the right to review the construction project and request modifications to it, to follow closely the construction work and schedule, to inspect and formally accept the completed work and to give final authorization for the operation of the facility.

70. On the other hand, in many privately financed infrastructure projects, the contracting authority may prefer to transfer such responsibility to the concessionaire. Instead of assuming direct responsibility for managing the details of the project, the contracting authorities may prefer to transfer that responsibility to the concessionaire by requiring the latter to assume full responsibility for the timely completion of the construction. The concessionaire, too, will be interested in ensuring that the project is completed on time and that the cost estimate is not exceeded, and will typically negotiate fixed-price, fixed-time turnkey contracts that include guarantees of performance by the construction

contractors. Therefore, in privately financed infrastructure projects it is the concessionaire that for most purposes performs the role that the employer would normally play under a construction contract.

71. For these reasons, legislative provisions on the construction of privately financed infrastructure facilities are in some countries limited to a general definition of the concessionaire's obligation to perform the public works in accordance with the provisions of the project agreement and give the contracting authority the general right to monitor the progress of the work with a view to ensuring that it conforms to the provisions of the agreement. In those countries, more detailed provisions are then left to the project agreement.

1. Review and approval of construction plans

72. Where it is felt necessary to deal with construction works and related matters in legislation, it is advisable to devise procedures that help to keep completion time and construction costs within estimates and lower the potential for disputes between the concessionaire and the public authorities involved. For instance, where statutory provisions require that the contracting authority review and approve the construction project, the project agreement should establish a deadline for the review of the construction project and provide that the approval shall be deemed to be granted if no objections are made by the contracting authority within the relevant period. It may also be useful to set out in the project agreement the grounds on which the contracting authority may raise objections to or request modifications in the project, such as safety, defence, security, environmental concerns or non-conformity with the specifications.

2. Variation in the project terms

73. During the course of construction of an infrastructure facility, it is common for situations to arise that make it necessary or advisable to alter certain aspects of the construction. The contracting authority may therefore wish to retain the right to order changes in respect of such aspects as the scope of construction, the technical characteristics of equipment or materials to be used in the work or the construction services required under the specifications. Such changes are referred to in this *Guide* as "variations". As used in the *Guide,* the word "variation" does not include tariff adjustments or revisions made as a result of cost changes or currency fluctuations (see paras. 39-44). Likewise, renegotiation of the project agreement in cases of substantial change in conditions (see paras. 126-130) is not regarded in the *Guide* as a variation.

74. Given the complexity of most infrastructure projects, it is not possible to exclude the need for variations in the construction specifications or other requirements of the project. However, such variations often cause delay in the execution of the project or in the delivery of the public service; they may also render the performance under the project agreement more onerous for the concessionaire. Furthermore, the cost of implementing extensive variation orders may exceed the concessionaire's own financial means, thus requiring

substantial additional funding that may not be obtainable at an acceptable cost. It is therefore advisable for the contracting authority to consider measures to control the possible need for variations. The quality of the feasibility studies required by the contracting authority and of the specifications provided during the selection process (see chap. III, "Selection of the concessionaire", paras. 61 and 64-66) play an important role in avoiding subsequent changes in the project.

75. The project agreement should set forth the specific circumstances under which the contracting authority may order variations in respect of construction specifications and the compensation that may be due to the concessionaire, as appropriate, to cover the additional cost and delay entailed by implementing the variations. The project agreement should also clarify the extent to which the concessionaire is obliged to implement those variations and whether the concessionaire may object to variations and, if so, on which grounds. According to the contractual practice of some legal systems, the concessionaire may be released of its obligations when the amount of additional costs entailed by the modification exceeds a set maximum limit.

76. Various contractual approaches for dealing with variations have been used in large construction contracts to deal with the extent of the contractor's obligation to implement changes and the required adjustments in the contract price or contract duration. Such solutions may also be used, *mutatis mutandis,* to deal with variations sought by the contracting authority under the project agreement.[1] It should be noted, however, that in infrastructure concessions the project company's payment consists of user fees or prices for the output of the facility, rather than a global price for the construction work. Thus, compensation methods used in connection with infrastructure concessions sometimes include a combination of various methods, ranging from lump-sum payments to tariff increases, or extensions of the concession period. For instance, there may be changes that result in an increase in the cost that the concessionaire may be able to absorb and finance itself and amortize by means of an adjustment in the tariff or payment mechanism, as appropriate. If the concessionaire cannot refinance or fund the changes itself, the parties may wish to consider lump-sum payments as an alternative to an expensive and complicated refinancing structure.

3. *Monitoring powers of the contracting authority*

77. In some legal systems, public authorities purchasing construction works customarily retain the power to order the suspension or interruption of the works for reasons of public interest. However, with a view to providing some reassurance to potential investors, it may be useful to limit the possibility of such interference and to provide that no such interruption should be of a duration or extent greater than is necessary, taking into consideration circumstances that gave rise to the requirement to suspend or interrupt the work. It

[1] For a discussion of approaches and possible solutions used in construction contracts for complex industrial works, see the *UNCITRAL Legal Guide on Drawing Up Contracts for the Construction of Industrial Works* (United Nation publication, Sales No. E.87.V.10), chap. XXIII, "Variation clauses".

may also be useful to agree on a maximum period of suspension and to provide for appropriate compensation to the concessionaire. Furthermore, guarantees may be provided to ensure payment of compensation or to indemnify the concessionaire for loss resulting from suspension of the project (see also chap. II, "Project risks and government support", paras. 48-50).

78. In some legal systems, facilities built for use in connection with the provision of certain public services become public property once construction is finished (see para. 24). In such cases, the law often requires that the completed facility be formally accepted by the contracting authority or another public authority. Such formal acceptance is typically given only after inspection of the completed facility and satisfactory conclusion of the necessary tests to ascertain that the facility is operational and meets the specifications and technical and safety requirements. Even where formal acceptance by the contracting authority is not required (for example, where the facility remains the property of the concessionaire), provisions concerning final inspection and approval of the construction work by the contracting authority are often required in order to ensure compliance with health, safety, building or labour regulations. The project agreement should set out in detail the nature of the completion tests or the inspection of the completed facility; the timetable for the tests (for instance, it may be appropriate to undertake partial tests over a period, rather than a single test at the end); the consequences of failure to pass a test; and the responsibility for organizing the resources for the test and covering the corresponding costs. In some countries, it has been found useful to authorize the facility to operate on a provisional basis, pending final approval by the contracting authority, and to provide an opportunity for the concessionaire to rectify defects that might be found at that juncture.

4. Guarantee period

79. The construction contracts negotiated by the concessionaire will typically provide for a quality guarantee under which the contractors assume liability for defects in the works and for inaccuracies or insufficiencies in technical documents supplied with the works, except for reasonable exclusions (such as normal wear and tear or faulty maintenance or operation by the concessionaire). Additional liability may also derive from statutory provisions or general principles of law under the applicable law, such as a special extended liability period for structural defects in works, which is provided in some legal systems. The project agreement should provide that final approval or acceptance of the facility by the contracting authority will not release the construction contractors from any liability for defects in the works and for inaccuracies or insufficiencies in technical documents that may be provided under the construction contracts and the applicable law.

I. Operation of infrastructure

80. Conditions for the operation and maintenance of the facility, as well as for quality and safety standards, are often enumerated in the law and spelled out in detail in the project agreement. In addition, especially in the areas of elec-

tricity, water and sanitation and public transportation, the contracting authority or an independent regulatory agency may exercise an oversight function over the operation of the facility. An exhaustive discussion of legal issues relating to the conditions of operation of infrastructure facilities would exceed the scope of this *Guide*. The following paragraphs therefore contain only a brief presentation of some of the main issues.

81. Regulatory provisions on infrastructure operation and legal requirements for the provision of public services are intended to achieve various objectives of public relevance. Given the usually long duration of infrastructure projects, there is a possibility that such provisions and requirements may need to be changed during the life of the project agreement. It is important, however, to bear in mind the private sector's need for a stable and predictable regulatory framework. Changes in regulations or the frequent introduction of new and stricter rules may have a disruptive impact on the implementation of the project and compromise its financial viability. Therefore, while contractual arrangements may be agreed to by the parties to counter the adverse effects of subsequent regulatory changes (see paras. 122-125), regulatory agencies would be well advised to avoid excessive regulation or unreasonably frequent changes in existing rules.

1. Performance standards

82. Public service providers generally have to meet a set of technical and service standards. Such standards are in most cases too detailed to figure in legislation and may be included in implementing decrees, regulations or other instruments. Service standards are often spelled out in great detail in the project agreement. They include quality standards, such as requirements with respect to water purity and pressure; ceilings on the length of time to perform repairs; ceilings on the number of defects or complaints; timely performance of transport services; continuity in supply; and health, safety and environmental standards. Legislation may, however, impose the basic principles that will guide the establishment of detailed standards or require compliance with international standards.

83. The contracting authority typically retains the power to monitor the adherence of the project company to the regulatory performance standards. The concessionaire will be interested in avoiding as much as possible any interruption in the operation of the facility and in protecting itself against the consequences of any such interruption. It will seek assurances that the exercise by the contracting authority of its monitoring or regulatory powers does not cause undue disturbance or interruption in the operation of the facility and that it does not result in undue additional costs to the concessionaire.

2. Extension of services

84. In some legal systems, an entity operating under a governmental concession to provide certain essential services such as electricity or potable water to a community or territory and its inhabitants is held to assume an obligation to

provide a service system that is reasonably adequate to meet the demand of the community or territory. That obligation often relates not only to the historic demand at the time the concession was awarded, but implies an obligation to keep pace with the growth of the community or territory served and gradually to extend the system as may be required by the reasonable demand of the community or territory. In some legal systems, the obligation has the nature of a public duty that may be invoked by any resident of the relevant community or territory. In other legal systems, it has the nature of a statutory or contractual obligation that may be enforced by the contracting authority or by a regulatory agency, as the case may be.

85. In some legal systems, this obligation is not absolute and unqualified. The concessionaire's duty to extend its service facilities may indeed depend upon various factors, such as the need and cost of the extension and the revenue that may be expected as a result of the extension; the concessionaire's financial situation; the public interest in effecting such an extension; and the scope of the obligations assumed by the concessionaire in that regard under the project agreement. In some legal systems, the concessionaire may be under an obligation to extend its service facilities even if the particular extension is not immediately profitable or even if, as a result of the extensions being carried out, the concessionaire's territory might eventually include unprofitable areas. That obligation is nevertheless subject to some limits, since the concessionaire is not required to carry out extensions that place an unreasonable burden on it or its customers. Depending on the particular circumstances, the cost of carrying out extensions of service facilities may be absorbed by the concessionaire, passed on to the customers or end users in the form of tariff increases or extraordinary charges or absorbed in whole or in part by the contracting authority or other public authority by means of subsidies or grants. Given the variety of factors that may need to be taken into account in order to assess the reasonableness of any particular extension, the project agreement should define the circumstances under which the concessionaire may be required to carry out extensions in its service facilities and the appropriate methods for financing the cost of any such extension.

3. Continuity of service

86. Another obligation of public service providers is to ensure the continuous provision of the service under most circumstances, except for narrowly defined exempting events (see also paras. 132-134). In some legal systems, that obligation has the nature of a statutory duty that applies even if it is not expressly stated in the project agreement. The corollary of that rule, in legal systems where it exists, is that various circumstances that under general principles of contract law might authorize a contract party to suspend or discontinue the performance of its obligations, such as economic hardship or breach by the other party, cannot be invoked by the concessionaire as grounds for suspending or discontinuing, in whole or in part, the provision of a public service. In some legal systems, the contracting authority may even have special enforcement powers to compel the concessionaire to resume providing service in the event of unlawful discontinuance.

87. That obligation, too, is subject to a general rule of reasonableness. Various legal systems recognize the concessionaire's right to fair compensation for having to deliver the service under situations of hardship (see paras. 126-130). Moreover, in some legal systems, it is held that a public service provider may not be required to operate where its overall operation results in a loss. Where the public service as a whole, and not only one or more of its branches or territories, ceases being profitable, the concessionaire may have the right to direct compensation by the contracting authority or, alternatively, the right to terminate the project agreement. However, termination typically requires the consent of the contracting authority or a judicial decision. In legal systems that allow such a solution, it is advisable to clarify in the project agreement which extraordinary circumstances would justify the suspension of the service or even release the concessionaire from its obligations under the project agreement (see paras. 132-139; also chap. V, "Duration, extension and termination of the project agreement", para. 34).

4. *Equal treatment of customers or users*

88. Entities that provide certain services to the general public are, in some jurisdictions, under a specific obligation to ensure the availability of the service under essentially the same conditions to all users and customers falling within the same category. However, differentiation based on a reasonable and objective classification of customers and users is accepted in those legal systems as long as like contemporaneous service is rendered to consumers and users engaged in like operations under like circumstances. It may thus not be inconsistent with the principle of equal treatment to charge different prices or to offer different access conditions to different categories of users (for example, domestic consumers, on the one hand, and business or industrial consumers, on the other), provided that the differentiation is based on objective criteria and corresponds to actual differences in the situation of the consumers or the conditions under which the service is provided to them. Nevertheless, where a difference in charges or other conditions of service is based on actual differences in service (such as higher charges for services provided at hours of peak consumption), it typically has to be commensurate with the amount of difference.

89. In addition to differentiation established by the concessionaire itself, different treatment of certain users or customers may be the result of legislative action. In many countries, the law requires that specific services must be provided at particularly favourable terms to certain categories of users and customers, such as discounted transport for schoolchildren or senior citizens, or reduced water or electricity rates for lower-income or rural users. Public service providers may recoup these service burdens or costs in several ways, including through government subsidies, through funds or other official mechanisms created to share the financial burden of these obligations among all public service providers or through internal cross-subsidies from more profitable services (see chap. II, "Project risks and government support", paras. 42-44).

5. Interconnection and access to infrastructure networks

90. Companies operating infrastructure networks in sectors such as railway transport, telecommunications or power or gas supply are sometimes required to allow other companies to have access to the network. That requirement may be stated in the project agreement or in sector-specific laws or regulations. Interconnection and access requirements have been introduced in certain infrastructure sectors as a complement to reforms in the structure of a given sector; in others, they have been adopted to foster competition in sectors that remained fully or partially integrated (for a brief discussion of market structure issues, see "Introduction and background information", paras. 21-46).

91. Network operators are often required to provide access on terms that are fair and non-discriminatory from a financial as well as a technical point of view. Non-discrimination implies that the new entrant or service provider should be able to use the infrastructure of the network operator on conditions that are not less favourable than those granted by the network operator to its own services or to those of competing providers. It should be noted, however, that many pipeline access regimes, for example, do not require completely equal terms for the carrier and rival users. The access obligation may be qualified in some way. It may, for instance, be limited to spare capacity only or be subject to reasonable, rather than equal, terms and conditions.

92. While access pricing is usually cost-based, regulatory agencies often retain the right to monitor access tariffs to ensure that they are high enough to give adequate incentive to invest in the required infrastructure and low enough to allow new entrants to compete on fair terms. Where the network operator provides services in competition with other providers, there may be requirements that its activities be separated from an accounting point of view in order to determine the actual cost of the use by third parties of the network or parts of it.

93. Technical access conditions may be equally important and network operators may be required to adapt their network to satisfy the access requirements of new entrants. Access may be to the network as a whole or to monopolistic parts or segments of the network (sometimes also referred to as bottleneck or essential facilities). Many Governments allow service providers to build their own infrastructure or to use alternative infrastructure where available. In such cases, the service provider may only need access to a small part of the network and cannot, under many regulations, be forced to pay more than the cost corresponding to the use of the specific facility it needs, such as the local telecommunications loop, transmission capacity for the supply of electricity or the use of a track section of railway.

6. Disclosure requirements

94. Many domestic laws impose on public service providers an obligation to provide to the regulatory agency accurate and timely information on their

operations and to grant it specific enforcement rights. The latter may encompass inquiries and audits, including detailed performance and compliance audits, sanctions for non-cooperative companies and injunctions or penalty procedures to enforce disclosure.

95. Public service providers are normally required to maintain and disclose to the regulatory agency their financial accounts and statements and to maintain detailed cost accounting allowing the regulatory agency to track various aspects of the company's activities separately. Financial transactions between the concessionaire company and affiliated companies may also require scrutiny, as concessionaire companies may try to transfer profits to non-regulated businesses or foreign affiliates. Infrastructure operators may also have detailed technical and performance reporting requirements. As a general rule, however, it is important to define reasonable limits to the extent and type of information that infrastructure operators are required to submit. Furthermore, appropriate measures should be taken to protect the confidentiality of any proprietary information that the concessionaire and its affiliated companies may submit to the regulatory agency.

7. *Enforcement powers of the concessionaire*

96. In countries with a well-established tradition of awarding concessions for the provision of public services, the concessionaire may have the power to establish rules designed to facilitate the provision of the service (such as instructions to users or safety rules), take reasonable measures to ensure compliance with those rules and suspend the provision of service for emergency or safety reasons. For that purpose, general legislative authority, or even case-by-case authorization from the legislature, may be required in most legal systems. The extent of powers given to the concessionaire is usually defined in the project agreement, however, and may not need to be provided in detail in legislation. It may be advisable to provide that the rules issued by the concessionaire become effective upon approval by the regulatory agency or the contracting authority, as appropriate. However, the right to approve operating rules proposed by the concessionaire should not be arbitrary and the concessionaire should have the right to appeal a decision to refuse approval of the proposed rules (see also chap. I, "General legislative and institutional framework", paras. 49 and 50).

97. Of particular importance for the concessionaire is the question whether the provision of the service may be discontinued because of default or non-compliance by its users. Despite the concessionaire's general obligation to ensure the continuous provision of the service (see paras. 86 and 87), many legal systems recognize that entities providing public services may establish and enforce rules that provide for shutting off of the service for a consumer or user who has defaulted in payment for it or who has seriously infringed the conditions for using it. The power to do so is often regarded as crucial in order to prevent abuse and ensure the economic viability of the service. However, given the essential nature of certain public services, that power may require legisla-

tive authority in some legal systems. Furthermore, there may be a number of expressed or implied limitations upon or conditions for the exercise of that power, such as special notice requirements and specific consumer remedies. Additional limitations and conditions may derive from the application of general consumer protection rules (see chap. VII, "Other relevant areas of law", paras. 45 and 46).

J. General contractual arrangements

98. This section discusses selected contractual arrangements that typically appear in project agreements in various sectors and are often reflected in standard contract clauses used by domestic contracting authorities. Although essentially contractual in nature, the arrangements discussed in this section may have some important implications for the legislation of the host country, according to its particular legal system.

1. Subcontracting

99. Given the complexity of infrastructure projects, the concessionaire typically retains the services of one or more construction contractors to perform some or the bulk of the construction work under the project agreement. The concessionaire may also wish to retain the services of contractors with experience in the operation and maintenance of infrastructure during the operational phase of the project. The laws of some countries generally acknowledge the concessionaire's right to enter into contracts as needed for the execution of the construction work. A legislative provision recognizing the concessionaire's authority to subcontract may be particularly useful in countries where there are limitations to the ability of government contractors to subcontract.

(a) Choice of subcontractors

100. The concessionaire's freedom to hire subcontractors is in some countries restricted by rules that prescribe the use of tendering and similar procedures for the award of subcontracts by public service providers. Such statutory rules have often been adopted when infrastructure facilities were primarily or exclusively operated by the Government, with little or only marginal private sector investment. The purpose of such statutory rules is to ensure economy, efficiency, integrity and transparency in the use of public funds. However, in the case of privately financed infrastructure projects, such provisions may discourage the participation of potential investors, since the project sponsors typically include engineering and construction companies that participate in the project in the expectation that they will be given the main contracts for the execution of the construction and other work.

101. The concessionaire's freedom to select its subcontractors is not unlimited, however. In some countries, the concessionaire has to identify in its proposal which contractors will be retained, including information on their

technical capability and financial standing. Other countries either require that such information be provided at the time the project agreement is concluded or subject such contracts to prior review and approval by the contracting authority. The purpose of such provisions is to avoid possible conflicts of interest between the project company and its shareholders, a point that would normally also be of interest to the lenders, who may wish to ensure that the project company's contractors are not overpaid. In any event, if it is deemed necessary for the contracting authority to have the right to review and approve the project company's subcontracts, the project agreement should clearly define the purpose of such review and approval procedures and the circumstances under which the contracting authority's approval may be withheld. As a general rule, approval should not normally be withheld unless the subcontracts are found to contain provisions manifestly contrary to the public interest (for example, provisions for excessive payments to subcontractors or unreasonable limitations of liability) or contrary to mandatory rules having the nature of public law that apply to the execution of privately financed infrastructure projects in the host country.

(b) Governing law

102. It is common for the concessionaire and its contractors to choose a law that is familiar to them and that in their view adequately governs the issues addressed in their contracts. Depending upon the type of contract, different issues concerning the governing law clause will arise. For example, equipment supply and other contracts may be entered into with foreign companies and the parties may wish to choose a law known to them as providing, for example, an adequate warranty regime for equipment failure or non-conformity of equipment. In turn, the concessionaire may agree to the application of the laws of the host country in connection with contracts entered into with local customers.

103. Domestic laws specific to privately financed infrastructure projects seldom contain provisions concerning the law governing the contracts entered into by the concessionaire. In fact, most countries have found no compelling reason for making specific provisions concerning the law governing the contracts between the concessionaire and its contractors and have preferred to leave the question to a choice-of-law clause in their contracts or to the applicable rules of private international law. It should be noted, however, that the freedom to choose the applicable law for contracts and other legal relationships is in some legal systems subject to conditions and restrictions pursuant to rules of private international law or certain rules of public law of the host country. For instance, States parties to some regional economic integration agreements are obliged to enact harmonized provisions of private international law dealing, *inter alia,* with contracts between public service providers and their contractors. While rules of private international law often allow considerable freedom to choose the law governing commercial contracts, that freedom is in some countries restricted for contracts and legal relationships that are not qualified as commercial, such as, for instance, certain contracts entered into by public authorities of the host country (for example, guarantees and assurances by the Government, power purchase or fuel supply commitments by a public authority) or contracts with consumers.

104. In some cases, provisions have been included in domestic legislation for the purpose of clarifying, as appropriate, that the contracts entered into between the concessionaire and its contractors are governed by private law and that the contractors are not agents of the contracting authority. A provision of that type may in some countries have a number of practical consequences, such as no subsidiary liability of the contracting authority for the acts of the subcontractors or no obligation on the part of the responsible public entity to pay worker's compensation for work-related illness, injury or death to the subcontractors' employees.

2. Liability with respect to users and third parties

105. Defective construction or operation of an infrastructure facility may result in the death of or personal injury to employees of the concessionaire, users of the facility or other third parties or in damage to their property. The issues concerning damages to be paid to third parties in such cases are complex and may be governed not by rules of the law applicable to the project agreement governing contractual liability, but rather by applicable legal rules governing extra-contractual liability, which are often mandatory. Also, in some legal systems, there are special mandatory rules governing the extra-contractual liability of public authorities to which the contracting authority may be subject. Moreover, the project agreement cannot limit the liability of the concessionaire or the contracting authority to compensate third parties who are not parties to the project agreement. It is therefore advisable for the contracting authority and the concessionaire to provide for the internal allocation of risks between them as regards damages to be paid to third parties due to death, personal injury or damage to their property, to the extent that this allocation is not governed by mandatory rules. It is also advisable for the parties to provide for insurance against such risks (see paras. 119 and 120).

106. If a third party suffers personal injury or damage to its property as a result of the construction or operation of the facility and brings a claim against the contracting authority, the law may provide that the concessionaire alone should bear any responsibility in that regard and that the contracting authority should not bear any liability as regards such third-party claims, except where the damage was caused by the serious breach or recklessness of the contracting authority. It may be useful to provide, in particular, that the mere approval of the design or specification of the facility by the contracting authority or its acceptance of the construction works or final authorization for the operation of the facility or its use by the public does not entail the assumption by the contracting authority of any liability for damage sustained by users of the facility or other third parties arising out of the construction or operation of the facility or the inadequacy of the approved design or specifications. Moreover, since provisions on the allocation of liability may not be enforceable against third parties under the applicable law, it may be advisable for the project agreement to provide that the contracting authority should be protected and indemnified in respect of compensation claims brought by third parties who sustain injury or damage to their property resulting from the construction or operation of the infrastructure facility.

107. The project agreement should also provide that the parties should inform each other of any claim or proceedings or anticipated claims or proceedings against them in respect of which the contracting authority is entitled to be indemnified and give reasonable assistance to one another in the defence of such claims or proceedings to the extent permitted by the law of the country where such proceedings are instituted.

3. *Performance guarantees and insurance*

108. The obligations of the concessionaire are usually complemented by the provision of some form of guarantee of performance in the event of breach and insurance coverage against a number of risks. The law in some countries generally requires that adequate guarantees of performance be provided by the concessionaire and refer the matter to the project agreement for further details. In other countries, the law contains more detailed provisions, for instance requiring the offer of a certain type of guarantee up to a stated percentage of the basic investment.

(a) Types, functions and nature of performance guarantees

109. Performance guarantees are generally of two types. Under one type, the monetary performance guarantee, the guarantor undertakes only to pay the contracting authority funds up to a stated limit to satisfy the liabilities of the concessionaire in the event of the latter's failure to perform. Monetary performance guarantees may take the form of a contract bond, a stand-by letter of credit or an on-demand guarantee. Under the other type of guarantee, the performance bond, the guarantor chooses one of two options: (a) to rectify defective or finish incomplete construction itself; or (b) to obtain another contractor to rectify defective or finish incomplete construction and compensate the contracting authority for losses caused by the failure to perform. The value of such an undertaking is limited to a stated amount or a certain percentage of the contract value. Under a performance bond, the guarantor also frequently reserves the option to discharge its obligations solely by the payment of money to the contracting authority. Performance bonds are generally furnished by specialized guarantee institutions, such as bonding and insurance companies. A special type of performance bond is the maintenance bond, which protects the contracting authority against future failures that could arise during the start-up or maintenance period and serve as guarantee that any repair or maintenance work during the post-completion warranty period will be duly carried out by the concessionaire.

110. As regards their nature, performance guarantees may be generally divided into independent guarantees and accessory guarantees. A guarantee is said to be "independent" if the guarantor's obligation is independent from the concessionaire's obligations under the project agreement. Under an independent guarantee (often called a first-demand guarantee) or a stand-by letter of credit, the guarantor or issuer is obligated to make payment on demand by the beneficiary and the latter is entitled to recover under the instrument if it presents the document or documents stipulated in the terms of the guarantee or stand-

by letter of credit. Such a document might be simply a statement by the beneficiary that the contractor has failed to perform. The guarantor or issuer is not entitled to withhold payment on the ground that there has in fact been no failure to perform under the main contract; however, under the law applicable to the instrument, payment may in very exceptional and narrowly defined circumstances be refused or restrained (for example, when the claim by the beneficiary is manifestly fraudulent). In contrast, a guarantee is accessory when the obligation of the guarantor involves more than the mere examination of a documentary demand for payment in that the guarantor may have to evaluate evidence of liability of the contractor for failure to perform under the works contract. The nature of the link may vary under different guarantees and may include the need to prove the contractor's liability in arbitral proceedings. By their nature, performance bonds have an accessory character to the underlying contract.

(b) Advantages and disadvantages of various types of performance guarantee

111. From the perspective of the contracting authority, monetary performance guarantees may be particularly useful in covering additional costs that may be incurred by the contracting authority as a result of delay or breach by the concessionaire. Monetary performance guarantees may also serve as an instrument to put pressure on the concessionaire to complete construction in time and to perform its other obligations in accordance with the requirements of the project agreement. However, the amount of those guarantees is typically only a fraction of the economic value of the obligation guaranteed and is usually not sufficient to cover the cost of engaging a third party to perform instead of the concessionaire or its contractors.

112. From the perspective of the contracting authority, a first-demand guarantee has the advantage of assuring prompt recovery of funds under the guarantee, without evidence of failure to perform by the contractor or of the extent of the beneficiary's loss. Furthermore, guarantors furnishing monetary performance guarantees, in particular banks, prefer first-demand guarantees, as the conditions are clear as to when their liability to pay accrues, and the guarantors will thus not be involved in disputes between the contracting authority and the concessionaire as to whether or not there has been a failure to perform under the project agreement. Another advantage for a bank issuing a first-demand guarantee is the possibility of quick and efficient recovery of the sums paid under a first-demand guarantee by direct access to the concessionaire's assets.

113. A disadvantage to the contracting authority of a first-demand guarantee or a stand-by letter of credit is that those instruments may increase the overall project costs, since the concessionaire is usually obliged to obtain and set aside large counter-guarantees in favour of the institutions issuing the first-demand guarantee or the stand-by letter of credit. Also, a concessionaire that furnishes such a guarantee may wish to take out insurance against the risk of recovery by the contracting authority under the guarantee or the stand-by letter of credit when there has been in fact no failure to perform by the concessionaire and the

cost of that insurance is included in the project cost. The concessionaire also may include in the project cost the potential costs of any action that it may need to institute against the contracting authority to obtain the repayment of the sum improperly claimed.

114. A disadvantage to the concessionaire of a first-demand guarantee or a stand-by letter of credit is that, if there is recovery by the contracting authority when there has been no failure to perform by the concessionaire, the latter may suffer immediate loss if the guarantor or the issuer of the letter of credit reimburses itself from the assets of the concessionaire after payment to the contracting authority. The concessionaire may also experience difficulties and delays in recovering from the contracting authority the sum improperly claimed.

115. The terms of an accessory guarantee usually require the beneficiary to prove the failure of the contractor to perform and the extent of the loss suffered by the beneficiary. Furthermore, the defences available to the debtor if it is sued for a failure to perform are also available to the guarantor. Accordingly, there is a risk that the contracting authority may face a protracted dispute when it makes a claim under the bond. In practice, this risk may be reduced, for instance, if the submission of claims under the terms of the bond is subject to a procedure such as that provided in article 7 *(j)*(i) of the Uniform Rules on Contract Bonds, drawn up by the International Chamber of Commerce.[2] Article 7 *(j)*(i) of the Uniform Rules provides that notwithstanding any dispute or difference between the principal and the beneficiary in relation to the performance of the contract or any contractual obligation, a default for the purposes of payment of a claim under a contract bond shall be deemed to be established upon issue of a certificate of default by a third party (who may without limitation be an independent architect or engineer or referee) if the bond so provides and the service of such a certificate or a certified copy thereof upon the guarantor. Where such a procedure is adopted, the contracting authority may be entitled to obtain payment under the contract bond even though its entitlement to that payment is disputed by the concessionaire.

116. As a reflection of the lesser risk borne by the guarantor, the monetary limit of liability of the guarantor may be considerably higher than under a first-demand guarantee, thus covering a larger percentage of work under the project agreement. A performance bond may also be advantageous if the contracting authority cannot conveniently arrange for the rectification of faults or completion of construction itself and requires the assistance of a third party to arrange for rectification or completion. Where, however, the construction involves the use of a technology known only to the concessionaire, rectification or completion by a third person may not be feasible and a performance bond may not have the last-mentioned advantage over a monetary performance guarantee. For the concessionaire, accessory guarantees have the advantage of preserving the concessionaire's borrowing power, since accessory guarantees, unlike first-demand guarantees and stand-by letters of credit, do not affect the concessionaire's line of credit with the lenders.

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[2]The text of the Uniform Rules on Contract Bonds is reproduced in document A/CN.9/459/Add.1.

117. It follows from the above considerations that different types of guarantees may be useful in connection with the various obligations assumed by the concessionaire. While it is useful to require the concessionaire to provide adequate guarantees of performance, it is advisable to leave it to the parties to determine the extent to which guarantees are needed and which guarantees should be provided in respect of the various obligations assumed by the concessionaire, rather than requiring in the law only one form of guarantee to the exclusion of others. It should be noted that the project company itself will require a series of performance guarantees to be provided by its contractors (see para. 6) and that additional guarantees to the benefit of the contracting authority usually increase the overall cost and complexity of a project. In some countries, practical guidance provided to domestic contracting authorities advises them to consider carefully whether and under what circumstances such guarantees are required, which specific risks or loss they should cover and which type of guarantee is best suited in each case. The ability of the project company to raise finance for the project may be jeopardized by bond requirements set at an excessive level.

(c) Duration of guarantees

118. One particular problem of privately financed infrastructure projects concerns the duration of the guarantee. The contracting authority may have an interest in obtaining guarantees of performance that remain valid during the entire life of the project, covering both the construction and the operational phase. However, given the long duration of infrastructure projects and the difficulty in evaluating the various risks that may arise, it may be problematic for the guarantor to issue a performance bond for the whole duration of the project or to procure reinsurance for its obligations under the performance bond. In practice, this problem is compounded by stipulations that the non-renewal of a performance bond constitutes a reason for a call on the bond, so that merely allowing the project company to provide bonds for shorter periods may not be a satisfactory solution. One possible solution, used in some countries, is to require separate bonds for the construction and the operation phase, thus allowing for better assessment of risks and reinsurance prospects. Such a system may be enhanced by defining in precise terms the risk to be covered during the operation period, thus allowing for a better assessment of risks and a reduction of the total amount of the bond. Another possibility to be considered by the contracting authority may be to require the provision of performance guarantees during specific crucial periods, rather than for the entire duration of the project. For instance, a bond might be required during the construction phase and last for an appropriate period beyond completion, so as to cover possible latent defects. Such a bond might then be replaced by a performance bond for a certain number of years of operation, as appropriate in order for the project company to demonstrate its capability to operate the facility in accordance with the required standards. If the project company's performance proves to be satisfactory, the bond requirement might be waived for the remainder of the operation phase, up to a certain period before the end of the concession term, when the project company might be required to place another bond to guarantee its obligations in connection with the handing over

of assets and other measures for the orderly wind-up of the project, as appropriate (see chap. V, "Duration, extension and termination of the project agreement", paras. 50-62).

(d) Insurance arrangements

119. Insurance arrangements made in connection with privately financed infrastructure projects typically vary according to the phase to which they apply, with certain types of insurance only being purchased during a particular project phase. Some forms of insurance, such as business interruption insurance, may be purchased by the concessionaire in its own interest, while other forms of insurance may be a requirement under the laws of the host country. Forms of insurance often required by law include insurance coverage against damage to the facility, third-party liability insurance, workers' compensation insurance and pollution and environmental damage insurance.

120. Mandatory insurance policies under the laws of the host country often need to be obtained from a local insurance company or from another institution admitted to operate in the country, which in some cases may pose a number of practical difficulties. In some countries, the type of coverage usually offered may be more limited than the standard coverage available on the international market, in which case the concessionaire may remain exposed to a number of perils that may exceed its self-insurance capacity. That risk is particularly serious in connection with environmental damage insurance. Further difficulties may arise in some countries as a result of limitations on the ability of local insurers to reinsure the risks on the international insurance and reinsurance markets. As a consequence, the project company may often need to procure additional insurance outside the country, thus adding to the overall cost of financing the project.

4. Changes in conditions

121. Privately financed infrastructure projects normally last for a long period of time, during which many circumstances relevant to the project may change. The impact of many changes may be automatically covered in the project agreement, either through financial arrangements such as a tariff structure that includes an indexation clause (see paras. 39-46), or by the assumption by either party, expressly or by exclusion, of certain risks (for example, if the price of fuel or electricity supply is not taken into account in the indexation mechanisms, then the risk of higher than expected prices is absorbed by the concessionaire). However, there are changes that might not lend themselves easily to inclusion in an automatic adjustment mechanism or that the parties may prefer to exclude from such a mechanism. From a legislative perspective, two particular categories deserve special attention: legislative or regulatory changes and unexpected changes in economic conditions.

(a) Legislative and regulatory changes

122. Given the long duration of privately financed infrastructure projects, the concessionaire may face additional costs in meeting its obligations under the

project agreement because of future, unforeseen changes in legislation applying to its activities. In extreme cases, legislation could even make it financially or physically impossible for the concessionaire to carry on with the project. For the purpose of considering the appropriate solution for dealing with legislative changes, it may be useful to distinguish between legislative changes having a particular incidence on privately financed infrastructure projects or on one specific project, on the one hand, and general legislative changes affecting other economic activities also, and not only infrastructure operation, on the other.

123. All business organizations, in the private and public sectors alike, are subject to changes in law and generally have to deal with the consequences that such changes may have for business, including the impact of changes on the price of or demand for their products. Possible examples might include changes in the structure of capital allowances that apply to entire classes of assets, whether owned by the public or private sector and whether related to infrastructure projects or not; regulations that affect the health and safety of construction workers on all construction projects, not just infrastructure projects; and changes in the regulations on the disposal of hazardous substances. General changes in law may be regarded as an ordinary business risk rather than a risk specific to the concessionaire's activities and it may be difficult for the Government to undertake to protect infrastructure operators from the economic and financial consequences of changes in legislation that affect other business organizations equally. Thus, there may not be a prima facie reason why the concessionaire should not bear the consequences of general legislative risks, including the risk of costs arising from changes in law applying to the whole business sector.

124. Nevertheless, it is important to take into account possible limitations in the concessionaire's capacity to respond to or absorb cost increases that result from general legislative changes. Infrastructure operators are often subject to service standards and tariff control mechanisms that make it difficult for them to respond to changes in the law in the same manner as other private companies (by increasing tariffs or by reducing services, for example). Where tariff control mechanisms are provided in the project agreement, the concessionaire will seek to obtain assurances from the contracting authority and the regulatory agency, as appropriate, that it will be allowed to recover the additional costs entailed by changes in legislation by means of tariff increases. Where such an assurance cannot be given, it is advisable to empower the contracting authority to negotiate with the concessionaire the compensation to which the concessionaire may be entitled in the event that tariff control measures do not allow for full recovery of the additional costs generated by general legislative changes.

125. A different situation arises when the concessionaire faces increased costs as a result of specific legislative changes that target the particular project, a class of similar projects or privately financed infrastructure projects in general. Such changes cannot be regarded as an ordinary business risk and may significantly alter the economic and financial assumptions based on which the project agreement was negotiated. Thus, the contracting authority often agrees

to bear the additional cost resulting from specific legislation that targets the particular project, a class of similar projects or privately financed infrastructure projects in general. For example, in highways projects, legislation aimed at a specified road project or road operating company, or at that class of privately operated road projects, might result in a tariff adjustment under the relevant provisions in the project agreement.

(b) Changes in economic conditions

126. Some legal systems have rules that allow a revision of the terms of the project agreement following changes in the economic or financial conditions that, without preventing the performance of a party's contractual obligations, render the performance of those obligations substantially more onerous than originally foreseen at the time they were entered into. In some legal systems, the possibility of a revision of the terms of the agreement is generally implied in all Government contracts or is expressly provided for in the relevant legislation.

127. The financial and economic considerations for the concessionaire's investment are negotiated in the light of assumptions based on the circumstances prevailing at the time of the negotiations and the reasonable expectations of the parties as to how those circumstances will evolve during the life of the project. To a certain extent, projections of economic and financial parameters and sometimes even a certain margin of risk will normally be included in the formulation of the financial proposals by the bidders (see chap. III, "Selection of the concessionaire", para. 68). However, certain events may occur that the parties could not reasonably have anticipated when the project agreement was negotiated and that, had they been taken into account, would have resulted in a different risk allocation or consideration for the concessionaire's investment. Given the long duration of infrastructure projects, it is important to devise mechanisms to deal with the financial and economic impact of such events. Revision rules have been applied in a number of countries and have been found useful to help parties find equitable solutions for ensuring the continued economic and financial viability of infrastructure projects, thus averting a disruptive failure of performance by the concessionaire. However, revision rules may also have some disadvantages, in particular from the perspective of the Government.

128. As with general legislative changes, changes in economic conditions are risks to which most business organizations are exposed without having recourse to a general guarantee of the Government that would protect them against the economic and financial effects of those changes. An unqualified obligation of the contracting authority to compensate the concessionaire for changes of economic conditions may result in a reversion to the public sector of a substantial portion of the commercial risks originally allocated to the concessionaire and represent an open-ended financial liability. Furthermore, it should be noted that the proposed tariff level and the essential elements of risk allocation are important, if not decisive, factors in the selection of the conces-

sionaire. An excessively generous recourse to renegotiation of the project may lead to unrealistically low proposals being submitted during the selection procedure in the expectation of tariff increases once the project has been awarded. Thus, the contracting authority may have an interest in establishing reasonable limits for statutory or contractual provisions authorizing revisions of the project agreement following changes in economic conditions.

129. It may be desirable to provide in the project agreement that a change in circumstances that justifies a revision of the project agreement must have been beyond the control of the concessionaire and of such a nature that the concessionaire could not reasonably be expected to have taken it into account at the time the project agreement was negotiated or to have avoided or overcome its consequences. For example, a tollroad operator holding an exclusive concession might not be expected to take into account and assume the risk of traffic shortfalls brought about by the subsequent opening of an alternative toll-free road by an entity other than the contracting authority. However, the concessionaire would normally be expected to take into account the possibility of reasonable labour cost increases over the life of the project. Thus, under normal circumstances, the fact that wages turned out to be higher than expected would not be sufficient reason for revising the project agreement.

130. It may also be desirable to provide in the project agreement that a request for revision of the project agreement requires that the alleged changes of economic and financial conditions amount to a certain minimum value in proportion to the total project cost or the concessionaire's revenue. Such a rule might be useful in order to avoid cumbersome adjustment negotiations for small changes until the changes have accumulated to comprise a significant figure. In some countries, there are rules that establish a ceiling for the cumulative amount of periodic revisions of the project agreement. The purpose of such rules is to avoid the misuse of the change mechanism as a means for achieving an overall financial balance that bears no relation to the one contemplated in the original project agreement. From the perspective of the concessionaire and the lenders, however, such limitations may represent exposure to considerable risk in the event, for instance, of dramatic cost increases resulting from an extraordinarily radical change of circumstances. Therefore, both the desirability of introducing a ceiling and the appropriate amount of such ceiling need to be carefully considered.

5. Exempting impediments

131. During the life of an infrastructure project, events may occur that impede the performance by a party of its contractual obligations. The events causing such an impediment are typically outside either party's control and may be of a physical nature, such as a natural disaster, or may be the result of human action, such as war, riots or terrorist attacks. Many legal systems generally recognize that a party that fails to perform a contractual obligation because of the occurrence of certain types of event may be exempted from the consequences of any such failure to perform.

(a) Definition of exempting impediments

132. Exempting impediments typically include occurrences beyond the control of a party that cause the party to be unable to perform its obligation and that the party has been unable to overcome by the exercise of due diligence. Common examples include the following: natural disasters (such as cyclones, floods, droughts, earthquakes, storms, fires or lightning); war (whether declared or not) or other military activity, including riots and civil disturbance; failure or sabotage of facilities, acts of terrorism, criminal damage or the threat of such acts; radioactive or chemical contamination or ionizing radiation; effects of the natural elements, including geological conditions that cannot be foreseen and resisted; and employees' strikes of exceptional importance.

133. Some laws make only a general reference to exempting impediments, whereas other laws contain extensive lists of circumstances that excuse the parties from performance under the project agreement. The latter technique may serve the purpose of ensuring a consistent treatment of the matter for all projects developed under the relevant legislation, thus avoiding situations where one concessionaire obtains a more favourable allocation of risks than that provided in other project agreements. However, it is important to consider the possible disadvantages of setting forth in statutory or regulatory provisions a list of events that are to be considered exempting impediments for all cases. There is a risk that the list might be incomplete, leaving out important impediments. Furthermore, certain natural disasters, such as storms, cyclones and floods, may be normal conditions at a particular time of the year at the project site. As such, those natural disasters may represent risks that any public service provider acting in the region would be expected to assume.

134. Another aspect that may need to be carefully considered is whether and to what extent certain acts of public authorities other than the contracting authority may constitute exempting impediments. The concessionaire may be required to secure a licence or other official approval for the performance of certain of its obligations. The project agreement might thus provide that, if the licence or approval is refused, or if it is granted but later withdrawn because of the concessionaire's own failure to meet the relevant criteria for the issuance of the licence or approval, the concessionaire cannot rely on the refusal as an exempting impediment. However, if the licence or approval is refused or withdrawn for extraneous or improper motives, it would be equitable to provide that the concessionaire may rely on the refusal as an exempting impediment. A further possibility of impediment might be an interruption of the project brought about by a public authority or organ of government other than the contracting authority, for instance, because of changes in governmental plans and policies that require the interruption or major revision of the project that substantially affect the original design. In such situations, it may be important to consider the institutional relationship between the contracting authority and the public authority that brings about the impediment as well as their degree of independence from one another. An event classified as an exempting impediment may in some cases amount to an outright breach of the project agreement by the contracting authority, depending on whether the contracting authority could reasonably control or influence the acts of the other public authority.

(b) Consequences for the parties

135. During the construction phase, the occurrence of exempting impediments usually justifies an extension of the time allowed for the completion of the facility. In that connection, it is important to consider the implications of any such extension for the overall duration of the project, in particular where the construction phase is taken into account for calculating the total concession period. Delays in the completion of the facility reduce the operational period and may adversely affect the global revenue estimates of the concessionaire and the lenders. It may therefore be advisable to consider under what circumstances it may be justified to extend the concession period so as to take into account possible extensions that occur during the construction phase. Lastly, it is advisable to provide that, if the event in question is of a permanent nature, the parties may have the option to terminate the project agreement (see also chap. V, "Duration, extension and termination of the project agreement", para. 34).

136. Another important question is whether the concessionaire will be entitled to compensation for loss of revenue or property damage that results from the occurrence of exempting impediments. The answer to that question is given by the risk allocation provided in the project agreement. Except for cases in which the Government provides some form of direct support, privately financed infrastructure projects are typically undertaken at the concessionaire's own risk, including the risk of losses that may result from natural disasters and other exempting impediments, against which the concessionaire is usually required to procure adequate insurance coverage. Thus, some laws expressly exclude any form of compensation to the concessionaire in the event of loss or damage that results from the occurrence of exempting impediments. It does not necessarily follow, however, that an event qualified as an exempting impediment may not, at the same time, justify a revision of the terms of the project agreement so as to restore its economic and financial balance (see also paras. 126-130).

137. However, a different type of risk allocation is sometimes contemplated for projects involving the construction of facilities that are permanently owned by the contracting authority or facilities that are required to be transferred to the contracting authority at the end of the project period. In some countries, the contracting authority is authorized to make arrangements for assisting the concessionaire to repair or rebuild infrastructure facilities damaged by natural disasters or similar occurrences defined in the project agreement, provided that the possibility of such assistance was contemplated in the request for proposals. Sometimes the contracting authority is authorized to agree to pay compensation to the concessionaire in case of an interruption of the work for more than a certain number of days up to a maximum time limit, if the interruption is caused by an event for which the concessionaire is not responsible.

138. Should the concessionaire become unable to perform because of any such impediment and should the parties fail to achieve an acceptable revision of the contract, some national laws authorize the concessionaire to terminate the project agreement, without prejudice to the compensation that might be due

under the circumstances (see chap. V, "Duration, extension and termination of the project agreement", para. 34).

139. Statutory and contractual provisions on exempting impediments also need to be considered in the light of other rules governing the provision of the service concerned. The law in some legal systems requires public service providers to make every effort to continue providing the service despite the occurrence of circumstances defined as contractual impediments (see paras. 86 and 87). In those cases, it is advisable to consider the extent to which such an obligation may reasonably be imposed on the concessionaire and what compensation may be due for the additional costs and hardship faced by it.

6. *Breach and remedies*

140. Generally, there is a wide range of remedies that the parties may agree on to deal with the consequences of breach, culminating with termination of the project agreement. The following paragraphs set out general considerations on breach and remedies by either party (see paras. 141 and 142). They consider the legislative implication of certain types of remedy intended to rectify the causes of breach and preserve the continuity of the project, in particular the intervention of the contracting authority (see paras. 143-146) or the substitution of the concessionaire (see paras. 147-150). The ultimate remedy of terminating the project agreement and the consequences that may result from termination are discussed elsewhere in the *Guide* (see chap. V, "Duration, extension and termination of the project agreement", sects. D and E).

(a) General considerations

141. The remedies for breach by the concessionaire typically include those which are customary in construction or long-term service contracts such as forfeiture of guarantees, contractual penalties and liquidated damages.[3] In most cases, such remedies are typically contractual in nature and do not give rise to significant legislative considerations. Nevertheless, it is important to establish adequate procedures for ascertaining failures and giving opportunity for rectifying such failures. In some countries, the imposition of contractual penalties requires findings of official inspections and other procedural steps, including review by senior officials of the contracting authority prior to the imposition of more serious sanctions. Those procedures may be complemented by provisions distinguishing between defects that can be rectified and those which cannot and by setting down the corresponding procedures and remedies. It is usually advisable to require that the concessionaire be given notice requiring it to remedy the breach within a sufficient period. It may also be advisable to contemplate the payment of penalties or liquidated damages by the concessionaire in the event of non-performance of essential obligations and to clarify that no penalties apply in case of breach of secondary or ancillary obligations and for which other remedies may be obtained under national law. Further-

[3]For a discussion of remedies used in construction contracts for complex industrial works, see the *UNCITRAL Legal Guide on Drawing Up Contracts for the Construction of Industrial Works,* chap. XVIII, "Delay, defects and other failures to perform".

more, a performance monitoring system that provides for penalties or liquidated damages may be complemented by a scheme of bonuses payable to the concessionaire for improving over agreed terms.

142. While the contracting authority may protect itself against the consequences of breach by the concessionaire through a variety of judicially enforceable contractual arrangements, the remedies available to the concessionaire in case of breach by the contracting authority may be subject to a number of limitations under the applicable law. Important limitations may derive from rules of law that recognize the immunity of public authorities from judicial suit and enforcement measures. Depending on the legal nature of the contracting authority or of other public authorities that assume obligations vis-à-vis the concessionaire, the latter may be deprived of the possibility of enforcing measures of execution to secure the fulfilment of obligations entered into by those public entities (see also chap. VI, "Settlement of disputes", paras. 33-35). This situation makes it the more important to provide mechanisms to protect the concessionaire against the consequences of breach by the contracting authority, for example by means of governmental guarantees covering specific events of breach or guarantees provided by third parties, such as multilateral lending institutions (see also chap. II, "Project risks and government support", paras. 61-71).

(b) Step-in rights for the contracting authority

143. Some national laws expressly authorize the contracting authority to take over temporarily the operation of the facility, normally in case of failure to perform by the concessionaire, in particular where the contracting authority has a statutory duty to ensure the effective delivery at all times of the service concerned. In some legal systems, such a prerogative is considered to be inherent in most government contracts and may be presumed to exist even without being expressly mentioned in legislation or in the project agreement.

144. It should be noted that the contracting authority's right to intervene, its "step-in right", is an extreme measure. Private investors may fear that the contracting authority may use it, or threaten to use it, in order to impose its own desires about the way in which the service is provided, or even to get control of the project assets. It is therefore advisable to define as clearly as possible the circumstances in which step-in rights can be exercised. It is important to limit the contracting authority's right to intervene to cases of serious failure of services and not merely in case of dissatisfaction with the concessionaire's performance. It may be useful to clarify in the law that the contracting authority's intervention in the project is temporary and is intended to remedy a specific, urgent problem that the concessionaire has failed to remedy. The concessionaire should resume responsibility for service delivery once the emergency situation has been remedied.

145. The contracting authority's ability to step in may be limited in that it may be difficult immediately to identify and engage a subcontractor to carry out the actions that the contracting authority is stepping in to do. Furthermore,

frequent interventions carry a risk of the reversion to the contracting authority of risks that have been transferred in the project agreement to the concessionaire. The concessionaire should not rely on the contracting authority to step in to deal with a particular risk instead of handling it itself, as required by the project agreement.

146. It is advisable to clarify in the project agreement which party bears the cost of an intervention by the contracting authority. In most cases, the concessionaire should bear the costs incurred by the contracting authority when the intervention is caused by a performance failure attributable to the concessionaire's own fault. In some cases, to prevent disputes about liability and about the appropriate level of costs, the agreement may authorize the contracting authority to take steps to remedy the problem itself and then charge the actual cost of having done so (including its own administrative costs) to the concessionaire. However, when such intervention takes place following the occurrence of an exempting impediment (see paras. 131-139), the parties might agree on a different solution, depending on how that particular risk has been allocated in the project agreement.

(c) Step-in rights for the lenders

147. During the life of the project situations may arise where, because of breach by the concessionaire or the occurrence of an extraordinary event outside the concessionaire's control, it may nevertheless be in the interest of the parties to avert termination of the project by allowing the project to continue under the responsibility of a different concessionaire. The lenders, whose main security is the revenue generated by the project, are particularly concerned about the risk of interruption or termination of the project prior to repayment of the loans. In the event of breach impediment affecting the concessionaire, the lenders will be interested in ensuring that the work will not be left incomplete and that the concession will be operated profitably. The contracting authority, too, may be interested in allowing the project to be carried out by a new concessionaire, as an alternative for having to take it over and continue it under its own responsibility.

148. Clauses allowing the lenders to select, with the consent of the contracting authority, a new concessionaire to perform under the existing project agreement have been included in a number of recent agreements for large infrastructure projects. Such clauses are typically supplemented by a direct agreement between the contracting authority and the lenders who are providing finance to the concessionaire. The main purpose of such a direct agreement is to allow the lenders to avert termination by the contracting authority when the concessionaire is in breach by substituting a concessionaire that will continue to perform under the project agreement in place of the concessionaire in breach. Unlike the contracting authority's right to intervene, which relates to a specific, temporary and urgent failure of the service, lenders' step-in rights are for cases where the concessionaire's failure to provide the service is recurrent or can reasonably be regarded as irremediable. In the experience of countries that have recently made use of such direct agreements, it has been found

that the ability to head off termination and provide an alternative concessionaire gives the lenders additional security against breach by the concessionaire. At the same time, it provides the contracting authority an opportunity to avoid the disruption entailed by terminating the project agreement, thus maintaining continuity of service.

149. However, in some countries, the implementation of such clauses may face difficulties in the absence of legislative authorization. The concessionaire's inability to carry out its obligations is usually a ground for the contracting authority to take over the operation of the facility or terminate the agreement (see chap. V, "Duration, extension and termination of the project agreement", paras. 15-23). For the purpose of selecting a new concessionaire to succeed the concessionaire in breach, the contracting authority often needs to follow the same procedures that applied to the selection of the original concessionaire and it might not be possible for the contracting authority to agree in consultation with the lenders on engaging a new concessionaire that has not been selected pursuant to those procedures. On the other hand, even where the contracting authority is authorized to negotiate with a new concessionaire under emergency conditions, a new project agreement might need to be entered into with the new concessionaire and there may be limitations to its ability to assume the obligations of its predecessor.

150. Therefore, it may be useful to acknowledge in the law the contracting authority's right to enter into agreements with the lenders providing for the appointment, with the consent of the contracting authority, of a new concessionaire to perform under the existing project agreement, when the concessionaire seriously fails to deliver the service required under the project agreement or following the occurrence of other specified events that could justify the termination of the project agreement. The agreement between the contracting authority and the lenders should, *inter alia,* specify the following: the circumstances in which the lenders are permitted to substitute a new concessionaire; the procedures for the substitution of the concessionaire; the grounds for refusal by the contracting authority of a proposed substitute; and the obligations of the lenders to maintain the service at the same standards and on the same terms as required by the project agreement.

V. Duration, extension and termination of the project agreement

A. General remarks

1. Most privately financed infrastructure projects are undertaken for a certain period, at the end of which the concessionaire transfers to the contracting authority the responsibility for the operation of the infrastructure facility. Section B deals with elements to be taken into account when establishing the concession period. Section C deals with the question of whether and under what circumstances the project agreement may be extended. Section D considers circumstances that may authorize the termination of the project agreement prior to the expiry of its term. Lastly, section E deals with the consequences of the expiry or termination of the project agreement, including the transfer of project assets and the compensation to which either party may be entitled upon termination, and the wind-up of the project.

B. Duration of the project agreement

2. The laws of some countries contain provisions that limit the duration of infrastructure concessions to a certain number of years. Some laws establish a general limit for most infrastructure projects and special limits for projects in particular infrastructure sectors. In some countries there are maximum duration periods only for certain infrastructure sectors.

3. The desirable duration of a project agreement may depend on a number of factors, such as the operational life of the facility; the period during which the service is likely to be required; the expected useful life of the assets associated with the project; how changeable the technology required for the project is; and the time needed for the concessionaire to repay its debts and amortize the initial investment. The notion of economic "amortization", in this context, refers to the gradual charging of the investment made against project revenue on the assumption that the facility would have no residual value at the end of the project term. Given the difficulty of establishing a single statutory limit for the duration of infrastructure projects, it is advisable to provide the contracting authority with some flexibility to negotiate, in each case, a term that is appropriate to the project in question.

4. In some legal systems, this result is achieved by provisions that require that all concessions should be subject to a maximum duration period, without specifying any number of years. Sometimes the law only indicates which elements are to be taken into account for determining the duration of the con-

cession, which may include the nature and amount of investment required to be made by the concessionaire and the normal amortization period for the particular facilities and installations concerned. Some project or sector-specific laws provide for a combined system requiring that the project agreement provide for the expiry of the concession at the end of a certain period or once the debts of the concessionaire have been fully repaid and a certain revenue, production or usage level has been achieved, whichever is the earliest.

5. However, where it is found necessary to adopt statutory limits, the maximum period should be sufficiently long to allow the concessionaire to repay its debts fully and to achieve a reasonable profit. Furthermore, it may be useful to authorize the contracting authority, in exceptional cases, to agree to longer concession periods, taking into account the amount of the investment and the required recovering period, and subject to special approval procedures.

C. Extension of the project agreement

6. In the contracting practice of some countries, the contracting authority and the concessionaire may agree on one or more extensions of the concession period. More often, however, domestic laws only authorize an extension of the project agreement under exceptional circumstances. In this case, upon expiry of the project agreement the contracting authority is normally required to select a new concessionaire, normally using the same procedures applied to select the concessionaire whose concession has expired (for a discussion of selection procedures, see chap. III, “Selection of the concessionaire“).

7. A number of countries have found it useful to require that exclusive concessions be rebid from time to time rather than freely extended by the parties. Periodic rebidding may give the concessionaire strong performance incentives. The period between the initial award and the first (and subsequent) rebidding should take into account the level of investment and other risks faced by the concessionaire. For example, for solid waste collection concessions not requiring heavy fixed investments, the periodicity may be relatively short (three to five years, for example), whereas longer periods may be desirable for power or water distribution concessions. In most countries, rebidding coincides with the end of the project term, but in others a concession may be granted for a long period (say 99 years), with periodic rebidding (for instance, every 10 or 15 years). In the latter mechanism, which has been adopted in a few countries, the first rebidding occurs before the concessionaire has fully recouped its investments. As an incentive to the incumbent operator, some laws provide that the concessionaire may be given preference over other bidders in the award of subsequent concessions for the same activity. However, the concessionaire may have rights to compensation if it does not win the next bidding round, in which case all or part of the bidding proceeds may revert to the incumbent concessionaire. Requiring that the winning bidder should pay off the incumbent concessionaire for any property rights and for the investment not yet recovered reduces the longer-term risk faced by investors and lenders and provides them a valuable exit option (see paras. 39 and 40).

8. Notwithstanding the above, it is advisable not to exclude entirely the option to negotiate an extension of the concession period under certain specified circumstances. The duration of an infrastructure project is one of the main factors taken into account in the negotiation of financial arrangements and has a direct impact on the price of the services provided by the concessionaire. The parties may find that an extension of the project agreement (as a substitute for or combined with other compensation mechanisms) may be a useful option to deal with unexpected impediments or other changes of circumstances arising during the life of the project. Such circumstances may include any of the following: extension to compensate for project suspension or loss of profit due to the occurrence of impeding events (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 131-139); extension to compensate for project suspension brought about by the contracting authority or other public authorities (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 140 and 141); or extension to allow the concessionaire to recover the cost of additional work required to be done on the facility and which the concessionaire would not be able to recover during the normal term of the project agreement without unreasonable tariff increases (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 73-76). For purposes of transparency and accountability, in some countries the extension of the concession period is subject to a global cumulative limit or requires the approval of a specially designated public authority.

D. Termination

9. The grounds for termination of the project agreement before the expiry of its term and the consequences of any such termination are often dealt with in domestic legislation. Usually the law authorizes the parties to terminate the project agreement following the occurrence of certain types of events. The main interest of all parties involved in a privately financed infrastructure project is to ensure the satisfactory completion of the facility and the continuous and orderly provision of the relevant public service. Given the serious consequences of termination, as provision of the service may be interrupted or even discontinued, termination should under most circumstances be regarded as a measure of last resort. The conditions for the exercise of this right by either party should be carefully considered. While they may not need to be identical, it is generally desirable to achieve a broadly equitable balance of rights and conditions regarding termination for both parties.

10. In addition to identifying the circumstances or types of events that may give rise to a termination right, it is advisable for the parties to consider appropriate procedures to establish whether there are valid grounds for terminating the project agreement. Of particular importance is the question whether the project agreement may be unilaterally terminated or whether termination requires a decision by a judicial or other dispute settlement body.

11. The concessionaire is usually not allowed to terminate the project agreement without cause and in some legal systems termination by the concessionaire even in the event of breach by the contracting authority requires a final judicial decision. However, in some countries, pursuant to rules applicable to contracts with government entities, such a right may be exercised by public authorities, subject to payment of compensation to the concessionaire. In other countries, however, an exception is made in the case of public service concessions, whose contractual nature is found to be incompatible with unilateral termination rights. Lastly, some legal systems do not recognize unilateral termination rights for public authorities. However, project promoters and lenders would be concerned about the risk of premature or unjustified termination by the contracting authority, even where a decision to terminate might be subject to review through the dispute settlement mechanism. It should also be noted that giving the contracting authority the unilateral right to terminate the project agreement would not be an adequate substitute for well-designed contractual mechanisms of performance monitoring or for appropriate guarantees of performance (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 80-97 and 108-120).

12. Provisions concerning termination should therefore be brought into line with the remedies for breach provided in the project agreement. In particular, it is useful to distinguish the conditions for termination from those for step-in by the contracting authority (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 143-146). It is also important to consider the contracting authority's termination rights against the background of the financing agreements negotiated by the concessionaire with its lenders. In most cases, events that may lead to the termination of the project agreement would also constitute events of default under the loan agreements, with the consequence that the entire outstanding debt of the concessionaire may fall due immediately. It would thus be useful to attempt to avoid the risk of termination by allowing the lenders to propose another concessionaire when termination of the project agreement with the original concessionaire appears imminent (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 108-120).

13. In the light of the above, it is generally advisable to provide that the termination of the project agreement in most cases require a final finding by the dispute settlement body provided in the agreement. Such a requirement would reduce concerns about premature or unjustified recourse to termination. At the same time, it would not preclude the taking of appropriate measures to ensure the continuity of the service, pending the final decision of the dispute settlement body, as long as contractual remedies for breach, such as step-in rights for the contracting authority and the lenders, are provided in the project agreement. In countries where such a requirement would not be consistent with general principles of administrative law applicable to government contracts, it might be important to ensure, at least, that the contracting authority's right to terminate the project agreement should be without prejudice to the concessionaire's right to seek subsequent judicial review of the contracting authority's decision to terminate.

1. *Termination by the contracting authority*

14. The contracting authority's termination rights usually relate to three categories of circumstances: serious breach by the concessionaire; insolvency or bankruptcy of the concessionaire; and termination for reasons of public interest.

(a) Serious breach by the concessionaire

15. The contracting authority has the duty to ensure that public services are provided in accordance with applicable laws, regulations and contractual provisions. Thus, a number of domestic laws expressly recognize the contracting authority's right to terminate the project agreement in the event of breach by the concessionaire. Because of the disruptive effects of termination and in the interest of preserving the continuity of the service, it is not advisable to regard termination as a sanction for each and any instance of unsatisfactory performance by the concessionaire. On the contrary, it is generally advisable to resort to the extreme remedy of termination only in cases of "particularly serious" or "repeated" failures to perform, especially when it can no longer be reasonably expected that the concessionaire will be able or willing to perform under the project agreement. Many legal systems use specific technical expressions to refer to situations where the degree of breach by one contracting party is of such a nature that the other party may terminate their contractual relation before the expiry of its term (for example, "fundamental breach", "material breach" or similar expressions). Such situations are referred to in the *Guide* as "serious breach".

16. Circumscribing the possibility of termination to cases of serious breach may give assurance to lenders and project promoters that they will be protected against unreasonable or premature decisions by the contracting authority. The law may generally provide for the contracting authority's right to terminate the project agreement upon serious breach by the concessionaire and leave it for the project agreement to define further the notion of serious breach and, as appropriate, provide illustrative examples of it. From a practical point of view, it is not advisable to attempt, by statute or in the project agreement, to provide a list of the events that justify termination.

17. As a general rule, it is desirable that the concessionaire be granted an additional period of time to fulfil its obligations and to avert the consequences of its breach prior to the contracting authority's resorting to remedies. For example, the concessionaire should be given notice specifying the nature of the relevant circumstances and requiring it to rectify them within a certain period. The possibility might also be given for the lenders and sureties, as the case may be, to avert the consequences of the concessionaire's breach, for instance by temporarily engaging a third party to cure the consequences of breach by the concessionaire, in accordance with the terms of the performance bonds provided to the contracting authority or the terms of a direct agreement between the lenders and the contracting authority (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 108-120 and 147-150). The project agreement may also provide that, if the circumstances are not rectified before the expiry of the relevant period, the

contracting authority may then terminate the project agreement, subject to first notifying the lenders and giving them an opportunity within a certain period to exercise any right of substitution that the lenders might have in accordance with a direct agreement between them and the contracting authority. However, reasonable deadlines need to be set, since the contracting authority cannot be expected to bear indefinitely the continuing cost of a situation of breach of the project agreement by the concessionaire. Furthermore, the procedures should be without prejudice to the contracting authority's right to step in to avert the risk of disruption of service by the concessionaire (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 145 and 146).

(i) Serious breach before the beginning of construction

18. The concessionaire typically needs to accomplish a series of steps prior to undertaking construction works. Some of these requirements may even constitute conditions precedent to the entry into force of the project agreement. Examples of events that often justify the withdrawal of the concession award at an early stage include the following:

(a) Failure to secure the required financial means, to sign the project agreement or to establish the project company within the established deadline;

(b) Failure to obtain licences or permits required for pursuing the activity that is the object of the concession;

(c) Failure to undertake the construction of the facility, to commence development of the project or to submit the plans and designs required within a set period of time from the award of the concession.

19. Termination should in principle be reserved for situations where the contracting authority may no longer reasonably expect that the selected concessionaire will take the necessary measures to commence execution of the project. In that connection, it is important for the contracting authority to take into account any circumstances that may excuse the concessionaire's delay in fulfilling its obligations. Furthermore, the concessionaire should not suffer the consequences of inaction or error on the part of the contracting authority or other public authorities. For instance, the termination of the project agreement would not normally be justified if the concessionaire's failure to obtain government licences and permits within the agreed schedule was not attributable to the concessionaire's own fault.

(ii) Serious breach during the construction phase

20. Examples of events that may justify the termination of the project agreement during the construction phase include the following:

(a) Failure to observe building regulations, specifications or minimum design and performance standards and non-excusable failure to complete work within the agreed schedule;

(b) Failure to provide or renew the required guarantees in the agreed terms;

(c) Violation of essential statutory or contractual obligations.

21. Termination should be commensurate with the degree of breach by the concessionaire and the consequences of breach for the contracting authority. For instance, the contracting authority may have a legitimate interest in specifying a date when the construction must be completed and may therefore be justified in regarding a delay in completion as an event of breach and hence a ground for termination. However, delay alone, in particular if it is not excessive in relation to the specifications of the project agreement, might not be sufficient reason for termination when the contracting authority is otherwise satisfied with the concessionaire's ability to complete the construction in accordance with the required quality standards and its commitment to doing so.

(iii) Serious breach during the operational phase

22. Examples of particular instances of breach that typically justify the termination of the concession during the operational phase include any of the following:

(a) Serious failure to provide services in accordance with the statutory and contractual standards of quality, including disregard of price control measures;

(b) Non-excusable suspension or interruption of the provision of the service without prior consent from the contracting authority;

(c) Serious failure by the concessionaire to maintain the facility, its equipment and appurtenances in accordance with the agreed standards of quality or non-excusable delay in carrying out maintenance works in accordance with the agreed plans, schedules and timetables;

(d) Failure to comply with sanctions imposed by the contracting authority or the regulatory agency, as appropriate, for infringements of the concessionaire's duties.

23. For the purpose of enhancing transparency and integrity in governmental matters, the laws of some countries also provide for the termination of project agreements if the concessionaire is guilty of tax fraud or other types of fraudulent acts, or if its agents or employees are involved in bribery of public officials and other corrupt practices (see also chap. VII, "Other relevant areas of law", paras. 50-52). The latter considerations underscore the importance of designing effective mechanisms to combat corruption and bribery and to afford the concessionaire the opportunity to file complaints against demands for illegal payments or unlawful threats by officials of the host country.

(b) Insolvency of the concessionaire

24. Infrastructure services typically need to be provided continuously and for that reason most domestic laws stipulate that the agreement may be terminated if the concessionaire is declared insolvent or bankrupt. In order to ensure the

continuity of the service, the assets and property required to be handed over to the contracting authority may be excluded from the insolvency proceedings and the law may require prior governmental approval for any act of disposition by a liquidator or insolvency administrator of any categories of assets owned by the concessionaire.

25. In a legal system that allows the establishment of security interests over the concession itself (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 57), the law provides that the contracting authority may, in consultation with the holders of such security creditors, appoint a temporary administrator so as to ensure the continued provision of the relevant service, until the secured creditors admitted to the insolvency proceedings decide, upon the recommendation of the insolvency administrator, whether the activity should be pursued or whether the right to exploit the concession should be put to a bidding process.

(c) Termination for reasons of public interest

26. In the contracting practice of some countries, public authorities procuring construction works traditionally retain the right to terminate the construction contract for reasons of public interest (that is, without having to provide any justification other than that the termination is in the Government's interest). In some common law jurisdictions, that right, which is sometimes referred to as "termination for convenience", can only be exercised if expressly provided for in a statute or in the relevant contract. Several legal systems belonging to the civil law tradition also recognize a similar power of public authorities to terminate contracts for reasons of public interest or "general interest". In some countries, such a right may be implied in the Government's contracting power, even in the absence of an explicit statutory or contractual provision to that effect. The Government's right to terminate for reasons of public interest, in those legal systems which recognize it, is regarded as essential in order to preserve the Government's unfettered ability to exercise its functions affecting the public good.

27. Nevertheless, the conditions for the exercise of this right, and the consequences of doing so, should be carefully considered. The authority to determine what constitutes public interest may lie within the Government's discretion, so that the contracting authority's decision to terminate the project agreement could only be challenged under specific circumstances (for instance, improper motive, "*détournement de pouvoir*"). However, a general and unqualified right to terminate the project agreement for reasons of public interest may represent an imponderable risk that neither the concessionaire nor the lenders may be ready to accept without sufficient guarantees that they will receive prompt compensation for the loss sustained. The possibility of termination for reasons of public interest, where contemplated, should therefore be made known to prospective investors on the earliest possible occasion and should be expressly mentioned in the draft project agreement circulated with the request for proposals (see chap. III, "Selection of the concessionaire", para.

67). The compensation due for termination for reasons of public interest may, in practice, cover items that are taken into account when calculating the compensation that is due for termination for serious breach by the contracting authority (see para. 42). Furthermore, it is generally advisable to limit the exercise of the right to terminate the project agreement to situations where such termination is needed for a compelling reason of public interest, which should be restrictively interpreted (for example, where major subsequent changes in governmental plans and policies require the integration of a project into a larger network or where changes in the contracting authority's plans require major project revisions that substantially affect the original design or the project's commercial feasibility under private operation). In particular, it is not advisable to regard the right of termination for reasons of public interest as a substitute for other contractual remedies in case of dissatisfaction with the concessionaire's performance (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 140-150).

2. *Termination by the concessionaire*

28. While the contracting authority in some legal systems may retain an unqualified right to terminate the project agreement, the grounds for termination by the concessionaire are usually limited to serious breach by the contracting authority or other exceptional situations and do not normally include a general right to terminate the project agreement at will. Moreover, some legal systems do not recognize the concessionaire's right to terminate the project agreement unilaterally, but only the right to request a third party, such as the competent court, to declare the termination of the project agreement.

(a) Serious breach by the contracting authority

29. Generally, the concessionaire's right to terminate the project agreement is limited to situations where the contracting authority is found to be in breach of a substantial part of its obligations (such as failure to make agreed payments to the concessionaire or failure to issue licences required for the operation of the facility for reasons other than the concessionaire's own fault). In those legal systems where the contracting authority has the right to request modifications in the project, the concessionaire may have the right to terminate the project agreement if the contracting authority alters or modifies the original project in such a fashion as to cause a substantial increase in the amount of investment required and the parties fail to agree on the appropriate amount of compensation (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 73-76).

30. In addition to serious breach by the contracting authority itself, it may be equitable to authorize termination by the concessionaire should the latter be rendered unable to provide the service as a result of acts of public authorities other than the contracting authority, such as failure to provide certain measures of support required for the execution of the project agreement (see chap. II, "Project risks and government support", paras. 35-60).

31. Although termination by the concessionaire may not always require a final finding by a judicial or other dispute settlement body, there may be limits to the remedies available to the concessionaire in the event of breach by the contracting authority. Pursuant to a rule of law followed in many legal systems, a party to a contract may withhold performance of its obligations in the event of breach by the other party of a substantial part of its obligations. However, in some legal systems that rule does not apply to government contracts and the law provides instead that government contractors are not excused from performing solely on the ground of breach by the contracting authority unless and until the contract is rescinded by a judicial or arbitral decision.

32. Limitations on the concessionaire's right to withhold performance are typically intended to ensure the continuity of public services (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 86 and 87). Nevertheless, it should be noted that while the contracting authority may mitigate the consequences of breach by the concessionaire by using its right to step in, the concessionaire does not usually have a comparable remedy. In the event of serious breach by the contracting authority, the concessionaire may sustain considerable or even irreparable damage, depending on the time required to obtain a final decision releasing the concessionaire from its obligations under the project agreement. These circumstances underscore the importance of government guarantees in respect of obligations assumed by contracting authorities (see chap. II, "Project risks and government support", paras. 45-50) and the need for allowing the parties the choice of expeditious and effective dispute settlement mechanisms (see chap. VI, "Settlement of disputes", paras. 3-42).

(b) Changes in conditions

33. Domestic laws often allow the concessionaire to terminate the project agreement if the concessionaire's performance has been rendered substantially more onerous by the occurrence of an unforeseen change in conditions and the parties have failed to agree on an appropriate revision to adapt the project agreement to the changed conditions (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 126-130).

3. Termination by either party

(a) Impediment of performance

34. Some laws provide that the parties may terminate the project agreement if the performance of their obligations is rendered permanently impossible as a result of a circumstance defined in the project agreement as an exempting impediment (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 132-139). In that connection, it is advisable to provide in the project agreement that if the exempting impediment persists for a certain period or if the cumulative duration of two

or more exempting impediments exceeds a certain time, the agreement may be terminated by either party. If the execution of the project is rendered impossible on legal grounds, because of changes in legislation or as a result of judicial decisions affecting the validity of the project agreement, for instance, such a termination right might not require any period of time to elapse and might be exercised immediately upon the change of legislation or other legal obstacle becoming effective.

(b) Mutual consent

35. Some domestic laws authorize the parties to terminate the project agreement by mutual consent, usually subject to the approval of a higher authority. Legislative power to this effect may be needed by the contracting authority in legal systems where the termination by mutual consent might amount to a discontinuation of the public service for which the contracting authority is responsible.

E. Consequences of expiry or termination of the project agreement

36. The concessionaire's right to operate the facility and to provide the relevant service typically finishes upon expiry of the project term or termination of the project agreement. Unless the infrastructure is to be permanently owned by the concessionaire, the expiry or termination of the project agreement often requires the transfer of assets to the contracting authority or to another concessionaire who undertakes to operate the facility. There may be important financial consequences that will need to be regulated in detail in the project agreement, in particular in the event of termination by either party. The parties will also need to agree on various wind-up measures to ensure the orderly transfer of the responsibility for operating the facility and providing the service.

1. Transfer of project-related assets

37. In most cases, the assets and property originally made available to the concessionaire and other goods related to the project are to revert to the contracting authority upon expiry or termination of the project agreement (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 23-29). In a typical "build-operate-transfer" project, the concessionaire would also be obliged to transfer to the contracting authority the physical infrastructure and other project-related assets upon expiry or termination of the project agreement. The assets required to be transferred to the contracting authority often include intangible assets, such as outstanding receivables and other rights existing at the time of transfer. Depending on the project, the assets to be transferred may include specific technology or know-how (see paras. 51-55). It should be noted that in some projects the assets are transferred directly from the concessionaire to another concessionaire who succeeds it in the provision of the service.

(a) Transfer of assets to the contracting authority

38. Different arrangements may be needed, depending on the type of asset to be transferred (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 28):

(a) *Assets that must be transferred to the contracting authority.* In the legal tradition of some countries, at the end of the project term, the concessionaire is required to transfer such assets free of any liens and encumbrances and at no cost to the contracting authority, except for compensation for improvements made to, or modernization of, the property for the purpose of ensuring the continuity of the service the cost of which has not yet been recovered by the concessionaire. In practice, such a rule presupposes the negotiation of a concession period sufficiently long and a level of revenue high enough for the concessionaire to amortize fully its investment and to repay its debts in full. Other laws allow for more flexibility by authorizing the contracting authority to compensate the concessionaire for the residual value, if any, of assets built by the concessionaire;

(b) *Assets that may be purchased by the contracting authority, at its option.* If the contracting authority decides to exercise its option to purchase those assets, the concessionaire is normally entitled to compensation corresponding to their fair market value at the time. However, if those assets were expected to be fully amortized (that is, if the concessionaire's financing arrangements do not envisage any expectation of residual value of the assets), then the price paid might be only nominal. In the contracting practice of some countries, it is usual for contracting authorities to be granted some security interest in such assets as a guarantee for their effective transfer;

(c) *Assets that remain the private property of the concessionaire.* Typically these assets may be freely removed or disposed of by the concessionaire.

(b) Transfer of assets to a new concessionaire

39. As indicated earlier, the contracting authority may wish to rebid the concession at the end of the project agreement, rather than to operate the facility itself (see para. 3). For that purpose, it may be useful for the law to require the concessionaire to make the assets available to a new concessionaire. In order to ensure an orderly transition and continuity of the service, the concessionaire should be required to cooperate with the new concessionaire in the handover. The transfer of assets between the concessionaires may require that some compensation be paid to the incumbent concessionaire, depending on whether or not the assets have been amortized.

40. One important element to consider in this connection is the structure of the financial proposal formulated by the concessionaire during the selection process (see also chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 27). In public infrastructure projects, one of the basic assumptions of the bidders' financial proposal is that all assets required to be built or acquired for the project will be fully amortized (that is, their cost will be recovered in full) in the life of the project. Thus, the financial

proposals will not normally include an expectation of residual value for the assets at the end of the project period. In such cases, there may not be a prima facie reason for requiring a successor concessionaire to pay any compensation to the original concessionaire, which may be required to make all assets available to its successor at no cost or only for a nominal consideration. Indeed, if the concessionaire has achieved its expected return, a transfer payment from a successor concessionaire would be an additional cost that would ultimately have to be remunerated by the prices charged by the successor under the second agreement. However, if the tariff level contemplated in the concessionaire's original proposal was based on the assumption of some residual value of the assets at the end of the project period or if the financial proposal assumed significant revenue from third parties, the concessionaire might be entitled to compensation for assets handed over to a successor concessionaire.

(c) Condition of assets at the time of transfer

41. Where assets are handed over to the contracting authority or transferred directly to a new concessionaire upon the expiry of the concession period, the concessionaire is typically obligated to transfer them, free of liens or encumbrances, and in such condition as would be necessary for normal functioning of the infrastructure facility, taking into account the needs of the service. The contracting authority's right to receive those assets in such operating condition is complemented in some laws by the obligation imposed upon the concessionaire to keep and transfer the project in such proper condition as prudent maintenance requires and to provide some sort of guarantee to that effect (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 118). Where the contracting authority requires the assets to be returned in a prescribed condition, the required conditions should be reasonable. While it may be reasonable for the contracting authority to require that the assets have some defined period of residual life, it would not be reasonable to expect them to be as new. Furthermore, these requirements may not be applicable in the event of termination of the project agreement, in particular termination prior to successful completion of the construction phase.

42. It is advisable to devise procedures for ascertaining the condition of the assets that should be transferred to the contracting authority. It may be useful, for example, to establish a committee comprised of representatives of both the contracting authority and the concessionaire to establish whether the facilities are in the prescribed condition and conform to the relevant requirements set forth in the project agreement. The project agreement may also provide for the appointment and terms of reference of such a committee, which may be given authority to request reasonable measures by the concessionaire to repair or eliminate any defects and deficiencies found in the facilities. It may be advisable to provide for a special inspection to take place one year prior to the termination of the concession, following which the contracting authority may require additional maintenance measures by the concessionaire so as to ensure that the goods are in proper condition at the time of the transfer. The contract-

ing authority may wish to require that the concessionaire provide special guarantees for the satisfactory handover of the facilities (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 118). The contracting authority might draw on such guarantees to pay the repair cost of damaged assets or property.

2. *Financial arrangements upon termination*

43. Termination of the project agreement may occur before the concessionaire has been able to recover its investment, repay its debts and yield the expected profit, which may cause significant loss to the concessionaire. Loss may also be sustained by the contracting authority, which may need to make additional investment or incur considerable expense in order, for instance, to ensure the completion of the facility or the continued provision of the relevant services. In view of these circumstances, project agreements typically contain extensive provisions dealing with the financial rights and obligations of the parties upon termination. The usual standards of compensation typically vary according to the various grounds for termination. Nevertheless, the following factors are usually taken into account in compensation arrangements:

(a) *Outstanding debt, equity investment and anticipated profit.* Project termination is typically included among the events of default in the concessionaire's loan agreements. Since loan agreements usually include a so-called "acceleration clause", whereby the entire debt may become due upon the occurrence of an event of default, the immediate loss sustained by the concessionaire upon termination of the project agreement may include the amount of debt then outstanding. Whether and to what extent such a loss might be compensated for by the contracting authority usually depends on the grounds for terminating the project agreement. Partial compensation may be limited to an amount corresponding to the value of works satisfactorily performed by the concessionaire, whereas full compensation would cover the entire outstanding debt. Another category of loss that is sometimes taken into account in compensation arrangements refers to loss of equity investment by the project promoters, to the extent that such an investment has not yet been recovered at the time of termination. Lastly, termination also deprives the concessionaire of future profits that the facility may generate. Although lost profits are not usually regarded as actual damage, in exceptional circumstances, such as wrongful termination by the contracting authority, the current value of expected future profit may be included in the compensation due to the concessionaire;

(b) *Degree of completion, residual value and amortization of assets.* Contractual compensation schemes for various termination grounds typically include compensation commensurate with the degree of completion of the works at the time of termination. The value of the works is usually determined on the basis of the investment required for construction (in particular if the termination takes place during the construction phase), the replacement cost or the "residual" value of the facility. The residual value means the market value of the infrastructure at the time of termination. Market value may be difficult

to determine or even non-existent for certain types of physical infrastructure (such as bridges or roads) or for facilities whose operational life is close to expiry. Sometimes the residual value may be estimated taking into account the expected usefulness of the facility for the contracting authority. However, difficulties may be found in establishing the value of unfinished works, in particular if the amount of the investment still required by the contracting authority to render the facility operational would exceed the amount actually invested by the concessionaire. In any event, full payment of residual value seldom takes place, in particular where the project's revenue constitutes the sole remuneration for the concessionaire's investment. Thus, instead of full compensation for the facility's value, the concessionaire often receives compensation only for the residual value of assets that have not yet been fully amortized at the time of termination.

(a) Termination due to breach by the concessionaire

44. The concessionaire is not usually entitled to damages in the event of termination due to its own breach. In some cases the concessionaire may be under an obligation to pay damages to the contracting authority, although, in practice, a defaulting concessionaire whose debts are declared due by its creditors would seldom have sufficient financial means left for actual payment of such damages.

45. It should be noted that termination due to breach, even where it is regarded as a sanction for serious performance failures, should not result in the unjust enrichment of either party. Thus, termination does not necessarily entail a right for the contracting authority to take over assets without making any payment to the concessionaire. An equitable solution for dealing with this issue may be to distinguish between the different types of asset, according to the arrangements envisaged for them in the project agreement (see para. 38):

(a) *Assets that must be transferred to the contracting authority.* Where the project agreement requires the automatic transfer of project assets to the contracting authority at the end of the project agreement, termination on breach does not usually entail the payment of compensation to the concessionaire for those assets, except for the residual value of work satisfactorily performed, to the extent that it has not yet been amortized by the concessionaire;

(b) *Assets that may be purchased by the contracting authority, at its option.* Financial compensation may be adequate in cases where the contracting authority has an option to buy the assets at market value on expiry of the project agreement or the right to require that such an option be given to the winner of a new project award. However, it may be legitimate to envisage a financial compensation that is less than the full value of the assets so as to stimulate performance by the concessionaire. By the same token, such compensation may not need to cover the full cost of repaying the concessionaire's outstanding debt. It is advisable to set forth the details of the formula for financial compensation in the project agreement (that is, whether it covers the break-up value of the asset or the lesser of the outstanding debt and the alternative use value);

(c) *Assets that remain the private property of the concessionaire.* Assets in the concessionaire's private property that do not fall under (a) or (b) above may usually be removed and disposed of by the concessionaire, so that the need for compensation arrangements seldom arises. However, a different situation may arise in the case of fully privatized projects, where all assets, including those essential for the provision of the services, are owned by the concessionaire. In such cases, in order to ensure the continuity of the services, the contracting authority may find it necessary to take over the assets, even though not contemplated in the project agreement. In such cases, it would be equitable to compensate the concessionaire for the fair market value of the assets. The project agreement may, however, provide that the compensation should be reduced by the costs incurred by the contracting authority in operating the facility or engaging another operator.

(b) Termination due to breach by the contracting authority

46. The concessionaire is usually entitled to full compensation for loss sustained as a result of termination on grounds attributable to the contracting authority. The compensation due to the concessionaire usually includes compensation for the value of the works and installations, to the extent they have not already been amortized, as well as for the loss caused to the concessionaire, including lost profits, which are usually calculated on the basis of the concessionaire's revenue during previous financial years, when termination occurs during the operational phase, or are based on a projection of the expected benefit during the duration originally envisaged. The concessionaire may be entitled to full compensation of debt and equity, including debt service and lost profits.

(c) Termination on other grounds

47. When considering compensation arrangements for termination due to circumstances unrelated to breach by either party, it may be useful to distinguish exempting impediments from termination declared by the contracting authority for reasons such as public interest or other similar reasons.

(i) Termination due to exempting impediments

48. By definition, exempting impediments are events beyond the parties' control and, as a general rule, termination under such circumstances might not give rise to claims for damages by either party. However, there may be circumstances where it might be equitable to provide for some compensation to the concessionaire, such as fair compensation for works already completed, in particular where, because of the specialized nature of the assets, they cannot be removed by the concessionaire or meaningfully used by it, but may be effectively used by the contracting authority for the purpose of providing the relevant service (a bridge, for instance). However, since termination in such cases cannot be attributed to the contracting authority, the compensation due to the concessionaire may not necessarily need to be "full" compensation (that is, repayment of debt, equity and lost profits).

(ii) Termination for reasons of public interest

49. Where the project agreement recognizes the contracting authority's right to terminate for reasons of public interest, the compensation payable to the concessionaire usually covers compensation for the same items included in compensation payable upon termination for breach by the contracting authority (see para. 46), although not necessarily to the full extent. In order to establish the equitable amount of compensation due to the concessionaire, it may be useful to distinguish between termination for reasons of public interest during the construction phase and termination for convenience during the operational phase:

(a) *Termination during the construction phase.* If the project agreement is terminated during the construction phase, the compensation arrangements may be similar to those which are followed in connection with large construction contracts that allow for termination for convenience. In those cases, the contractor is usually entitled to the portion of the price that is attributable to the construction satisfactorily performed, as well as for expenses and losses incurred by the contractor arising from the termination. However, since the contracting authority does not normally pay a price for the construction work carried out by the concessionaire, the main criterion for calculating compensation would typically be the total investment effectively made by the concessionaire up to the time of termination, including all sums actually disbursed under the loan facilities extended by the lenders to the concessionaire for the purpose of carrying out construction under the project agreement, and expenses related to the cancellation of loan agreements. One additional question is whether and to what extent the concessionaire may be entitled to recover lost profit for the portion of the contract that has been terminated for convenience. On the one hand, the concessionaire might have foregone other business opportunities in anticipation of completing the project and operating the facility through the anticipated duration of the concession. On the other hand, an obligation of the contracting authority to compensate the concessionaire for its lost profit might make it financially prohibitive for the contracting authority to exercise its right of termination for convenience. One approach may be for the project agreement to establish a scale of payments to be made by the contracting authority as compensation for lost profits and the amount of the payments depending upon the stage of the construction that has been completed when the project agreement is terminated for convenience;

(b) *Termination during the operational phase.* As regards the construction work satisfactorily completed by the concessionaire, the compensation arrangements may be the same as for termination during the construction phase. However, equitable compensation for termination during the operational phase might require fair compensation for lost profits. The higher standard of compensation in this case may be justified by the fact that, unlike termination during the construction phase, when the contracting authority might need to undertake to complete the work at its own expense, upon termination during the operational phase the contracting authority might be able to receive a completed facility capable of being operated profitably. Compensation for lost profits is often calculated on the basis of the concessionaire's revenue during

a certain number of previous financial years, but in some cases other elements, such as the anticipated profit on the basis of the agreed tariffs, may need to be taken into account. This is so because in some infrastructure projects such as toll roads and similar projects, which are characterized by high financial costs and relatively low income at the early stages of operation, termination may occur before the project has a history of profitability.

3. *Wind-up and transitional measures*

50. Where the facility is transferred to the contracting authority at the end of the concession period, the parties may need to make a series of arrangements in order to ensure that the contracting authority will be able to operate the facility at the prescribed standards of efficiency and safety. The project agreement may provide for the concessionaire's obligation to transfer certain technology or know-how required to operate the infrastructure facility. The project agreement may also provide for the continuation, for a certain transitional period, of certain obligations of the concessionaire in respect of the operation and maintenance of the facility. It may further include an obligation, on the part of the concessionaire, to supply or facilitate the supply of spare parts that may be needed by the contracting authority to carry out repairs in the facility. It should be noted, however, that the concessionaire might not be in a position to undertake itself some of the transitional measures referred to below, since in most cases the concessionaire would have been established for the sole purpose of carrying out the project and would need to procure the relevant technology or spare parts from third parties.

(a) Transfer of technology

51. In some cases, the facility transferred to the contracting authority will embody various technological processes necessary for the generation of certain goods, such as electricity or potable water, or the provision of the relevant services, such as telephone services. The contracting authority will often wish to acquire a knowledge of those processes and their application. The contracting authority will also wish to acquire the technical information and skills necessary for the operation and maintenance of the facility. Even where the contracting authority has the basic capability to undertake certain elements of the operation and maintenance (for example, building or civil engineering), the contracting authority may need to acquire a knowledge of special technical processes necessary to effect the operation in a manner appropriate to the facility in question. The communication to the contracting authority of that knowledge, information and skills is often referred to as the "transfer of technology". Obligations concerning the transfer of technology cannot be unilaterally imposed on the concessionaire and, in practice, these matters are the subject of extensive negotiations between the parties concerned. While the host country has a legitimate interest in gaining access to the technology needed to operate the facility, due account should be taken of the commercial interests and business strategies of the private investors.

52. Differing contractual arrangements can be adopted for the transfer of technology and the performance of the other obligations necessary to construct and operate the facility. The transfer of technology itself may occur in different ways, for example, through the licensing of industrial property, through the creation of a joint venture between the parties or the supply of confidential know-how. The *Guide* does not attempt to deal comprehensively with contract negotiation and drafting relating to the licensing of industrial property or the supply of know-how, as this subject has already been dealt with in detail in publications issued by other United Nations bodies.[1] The following paragraphs merely note certain major issues concerning the communication of skills necessary for the operation and maintenance of the facility through the training of the contracting authority's personnel or through documentation.

53. The most important method of conveying to the contracting authority the technical information and skills necessary for the proper operation and maintenance of the works is the training of the contracting authority's personnel. In order to enable the contracting authority to decide on its training requirements, in the request for proposals or during the contract negotiations the contracting authority might request the concessionaire to supply the contracting authority with an organizational chart showing the personnel requirements for the operation and maintenance of the works, including the basic technical and other qualifications the personnel must possess. Such a statement of requirements should be sufficiently detailed to enable the contracting authority to determine the extent of training required in relation to the personnel available to it. The concessionaire will often have the capability to provide the training. In some cases, however, the training may be given more effectively by a consulting engineer or through an institution specializing in training.

54. Technical information and skills necessary for the proper operation and maintenance of the facility may also be conveyed through the supply of technical documentation. The documentation to be supplied may consist of plans, drawings, formulas, manuals of operation and maintenance and safety instructions. It may be advisable to list in the project agreement the documents to be supplied. The concessionaire may be required to supply documents that are comprehensive and clearly drafted and are in a specified language. It may be advisable to obligate the concessionaire, at the request of the contracting authority, to give demonstrations of procedures described in the documentation if the procedures cannot be understood without demonstrations.

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[1]The negotiation and drafting of contracts for the licensing of industrial property and the supply of know-how is dealt with in detail in World Intellectual Property Organization, Licensing Guide for Developing Countries (WIPO publication No. 620 (E), 1977). The main issues to be considered in negotiating and drafting such contracts are set forth in the *Guidelines for Evaluation of Transfer of Technology Agreements*, Development and Transfer of Technology Series, No. 12 (ID/233, 1979), and in the *Guide for Use in Drawing Up Contracts Relating to the International Transfer of Know-How in the Engineering Industry* (United Nations publication, Sales No. E.70.II.E.15). Another relevant publication is the *Handbook on the Acquisition of Technology by Developing Countries* (United Nations publication, Sales No. E.78.II.D.15). For a discussion of transfer of technology in the context of contracts for the construction of industrial works, see the *UNCITRAL Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (United Nations publication, Sales No. E.87.V.10), chap. VI, "Transfer of technology".

55. The points in time when the documentation is to be supplied may be specified. The project agreement may provide that the supply of all documentation is to be completed by the time fixed in the contract for completion of the construction. The parties may also wish to provide that transfer of the facility is not to be considered completed unless all documentation relating to the operation of the works and required under the contract to be delivered prior to the completion has been supplied. It may be advisable to provide that some documentation, such as operating manuals, is to be supplied during the course of construction, as such documentation may enable the contracting authority's personnel or engineer to obtain an understanding of the working of machinery or equipment while it is being erected.

(b) Assistance in connection with operation and maintenance of the facility after its transfer

56. The degree of assistance from the concessionaire needed by the contracting authority will depend on the technology and skilled personnel available to the contracting authority. If the contracting authority lacks personnel sufficiently skilled for the technical operation of the facility, it may wish to obtain the concessionaire's assistance in operating the facility, at least for an initial period. The contracting authority may, in some cases, wish the concessionaire to provide the personnel to occupy many of the technical posts in the facility, while in other cases the contracting authority may wish the concessionaire only to provide technical experts to collaborate in an advisory capacity with the contracting authority's personnel in the performance of a few highly specialized operations.

57. In order to assist the contracting authority in operating and maintaining the facility, the project agreement may obligate the concessionaire to submit, prior to the transfer of the facility, an operation and maintenance programme designed to keep the facility operating over its remaining lifetime at the level of efficiency required under the project agreement. An operation and maintenance programme would include matters such as an organizational chart showing the key personnel required for the technical operation of the facility and the functions to be discharged by each person; periodic inspection of the facility; lubrication, cleaning and adjustment; and replacement of defective or worn-out parts. Maintenance may also include operations of an organizational character, such as establishing a maintenance schedule or maintenance records. The concessionaire may also be required by the contracting authority to supply operation and maintenance manuals setting out appropriate operation and maintenance procedures. Those manuals should be in a format and language readily understood by the contracting authority's personnel.

58. An effective means of training the contracting authority's personnel in operation and maintenance procedures may be to provide in the project agreement that the personnel of the contracting authority are to be associated with the personnel of the concessionaire in carrying out the operation and maintenance for a certain time prior to or beyond the transfer of the facility. The positions to be occupied by the personnel employed by the contracting author-

ity can then be identified and their qualifications and experience specified. In order to avoid friction and inefficiency, it is desirable that any authority to be exercised by the personnel of each party over the personnel of the other during the relevant period be clearly described.

(c) Supplies of spare parts

59. In projects that provide for the transfer of the facility to the contracting authority, the contracting authority will have to obtain spare parts to replace those which are worn out or damaged and to maintain, repair and operate the facility. Spare parts may not be available locally and the contracting authority may have to depend on the concessionaire to supply them. The planning of the parties with respect to the supply of spare parts and services after the transfer of the facility would be greatly facilitated if the parties were to anticipate and provide in the project agreement for the needs of the contracting authority in that regard. However, given the long duration of most infrastructure projects, it may be difficult for the parties to anticipate and provide in the project agreement for the needs of the contracting authority after the transfer of the facility.

60. A possible approach may be for the parties to enter into a separate contract regulating these matters.[2] Such a contract may be entered into closer in time to the transfer of the facility, when the contracting authority may have a clearer view of its requirements. If spare parts are manufactured not by the concessionaire but for the concessionaire by suppliers, the contracting authority may prefer to enter into contracts with those suppliers rather than to obtain them from the concessionaire or, alternatively, the contracting authority may wish to have the concessionaire procure them as the contracting authority's agent.

61. It is desirable for the contracting authority's personnel to develop the technical capacity to install the spare parts. For this purpose, the project agreement may obligate the concessionaire to supply the necessary instruction manuals, tools and equipment. The instruction manuals should be in a format and language readily understood by the contracting authority's personnel. The contract may also require the concessionaire to furnish "as built" drawings indicating how the various pieces of equipment interconnect and how access can be obtained to them to enable the spare parts to be installed and to enable maintenance and repairs to be carried out. In certain cases, it may be appropriate for the concessionaire to be required to train the contracting authority's personnel in the installation of spare parts.

(d) Repairs

62. It is in the contracting authority's interest to enter into contractual arrangements that will ensure that the facility will be repaired expeditiously in the

[2]The Economic Commission for Europe has prepared a *Guide on Drawing Up International Contracts for Services Relating to Maintenance, Repair and Operation of Industrial and Other Works* (ECE/TRADE/154), *mutatis mutandis,* which may, assist parties in drafting a separate contract or contracts dealing with maintenance and repair of the facility after its transfer to the contracting authority.

event of a breakdown. In many cases, the concessionaire may be better qualified than a third person to effect repairs. In addition, if the project agreement prevents the contracting authority from disclosing to third persons the technology supplied by the concessionaire, this may limit the selection of third persons to effect repairs to those who provide assurances regarding non-disclosure of the concessionaire's technology that are acceptable to the concessionaire. On the other hand, if major items of equipment have been manufactured for the concessionaire by suppliers, the contracting authority may find it preferable to enter into independent contracts for repair with them. In defining the nature and duration of repair obligations imposed on the concessionaire, if any, it is advisable to do so clearly and to distinguish them from obligations assumed by the concessionaire under quality guarantees to remedy defects in the facility.

VI. Settlement of disputes

A. General remarks

1. An important factor for the implementation of privately financed infrastructure projects is the legal framework in the host country for the settlement of disputes. Investors, contractors and lenders will be encouraged to participate in projects in countries where they have the confidence that any disputes arising out of contracts forming part of the project will be resolved fairly and efficiently. By the same token, efficient procedures for avoiding disputes or settling them expeditiously will facilitate the exercise of the contracting authority's monitoring functions and reduce the contracting authority's overall administrative cost. In order to create a more hospitable climate for investors, the legal framework of the host country should give effect to certain basic principles, such as the following: foreign firms should be guaranteed access to the courts under substantially the same conditions as domestic ones; parties to private contracts should have the right to choose foreign law as the law applicable to their contracts; foreign judgements should be enforceable; and there should be neither unnecessary restrictions to access to non-judicial dispute settlement mechanisms nor legal impediments for the creation of facilities for settling disputes amicably outside the judicial system.

2. Privately financed infrastructure projects typically require the establishment of a network of interrelated contracts and other legal relationships involving various parties. Legislative provisions dealing with the settlement of disputes arising in the context of these projects must take account of the diversity of relations, which may call for different dispute settlement methods depending on the type of dispute and the parties involved. The main disputes may be divided into three broad categories:

(a) *Disputes arising under agreements between the concessionaire and the contracting authority and other governmental agencies.* In most civil law countries, the project agreement is governed by administrative law (see chap. VII, "Other relevant areas of law", paras. 24-27), while in other countries the agreement is in principle governed by contract law as supplemented by special provisions developed for government contracts for the provision of public services. This regime may have implications for the dispute settlement mechanism that the parties to the project agreement may be able to agree upon. Similar considerations may also apply to certain contracts entered into between the concessionaire and governmental agencies or government-owned companies supplying goods or services to the project or purchasing goods or services generated by the infrastructure facility;

(b) *Disputes arising under contracts and agreements entered into by the project promoters or the concessionaire with related parties for the implemen-*

tation of the project. These contracts usually include at least the following: (i) contracts between parties holding equity in the project company (e.g. shareholders' agreements, agreements regarding the provision of additional financing or arrangements regarding voting rights); (ii) loan and related agreements, which involve, apart from the project company, parties such as commercial banks, governmental lending institutions, international lending institutions and export credit insurers; (iii) contracts between the project company and contractors, which themselves may be consortia of contractors, equipment suppliers and providers of services; (iv) contracts between the project company and the parties who operate and maintain the project facility; and (v) contracts between the concessionaire and private companies for the supply of goods and services needed for the operation and maintenance of the facility;

(c) *Disputes between the concessionaire and other parties.* These other parties include the users or customers of the facility, who may be, for example, a government-owned utility company that purchases electricity or water from the project company so as to resell it to the ultimate users; commercial companies, such as airlines or shipping lines contracting for the use of the airport or port; or individual persons paying for the use of a toll road. The parties to these disputes may not necessarily be bound by any prior legal relationship of a contractual or similar nature.

B. Disputes between the contracting authority and the concessionaire

3. Disputes that arise under the project agreement often involve problems that do not frequently arise in connection with other types of contracts. This is due to the complexity of infrastructure projects and the fact that they are to be performed over a long period of time, with a number of enterprises participating in the construction and in the operational phases. Also, these projects usually involve governmental agencies and a high level of public interest. These circumstances place emphasis on the need to have mechanisms in place that avoid as much as possible the escalation of disagreements between the parties and preserve their business relationship; that prevent the disruption of the construction works or the provision of the services; and that are tailored to the particular characteristics of the disputes that may arise.

4. Some of the main considerations particular to the various phases of implementation of privately financed infrastructure projects are discussed in this section. The settlement of the concessionaire's grievances in connection with decisions by regulatory agencies has been considered in the context of the authority to regulate infrastructure services (see chap. I, "General legislative and institutional framework", paras. 51-53). The settlement of disputes arising during the process of selecting a concessionaire (that is, pre-contractual disputes) has also been dealt with earlier in the *Guide* (see chap. III, "Selection of the concessionaire", paras. 127-131).

1. General considerations on methods for prevention and settlement of disputes

5. The issues that most frequently give rise to disputes during the life of the project agreement are those related to possible breaches of the agreement during the construction phase, the operation of the infrastructure facility or in connection with the expiry or termination of the project agreement. These disputes may be very complex and they often involve highly technical matters that need to be resolved speedily in order not to disrupt the construction or the operation of the infrastructure facility. For these reasons it is advisable for the parties to devise mechanisms that allow for the choice of competent experts to assist in the settlement of disputes. Furthermore, the long duration of privately financed infrastructure projects makes it important to devise mechanisms to prevent, as much as possible, disputes from arising so as to preserve the business relationship between the parties.

6. With a view to achieving the objectives mentioned above, project agreements often provide for composite dispute-settlement clauses designed to prevent, to the extent possible, disputes from arising, to foster reaching agreed solutions and to put in place efficient dispute settlement methods when disputes nevertheless arise. Such clauses typically provide for a sequential series of steps starting with an early warning of issues that may develop into a dispute unless the parties take action to prevent them. When a dispute does occur it is provided that the parties should exchange information and discuss the dispute with a view to identifying a solution. If the parties are unable to resolve the dispute themselves, then either party may require participation of an independent and impartial third party to assist them to find an acceptable solution. In most cases, adversarial dispute settlement mechanisms are only used when the disputes cannot be settled through the use of such conciliatory methods.

7. However, there may be limits to the parties' freedom to agree to certain dispute prevention or dispute settlement methods: one such limit may arise from the subject matter of the dispute; another limit may in some legal systems arise from the governmental character of the contracting authority. In some legal systems, the traditional position has been that the Government and its agencies may not agree on certain dispute settlement methods, in particular, arbitration. This position has often been restricted to mean that it does not apply to public enterprises of industrial or commercial character, which, in their relations with third parties, act pursuant to private law or commercial law.

8. Limitations to the freedom to agree on dispute settlement methods, including arbitration, may also relate to the legal nature of the project agreement. Under some civil law systems where project agreements are regarded as administrative contracts, disputes arising thereunder may need to be settled through the judiciary or through administrative courts of the host country. Under other legal systems, similar prohibitions may be expressly included in legislation or judicial precedents directly applicable to project agreements, or may be the result of established contract practices, usually based on legislative rules or regulations.

9. For countries that wish to allow the use of non-judicial methods, including arbitration, for the settlement of disputes arising in connection with privately financed infrastructure projects, it is important to remove possible legal obstacles and to provide a clear authorization for domestic contracting authorities to agree on dispute settlement methods. The absence of such legislative authority may give rise to questions as to the validity of the dispute-settlement clause and cause delay in the settlement of disputes. If, for example, an arbitral tribunal finds that the arbitration agreement has been validly concluded despite any subsequent defence that the contracting authority had no authorization to conclude it, the question may reappear at the recognition and enforcement stage before a court in the host country or before a court of a third country where the award is to be recognized or enforced.

2. *Commonly used methods for preventing and settling disputes*

10. The following paragraphs set out the essential features of methods used for preventing and settling disputes and consider their suitability for the various phases of large infrastructure projects, namely, the construction phase, the operational phase and the post-termination phase. Although the project agreement usually provides for composite dispute prevention and dispute settlement mechanisms, care should be taken to avoid excessively complex procedures or to impose too many layers of different procedures. The brief presentation of selected methods for dispute prevention and dispute settlement methods contained in the following paragraphs is intended to inform legislators about the particular features and usefulness of these various methods. It should not be understood as a recommendation for the use of any particular combination of methods.

(a) Early warning

11. Early warning provisions may be an important tool to avoid disputes. Under these provisions, if one of the parties to a contract feels that events that have occurred, or claims that the party intends to make, have the potential to cause disputes, these events or claims should be brought to the attention of the other party as soon as possible. Delays in making these claims are not only a source of conflict, because they are likely to surprise the other party and therefore create resentment and hostility, but they also render the claims more difficult to prove. For that reason, early warning provisions typically require the claiming party to submit a quantified claim, along with the necessary proof, within an established time period. To make the provision effective, a sanction is frequently included for non-compliance with the provision, such as the loss of the right to pursue the claim or an increased burden of proof. In infrastructure projects, early warning frequently refers to events that might adversely affect the quality of the works or the public services, increase their cost, cause delays or endanger the continuity of the service. Early warning provisions are therefore useful throughout the duration of an infrastructure project.

(b) Partnering

12. Another tool that is used as a means of dispute avoidance is partnering. The object of partnering is to create, through mutually developed formal strategies and from the outset of a project, an environment of trust, teamwork and cooperation among all key parties involved in the project. Partnering has been found to be useful to avoid disputes and to commit the parties to work efficiently to achieve the goals of the project. The partnering relationships are defined in workshops attended by the key parties to the project and usually organized by the contracting authority. At the initial workshop, a mutual understanding of the concept of partnering is established, goals for the project for all the parties are defined and a procedure to resolve critical issues quickly is developed. At the conclusion of this workshop, a "partnering charter" is drafted and signed by the participants, signifying their commitment to work jointly towards the success of the project. The charter usually includes an issue resolution procedure designed to determine claims and resolve other problems, beginning at the lowest possible level of management and at the earliest possible opportunity. If a solution is not reached within a given time-frame, the issue is raised to the next level of management. Outsiders to the project are only called in if no agreement by the people responsible for the project is achieved.

(c) Facilitated negotiation

13. The purpose of this procedure is to aid the parties in the negotiation process. The parties appoint a facilitator at the commencement of the project. His function is to assist the parties in resolving any disputes, without providing subjective opinions on the issues, but rather coaxing them into analysing thoroughly the merits of their cases. This procedure is specially useful when there are numerous parties involved who would find it difficult to negotiate and coordinate all the differing opinions without such facilitation.

(d) Conciliation and mediation

14. The term "conciliation" is used in the *Guide* as a broad notion referring to proceedings in which a person or a panel assists the parties in an independent and impartial manner in their attempt to reach an amicable settlement of their dispute. Conciliation differs from negotiations between the parties in dispute (in which the parties would typically engage after the dispute has arisen) in that conciliation involves independent and impartial assistance to settle the dispute, whereas in settlement negotiations between the parties no third-person assistance is involved. The difference between conciliation and arbitration is that conciliation ends either in the settlement of the dispute agreed by the parties or it ends unsuccessfully; in arbitration, however, the arbitral tribunal imposes a binding decision on the parties, unless they have settled the dispute before the award is made. In practice, such conciliation proceedings are referred to by various expressions, including "mediation". Nevertheless, in the legal tradition of some countries, a distinction is drawn

between conciliation and mediation to emphasize the fact that, in conciliation, a third party is trying to bring together the disputing parties to help them reconcile their differences, while mediation goes further by allowing the mediator to suggest terms for the resolution of the dispute. However, the terms "conciliation" and "mediation" are used as synonyms more frequently than not.

15. Conciliation is increasingly being increasingly practised in various parts of the world, including in regions where it was not commonly used in the past. This trend is reflected, *inter alia,* in the establishment of a number of private and public bodies offering conciliation services to interested parties. The conciliation procedure is usually private, confidential, informal and easily pursued. It may also be quick and inexpensive. The conciliator may assume multiple roles and is in general more active than a facilitator. He or she may frequently challenge the parties' position to stress weaknesses that usually facilitate agreement and, if authorized, may suggest possible settlement scenarios. The procedure is generally non-binding and the conciliator's responsibility is to facilitate settlement by directing the parties' attention to the issues and possible solutions, rather than passing judgement. This procedure is particularly useful when there are many parties involved and it would therefore be difficult to achieve an agreement by direct negotiations.

16. If the parties provide for conciliation in the project agreement, they will have to settle a number of procedural questions in order to increase the chance of a settlement. Settling such procedural questions is greatly facilitated by the incorporation into the contract, by reference, of a set of conciliation rules such as the UNCITRAL Conciliation Rules.[1] Other sets of conciliation rules have been prepared by various international and national organizations.

(e) Non-binding expert appraisal

17. This is a procedure where a neutral third party is charged with providing an appraisal on the merits of the dispute and suggested outcome. It serves as a "reality check" showing the contesting parties what the possible outcome of the more expensive and usually slower binding procedures such as arbitration or court proceedings would be. This procedure is useful where the parties have difficulty in communicating because their positions have become entrenched or where they do not see clearly the weaknesses of their positions or the strengths of the other party's positions. A non-binding expert appraisal is usually followed by negotiations, either direct or facilitated.

[1] For the official text of the *UNCITRAL Conciliation Rules, see Official Records of the General Assembly, Thirty-fifth Session, Supplement No. 17* (A/35/17), para. 106 *(Yearbook of the United Nations Commission on International Trade Law,* vol. XI, 1980, part one, chap. II, sect. A (United Nations publication, Sales No. E.81.V.8)). The UNCITRAL Conciliation Rules have also been reproduced in booklet form (United Nations publication, Sales No. E.81.V.6). Accompanying the Rules is a model conciliation clause, which reads: "Where, in the event of a dispute arising out of or relating to this contract, the parties wish to seek an amicable settlement of that dispute by conciliation, the conciliation shall take place in accordance with the UNCITRAL Conciliation Rules as at present in force". The use of the UNCITRAL Conciliation Rules was recommended by the General Assembly in its resolution 35/52 of 4 December 1980.

(f) Mini-trial

18. This procedure assumes the form of a mock trial in which site-level personnel of each party make submissions to a "tribunal" composed of a senior executive of each party and a third neutral person. After the submissions, which are typically to be made within predetermined time periods, the executives enter into a facilitated negotiation procedure with the assistance of a neutral person, to try to reach an agreement taking advantage of the issues that have been elucidated during the "trial". Counsel for the parties are frequently present and are useful in identifying the relevant issues. The purpose of the mini-trial is to inform senior executives of the issues involved in the dispute and to serve as a reality check of what the outcome of a real trial might be.

(g) Senior executive appraisal

19. This procedure is similar to the mini-trial but it is less adversarial and uses a more consensus-oriented approach. The procedure begins with the presentation of short position papers by each party, followed by short responses. At an "appraisal conference" headed by a facilitator, a senior executive from each of the parties makes brief oral presentations elucidating the issues submitted in the position papers or other points raised by the parties or the facilitator. This conference is followed by a negotiation meeting, chaired by the facilitator, with a view to reaching an agreement. Both the mini-trial and the senior executive appraisal tend to be less of a strong reality check than the non-binding expert appraisal and therefore less likely to motivate difficult decisions in the absence of commercial pressure to do so.

(h) Review of technical disputes by independent experts

20. During the construction phase, the parties may wish to consider providing for certain types of dispute to be referred to an independent expert appointed by both parties. This method may be of particular use in connection with disagreements relating to technical aspects of the construction of the infrastructure facility (for example, whether the works comply with contractual specifications or technical standards).

21. The parties may, for instance, appoint a design inspector or a supervisor engineer, respectively, to review disagreements relating to the inspection and approval of the design, and the progress of construction works (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 69-79). The independent experts should have expertise in the designing and construction of similar projects. The powers of the independent expert (such as whether the independent expert makes recommendations or issues binding decisions), as well as the circumstances under which the independent expert's advice or decision may be sought by the parties, should be set forth in the project agreement. In some large infrastructure projects, for instance, the advice of the independent expert may be sought by the concessionaire whenever there is a disagreement between the concessionaire and the contracting authority as to whether certain aspects of the design

or construction works conform with the applicable specifications or contractual obligations. Referral of a matter to a design inspector or to a supervising engineer, as appropriate, may be particularly relevant in connection with provisions in the project agreement that require prior consent of the contracting authority for certain actions by the concessionaire, such as final authorization for operation of the infrastructure facility (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 78).

22. Independent experts have often been used for the settlement of technical disputes under construction contracts, and the various mechanisms and procedures developed in the practice of the construction industry may be used, *mutatis mutandis,* in connection with privately financed infrastructure projects. However, it should be noted that the scope of disputes between the contracting authority and the concessionaire is not necessarily the same as would be the case for disputes that typically arise under a construction contract. This is so because the respective positions of the contracting authority and the concessionaire under the project agreement are not fully comparable with those of the owner and the performer of works under a construction contract. For instance, disputes concerning the amount of payment due to the contractor for the quantities of works actually performed, which are frequent in construction contracts, are not typical for the relations between contracting authority and concessionaire, since the latter does not usually receive payments from the contracting authority for the construction works performed.

(i) Dispute review boards

23. Project agreements for large infrastructure projects often establish permanent boards composed of experts appointed by both parties, possibly with the assistance of an appointing authority, for the purpose of assisting in the settlement of disputes that may arise during the construction and the operational phases (referred to in the *Guide* as "dispute review boards"). Proceedings before a dispute review board can be informal and expeditious, and tailored to suit the characteristics of the dispute that it is called upon to settle. The appointment of a dispute review board may prevent misunderstandings or differences between the parties from developing into formal disputes that would require settlement in arbitral or judicial proceedings. In fact, its effectiveness as a tool for avoiding disputes is one of the special strengths of this procedure, but a dispute review board may also serve as a mechanism to resolve disputes, in particular when the board is given the power to render binding decisions.

24. Under the dispute review board procedure, the parties typically select, at the outset of the project, three experts renowned for their knowledge in the field of the project to constitute the board. These experts may be replaced if the project comprises different stages that may require different expertise (that is, different expertise will be required during the construction of the facility and during the later administration of the public service), and in some large infrastructure projects more than one board has been established. For example, one dispute review board may deal exclusively with disputes regarding matters

of a technical nature (e.g. engineering design, fitness of certain technology, compliance with environmental standards) whereas another board may deal with disputes of a contractual or financial nature (regarding, for instance, the amount of compensation due for delay in issuing licences or disagreements on the application of price adjustment formulas). Each board member should be experienced in the particular type of project, including experience in the interpretation and administration of project agreements, and should undertake to remain impartial and independent of the parties. These persons may be furnished with periodic reports on the progress of construction or on the operation of the infrastructure facility, as appropriate, and may be informed immediately of differences arising between the parties. They may meet with the parties, either at regular intervals or when the need arises, to consider differences that have arisen and to suggest possible ways of resolving those differences.

25. In their capacity as agents to avert disputes, the members of the board may make periodic visits to the project site, meet with the parties and keep informed of the progress of the work. These meetings help identify any potential conflicts early, before they start festering and turn into full-fledged disputes. When potential conflicts are detected, the board proposes solutions, which, given the expertise and prestige of its members, are likely to be accepted by the parties. Referral of a dispute triggers an evaluation by the board, which is done in an informal manner, typically by discussion with the parties during a regular site visit. The board controls the discussion, but each party is given a full opportunity to state its views, and the dispute review board is free to ask questions and to request documents and other evidence. The advantages of conducting hearings at the job site, soon after the events have occurred and before adversarial positions have hardened, are obvious. The board then meets privately and seeks to formulate a recommendation or a decision. If the parties do not accept these proposals and disputes do arise, the board, if authorized to do so by the parties, is in a unique position to solve them expeditiously because of its familiarity with the problems and contractual documents.

26. Given their usually long duration, many circumstances relevant to the execution of privately financed infrastructure projects may change before the end of the concession term. While the impact of some changes may be automatically covered in the project agreement (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 126-130) there are changes that might not lend themselves easily to inclusion in an automatic adjustment mechanism or that the parties may prefer to exclude from such a mechanism. It is therefore important for the parties to establish mechanisms for dealing with disputes that may arise in connection with changing circumstances. This is of particular significance for the operational phase of the project. Where the parties have agreed on rules that allow a revision of the terms of the project agreement following certain circumstances, the question may arise as to whether those circumstances have occurred and, if so, how the contractual terms should be changed or supplemented. With a view to facilitating a resolution of possible disputes and avoiding a stalemate in case the parties are unable to agree on a contract revision, it is advisable for the parties to clarify whether and to what extent

certain contractual terms may be changed or supplemented by the dispute review board. It may be noted, in this context, that the parties might not always be able to rely on an arbitral tribunal or a domestic court for that purpose. Indeed, under some legal systems, courts and arbitrators are not competent to change or supplement contractual terms. Under other legal systems, courts and arbitrators may do so only if they are expressly so authorized by the parties. Under yet other legal systems, arbitrators may do so but courts may not.

27. The law governing arbitral or judicial proceedings may determine the extent to which the parties may authorize arbitrators or a court to review a decision of the dispute review board. Excluding such review has the advantage that the decision of the dispute review board would be immediately final and binding. However, permitting such a review gives the parties greater assurance that the decision will be correct. Early clauses on dispute review boards did not provide that their recommendations would become binding if not challenged in arbitral or judicial proceedings. In practice, however, the combination of the persuasive force of unanimous recommendations by independent experts agreed by the parties has led both contracting authorities and project companies to accept the recommendations voluntarily rather than litigate or arbitrate. Recent contract provisions on dispute review boards usually provide that a decision of the board, while not immediately binding on the parties, becomes binding unless one or both parties refer the dispute to arbitration or initiate judicial proceedings within a specified period of time. Apart from avoiding potentially protracted litigation or arbitration, the parties often take into account the potential difficulty of overcoming what might be regarded by the court or arbitral tribunal as a powerful recommendation, inasmuch as it had been made by independent experts familiar with the project from the outset and was based on contemporaneous observation of the project prior to, and at the time of, the dispute having first arisen.

28. Although this occurs very rarely, the parties may agree to make the board's decision final and binding. It should be noted, however, that despite the parties' agreement to be bound by the board's decision, under many legal systems, the decision by the dispute review board, while binding as a contract, may not be enforceable in a summary proceeding, such as a proceeding for the enforcement of an arbitral award, since it does not have the status of an arbitral award. If the parties contemplate providing for proceedings before a dispute review board, it will be necessary for them to settle various aspects of those proceedings in the project agreement. It would be desirable for the project agreement to delimit as precisely as possible the authority conferred upon the dispute review board. With regard to the nature of their functions, the project agreement might authorize the dispute review board to make findings of fact and to order interim measures. It may specify the functions to be performed by the dispute review board and the type of issues with which they may deal. If the parties are permitted to initiate arbitral or judicial proceedings within a specified period of time after the decision is rendered, the parties might specify that findings of fact made by a dispute review board are to be regarded as conclusive in arbitral or judicial proceedings. The project agreement might also obligate the parties to implement a decision by the dispute review board con-

cerning interim measures or a decision on the substance of specified issues; if the parties fail to do so, they will be considered as having failed to perform a contractual obligation. Regarding the duration of the board's functions, the project agreement may provide that the board will continue to function for a certain period beyond the expiry or termination of the project agreement, in order to deal with disputes that may arise at that stage (for example, disputes as to the condition of and compensation due for assets handed over to the contracting authority).

(j) Non-binding arbitration

29. This procedure is sometimes used when less adversarial methods such as facilitated negotiation, conciliation or dispute review board procedures have been unsuccessful. Non-binding arbitration is conducted in the same manner as binding arbitration, and the same rules may be used except that the procedure ends with a recommendation. The procedure contemplates that the parties will proceed directly to litigation if the dispute is still unresolved under non-binding arbitration. Those who choose this procedure do so (a) if they have reservations about the binding nature of arbitration; or (b) as an incentive to avoid both arbitration and litigation, arbitration because it would seem redundant to go through the same procedure twice and litigation because of its length and cost.

(k) Arbitration

30. In recent years, arbitration has been used increasingly for settling disputes arising under privately financed infrastructure projects. Arbitration is typically used both for the settlement of disputes that arise during the construction or operation of the infrastructure facility and for the settlement of disputes related to the expiry or termination of the project agreement. Arbitration, often in a country other than the host country, is preferred, and in many cases required, by private investors and lenders, in particular foreign ones, since arbitral proceedings may be structured by the parties so as to be less formal than judicial proceedings and better suited to the needs of the parties and to the specific features of the disputes likely to arise under the project agreement. The parties can choose as arbitrators persons who have expert knowledge of the particular type of project. They may choose the place where the arbitral proceedings are to be conducted. They can also choose the language or languages to be used in the arbitral proceedings. Arbitral proceedings may be less disruptive of business relations between the parties than judicial proceedings. The proceedings and arbitral awards can be kept confidential, while judicial proceedings and decisions usually cannot. Furthermore, the enforcement of arbitral awards in countries other than the country in which the award was rendered is facilitated by the wide acceptance of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958.[2]

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[2]See United Nations, *Treaty Series,* vol. 330, No. 4739, reproduced in the *Register of Conventions and Other Instruments concerning International Trade Law,* vol. II (United Nations publication, Sales No. E.73.V.3).

31. With regard, in particular, to infrastructure projects involving foreign investors, it may be noted that a framework for the settlement of disputes between the contracting authority and foreign companies participating in a project consortium may be provided through adherence to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States.[3] The Convention, which has thus far been adhered to by 131 States, established the International Centre for the Settlement of Investment Disputes (ICSID). ICSID is an autonomous international organization with close links to the World Bank. ICSID provides facilities for the conciliation and arbitration of disputes between member countries and investors who qualify as nationals of other member countries. Recourse to ICSID conciliation and arbitration is voluntary. However, once the parties to a contract or dispute have consented to arbitration under the ICSID Convention, neither can withdraw its consent unilaterally. All ICSID members, whether or not parties to the dispute, are required by the Convention to recognize and enforce ICSID arbitral awards. The consent of the parties to ICSID arbitration may be given with regard to an existing dispute or with respect to a defined class of future disputes. The consent of the parties need not, however, be expressed in relation to a specific project; a host country might in its legislation on the promotion of investment offer to submit disputes arising out of certain classes of investment to the jurisdiction of ICSID and the investor might give its consent by accepting the offer in writing.

32. Bilateral investment agreements may also provide a framework for the settlement of disputes between the contracting authority and foreign companies. In these treaties, the host State typically extends to investors that qualify as nationals of the other signatory State a number of assurances and guarantees (see chap. VII, "Other relevant areas of law", paras. 4-6) and expresses its consent to arbitration, for instance, by referral to ICSID or to an arbitral tribunal applying the UNCITRAL Arbitration Rules.[4]

(i) Sovereign immunity

33. The legislator may wish to review its laws on sovereign immunity and, to the extent considered advisable, clarify in which areas contracting authorities may or may not plead sovereign immunity. When arbitration is allowed and agreed upon between the parties to the project agreement, the implementation of an agreement to arbitrate may be frustrated or hindered if the contracting

[3]United Nations *Treaty Series,* vol. 575, No. 8359.

[4]The official text of the UNCITRAL Arbitration Rules is reproduced in *Official Records of the General Assembly, Thirty-first Session, Supplement No. 17* (A/31/17), chap.V, sect. C. (*Yearbook of the United Nations Commission on International Trade Law,* vol. VII, 1976, part one, chap. II, sect. A (United Nations publication, Sales No. E.77.V.1)). The UNCITRAL Arbitration Rules have also been reproduced in booklet form (United Nations publication, Sales No. E.77.V.6). Accompanying the Rules is a model arbitration clause, which reads: "Any dispute, controversy or claim arising out of or relating to this contract, or the breach, termination or invalidity thereof, shall be settled by arbitration in accordance with the UNCITRAL Arbitration Rules as at present in force." The use of the UNCITRAL Arbitration Rules was recommended by the General Assembly in its resolution 31/98 of 15 December 1976.

authority is able to plead sovereign immunity, either as a bar to the commencement of arbitral proceedings or as a defence against recognition and enforcement of the award. Sometimes the law on this matter is not clear, which may raise concerns with the interested parties (for instance, the concessionaire, project promoters and lenders) that an agreement to arbitrate might not be effective. In order to address such possible concerns, it is advisable to review the law on this topic and to indicate the extent to which the contracting authority may raise a plea of sovereign immunity.

34. In addition, a contracting authority against which an award has been issued may raise a plea of immunity from execution against public property. There is a diversity of approaches to the question of sovereign immunity from execution. For example, under some national laws immunity does not cover governmental entities when engaged in commercial activities. In other national laws a link is required between the property to be attached and the claim in that, for example, immunity cannot be pleaded in respect of funds allocated for economic or commercial activity governed by private law upon which the claim is based or that immunity cannot be pleaded with respect to assets set aside by the State to pursue its commercial activities. In some countries, it is considered that it is for the Government to prove that the assets to be attached are in non-commercial use.

35. In some contracts involving entities that might plea sovereign immunity, clauses have been included to the effect that the Government waives its right to plead sovereign immunity. Such a consent or waiver might be contained in the project agreement or an international agreement; it may be limited to recognizing that certain property is used or intended to be used for commercial purposes. Such written clauses may be necessary inasmuch as it is not clear whether the conclusion of an arbitration agreement and participation in arbitral proceedings by the governmental entity constitutes an implied waiver of sovereign immunity from execution.

(ii) Effectiveness of the arbitration agreement and enforceability of the award

36. The effectiveness of an agreement to arbitrate depends on the legislative regime where the arbitration takes place. If the legislative regime for arbitration in the host country is seen as unsatisfactory, for instance, because it is found to pose unreasonable restrictions on party autonomy, a party might wish to agree on a place of arbitration outside the host country. It is therefore important for the host country to ensure that the domestic legislative regime for arbitration resolves the principal procedural issues in a manner appropriate for international arbitration cases. Such a regime is contained in the UNCITRAL Model Law on International Commercial Arbitration.[5]

[5]For the report of the United Nations Commission on International Trade Law on the work of its eighteenth session, see *Official Records of the General Assembly, Fortieth Session, Supplement No. 17* (A/40/17), para. 332 and annex I. The General Assembly, in its resolution 40/72 of 11 December 1985, recommended that all States give due consideration to the Model Law on International Commercial Arbitration, in view of the desirability of uniformity of the law of arbitral procedures and the specific needs of international commercial arbitration practice.

37. If the arbitration takes place outside the host country or if an award rendered in the host country would need to be enforced abroad, the effectiveness of the arbitration agreement would also depend on legislation governing the recognition and enforcement of arbitral awards. The Convention on the Recognition and Enforcement of Foreign Arbitral Awards (see para. 30), *inter alia,* deals with the recognition of an arbitration agreement and the grounds on which the court may refuse to recognize or enforce an award. The Convention is generally regarded as providing an acceptable and balanced regime for the recognition and enforcement of arbitral awards. The fact that the host country is a party to the Convention is likely to be seen as a crucial element in assessing the legal certainty of binding commitments and of the reliability of arbitration as a method for solving disputes by arbitration with parties from the country. It would also facilitate the enforcement abroad of an arbitral award rendered in the host country.

(l) Judicial proceedings

38. As indicated earlier, there are legal systems where the settlement of disputes arising out of agreements related to the provision of public services is a matter of the exclusive competence of the domestic judiciary or administrative courts. In some countries, governmental agencies lack the power to agree to arbitration, except under specific circumstances (see paras. 7-9), while in other legal systems the parties have the freedom to choose between judicial and arbitral proceedings.

39. Where it is possible for the parties to choose between judicial and arbitral proceedings, the contracting authority may see reasons for leaving any dispute to be resolved by the courts of the host country. Those courts are familiar with the law of the country, which often includes legislation specifically concerned with the project agreement. Furthermore, the contracting authority or other governmental agencies involved in the dispute may prefer local courts because of the familiarity with the court procedures and the language of the proceedings. It may also be considered that, to the extent project agreements involve issues of public policy and the protection of public interest, State courts are in a better position to give them proper effect.

40. However, such a view by the contracting authority may not be shared by prospective investors, financiers and other private parties. These parties may consider that arbitration is preferable to judicial proceedings because arbitration, being to a larger degree subject to the agreement of the parties than judicial proceedings, is in a position to resolve a dispute more efficiently. Private investors, in particular foreign ones, may also be reluctant to submit to the jurisdiction of domestic courts functioning under rules unfamiliar to them. In some countries it has been found that allowing the parties to choose the dispute settlement mechanism helped to attract foreign investment for the development of its infrastructure.

41. In considering whether any dispute should be resolved in judicial proceedings or whether an arbitration agreement should be entered into, where such

choice is permitted under the applicable law, factors typically taken into account by the parties include, for example, their confidence that the courts competent to decide a dispute will be unbiased and that the dispute will be resolved without inordinate delay. The efficiency of the national judicial system and the availability of forms of judicial relief that are adequate to disputes that might arise under the project agreement are additional factors to be taken into account. Furthermore, in view of the highly technical and complex issues involved in infrastructure projects, the parties will also consider the implications of using arbitrators selected for their particular knowledge and experience as compared with domestic courts, which may lack specific knowledge or experience in handling the technical questions in the area where the dispute arose. Another consideration may be the confidentiality of arbitration proceedings, relative informality of arbitral procedures and the possibly greater flexibility arbitrators may have in awarding appropriate remedies, all of which may be beneficial for preserving and developing the long-term relationship implicit in project agreements.

C. Disputes between project promoters and between the concessionaire and its lenders, contractors and suppliers

42. Domestic laws generally recognize that in commercial transactions, in particular international ones, the parties are free to agree on the forum that will settle in a binding decision any dispute that may arise between them. In international transactions, arbitration has become the preferred method, whether or not it is preceded by, or combined with, conciliation. Contracts between the concessionaire and lenders, contractors and suppliers in connection with infrastructure projects, are generally considered as commercial agreements. Accordingly, the parties to those contracts are usually free to choose their preferred dispute settlement method, which in most cases includes arbitration. Lenders, however, although in most cases favouring arbitration for the settlement of disputes arising out of the project agreement (and increasingly also for disputes between different lenders), often prefer judicial proceedings for the settlement of disputes between them and the concessionaire arising out of loan agreements. Where arbitration is the preferred method, the parties will typically wish to be able to select the place of arbitration and to determine whether or not any arbitration case should be administered by an arbitral institution. Host countries wishing to establish a hospitable legal climate for privately financed infrastructure projects would be well advised to review their laws with respect to such commercial contracts so as to eliminate any uncertainty regarding the freedom of the parties to agree to dispute settlement mechanisms of their choice.

D. Disputes involving customers or users of the infrastructure facility

43. Depending on the type of project, the concessionaire may provide goods or services to various different persons and entities, such as, for example,

government-owned utility companies that purchase electricity or water from the concessionaire so as to resell it to the ultimate users; commercial companies, such as airlines or shipping lines contracting for the use of the airport or port; or individuals paying for the use of a toll road. The considerations and policies regarding the settlement of disputes arising out of those legal relationships may vary according to who the parties are, the conditions under which the services are provided and the applicable regulatory regime.

44. In some countries, public service providers are required by law to establish special simplified and efficient mechanisms for handling claims brought by their customers. Such special regulation is typically limited to certain industrial sectors and applies to purchases of goods or services by customers. Statutory requirements for the establishment of such dispute settlement mechanisms may apply generally to claims brought by any of the concessionaire's customers or may be limited to customers who are individual persons acting in their non-commercial capacity. The concessionaire's obligation may be limited to the establishment of a mechanism for receiving and dealing with complaints by individual consumers. Such mechanisms may include a special facility or department set up within the project company for receiving and handling claims expeditiously, for instance by making available to the customers standard claim forms or toll-free telephone numbers for voicing grievances. If the matter is not satisfactorily resolved, the customer may have the right to file a complaint with a regulatory agency, if any, which in some countries may have the authority to issue a binding decision on the matter. Such mechanisms are often optional for the consumer and typically do not preclude resort by the aggrieved persons to courts.

45. If the customers are utility companies (such as a power distribution company) or commercial enterprises (for instance, a large factory purchasing power directly from an independent producer) who freely choose the services provided by the concessionaire and negotiate the terms of their contracts, the parties would typically settle any disputes by methods usual in trade contracts, including arbitration. Accordingly, there may not be a need for addressing the settlement of these disputes in legislation relating to privately financed infrastructure projects. However, where the concessionaire's customers are government-owned entities, their ability to agree on dispute settlement methods may be limited by rules of administrative law governing the settlement of disputes involving governmental entities. For countries that wish to allow the use of non-judicial methods, including arbitration, for the settlement of disputes between the concessionaire and its government-owned customers, it is important to remove possible legal obstacles and to provide a clear authorization for those entities to agree on dispute settlement methods (see paras. 7-9).

VII. Other relevant areas of law

A. General remarks

1. The stage of development of the relevant laws of the host country, the stability of its legal system and the adequacy of remedies available to private parties are essential elements of the overall legal framework for privately financed infrastructure projects. By reviewing and, as appropriate, improving its laws in those areas of immediate relevance for privately financed infrastructure projects, the host country will make an important contribution to securing a hospitable climate for private sector investment in infrastructure. Greater legal certainty and a favourable legal framework will translate into a better assessment of country risks by lenders and project sponsors. This will have a positive influence on the cost of mobilizing private capital and reduce the need for governmental support or guarantees (see chap. II, "Project risks and government support", paras. 30-60).

2. Section B points out a few selected aspects of the laws of the host country that, without necessarily dealing directly with privately financed infrastructure projects, may have an impact on their implementation (see paras. 3-52). Section C indicates the possible relevance of a few international agreements for the implementation of privately financed infrastructure projects in the host country (see paras. 53-57).

B. Other relevant areas of law

3. In addition to issues pertaining to legislation directed specifically towards privately financed infrastructure projects, a favourable legal framework also requires supportive provisions in other areas of legislation. Private investment in infrastructure will be encouraged by the existence of legislation that promotes and protects private investment in economic activities. The following paragraphs pinpoint only a few selected aspects of other fields of law that may have an impact on the implementation of infrastructure projects. The existence of adequate legal provisions in those other fields may facilitate a number of transactions necessary to carry out infrastructure projects and help to reduce the perceived legal risk of investment in the host country.

1. Promotion and protection of investment

4. One matter of particular concern for the project promoters and lenders is the degree of protection afforded to investment in the host country. Foreign investors in the host country will require assurances that they will be protected

from nationalization or dispossession without judicial review and appropriate compensation in accordance with the rules in force in the host country and in accordance with international law. Project promoters will also be concerned about their ability, *inter alia*, to bring to the country without unreasonable restriction the qualified personnel required to work with the project, to import needed goods and equipment, to gain access to foreign exchange as needed and to transfer abroad or repatriate their profits or sums needed to repay loans that the company has entered into for the purpose of the infrastructure project. In addition to specific guarantees that may be provided by the Government (see chap. II, "Project risks and government support", paras. 45-50), legislation on promotion and protection of investment may play an important role in connection with privately financed infrastructure projects. For countries that already have adequate investment protection legislation, it may be useful to consider expressly extending the protection provided in such legislation to private investment in infrastructure projects.

5. An increasing number of countries have entered into bilateral investment agreements that aim at facilitating and protecting the flow of investment between the contracting parties. Investment protection agreements usually contain provisions concerning the admission and treatment of foreign investment; transfer of capital between the contracting parties (payment of dividends abroad or repatriation of investment, for example); availability of foreign exchange for transfer or repatriation of proceeds of investment; protection from expropriation and nationalization; and settlement of investment disputes. The existence of such an agreement between the host country and the originating country or countries of the project sponsors may play an important role in their decision to invest in the host country. Depending on its terms, such an agreement may reduce the need for assurances or guarantees by the Government geared to individual infrastructure projects. Multilateral treaties may also be a source of investment protection provisions.

6. Moreover, in a number of countries rules aimed at facilitating and protecting the flow of investment (which also include areas such as immigration legislation, import control and foreign exchange rules) are contained in legislation that might not necessarily be based on a bilateral or multilateral treaty.

2. *Property law*

7. It is desirable for the property laws of the host country to reflect acceptable international standards, contain adequate provisions on the ownership and use of land and buildings, as well as movable and intangible property, and ensure the concessionaire's ability to purchase, sell, transfer and license the use of property, as appropriate. Constitutional provisions protecting property rights have been found to be important factors in fostering private investment in many countries.

8. Where the concessionaire owns the land on which the facility is built, it is important that the ownership of the land can be clearly and unequivocally

established through adequate registration and publicity procedures. The concessionaire and lenders will need clear proof that ownership of the land will not be subject to dispute. They will therefore be reluctant to commit funds to the project if the laws of the host country do not provide adequate means for ascertaining ownership of the land.

9. It is also necessary to provide effective mechanisms for the enforcement of the property and possessory rights granted to the concessionaire against violation by third parties. Enforcement should also extend to easements and rights of way that may be needed by the concessionaire for providing and maintaining the relevant service (such as placing of poles and cables on private property to ensure the distribution of electricity) (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 30-35).

3. Security interests

10. As indicated earlier (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 52-61), security arrangements in privately financed infrastructure projects may be complex and consist of a variety of forms of security, including fixed security over physical assets of the concessionaire (for example, mortgages or charges), pledges of shares of the concessionaire and assignment of intangible assets (receivables) of the project. While the loan agreements are usually subject to the governing law chosen by the parties, the laws of the host country will in most cases determine the type of security that can be enforced against assets located in the host country and the remedies available.

11. Differences in the type of security or limitations in the remedies available under the laws of the host country may be a cause of concern to potential lenders. It is therefore important to ensure that domestic laws provide adequate legal protection to secured creditors and do not hinder the ability of the parties to establish appropriate security arrangements. Because of the significant differences between legal systems regarding the law of security interests, the *Guide* does not discuss in detail the technicalities of the requisite legislation and the following paragraphs provide only a general outline of the main elements of a modern regime for secured transactions.

12. In some legal systems, security interests can be created in virtually all kinds of assets, including intellectual property, whereas in other systems security interests can only be created in a limited category of assets, such as land and buildings. In some countries, security interests can be created over assets that do not yet exist (future assets) and security may be taken over all of a company's assets, while allowing the company to continue to deal with those assets in the ordinary course of business. Some legal systems provide for a non-possessory security interest, so that security can be taken over assets without taking actual possession of the assets; in other systems, as regards

those assets which are not subject to a title registration system, security may only be taken by physical possession or constructive possession. Under some systems, enforcement of the security interest can be undertaken without court involvement, whereas in other systems it may only be enforced through court procedures. Some countries provide enforcement remedies that not only include sale of the asset, but also enable the secured lender to operate the asset either by taking possession or appointing a receiver; in other countries, judicial sale may be the primary enforcement mechanism. Under some systems, certain types of security will rank ahead of preferential creditors, whereas in others the preferential creditors rank ahead of all types of security. In some countries, creation of a security interest is cost-efficient, with minimal fees and duties payable, whereas in other countries it can be costly. In some countries, the value of the amount of security taken may be unlimited, while in others the value of security cannot be excessive in comparison with the debt owed. Some legal systems impose obligations on the secured lender on enforcement of the security, such as the obligation to take steps ensuring that assets will be sold at fair market value.

13. Basic legal protection may include provisions ensuring that fixed security (such as a mortgage) is a registrable interest and that, once such security is registered in the register of title or other public register, any purchaser of the property to which the security attaches should take the property subject to such security. This may be difficult, since in many countries no specialized registers of title exist. Furthermore, security should be enforceable against third parties, which may require that they have the nature of a property right and not a mere obligation, and should entitle the person receiving security to a sale, in enforcement proceedings, of the assets taken as security.

14. Another important aspect concerns the flexibility given to the parties to define the assets that are given as security. In some legal systems, broad freedom is given to the parties in the definition of assets that may be given as security. In some legal systems, it is possible to create security that covers all the assets of an enterprise, making it possible to sell the enterprise as a going concern, which may enable an enterprise in financial difficulties to be rescued while increasing the recovery of the secured creditor. Other legal systems, however, allow only the creation of security that attaches to specific assets and do not recognize security covering the entirety of the debtor's assets. There may also be limitations on the debtor's ability to trade in goods given as security. The existence of limitations and restrictions of this type makes it difficult or even impossible for the debtor to create security over generically described assets or over assets traded in the ordinary course of its business.

15. Given the long-term nature of privately financed infrastructure projects, the parties may wish to be able to define the assets that are given as security specifically or generally. They may also wish such security to cover present or future assets and assets that might change during the life of the security. It may be desirable to review existing provisions on security interests with a view to including provisions enabling the parties to agree on suitable security arrangements.

16. Thus far, no comprehensive uniform regime or model for the development of domestic security laws has been developed by international intergovernmental bodies. Governments might be advised, however, to take account of various efforts being undertaken in different organizations.[1] A model for the development of modern legislation on security interests is offered in the Model Law on Secured Transactions, which was prepared by the European Bank for Reconstruction and Development (EBRD) to assist legislative reform efforts in central and eastern European countries. Besides general provisions on who can create and who can receive a security right and general rules concerning the secured debts and the charged property, the EBRD Model Law on Secured Transactions covers other matters, such as the creation of security rights, the interests of third parties, enforcement of security and registration proceedings.

4. *Intellectual property law*

17. Privately financed infrastructure projects frequently involve the use of new or advanced technologies protected under patents or similar intellectual property rights. They may also involve the formulation and submission of original or innovative solutions, which may constitute the proponent's proprietary information under copyright protection. Therefore, private investors, national and foreign, bringing new or advanced technology into the host country or developing original solutions will need to be assured that their intellectual property rights will be protected and that they will be able to enforce those rights against infringements, which may require the enactment of criminal law provisions designed to combat infringements of intellectual property rights.

18. A legal framework for the protection of intellectual property may be provided by adherence to international agreements regarding the protection and registration of intellectual property rights. It would be desirable to strengthen the protection of intellectual property rights in line with such instruments as the Paris Convention for the Protection of Industrial Property of 1883.[2] The Con-

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[1]UNCITRAL is currently preparing a convention on assignment of receivables in international trade. The draft convention is intended to create certainty and transparency, to contribute to the modernization of law relating to assignments of receivables and to promote the availability of capital and credit at more affordable rates. The rules contained in the draft convention facilitate those objectives, *inter alia,* by recognizing the validity and supporting the use of assignments of receivables, especially for future claims and bulk assignments, which have become the backbone of new sources of credit in international capital markets. It is expected that the draft convention will be finalized in 2001. Another international initiative is the draft convention on international interests in mobile equipment currently being prepared by the International Institute for the Unification of Private Law (UNIDROIT) and other organizations. The essential purpose of the draft UNIDROIT convention is to provide for the constitution and effects of a new international interest in mobile equipment, defined so as to embrace not only classic security interests but also what is increasingly recognized as their functional equivalent, namely the lessor's interest under a leasing agreement. The draft UNIDROIT convention and the preliminary draft protocols thereto (which include a preliminary draft protocol on matters specific to aircraft equipment, a preliminary draft protocol on matters specific to railway rolling stock and a preliminary draft protocol on matters specific to space property) cover categories of high-value mobile equipment that by their nature are likely to be moving across or beyond national frontiers on a regular basis in the ordinary course of business and that are capable of unique identification.

[2]As revised in Brussels on 14 December 1900, in Washington, D.C., on 2 June 1911, in The Hague on 6 November 1925, at London on 2 June 1934, in Lisbon on 31 October 1958 and in Stockholm on 14 July 1967 and as amended on 2 October 1979.

vention applies to industrial property in the widest sense, including inventions, marks, industrial designs, utility models, trade names, geographical indications and the repression of unfair competition. The Convention provides that, as regards the protection of industrial property, each contracting State must grant national treatment. It also provides for the right of priority in the case of patents, marks and industrial designs and establishes a few common rules that all the contracting States must follow in relation to patents, marks, industrial designs, trade names, indications of source, unfair competition and national administrations. A framework for further international patent protection is provided under the Patent Cooperation Treaty of 1970, which makes it possible to seek patent protection for an invention simultaneously in each of a large number of countries by filing an international patent application. In some countries, international standards are supplemented by legislation aimed at affording legal protection to new technological developments, such as legislation that protects intellectual property rights in computer software and computer hardware design.

19. Other important instruments providing international protection of industrial property rights are the Madrid Agreement Concerning the International Registration of Marks of 1891,[3] the Protocol Relating to the Madrid Agreement of 1989 and the Common Regulations under the Madrid Agreement and the Protocol Relating thereto of 1998. The Madrid Agreement provides for the international registration of marks (both trademarks and service marks) at the International Bureau of the World Intellectual Property Organization. International registration of marks under the Madrid Agreement has effect in several countries, potentially in all the contracting States (except the country of origin). Furthermore, the Trademark Law Treaty of 1994 simplifies and harmonizes procedures for the application for registration of trademarks, changes after registration and renewal.

20. In the area of industrial designs, the Hague Agreement Concerning the International Deposit of Industrial Designs of 1925[4] provides for the international deposit of industrial designs at the International Bureau of WIPO. The international deposit has, in each of the contracting States designated by the applicant, the same effect as if all the formalities required by the domestic law for the grant of protection had been complied with by the applicant and as if all administrative acts required to that end had been accomplished by the office of that country.

21. The most comprehensive multilateral agreement on intellectual property to date is the Agreement on Trade-Related Aspects of Intellectual Property Rights (the "TRIPS Agreement") which was negotiated under the auspices of the World Trade Organization (WTO) and came into effect on 1 January 1995.

[3]As revised in Brussels on 14 December 1900, in Washington, D.C., on 2 June 1911, in The Hague on 6 November 1925, in London on 2 June 1934, in Nice on 15 June 1957 and in Stockholm on 14 July 1967.

[4]With the Additional Act of Monaco of 1961, the Complementary Act of Stockholm of 1967 as amended on 28 September 1979 and the Regulations Under the Hague Agreement Concerning the International Deposit of Industrial Designs of 1998.

The areas of intellectual property that it covers are copyright and related rights (that is, the rights of performers, producers of sound recordings and broadcasting organizations); trademarks, including service marks; geographical indications, including appellations of origin; industrial designs; patents, including the protection of new varieties of plants; the layout-designs of integrated circuits; and undisclosed information, including trade secrets and test data. In respect of each of the main areas of intellectual property covered by it, the TRIPS Agreement sets out the minimum standards of protection to be provided by each contracting party by requiring, first, compliance with the substantive obligations, *inter alia,* of the Paris Convention in its most recent version. The main substantive provisions of the Paris Convention are incorporated by reference and thus become obligations under the TRIPS Agreement. The TRIPS Agreement also adds a substantial number of additional obligations on matters where the pre-existing conventions on intellectual property are silent or were seen as being inadequate. In addition, the Agreement lays down certain general principles applicable to all procedures for the enforcement of intellectual property rights. Furthermore, the TRIPS Agreement contains provisions on civil and administrative procedures and remedies, provisional measures, special requirements related to border measures and criminal procedures, which specify, in a certain amount of detail, the procedures and remedies that must be available so that intellectual property rights can effectively be enforced by their holders.

5. *Rules and procedures on compulsory acquisition of private property*

22. Where the Government assumes responsibility for providing the land required for the implementation of the project, that land may be either purchased from its owners or, if necessary, compulsorily acquired against the payment of adequate compensation by procedures sometimes referred to as "compulsory acquisition" or "expropriation" (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 27-29). Many countries have legislation governing compulsory acquisition of private property and that legislation would probably apply to the compulsory acquisition of property required for privately financed infrastructure projects.

23. Compulsory acquisition may be carried out in judicial or administrative proceedings or may be effected by an ad hoc legislative act. In most cases, the proceedings involve both administrative and judicial phases, which may be lengthy and complex. The Government may thus wish to review existing provisions on compulsory acquisition for reasons of public interest with a view to assessing their adequacy to the needs of large infrastructure projects and to determining whether such provisions allow quick and cost-effective procedures, while affording adequate protection to the rights of the owners. To the extent permitted by law, it is important to enable the Government to take possession of the property without unnecessary delay, so as to avoid increased project costs.

6. *Rules on government contracts and administrative law*

24. In many legal systems belonging to or influenced by the tradition of civil law, the provision of public services may be governed by a body of law known as "administrative law", which regulates a wide range of governmental functions. Such systems operate under the principle that the Government can exercise its powers and functions either by means of an administrative act or an administrative contract. It is also generally understood that, alternatively, the Government may enter into a private contract, subject to the law governing private commercial contracts. The differences between the two types of contract may be significant.

25. Under the concept of the administrative contract, the freedom and autonomy enjoyed by the parties to a private contract are subordinate to the public interest. In some legal systems, the Government has the right to modify the scope and terms of administrative contracts or even terminate them for reasons of public interest, usually subject to compensation for loss sustained by the private contracting party (see chap. V, "Duration, extension and termination of the project agreement", paras. 26, 27 and 49). Additional rights might include extensive monitoring and inspection rights, as well as the right to impose sanctions on the private operator for failure to perform. This is often balanced by the requirement that other changes may be made to the contract as may be necessary to restore the original financial equilibrium between the parties and to preserve the contract's general value for the private contracting party (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 126-130). In some legal systems, disputes arising out of government contracts are subject to the exclusive jurisdiction of special tribunals dealing solely with administrative matters, which in some countries are separate from the judicial system (see chap. VI, "Settlement of disputes", paras. 38-41).

26. The existence of a special legal regime applicable to infrastructure operators and public service providers is not limited to the legal systems referred to above. Although in legal systems influenced by the tradition of common law no such categorical distinction is made between administrative contracts and private contracts, similar consequences may be achieved by different means. While under such systems of law it is frequently held that the rule of law is best maintained by subjecting the Government to ordinary private law, it is generally recognized that the administration cannot by contract fetter the exercise of its sovereign functions. It cannot hamper its future executive authority in the performance of those governmental functions which affect the public interest. Under the doctrine of sovereign acts, which is upheld in some common law jurisdictions, the Government as contractor is excused from the performance of its contracts if the Government as sovereign enacts laws, regulations or orders in the public interest that prevent that performance. Thus, the law may permit a public authority to interfere with vested contractual rights. Usually such action is limited so that the changes cannot be of such magnitude that the other party could not fairly adapt to them. In those circumstances, the private party is ordinarily entitled to some sort of compensation or equitable

adjustment. In anticipation of such possibilities, in some countries a standard "changes" clause is included in a governmental contract that enables the Government to alter the terms on a unilateral basis or that provides for changes as a result of an intervening sovereign act.

27. Special prerogatives for governmental agencies are justified in those legal systems by reasons of public interest. It is however recognized that special governmental prerogatives, in particular the power to alter the terms of contracts unilaterally, may, if improperly used, adversely affect the vested rights of government contractors. For this reason, countries with a well established tradition of private participation in infrastructure projects have developed a series of control mechanisms and remedies to protect government contractors against arbitrary or improper acts by public authorities, such as access to impartial dispute settlement bodies and full compensation schemes for governmental wrongdoing. Where protection of this nature is not afforded, rules of law providing public authorities with special prerogatives may be regarded by potential investors as an imponderable risk, which may discourage them from investing in particular jurisdictions. For this reason, some countries have reviewed their legislation on government contracts so as to provide the degree of protection needed to foster private investment and remove those provisions which gave rise to concern about the long-term contractual stability required for infrastructure projects.

7. *Private contract law*

28. The laws governing private contracts play an important role in connection with contracts entered into by the concessionaire with subcontractors, suppliers and other private parties. The domestic law on private contracts should provide adequate solutions to the needs of the contracting parties, including flexibility in devising the contracts needed for the construction and operation of the infrastructure facility. Apart from some essential elements of adequate contract law, such as general recognition of party autonomy, judicial enforceability of contract obligations and adequate remedies for breach of contract, the laws of the host country may create a favourable environment for privately financed infrastructure projects by facilitating contractual arrangements likely to be used in those projects. An adequate set of rules of private international law is also important, given the likelihood that contracts entered into by the concessionaire will include some international elements.

29. Where new infrastructure is to be built, the concessionaire may need to import large quantities of supplies and equipment. Greater legal certainty for such transactions will be ensured if the laws of the host country contain provisions specially adapted to international sales contracts. A particularly suitable legal framework may be provided by adherence to the United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980)[5] or other

[5]*Official Records of the United Nations Conference on Contracts for the International Sale of Goods, Vienna, 10 March-11 April 1980* (United Nations publication, Sales No. E.82.V.5), part I.

international instruments dealing with specific contracts, such as the Unidroit Convention on International Financial Leasing (Ottawa, 1988),[6] drawn up by the International Institute for the Unification of Private Law (Unidroit).

8. Company law

30. In most projects involving the development of a new infrastructure, the project promoters will establish the project company as a separate legal entity in the host country (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 12-18). It is recognized that the project company may take various forms in different countries, which may not necessarily entail a corporation. As in most cases it is a corporate form that is selected, it is particularly important for the host country to have adequate company laws with modern provisions on essential matters such as establishment procedures, corporate governance, issuance of shares and their sale or transfer, accounting and financial statements and protection of minority shareholders. Furthermore, the recognition of the investors' ability to establish separate entities to serve as special-purpose vehicles for raising financing and disbursing funds may facilitate the closing of project finance transactions (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 59).

31. Although various corporate forms may be used, a common characteristic is that the concessionaire's owners (or shareholders) will require that their liability be limited to the value of their shares in the company's capital. If it is intended that the project company will offer shares to the public, limited liability will be necessary, as the prospective investors will usually only purchase those shares for their investment value and will not be closely involved in the operation of the project company. It is therefore important that the laws of the host country provide adequately for the limitation of liability of shareholders. Furthermore, adequate provisions governing the issuance of bonds, debentures or other securities by commercial companies will enable the concessionaire to obtain funds from investors on the security market, thus facilitating the financing of certain infrastructure projects.

32. Legislation should establish the responsibilities of directors and administrators of the project company, including the basis for criminal responsibility. It can also set out provisions for the protection of third parties affected by any breach of corporate responsibility. Modern company laws often contain specific provisions regulating the conduct of managers so as to prevent conflicts of interest. Provisions of this type require that managers act in good faith in the best interest of the company and do not use their position to foster their own or any other person's financial interests to the detriment of the company.

[6]*Acts and Proceedings of the Diplomatic Conference for the adoption of the draft Unidroit Conventions on International Factoring and International Financial Leasing, Ottawa, 9-28 May 1988,* vol. I.

Provisions intended to curb conflicts of interest in corporate management may be particularly relevant in connection with infrastructure projects, where the concessionaire may wish to engage its own shareholders, at some stage of the project, to perform work or provide services in connection with it (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 100 and 101).

33. It is important for the law to regulate adequately the decision-making process both for meetings of the shareholders and meetings of management organs of the company (the board of directors or supervisory board, for example). Protection of shareholders' rights and, in particular, protection for minority shareholders from abuse by controlling or majority shareholders are important elements of modern company laws. Mechanisms for the settlement of disputes among shareholders are also critical. It is useful to recognize the right of the shareholders to regulate a number of additional matters concerning the management of the concessionaire through agreements among themselves or through management contracts with the directors of the concessionaire.

9. *Tax law*

34. In addition to possible tax incentives that may be generally available in the host country or that may be specially granted to privately financed infrastructure projects (see chap. II, "Project risks and government support", paras. 51-54), the general taxation regime of the host country plays a significant role in the investment decisions of private companies. Beyond an assessment of the impact of taxation in the project cost and the expected margin of profit, private investors consider questions such as the overall transparency of the domestic taxation system, the degree of discretion exercised by taxation authorities, the clarity of guidelines and instructions issued to taxpayers and the objectivity of criteria used to calculate tax liabilities. This may be a complex matter, in particular in those countries where the authority to establish or increase taxes or to enforce tax legislation has been decentralized.

35. Privately financed infrastructure projects are typically highly leveraged and require a predictable cash flow. For that reason, it is crucial for all potential tax implications to be readily assessable throughout the life of the project. Unanticipated changes in the taxes that reduce that cash flow can have serious consequences for the project. In some countries, the Government is authorized to enter into agreements with the investors for the purpose of guaranteeing that the cash flow of the project will not be adversely affected by unexpected increases in taxation. Such arrangements are sometimes referred to as "tax stabilization agreements". However, the Government may be restrained, by constitutional law or for political reasons, from providing this type of guarantee, in which case the parties may agree on compensation or contractual revision mechanisms for dealing with cost increases due to tax changes (see also chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 122-125).

36. Most national tax regimes fall into one of three general categories. One approach is worldwide taxation with credits, in which all income earned anywhere is taxed in the home country and double taxation is avoided through the use of a foreign tax credit system; home country taxes are reduced by the amount of foreign taxes already paid. If this approach is used by an investor's home country, the investor's tax liability can be no less than it would be at home. Under a different taxation approach, the foreign income that has already been subject to foreign tax is exempt from taxation by the home country of the investor. Under a territorial approach, foreign income is exempt from home country taxation altogether. Investors in home countries that use the latter two systems of taxation would benefit from tax holidays and lower tax rates in the host country, but such tax relief would offer no incentive to an investor located in a tax haven.

37. The parties involved in the project may have different concerns over potential tax liability. Investors are usually concerned about the taxation of profits earned in the host country, taxation on payments made to contractors, suppliers, investors and lenders, and tax treatment of any capital gains (or losses) when the concessionaire is wound up. Investors may find that payments used to reduce taxes under their home country regime (such as payments for interest on borrowed funds, investigation costs, bidding costs and foreign exchange losses) may not be available in the host country, or vice versa. Since foreign tax credits are only allowed for foreign income taxes, investors need to ensure that any income tax paid in the host country satisfies the definition of income tax of their own country's taxing authority. Similarly, the project company in the host country may be treated for tax purposes as a different type of entity in the home country. In projects where the assets become public property, this may preclude deductions for depreciation under the laws of the home country.

38. One particular problem of privately financed infrastructure projects involving foreign investment is the possibility that foreign companies participating in a project consortium may be exposed to double taxation, that is, taxation of profits, royalties and interests in their own home countries as well as in the host country. The timing of tax payments and requirements to pay withholding taxes can also pose problems. A number of countries have entered into bilateral agreements to eliminate or at least reduce the negative effects of double taxation and the existence of such agreements between the host country and the home countries of the project sponsors often plays a role in their tax considerations.

39. Ultimately, it is the cumulative effect of all taxes combined that needs to be taken into consideration. For example, there may be taxes imposed by more than one level of taxing authority; in addition to taxation by the national Government, the concessionaire may also face municipal or provincial taxes. There may also be certain levies other than income taxes, which often are due and payable before the concessionaire has earned any revenues. These include sales taxes, sometimes referred to as "turnover taxes", value-added taxes, property taxes, stamp duties and import duties. Sometimes special provisions can be made to offer relief from these payments as well.

10. Accounting rules and practices

40. In several countries, companies are required by law to follow internationally acceptable standard accounting practices and retain the services of professional accountants or accounting auditors. Among the reasons for this is that the adoption of standard accounting practices is a measure taken to achieve uniformity in the valuation of businesses. In connection with the selection of the concessionaire, the use of standard accounting practices may also facilitate the task of evaluating the financial standing of bidders in order to determine whether they meet the pre-selection criteria required by the contracting authority (see chap. III, "Selection of the concessionaire", paras. 38-40). Standard accounting practices are also essential for carrying out audits of the profits of companies, which may be required for the application of tariff structures and the monitoring of the concessionaire's performance by the regulatory body (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 39-46).

41. Special accounting rules for infrastructure operators have also been introduced in some countries to take into account the particular revenue profile of infrastructure projects. Projects involving the construction of infrastructure facilities, in particular roads and other transportation facilities, are typically characterized by a relatively short investment period, with high financial cost and no revenue stream, followed by a longer period with increasing revenue and decreasing financial cost and, under normal circumstances, stable operating costs. Accordingly, if traditional accounting rules were applied, the particular financial structure of such projects would need to be recorded in the project company's accounts as a period of continuous negative results followed by a long period of net profit. This would not only have negative consequences, for instance, for the project company's credit rating during the construction phase, but might also result in a disproportionate tax debt during the operational phase of the project. In order to avoid such a distortion, some countries have adopted special accounting rules for companies undertaking infrastructure projects that take into account the fact that the financial results of privately financed infrastructure projects may only become positive on a medium-term basis. Those special rules typically authorize infrastructure developers to defer part of the financial cost accrued during the deficit phase to the subsequent financial years, in accordance with financial schedules provided in the project agreement. However, the special accounting rules are typically without prejudice to other rules of law that may prohibit the distribution of dividends during financial years closed with negative results.

11. Environmental protection

42. Environmental protection encompasses a wide variety of issues, ranging from handling of wastes and hazardous substances to relocation of persons displaced by large land-use projects. It is widely recognized that environmental protection is a critical prerequisite to sustainable development. Environmental protection legislation is likely to have a direct impact on the implementation

of infrastructure projects at various levels, and environmental matters are among the most frequent causes of disputes. Environmental protection laws may include various requirements, such as the consent by various environmental authorities, evidence of no outstanding environmental liability, assurances that environmental standards will be maintained, commitments to remedy environmental damage and notification requirements. These laws often require prior authorization for the exercise of a number of business activities, which may be particularly stringent for some types of infrastructure (for instance, waste water treatment, waste collection, the coal-fired power sector, power transmission, roads and railways).

43. It is therefore advisable to include in legislation measures that make obligations arising from environmental laws transparent. It is important to ensure the highest possible degree of clarity in provisions concerning the tests that may be applied by the environmental authorities, the documentary and other requirements to be met by the applicants, the conditions under which licences are to be issued and the circumstances that justify the denial or withdrawal of a licence. Particularly important are provisions that guarantee the applicant's access to expeditious appeals procedures and judicial recourse, as appropriate. It may also be advisable to ascertain to the extent possible, prior to the final award of the project, whether the conditions for obtaining the required environmental licences are met. In some countries, special public authorities or advocacy groups may have the right to institute legal proceedings to seek to prevent environmental damage, which may include the right to seek the withdrawal of a licence deemed to be inconsistent with applicable environmental standards. In some of those countries, it has been found useful to involve representatives of the public in the proceedings that lead to the issuance of environmental licences. The legislation may also establish the range of penalties that may be imposed and specify the parties that may be held responsible for the damage.

44. Adhering to treaties relating to the protection of the environment may help to strengthen the international regime of environmental protection. A large number of international instruments have been developed in the past decades to establish common international standards. These include the following: Agenda 21[7] and the Rio Declaration on Environment and Development,[8] adopted by the United Nations Conference on Environment and Development in 1992; the World Charter for Nature (General Assembly resolution 37/7, annex); the Basel Convention on the Control of Transboundary Movement of Hazardous Wastes and Their Disposal of 1989; the Convention on Environmental Impact Assessment in a Transboundary Context of 1991;[9] and the Convention on the Protection and Use of Transboundary Watercourses and International Lakes of 1992.[10]

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[7]Report of the United Nations Conference on Environment and Development, Rio de Janeiro, 3-14 June 1992 (United Nations publication, Sales No. E.93.I.8 and corrigenda), vol. I: *Resolutions adopted by the Conference,* resolution 1, annex II.

[8]Ibid., annex I.

[9]United Nations, *Treaty Series,* vol. 1989, No. I-34028 (not yet published).

[10]Ibid., vol. 1936, No. I-33207 (not yet published).

12. Consumer protection laws

45. A number of countries have special rules of law on consumer protection. Consumer protection laws vary greatly from country to country, both in the way they are organized and in their substance. Nevertheless, consumer protection laws often include provisions such as favourable time limits for asserting claims and enforcing contractual rights; special rules for the interpretation of contracts whose terms are not usually negotiated with the consumer (sometimes referred to as "adhesion contracts"); extended warranties in favour of consumers; special termination rights; access to simplified dispute settlement instances (see also chap. VI, "Settlement of disputes", paras. 43-45); or other protective measures.

46. From the concessionaire's perspective, it is important to consider whether the host country's laws on consumer protection may limit or hinder the concessionaire's ability to enforce, for instance, its right to obtain payment for the services provided, to adjust prices or to discontinue services to customers who breach essential terms of their contracts or violate essential conditions for the provision of the services.

13. Insolvency law

47. The insolvency of an infrastructure operator or public service provider raises a number of issues that have led some countries to establish special rules to deal with such situations, including rules that enable the contracting authority to take the measures required to ensure the continuity of the project (see chap. V, "Duration, extension and termination of the project agreement", paras. 24 and 25). The continuity in the provision of the service may be achieved by means of a legal framework that allows for the rescue of enterprises facing financial difficulties, such as reorganization and similar proceedings. In the event that bankruptcy proceedings become inevitable, the secured lenders will be specially concerned about provisions concerning secured claims, in particular as to whether secured creditors may foreclose on the security despite the opening of bankruptcy proceedings, whether secured creditors are given priority for payments made with the proceeds of the security and how claims of secured creditors are ranked. As noted earlier, a substantial portion of the concessionaire's debt takes the form of "senior" loans, with the lenders requiring precedence of payment over payment of the subordinated debt of the concessionaire (see "Introduction and background information on privately financed infrastructure projects", para. 58). The extent to which the lenders will be able to enforce such subordination arrangements will depend on the rules and provisions of the laws of the country that govern the ranking of creditors in insolvency proceedings. The legal recognition of party autonomy on the establishment of contractual subordination of different classes of loans may facilitate the financing of infrastructure projects.

48. Among the issues that the legislation should address are the following: the question of the ranking of creditors; the relationship between the insolvency administrator and creditors; legal mechanisms for reorganization of the insolvent debtor; special rules designed to ensure the continuity of the public serv-

ice in case of insolvency of the concessionaire; and provisions on avoidance of transactions entered into by the debtor shortly before the opening of the insolvency proceedings.

49. In large infrastructure projects, the insolvency of the project company is likely to involve creditors from more than one country or affect assets located in more than one country. It may therefore be desirable for the host country to have provisions in place that facilitate judicial cooperation, court access for foreign insolvency administrators and recognition of foreign insolvency proceedings. A suitable model that may be used by countries wishing to adopt legislation for that purpose is provided in the UNCITRAL Model Law on Cross-Border Insolvency.

14. Anti-corruption measures

50. The investment and business environment in the host country may also be enhanced by measures to fight corruption in the administration of government contracts. It is particularly important for the host country to take effective and concrete action to combat bribery and related illicit practices, in particular to pursue effective enforcement of existing laws prohibiting bribery.

51. The enactment of laws that incorporate international agreements and standards on integrity in the conduct of public business may represent a significant step in that direction. Important standards are contained in two resolutions of the United Nations General Assembly: resolution 51/59 of 12 December 1996, by which the Assembly adopted the International Code of Conduct for Public Officials, and resolution 51/191 of 16 December 1996, by which it adopted the United Nations Declaration against Corruption and Bribery in International Commercial Transactions. Other important instruments include the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions of 1997, which was negotiated under the auspices of the Organisation for Economic Cooperation and Development.

52. Furthermore, it is important that the rules covering the functioning of contracting authorities and the monitoring of public contracts ensure the required degree of transparency and integrity. Where such rules do not exist, appropriate legislation and regulations should be developed and adopted. Simplicity and consistency, coupled with the elimination of unnecessary procedures that prolong the administrative procedures or make them cumbersome, are additional elements to be taken into consideration in this context.

C. International agreements

53. In addition to the internal legislation of the host country, privately financed infrastructure projects may be affected by international agreements entered into by the host country. The implications of certain international agreements is discussed briefly below, in addition to other international agreements mentioned throughout the *Guide*.

1. Membership in international financial institutions

54. Membership in multilateral financial institutions such as the World Bank, the International Development Association, the International Finance Corporation, the Multilateral Investment Guarantee Agency and the regional development banks may have a direct impact on privately financed infrastructure projects in various ways. Firstly, the host country's membership in those institutions is typically a requirement in order for projects in the host country to receive financing and guarantees provided by those institutions. Secondly, the rules on financing and guarantee instruments provided by those institutions typically contain a variety of terms and conditions of direct relevance for the terms of the project agreement and the loan agreements negotiated by the concessionaire (for example, a clause of negative pledge of public assets and provision of counter-guarantees in favour of the multilateral financial institution). Lastly, multilateral financial institutions usually follow a number of policy objectives whose implementation they seek to ensure in connection with projects supported by them (such as adherence to internationally acceptable environmental standards, long-term sustainability of the project beyond the initial concession period and transparency and integrity in the selection of the concessionaire and the disbursement of their loans).

2. General agreements on trade facilitation and promotion

55. A number of multilateral agreements have been negotiated to promote free trade at the global level. The most notable of those agreements have been negotiated under the auspices of the General Agreement on Tariffs and Trade and later WTO. Those agreements may contain general provisions on trade promotion and facilitation of trade in goods (such as a most-favoured-nation clause or prohibition of the use of quantitative restrictions and other discriminatory trade barriers) and on the promotion of fair trade practices (such as prohibition of dumping and limitations on the use of subsidies). Some specific agreements are aimed at the removal of barriers for the provision of services by foreigners in the contracting States or promoting transparency and eliminating discrimination of suppliers in public procurement. Those agreements may be relevant for national legislation on privately financed infrastructure projects that contemplates restrictions on the participation of foreign companies in infrastructure projects or establishes preferences for national entities or for the procurement of supplies on the local market.

3. International agreements on specific industries

56. In the context of the negotiations on basic telecommunications concluded as part of the General Agreement on Trade in Services (GATS), a number of States members of WTO representing most of the world market for telecommunication services have made specific commitments to facilitate trade in telecommunication services. It should be noted that all WTO member States (even those which have not made specific telecommunication commitments) are bound by the general GATS rules on services, including

specific requirements dealing with most-favoured-nation treatment, transparency, regulation, monopolies and business practices. The WTO telecommunication agreement adds sector- and country-specific commitments to the overall GATS agreement. Typical commitments cover the opening of various segments of the market, including voice telephony, data transmission and enhanced services, to competition and foreign investment. Legislators of current or prospective WTO member States should thus ensure that the country's telecommunication laws are consistent with the GATS agreement and their specific telecommunication commitments.

57. Another important sector-specific agreement at the international level is the Energy Charter Treaty, concluded in Lisbon on 17 December 1994 and in force since 16 April 1998, which has been enacted to promote long-term co-operation in the energy field. The Treaty provides for various commercial measures, such as the development of open and competitive markets for energy materials and products and the facilitation of transit and access to and transfer of energy technology. Furthermore, the Treaty aims at avoiding market distortions and barriers to economic activity in the energy sector and promotes the opening of capital markets to encourage the flow of capital in order to finance trade in materials and products. The Treaty also contains regulations about investment promotion and protection: equitable conditions for investors, monetary transfers related to investments, compensation for losses due to war, civil disturbance or other similar events and compensation for expropriation.

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Related documents are available from:

- twenty seventh, twenty eighth, twenty ninth, thirtieth, thirty first, thirty second and thirty third sessions of the Commission.

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UNCITRAL

United Nations Commission on International Trade Law

1994 - UNCITRAL Model Law on Procurement of Goods, Construction and Services, with Guide to Enactment

Adopted by UNCITRAL on 15 June 1994, the Model Law recognizes that certain aspects of the procurement of services are governed by different considerations from those applicable to the procurement of goods and construction. The Model Law therefore includes changes that would need to be made to the Model Law on Procurement of Goods and Construction so as to encompass procurement of services, without superseding the earlier text.

General Assembly resolution

Text

Status

Travaux préparatoires

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Forty-ninth session
Agenda item 138

RESOLUTION ADOPTED BY THE GENERAL ASSEMBLY

[on the report of the Sixth Committee (A/49/739)]

49/54. Model Law on Procurement of Goods, Construction and Services of the United Nations Commission on International Trade Law

The General Assembly,

Recalling its resolution 2205 (XXI) of 17 December 1966, by which it created the United Nations Commission on International Trade Law with a mandate to further the progressive harmonization and unification of the law of international trade and in that respect to bear in mind the interests of all peoples, in particular those of developing countries, in the extensive development of international trade,

Noting that procurement constitutes a large portion of public expenditure in most States,

Recalling the completion and adoption by the United Nations Commission on International Trade Law at its twenty-sixth session of the Model Law on Procurement of Goods and Construction, 1/

Recalling also the decision of the Commission at its twenty-sixth session to draw up model legislative provisions on procurement of services, while leaving intact the Model Law on Procurement of Goods and Construction of the United Nations Commission on International Trade Law,

---

1/ *Official Records of the General Assembly, Forty-eighth Session, Supplement No. 17*, (A/48/17), annex I.

Noting that model legislative provisions on procurement of services establishing procedures designed to foster integrity, confidence, fairness and transparency in the procurement process will also promote economy, efficiency and competition in procurement and thus lead to increased economic development,

Being of the opinion that the establishment of model legislative provisions on procurement of services that are acceptable to States with different legal, social and economic systems contributes to the development of harmonious international economic relations,

Convinced that model legislative provisions on services contained in a consolidated text dealing with procurement of goods, construction and services will significantly assist all States, including developing countries and States whose economies are in transition, in enhancing their existing procurement laws and formulating procurement laws where none presently exist,

1. *Takes note with satisfaction* of the completion and adoption by the United Nations Commission on International Trade Law of the Model Law on Procurement of Goods, Construction and Services 2/ together with the Guide to Enactment of the Model Law; 3/

2. *Recommends* that, in view of the desirability of improvement and uniformity of the laws of procurement, all States give favourable consideration to the Model Law when they enact or revise their procurement laws;

3. *Recommends also* that all efforts be made to ensure that the Model Law together with the Guide become generally known and available.

84th plenary meeting
9 December 1994

2/ Ibid., *Forty-ninth Session, Supplement No. 17* and corrigendum (A/49/17 and Corr.1), annex I.

3/ To be issued under the symbol A/CN.9/403.

UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW (UNCITRAL)

UNCITRAL Model Law on Procurement of Goods, Construction and Services with Guide to Enactment

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I. UNCITRAL MODEL LAW ON PROCUREMENT OF GOODS, CONSTRUCTION AND SERVICES *

Preamble

WHEREAS the [Government] [Parliament] of ... considers it desirable to regulate procurement of goods, construction and services so as to promote the objectives of:

(a) Maximizing economy and efficiency in procurement;

(b) Fostering and encouraging participation in procurement proceedings by suppliers and contractors, especially where appropriate, participation by suppliers and contractors regardless of nationality, and thereby promoting international trade;

(c) Promoting competition among suppliers and contractors for the supply of the goods, construction or services to be procured;

(d) Providing for the fair and equitable treatment of all suppliers and contractors;

(e) Promoting the integrity of, and fairness and public confidence in, the procurement process; and

(f) Achieving transparency in the procedures relating to procurement,

Be it therefore enacted as follows.

---

* The UNCITRAL Model Law on Procurement of Goods, Construction and Services was adopted by the United Nations Commission on International Trade Law (UNCITRAL) at its twenty-seventh session, without thereby superseding the UNCITRAL Model Law on Procurement of Goods and Construction, adopted by the Commission at its twenty-sixth session. The present consolidated text consists of the provisions found in the Model Law on Procurement of Goods and Construction and provisions on procurement of services. The Commission has also issued a Guide to Enactment of the UNCITRAL Model Law on Procurement of Goods, Construction and Services (A/CN.9/403).

CHAPTER I. GENERAL PROVISIONS

Article 1. Scope of application

(1) This Law applies to all procurement by procuring entities, except as otherwise provided by paragraph (2) of this article.

(2) Subject to the provisions of paragraph (3) of this article, this Law does not apply to:

(a) Procurement involving national defence or national security;

(b) ... (the enacting State may specify in this Law additional types of procurement to be excluded); or

(c) Procurement of a type excluded by the procurement regulations.

(3) This Law applies to the types of procurement referred to in paragraph (2) of this article where and to the extent that the procuring entity expressly so declares to suppliers or contractors when first soliciting their participation in the procurement proceedings.

Article 2. Definitions

For the purposes of this Law:

(a) "Procurement" means the acquisition by any means of goods, construction or services;

(b) "Procuring entity" means:

(i) *Option I*

Any governmental department, agency, organ or other unit, or any subdivision thereof, in this State that engages in procurement, except ...; (and)

Option II

Any department, agency, organ or other unit, or any subdivision thereof, of the ("Government" or other term used to refer to the national Government of the enacting State) that

engages in procurement, except ...; (and)

(ii) (The enacting State may insert in this subparagraph and, if necessary, in subsequent subparagraphs, other entities or enterprises, or categories thereof, to be included in the definition of "procuring entity");

(c) "Goods" means objects of every kind and description including raw materials, products and equipment and objects in solid, liquid or gaseous form, and electricity, as well as services incidental to the supply of the goods if the value of those incidental services does not exceed that of the goods themselves; (the enacting State may include additional categories of goods)

(d) "Construction" means all work associated with the construction, reconstruction, demolition, repair or renovation of a building, structure or works, such as site preparation, excavation, erection, building, installation of equipment or materials, decoration and finishing, as well as services incidental to construction such as drilling, mapping, satellite photography, seismic investigations and similar services provided pursuant to the procurement contract, if the value of those services does not exceed that of the construction itself;

(e) "Services" means any object of procurement other than goods or construction; (the enacting State may specify certain objects of procurement which are to be treated as services)

(f) "Supplier or contractor" means, according to the context, any potential party or the party to a procurement contract with the procuring entity;

(g) "Procurement contract" means a contract between the procuring entity and a supplier or contractor resulting from procurement proceedings;

(h) "Tender security" means a security provided to the procuring entity to secure the fulfilment of any obligation referred to in article 32 (1) (f) and includes such arrangements as bank guarantees, surety bonds, stand-by letters of credit, cheques on which a bank is primarily liable, cash deposits, promissory notes and bills of exchange;

(i) "Currency" includes monetary unit of account.

Article 3. International obligations of this State relating to procurement [and intergovernmental agreements within (this State)]

To the extent that this Law conflicts with an obligation of this State under or arising out of any

(a) Treaty or other form of agreement to which it is a party with one or more other States,

(b) Agreement entered into by this State with an intergovernmental international financing institution, or

(c) Agreement between the federal Government of [name of federal State] and any subdivision or subdivisions of [name of federal State], or between any two or more such subdivisions,

the requirements of the treaty or agreement shall prevail; but in all other respects, the procurement shall be governed by this Law.

Article 4. Procurement regulations

The ... (the enacting State specifies the organ or authority authorized to promulgate the procurement regulations) is authorized to promulgate procurement regulations to fulfil the objectives and to carry out the provisions of this Law.

Article 5. Public accessibility of legal texts

The text of this Law, procurement regulations and all administrative rulings and directives of general application in connection with procurement covered by this Law, and all amendments thereof, shall be promptly made accessible to the public and systematically maintained.

Article 6. Qualifications of suppliers and contractors

(1) (a) This article applies to the ascertainment by the procuring entity of the qualifications of suppliers or contractors at any stage of the procurement proceedings;

(b) In order to participate in procurement proceedings, suppliers or contractors must qualify by meeting such of the following criteria as the procuring entity considers appropriate in the particular procurement proceedings:

(i) That they possess the necessary professional and technical qualifications, professional and technical competence, financial resources, equipment and other physical facilities, managerial capability, reliability, experience, and reputation, and the personnel, to perform the procurement contract;

(ii) That they have legal capacity to enter into the procurement contract;

(iii) That they are not insolvent, in receivership, bankrupt or being wound up, their affairs are not being administered by a court or a judicial officer, their business activities have not been suspended, and they are not the subject of legal proceedings for any of the foregoing;

(iv) That they have fulfilled their obligations to pay taxes and social security contributions in this State;

(v) That they have not, and their directors or officers have not, been convicted of any criminal offence related to their professional conduct or the making of false statements or misrepresentations as to their qualifications to enter into a procurement contract within a period of ... years (the enacting State specifies the period of time) preceding the commencement of the procurement proceedings, or have not been otherwise disqualified pursuant to administrative suspension or disbarment proceedings.

(2) Subject to the right of suppliers or contractors to protect their intellectual property or trade secrets, the procuring entity may require suppliers or contractors participating in procurement proceedings to provide such appropriate documentary evidence or other information as it may deem useful to satisfy itself that the suppliers or contractors are qualified in accordance with the criteria referred to in paragraph (1) (b).

(3) Any requirement established pursuant to this article shall be set forth in the prequalification documents, if any, and in the solicitation documents or other documents for solicitation of proposals, offers or quotations, and shall apply equally to all suppliers or contractors. A procuring entity shall impose no criterion, requirement or procedure with respect to the qualifications of suppliers or contractors other than those provided for in this article.

(4) The procuring entity shall evaluate the qualifications of suppliers or contractors in accordance with the qualification criteria and procedures set forth in the prequalification documents, if any, and in the solicitation documents or other documents for solicitation of proposals, offers or quotations.

(5) Subject to articles 8 (1), 34 (4) (d) and 39 (2), the procuring entity shall establish no criterion, requirement or procedure with respect to the qualifications of suppliers or contractors that discriminates

against or among suppliers or contractors or against categories thereof on the basis of nationality, or that is not objectively justifiable.

(6) (a) The procuring entity shall disqualify a supplier or contractor if it finds at any time that the information submitted concerning the qualifications of the supplier or contractor was false;

(b) A procuring entity may disqualify a supplier or contractor if it finds at any time that the information submitted concerning the qualifications of the supplier or contractor was materially inaccurate or materially incomplete;

(c) Other than in a case to which subparagraph (a) of this paragraph applies, a procuring entity may not disqualify a supplier or contractor on the ground that information submitted concerning the qualifications of the supplier or contractor was inaccurate or incomplete in a non-material respect. The supplier or contractor may be disqualified if it fails to remedy such deficiencies promptly upon request by the procuring entity.

Article 7. Prequalification proceedings

(1) The procuring entity may engage in prequalification proceedings with a view towards identifying, prior to the submission of tenders, proposals or offers in procurement proceedings conducted pursuant to chapter III, IV or V, suppliers and contractors that are qualified. The provisions of article 6 shall apply to prequalification proceedings.

(2) If the procuring entity engages in prequalification proceedings, it shall provide a set of prequalification documents to each supplier or contractor that requests them in accordance with the invitation to prequalify and that pays the price, if any, charged for those documents. The price that the procuring entity may charge for the prequalification documents shall reflect only the cost of printing them and providing them to suppliers or contractors.

(3) The prequalification documents shall include, at a minimum:

(a) The following information:

(i) Instructions for preparing and submitting prequalification applications;

(ii) A summary of the principal required terms and conditions of the procurement contract to be entered into as a result of the procurement proceedings;

(iii) Any documentary evidence or other information that must be submitted by suppliers or contractors to demonstrate their qualifications;

(iv) The manner and place for the submission of applications to prequalify and the deadline for the submission, expressed as a specific date and time and allowing sufficient time for suppliers or contractors to prepare and submit their applications, taking into account the reasonable needs of the procuring entity;

(v) Any other requirements that may be established by the procuring entity in conformity with this Law and the procurement regulations relating to the preparation and submission of applications to prequalify and to the prequalification proceedings; and

(b) (i) In proceedings under chapter III, the information required to be specified in the invitation to tender by article 25 (1) (a) to (e), (h) and, if already known, (j);

(ii) In proceedings under chapter IV, the information referred to in article 38 (a), (c), if already known, (g), (p) and (s).

(4) The procuring entity shall respond to any request by a supplier or contractor for clarification of the prequalification documents that is received by the procuring entity within a reasonable time prior to the deadline for the submission of applications to prequalify. The response by the procuring entity shall be given within a reasonable time so as to enable the supplier or contractor to make a timely submission of its application to prequalify. The response to any request that might reasonably be expected to be of interest to other suppliers or contractors shall, without identifying the source of the request, be communicated to all suppliers or contractors to which the procuring entity provided the prequalification documents.

(5) The procuring entity shall make a decision with respect to the qualifications of each supplier or contractor submitting an application to prequalify. In reaching that decision, the procuring entity shall apply only the criteria set forth in the prequalification documents.

(6) The procuring entity shall promptly notify each supplier or contractor submitting an application to prequalify whether or not it has been prequalified and shall make available to any member of the general public, upon request, the names of all suppliers or contractors that have been prequalified. Only suppliers or contractors that have been prequalified are entitled to participate further in the procurement proceedings.

(7) The procuring entity shall upon request communicate to suppliers or contractors that have not been prequalified the grounds therefor, but the procuring entity is not required to specify the evidence or give the reasons for its finding that those grounds were present.

(8) The procuring entity may require a supplier or contractor that has been prequalified to demonstrate again its qualifications in accordance with the same criteria used to prequalify such supplier or contractor. The procuring entity shall disqualify any supplier or contractor that fails to demonstrate again its qualifications if requested to do so. The procuring entity shall promptly notify each supplier or contractor requested to demonstrate again its qualifications as to whether or not the supplier or contractor has done so to the satisfaction of the procuring entity.

Article 8. Participation by suppliers or contractors

(1) Suppliers or contractors are permitted to participate in procurement proceedings without regard to nationality, except in cases in which the procuring entity decides, on grounds specified in the procurement regulations or according to other provisions of law, to limit participation in procurement proceedings on the basis of nationality.

(2) A procuring entity that limits participation on the basis of nationality pursuant to paragraph (1) of this article shall include in the record of the procurement proceedings a statement of the grounds and circumstances on which it relied.

(3) The procuring entity, when first soliciting the participation of suppliers or contractors in the procurement proceedings, shall declare to them that they may participate in the procurement proceedings regardless of nationality, a declaration which may not later be altered. However, if it decides to limit participation pursuant to paragraph (1) of this article, it shall so declare to them.

Article 9. Form of communications

(1) Subject to other provisions of this Law and any requirement of form specified by the procuring entity when first soliciting the participation of suppliers or contractors in the procurement proceedings, documents, notifications, decisions and other communications referred to in this Law to be submitted by the procuring entity or administrative authority to a supplier or contractor or by a supplier or contractor to the procuring entity shall be in a form that provides a record of the content of the communication.

(2) Communications between suppliers or contractors and the procuring entity referred to in articles 7 (4) and (6), 12 (3), 31 (2) (a), 32 (1) (d), 34 (1), 36 (1), 37 (3), 44 (b) to (f) and 47 (1) may be made by a means of communication that does not provide a record of the content of the communication provided that, immediately thereafter, confirmation of the communication is given to the recipient of the communication in a form which provides a record of the confirmation.

(3) The procuring entity shall not discriminate against or among suppliers or contractors on the basis of the form in which they transmit or receive documents, notifications, decisions or other communications.

Article 10. Rules concerning documentary evidence provided by suppliers or contractors

If the procuring entity requires the legalization of documentary evidence provided by suppliers or contractors to demonstrate their qualifications in procurement proceedings, the procuring entity shall not impose any requirements as to the legalization of the documentary evidence other than those provided for in the laws of this State relating to the legalization of documents of the type in question.

Article 11. Record of procurement proceedings

(1) The procuring entity shall maintain a record of the procurement proceedings containing, at a minimum, the following information:

(a) A brief description of the goods, construction or services to be procured, or of the procurement need for which the procuring entity requested proposals or offers;

(b) The names and addresses of suppliers or contractors that submitted tenders, proposals, offers or quotations, and the name and address of the supplier or contractor with whom the procurement contract is entered into and the contract price;

(c) Information relative to the qualifications, or lack thereof, of suppliers or contractors that submitted tenders, proposals, offers or quotations;

(d) The price, or the basis for determining the price, and a summary of the other principal terms and conditions of each tender, proposal, offer or quotation and of the procurement contract, where these are known to the procuring entity;

(e) A summary of the evaluation and comparison of tenders, proposals, offers or quotations, including the application of any margin of preference pursuant to articles 34 (4) (d) and 39 (2);

(f) If all tenders, proposals, offers or quotations were rejected pursuant to article 12, a statement to that effect and the grounds therefor, in accordance with article 12 (1);

(g) If, in procurement proceedings involving methods of procurement other than

tendering, those proceedings did not result in a procurement contract, a statement to that effect and of the grounds therefor;

(h) The information required by article 15, if a tender, proposal, offer or quotation was rejected pursuant to that provision;

(i) In procurement proceedings involving the use of a procurement method pursuant to paragraph (2) or subparagraph (a) or (b) of paragraph (3) of article 18, the statement required under article 18 (4) of the grounds and circumstances on which the procuring entity relied to justify the selection of the method of procurement used;

(j) In the procurement of services by means of chapter IV, the statement required under article 41 (2) of the grounds and circumstances on which the procuring entity relied to justify the selection procedure used;

(k) In procurement proceedings involving direct solicitation of proposals for services in accordance with article 37 (3), a statement of the grounds and circumstances on which the procuring entity relied to justify the direct solicitation;

(l) In procurement proceedings in which the procuring entity, in accordance with article 8 (1), limits participation on the basis of nationality, a statement of the grounds and circumstances relied upon by the procuring entity for imposing the limitation;

(m) A summary of any requests for clarification of the prequalification or solicitation documents, the responses thereto, as well as a summary of any modification of those documents.

(2) Subject to article 33 (3), the portion of the record referred to in subparagraphs (a) and (b) of paragraph (1) of this article shall, on request, be made available to any person after a tender, proposal, offer or quotation, as the case may be, has been accepted or after procurement proceedings have been terminated without resulting in a procurement contract.

(3) Subject to article 33 (3), the portion of the record referred to in subparagraphs (c) to (g), and (m), of paragraph (1) of this article shall, on request, be made available to suppliers or contractors that submitted tenders, proposals, offers or quotations, or applied for prequalification, after a tender, proposal, offer or quotation has been accepted or procurement proceedings have been terminated without resulting in a procurement contract. Disclosure of the portion of the record referred to in subparagraphs (c) to (e), and (m), may be ordered at an earlier stage by a competent court. However, except when ordered to do so by a competent court, and subject to the conditions of such an order, the procuring entity shall not disclose:

(a) Information if its disclosure would be contrary to law, would impede law enforcement,

would not be in the public interest, would prejudice legitimate commercial interests of the parties or would inhibit fair competition;

(b) Information relating to the examination, evaluation and comparison of tenders, proposals, offers or quotations, and tender, proposal, offer or quotation prices, other than the summary referred to in paragraph (1) (e).

(4) The procuring entity shall not be liable to suppliers or contractors for damages owing solely to a failure to maintain a record of the procurement proceedings in accordance with the present article.

Article 12. Rejection of all tenders, proposals, offers or quotations

(1) (Subject to approval by ... (the enacting State designates an organ to issue the approval)), and if so specified in the solicitation documents or other documents for solicitation of proposals, offers or quotations, the procuring entity may reject all tenders, proposals, offers or quotations at any time prior to the acceptance of a tender, proposal, offer or quotation. The procuring entity shall upon request communicate to any supplier or contractor that submitted a tender, proposal, offer or quotation, the grounds for its rejection of all tenders, proposals, offers or quotations, but is not required to justify those grounds.

(2) The procuring entity shall incur no liability, solely by virtue of its invoking paragraph (1) of this article, towards suppliers or contractors that have submitted tenders, proposals, offers or quotations.

(3) Notice of the rejection of all tenders, proposals, offers or quotations shall be given promptly to all suppliers or contractors that submitted tenders, proposals, offers or quotations.

Article 13. Entry into force of the procurement contract

(1) In tendering proceedings, acceptance of the tender and entry into force of the procurement contract shall be carried out in accordance with article 36.

(2) In all the other methods of procurement, the manner of entry into force of the procurement contract shall be notified to the suppliers or contractors at the time that proposals, offers or quotations are requested.

Article 14. Public notice of procurement contract awards

(1) The procuring entity shall promptly publish notice of procurement contract awards.

(2) The procurement regulations may provide for the manner of publication of the notice required by paragraph (1).

(3) Paragraph (1) is not applicable to awards where the contract price is less than [...].

Article 15. Inducements from suppliers or contractors

(Subject to approval by ... (the enacting State designates an organ to issue the approval),) a procuring entity shall reject a tender, proposal, offer or quotation if the supplier or contractor that submitted it offers, gives or agrees to give, directly or indirectly, to any current or former officer or employee of the procuring entity or other governmental authority a gratuity in any form, an offer of employment or any other thing of service or value, as an inducement with respect to an act or decision of, or procedure followed by, the procuring entity in connection with the procurement proceedings. Such rejection of the tender, proposal, offer or quotation and the reasons therefor shall be recorded in the record of the procurement proceedings and promptly communicated to the supplier or contractor.

Article 16. Rules concerning description of goods, construction or services

(1) Any specifications, plans, drawings and designs setting forth the technical or quality characteristics of the goods, construction or services to be procured, and requirements concerning testing and test methods, packaging, marking or labelling or conformity certification, and symbols and terminology, or description of services, that create obstacles to participation, including obstacles based on nationality, by suppliers or contractors in the procurement proceedings shall not be included or used in the prequalification documents, solicitation documents or other documents for solicitation of proposals, offers or quotations.

(2) To the extent possible, any specifications, plans, drawings, designs and requirements or descriptions of goods, construction or services shall be based on the relevant objective technical and quality characteristics of the goods, construction or services to be procured. There shall be no requirement of or reference to a particular trade mark, name, patent, design, type, specific origin or producer unless there is no other sufficiently precise or intelligible way of describing the characteristics of the goods, construction or services to be procured and provided that words such as "or equivalent" are included.

(3) (a) Standardized features, requirements, symbols and terminology relating to the technical and

quality characteristics of the goods, construction or services to be procured shall be used, where available, in formulating any specifications, plans, drawings and designs to be included in the prequalification documents, solicitation documents or other documents for solicitation of proposals, offers or quotations;

(b) Due regard shall be had for the use of standardized trade terms, where available, in formulating the terms and conditions of the procurement contract to be entered into as a result of the procurement proceedings and in formulating other relevant aspects of the prequalification documents, solicitation documents or other documents for solicitation of proposals, offers or quotations.

Article 17. Language

The prequalification documents, solicitation documents and other documents for solicitation of proposals, offers or quotations shall be formulated in ... (the enacting State specifies its official language or languages) (and in a language customarily used in international trade except where:

(a) The procurement proceedings are limited solely to domestic suppliers or contractors pursuant to article 8 (1), or

(b) The procuring entity decides, in view of the low value of the goods, construction or services to be procured, that only domestic suppliers or contractors are likely to be interested).

CHAPTER II. METHODS OF PROCUREMENT AND THEIR CONDITIONS FOR USE

Article 18. Methods of procurement*

(1) Except as otherwise provided by this chapter, a procuring entity engaging in procurement of goods or construction shall do so by means of tendering proceedings.

(2) In the procurement of goods and construction, a procuring entity may use a method of procurement other than tendering proceedings only pursuant to article 19, 20, 21 or 22.

(3) In the procurement of services, a procuring entity shall use the method of procurement set forth in

chapter IV, unless the procuring entity determines that:

(a) It is feasible to formulate detailed specifications and tendering proceedings would be more appropriate taking into account the nature of the services to be procured; or

(b) It would be more appropriate (, subject to approval by ... (the enacting State designates an organ to issue the approval),) to use a method of procurement referred to in articles 19 to 22, provided that the conditions for the use of that method are satisfied.

(4) If the procuring entity uses a method of procurement pursuant to paragraph (2) or subparagraph (a) or (b) of paragraph (3), it shall include in the record required under article 11 a statement of the grounds and circumstances on which it relied to justify the use of that method.

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* States may choose not to incorporate all these methods of procurement into their national legislation. On this question, see Guide to Enactment of the UNCITRAL Model Law on Procurement of Goods, Construction and Services (A/CN.9/403).

Article 19. Conditions for use of two-stage tendering, request for proposals or competitive negotiation

(1) (Subject to approval by ... (the enacting State designates an organ to issue the approval),) a procuring entity may engage in procurement by means of two-stage tendering in accordance with article 46, or request for proposals in accordance with article 48, or competitive negotiation in accordance with article 49, in the following circumstances:

(a) It is not feasible for the procuring entity to formulate detailed specifications for the goods or construction or, in the case of services, to identify their characteristics and, in order to obtain the most satisfactory solution to its procurement needs,

(i) It seeks tenders, proposals or offers as to various possible means of meeting its needs; or,

(ii) Because of the technical character of the goods or construction, or because of the nature of the services, it is necessary for the procuring entity to negotiate with suppliers or contractors;

(b) When the procuring entity seeks to enter into a contract for the purpose of research, experiment, study or development, except where the contract includes the production of

goods in quantities sufficient to establish their commercial viability or to recover research and development costs;

(c) When the procuring entity applies this Law, pursuant to article 1 (3), to procurement involving national defence or national security and determines that the selected method is the most appropriate method of procurement; or

(d) When tendering proceedings have been engaged in but no tenders were submitted or all tenders were rejected by the procuring entity pursuant to article 12, 15 or 34 (3), and when, in the judgement of the procuring entity, engaging in new tendering proceedings would be unlikely to result in a procurement contract.

(2) (Subject to approval by ... (the enacting State designates an organ to issue the approval),) the procuring entity may engage in procurement by means of competitive negotiation also when:

(a) There is an urgent need for the goods, construction or services, and engaging in tendering proceedings would therefore be impractical, provided that the circumstances giving rise to the urgency were neither foreseeable by the procuring entity nor the result of dilatory conduct on its part; or,

(b) Owing to a catastrophic event, there is an urgent need for the goods, construction or services, making it impractical to use other methods of procurement because of the time involved in using those methods.

Article 20. Conditions for use of restricted tendering

(Subject to approval by ... (the enacting State designates an organ to issue the approval),) the procuring entity may, where necessary for reasons of economy and efficiency, engage in procurement by means of restricted tendering in accordance with article 47, when:

(a) The goods, construction or services, by reason of their highly complex or specialized nature, are available only from a limited number of suppliers or contractors; or

(b) The time and cost required to examine and evaluate a large number of tenders would be disproportionate to the value of the goods, construction or services to be procured.

Article 21. Conditions for use of request for quotations

(1) (Subject to approval by ... (the enacting State designates an organ to issue the approval),) a procuring entity may engage in procurement by means of a request for quotations in accordance with article 50 for the procurement of readily available goods or services that are not specially produced or provided to the particular specifications of the procuring entity and for which there is an established market, so long as the estimated value of the procurement contract is less than the amount set forth in the procurement regulations.

(2) A procuring entity shall not divide its procurement into separate contracts for the purpose of invoking paragraph (1) of this article.

Article 22. Conditions for use of single-source procurement

(1) (Subject to approval by ... (the enacting State designates an organ to issue the approval),) a procuring entity may engage in single-source procurement in accordance with article 51 when:

(a) The goods, construction or services are available only from a particular supplier or contractor, or a particular supplier or contractor has exclusive rights in respect of the goods, construction or services, and no reasonable alternative or substitute exists;

(b) There is an urgent need for the goods, construction or services, and engaging in tendering proceedings or any other method of procurement would therefore be impractical, provided that the circumstances giving rise to the urgency were neither foreseeable by the procuring entity nor the result of dilatory conduct on its part;

(c) Owing to a catastrophic event, there is an urgent need for the goods, construction or services, making it impractical to use other methods of procurement because of the time involved in using those methods;

(d) The procuring entity, having procured goods, equipment, technology or services from a supplier or contractor, determines that additional supplies must be procured from that supplier or contractor for reasons of standardization or because of the need for compatibility with existing goods, equipment, technology or services, taking into account the effectiveness of the original procurement in meeting the needs of the procuring entity, the limited size of the proposed procurement in relation to the original procurement, the reasonableness of the price and the unsuitability of alternatives to the goods or services in question;

(e) The procuring entity seeks to enter into a contract with the supplier or contractor for the purpose of research, experiment, study or development, except where the contract includes the production of goods in quantities to establish their commercial viability or to

recover research and development costs; or

(f) The procuring entity applies this Law, pursuant to article 1 (3), to procurement involving national defence or national security and determines that single-source procurement is the most appropriate method of procurement.

(2) Subject to approval by ... (the enacting State designates an organ to issue the approval), and following public notice and adequate opportunity to comment, a procuring entity may engage in single-source procurement when procurement from a particular supplier or contractor is necessary in order to promote a policy specified in article 34 (4) (c) (iii) or 39 (1) (d), provided that procurement from no other supplier or contractor is capable of promoting that policy.

CHAPTER III. TENDERING PROCEEDINGS

SECTION I. SOLICITATION OF TENDERS AND OF APPLICATION TO PREQUALIFY

Article 23. Domestic tendering

In procurement proceedings in which

(a) Participation is limited solely to domestic suppliers or contractors pursuant to article 8 (1), or

(b) The procuring entity decides, in view of the low value of the goods, construction or services to be procured, that only domestic suppliers or contractors are likely to be interested in submitting tenders,

the procuring entity shall not be required to employ the procedures set out in articles 24 (2), 25 (1) (h), 25 (1) (i), 25 (2) (c), 25 (2) (d), 27 (j), 27 (k), 27 (s) and 32 (1) (c) of this Law.

Article 24. Procedures for soliciting tenders or applications to prequalify

(1) A procuring entity shall solicit tenders or, where applicable, applications to prequalify by causing an invitation to tender or an invitation to prequalify, as the case may be, to be published in ... (the enacting State specifies the official gazette or other official publication in which the invitation to tender or to prequalify is to be published).

(2) The invitation to tender or invitation to prequalify shall also be published, in a language customarily used in international trade, in a newspaper of wide international circulation or in a relevant trade publication or technical or professional journal of wide international circulation.

Article 25. Contents of invitation to tender and invitation to prequalify

(1) The invitation to tender shall contain, at a minimum, the following information:

(a) The name and address of the procuring entity;

(b) The nature and quantity, and place of delivery of the goods to be supplied, the nature and location of the construction to be effected, or the nature of the services and the location where they are to be provided;

(c) The desired or required time for the supply of the goods or for the completion of the construction, or the timetable for the provision of the services;

(d) The criteria and procedures to be used for evaluating the qualifications of suppliers or contractors, in conformity with article 6 (1) (b);

(e) A declaration, which may not later be altered, that suppliers or contractors may participate in the procurement proceedings regardless of nationality, or a declaration that participation is limited on the basis of nationality pursuant to article 8 (1), as the case may be;

(f) The means of obtaining the solicitation documents and the place from which they may be obtained;

(g) The price, if any, charged by the procuring entity for the solicitation documents;

(h) The currency and means of payment for the solicitation documents;

(i) The language or languages in which the solicitation documents are available;

(j) The place and deadline for the submission of tenders.

(2) An invitation to prequalify shall contain, at a minimum, the information referred to in paragraph (1) (a) to (e), (g), (h) and, if it is already known, (j), as well as the following information:

(a) The means of obtaining the prequalification documents and the place from which they may be obtained;

(b) The price, if any, charged by the procuring entity for the prequalification documents;

(c) The currency and terms of payment for the prequalification documents;

(d) The language or languages in which the prequalification documents are available;

(e) The place and deadline for the submission of applications to prequalify.

Article 26. Provision of solicitation documents

The procuring entity shall provide the solicitation documents to suppliers or contractors in accordance with the procedures and requirements specified in the invitation to tender. If prequalification proceedings have been engaged in, the procuring entity shall provide a set of solicitation documents to each supplier or contractor that has been prequalified and that pays the price, if any, charged for those documents. The price that the procuring entity may charge for the solicitation documents shall reflect only the cost of printing them and providing them to suppliers or contractors.

Article 27. Contents of solicitation documents

The solicitation documents shall include, at a minimum, the following information:

(a) Instructions for preparing tenders;

(b) The criteria and procedures, in conformity with the provisions of article 6, relative to the evaluation of the qualifications of suppliers or contractors and relative to the further demonstration of qualifications pursuant to article 34 (6);

(c) The requirements as to documentary evidence or other information that must be submitted by suppliers or contractors to demonstrate their qualifications;

(d) The nature and required technical and quality characteristics, in conformity with article 16, of the goods, construction or services to be procured, including, but not limited to, technical specifications, plans, drawings and designs as appropriate; the quantity of the goods; any incidental services to be performed; the location where the construction is to be effected or the services are to be provided; and the desired or required time, if any, when the goods are to be delivered, the construction is to be effected or the services are to

be provided;

(e) The criteria to be used by the procuring entity in determining the successful tender, including any margin of preference and any criteria other than price to be used pursuant to article 34 (4) (b), (c) or (d) and the relative weight of such criteria;

(f) The terms and conditions of the procurement contract, to the extent they are already known to the procuring entity, and the contract form, if any, to be signed by the parties;

(g) If alternatives to the characteristics of the goods, construction, services, contractual terms and conditions or other requirements set forth in the solicitation documents are permitted, a statement to that effect, and a description of the manner in which alternative tenders are to be evaluated and compared;

(h) If suppliers or contractors are permitted to submit tenders for only a portion of the goods, construction or services to be procured, a description of the portion or portions for which tenders may be submitted;

(i) The manner in which the tender price is to be formulated and expressed, including a statement as to whether the price is to cover elements other than the cost of the goods, construction or services themselves, such as any applicable transportation and insurance charges, customs duties and taxes;

(j) The currency or currencies in which the tender price is to be formulated and expressed;

(k) The language or languages, in conformity with article 29, in which tenders are to be prepared;

(l) Any requirements of the procuring entity with respect to the issuer and the nature, form, amount and other principal terms and conditions of any tender security to be provided by suppliers or contractors submitting tenders, and any such requirements for any security for the performance of the procurement contract to be provided by the supplier or contractor that enters into the procurement contract, including securities such as labour and materials bonds;

(m) If a supplier or contractor may not modify or withdraw its tender prior to the deadline for the submission of tenders without forfeiting its tender security, a statement to that effect;

(n) The manner, place and deadline for the submission of tenders, in conformity with article 30;

(o) The means by which, pursuant to article 28, suppliers or contractors may seek clarifications of the solicitation documents, and a statement as to whether the procuring entity intends, at this stage, to convene a meeting of suppliers or contractors;

(p) The period of time during which tenders shall be in effect, in conformity with article 31;

(q) The place, date and time for the opening of tenders, in conformity with article 33;

(r) The procedures to be followed for opening and examining tenders;

(s) The currency that will be used for the purpose of evaluating and comparing tenders pursuant to article 34 (5) and either the exchange rate that will be used for the conversion of tenders into that currency or a statement that the rate published by a specified financial institution prevailing on a specified date will be used;

(t) References to this Law, the procurement regulations and other laws and regulations directly pertinent to the procurement proceedings, provided, however, that the omission of any such reference shall not constitute grounds for review under article 52 or give rise to liability on the part of the procuring entity;

(u) The name, functional title and address of one or more officers or employees of the procuring entity who are authorized to communicate directly with and to receive communications directly from suppliers or contractors in connection with the procurement proceedings, without the intervention of an intermediary;

(v) Any commitments to be made by the supplier or contractor outside of the procurement contract, such as commitments relating to countertrade or to the transfer of technology;

(w) Notice of the right provided under article 52 of this Law to seek review of an unlawful act or decision of, or procedure followed by, the procuring entity in relation to the procurement proceedings;

(x) If the procuring entity reserves the right to reject all tenders pursuant to article 12, a statement to that effect;

(y) Any formalities that will be required once a tender has been accepted for a procurement contract to enter into force, including, where applicable, the execution of a written procurement contract pursuant to article 36, and approval by a higher authority or the Government and the estimated period of time following the dispatch of the notice of acceptance that will be required to obtain the approval;

(z) Any other requirements established by the procuring entity in conformity with this Law and the procurement regulations relating to the preparation and submission of tenders and to other aspects of the procurement proceedings.

Article 28. Clarifications and modifications of solicitation documents

(1) A supplier or contractor may request a clarification of the solicitation documents from the procuring entity. The procuring entity shall respond to any request by a supplier or contractor for clarification of the solicitation documents that is received by the procuring entity within a reasonable time prior to the deadline for the submission of tenders. The procuring entity shall respond within a reasonable time so as to enable the supplier or contractor to make a timely submission of its tender and shall, without identifying the source of the request, communicate the clarification to all suppliers or contractors to which the procuring entity has provided the solicitation documents.

(2) At any time prior to the deadline for submission of tenders, the procuring entity may, for any reason, whether on its own initiative or as a result of a request for clarification by a supplier or contractor, modify the solicitation documents by issuing an addendum. The addendum shall be communicated promptly to all suppliers or contractors to which the procuring entity has provided the solicitation documents and shall be binding on those suppliers or contractors.

(3) If the procuring entity convenes a meeting of suppliers or contractors, it shall prepare minutes of the meeting containing the requests submitted at the meeting for clarification of the solicitation documents, and its responses to those requests, without identifying the sources of the requests. The minutes shall be provided promptly to all suppliers or contractors to which the procuring entity provided the solicitation documents, so as to enable those suppliers or contractors to take the minutes into account in preparing their tenders.

SECTION II. SUBMISSION OF TENDERS

Article 29. Language of tenders

Tenders may be formulated and submitted in any language in which the solicitation documents have been issued or in any other language that the procuring entity specifies in the solicitation documents.

Article 30. Submission of tenders

(1) The procuring entity shall fix the place for, and a specific date and time as the deadline for, the submission of tenders.

(2) If, pursuant to article 28, the procuring entity issues a clarification or modification of the solicitation documents, or if a meeting of suppliers or contractors is held, it shall, prior to the deadline for the submission of tenders, extend the deadline if necessary to afford suppliers or contractors reasonable time to take the clarification or modification, or the minutes of the meeting, into account in their tenders.

(3) The procuring entity may, in its absolute discretion, prior to the deadline for the submission of tenders, extend the deadline if it is not possible for one or more suppliers or contractors to submit their tenders by the deadline owing to any circumstance beyond their control.

(4) Notice of any extension of the deadline shall be given promptly to each supplier or contractor to which the procuring entity provided the solicitation documents.

> (5) (a) Subject to subparagraph (b), a tender shall be submitted in writing, signed and in a sealed envelope;
>
> (b) Without prejudice to the right of a supplier or contractor to submit a tender in the form referred to in subparagraph (a), a tender may alternatively be submitted in any other form specified in the solicitation documents that provides a record of the content of the tender and at least a similar degree of authenticity, security and confidentiality;
>
> (c) The procuring entity shall, on request, provide to the supplier or contractor a receipt showing the date and time when its tender was received.

(6) A tender received by the procuring entity after the deadline for the submission of tenders shall not be opened and shall be returned to the supplier or contractor that submitted it.

Article 31. Period of effectiveness of tenders; modification and withdrawal of tenders

(1) Tenders shall be in effect during the period of time specified in the solicitation documents.

(2) (a) Prior to the expiry of the period of effectiveness of tenders, the procuring entity may request suppliers or contractors to extend the period for an additional specified period of time. A supplier or contractor may refuse the request without forfeiting its tender security, and the effectiveness of its tender will terminate upon the expiry of the unextended period of effectiveness;

> (b) Suppliers or contractors that agree to an extension of the period of effectiveness of

their tenders shall extend or procure an extension of the period of effectiveness of tender securities provided by them or provide new tender securities to cover the extended period of effectiveness of their tenders. A supplier or contractor whose tender security is not extended, or that has not provided a new tender security, is considered to have refused the request to extend the period of effectiveness of its tender.

(3) Unless otherwise stipulated in the solicitation documents, a supplier or contractor may modify or withdraw its tender prior to the deadline for the submission of tenders without forfeiting its tender security. The modification or notice of withdrawal is effective if it is received by the procuring entity prior to the deadline for the submission of tenders.

Article 32. Tender securities

(1) When the procuring entity requires suppliers or contractors submitting tenders to provide a tender security:

(a) The requirement shall apply to all such suppliers or contractors;

(b) The solicitation documents may stipulate that the issuer of the tender security and the confirmer, if any, of the tender security, as well as the form and terms of the tender security, must be acceptable to the procuring entity;

(c) Notwithstanding the provisions of subparagraph (b) of this paragraph, a tender security shall not be rejected by the procuring entity on the grounds that the tender security was not issued by an issuer in this State if the tender security and the issuer otherwise conform to requirements set forth in the solicitation documents (, unless the acceptance by the procuring entity of such a tender security would be in violation of a law of this State);

(d) Prior to submitting a tender, a supplier or contractor may request the procuring entity to confirm the acceptability of a proposed issuer of a tender security, or of a proposed confirmer, if required; the procuring entity shall respond promptly to such a request;

(e) Confirmation of the acceptability of a proposed issuer or of any proposed confirmer does not preclude the procuring entity from rejecting the tender security on the ground that the issuer or the confirmer, as the case may be, has become insolvent or otherwise lacks creditworthiness;

(f) The procuring entity shall specify in the solicitation documents any requirements with respect to the issuer and the nature, form, amount and other principal terms and conditions of the required tender security; any requirement that refers directly or indirectly to conduct

by the supplier or contractor submitting the tender shall not relate to conduct other than:

(i) Withdrawal or modification of the tender after the deadline for submission of tenders, or before the deadline if so stipulated in the solicitation documents;

(ii) Failure to sign the procurement contract if required by the procuring entity to do so;

(iii) Failure to provide a required security for the performance of the contract after the tender has been accepted or to comply with any other condition precedent to signing the procurement contract specified in the solicitation documents.

(2) The procuring entity shall make no claim to the amount of the tender security, and shall promptly return, or procure the return of, the tender security document, after whichever of the following that occurs earliest:

(a) The expiry of the tender security;

(b) The entry into force of a procurement contract and the provision of a security for the performance of the contract, if such a security is required by the solicitation documents;

(c) The termination of the tendering proceedings without the entry into force of a procurement contract;

(d) The withdrawal of the tender prior to the deadline for the submission of tenders, unless the solicitation documents stipulate that no such withdrawal is permitted.

SECTION III. EVALUATION AND COMPARISON OF TENDERS

Article 33. Opening of tenders

(1) Tenders shall be opened at the time specified in the solicitation documents as the deadline for the submission of tenders, or at the deadline specified in any extension of the deadline, at the place and in accordance with the procedures specified in the solicitation documents.

(2) All suppliers or contractors that have submitted tenders, or their representatives, shall be permitted by the procuring entity to be present at the opening of tenders.

(3) The name and address of each supplier or contractor whose tender is opened and the tender price shall be announced to those persons present at the opening of tenders, communicated on request to suppliers or contractors that have submitted tenders but that are not present or represented at the opening of tenders, and recorded immediately in the record of the tendering proceedings required by article 11.

Article 34. Examination, evaluation and comparison of tenders

(1) (a) The procuring entity may ask suppliers or contractors for clarifications of their tenders in order to assist in the examination, evaluation and comparison of tenders. No change in a matter of substance in the tender, including changes in price and changes aimed at making an unresponsive tender responsive, shall be sought, offered or permitted;

> (b) Notwithstanding subparagraph (a) of this paragraph, the procuring entity shall correct purely arithmetical errors that are discovered during the examination of tenders. The procuring entity shall give prompt notice of any such correction to the supplier or contractor that submitted the tender.

(2) (a) Subject to subparagraph (b) of this paragraph, the procuring entity may regard a tender as responsive only if it conforms to all requirements set forth in the tender solicitation documents;

> (b) The procuring entity may regard a tender as responsive even if it contains minor deviations that do not materially alter or depart from the characteristics, terms, conditions and other requirements set forth in the solicitation documents or if it contains errors or oversights that are capable of being corrected without touching on the substance of the tender. Any such deviations shall be quantified, to the extent possible, and appropriately taken account of in the evaluation and comparison of tenders.

(3) The procuring entity shall not accept a tender:

> (a) If the supplier or contractor that submitted the tender is not qualified;

> (b) If the supplier or contractor that submitted the tender does not accept a correction of an arithmetical error made pursuant to paragraph (1) (b) of this article;

> (c) If the tender is not responsive;

> (d) In the circumstances referred to in article 15.

(4) (a) The procuring entity shall evaluate and compare the tenders that have been accepted in order to ascertain the successful tender, as defined in subparagraph (b) of this paragraph, in accordance with the procedures and criteria set forth in the solicitation documents. No criterion shall be used that has not

been set forth in the solicitation documents;

(b) The successful tender shall be:

(i) The tender with the lowest tender price, subject to any margin of preference applied pursuant to subparagraph (d) of this paragraph; or

(ii) If the procuring entity has so stipulated in the solicitation documents, the lowest evaluated tender ascertained on the basis of criteria specified in the solicitation documents, which criteria shall, to the extent practicable, be objective and quantifiable, and shall be given a relative weight in the evaluation procedure or be expressed in monetary terms wherever practicable;

(c) In determining the lowest evaluated tender in accordance with subparagraph (b) (ii) of this paragraph, the procuring entity may consider only the following:

(i) The tender price, subject to any margin of preference applied pursuant to subparagraph (d) of this paragraph;

(ii) The cost of operating, maintaining and repairing the goods or construction, the time for delivery of the goods, completion of construction or provision of the services, the functional characteristics of the goods or construction, the terms of payment and of guarantees in respect of the goods, construction or services;

(iii) The effect that acceptance of a tender would have on the balance of payments position and foreign exchange reserves of [this State], the countertrade arrangements offered by suppliers or contractors, the extent of local content, including manufacture, labour and materials, in goods, construction or services being offered by suppliers or contractors, the economic-development potential offered by tenders, including domestic investment or other business activity, the encouragement of employment, the reservation of certain production for domestic suppliers, the transfer of technology and the development of managerial, scientific and operational skills [... (the enacting State may expand subparagraph (iii) by including additional criteria)]; and

(iv) National defence and security considerations;

(d) If authorized by the procurement regulations, (and subject to approval by ... (the enacting State designates an organ to issue the approval),) in evaluating and comparing

tenders a procuring entity may grant a margin of preference for the benefit of tenders for construction by domestic contractors or for the benefit of tenders for domestically produced goods or for the benefit of domestic suppliers of services. The margin of preference shall be calculated in accordance with the procurement regulations and reflected in the record of the procurement proceedings.

(5) When tender prices are expressed in two or more currencies, the tender prices of all tenders shall be converted to the same currency, and according to the rate specified in the solicitation documents pursuant to article 27 (s), for the purpose of evaluating and comparing tenders.

(6) Whether or not it has engaged in prequalification proceedings pursuant to article 7, the procuring entity may require the supplier or contractor submitting the tender that has been found to be the successful tender pursuant to paragraph (4) (b) of this article to demonstrate again its qualifications in accordance with criteria and procedures conforming to the provisions of article 6. The criteria and procedures to be used for such further demonstration shall be set forth in the solicitation documents. Where prequalification proceedings have been engaged in, the criteria shall be the same as those used in the prequalification proceedings.

(7) If the supplier or contractor submitting the successful tender is requested to demonstrate again its qualifications in accordance with paragraph (6) of this article but fails to do so, the procuring entity shall reject that tender and shall select a successful tender, in accordance with paragraph (4) of this article, from among the remaining tenders, subject to the right of the procuring entity, in accordance with article 12 (1), to reject all remaining tenders.

(8) Information relating to the examination, clarification, evaluation and comparison of tenders shall not be disclosed to suppliers or contractors or to any other person not involved officially in the examination, evaluation or comparison of tenders or in the decision on which tender should be accepted, except as provided in article 11.

Article 35. Prohibition of negotiations with suppliers or contractors

No negotiations shall take place between the procuring entity and a supplier or contractor with respect to a tender submitted by the supplier or contractor.

Article 36. Acceptance of tender and entry into force of procurement contract

(1) Subject to articles 12 and 34 (7), the tender that has been ascertained to be the successful tender pursuant to article 34 (4) (b) shall be accepted. Notice of acceptance of the tender shall be given

promptly to the supplier or contractor submitting the tender.

(2) (a) Notwithstanding the provisions of paragraph (4) of this article, the solicitation documents may require the supplier or contractor whose tender has been accepted to sign a written procurement contract conforming to the tender. In such cases, the procuring entity (the requesting ministry) and the supplier or contractor shall sign the procurement contract within a reasonable period of time after the notice referred to in paragraph (1) of this article is dispatched to the supplier or contractor;

(b) Subject to paragraph (3) of this article, where a written procurement contract is required to be signed pursuant to subparagraph (a) of this paragraph, the procurement contract enters into force when the contract is signed by the supplier or contractor and by the procuring entity. Between the time when the notice referred to in paragraph (1) of this article is dispatched to the supplier or contractor and the entry into force of the procurement contract, neither the procuring entity nor the supplier or contractor shall take any action that interferes with the entry into force of the procurement contract or with its performance.

(3) Where the solicitation documents stipulate that the procurement contract is subject to approval by a higher authority, the procurement contract shall not enter into force before the approval is given. The solicitation documents shall specify the estimated period of time following dispatch of the notice of acceptance of the tender that will be required to obtain the approval. A failure to obtain the approval within the time specified in the solicitation documents shall not extend the period of effectiveness of tenders specified in the solicitation documents pursuant to article 31 (1) or the period of effectiveness of tender securities that may be required pursuant to article 32 (1).

(4) Except as provided in paragraphs (2) (b) and (3) of this article, a procurement contract in accordance with the terms and conditions of the accepted tender enters into force when the notice referred to in paragraph (1) of this article is dispatched to the supplier or contractor that submitted the tender, provided that it is dispatched while the tender is in force. The notice is dispatched when it is properly addressed or otherwise directed and transmitted to the supplier or contractor, or conveyed to an appropriate authority for transmission to the supplier or contractor, by a mode authorized by article 9.

(5) If the supplier or contractor whose tender has been accepted fails to sign a written procurement contract, if required to do so, or fails to provide any required security for the performance of the contract, the procuring entity shall select a successful tender in accordance with article 34 (4) from among the remaining tenders that are in force, subject to the right of the procuring entity, in accordance with article 12 (1), to reject all remaining tenders. The notice provided for in paragraph (1) of this article shall be given to the supplier or contractor that submitted that tender.

(6) Upon the entry into force of the procurement contract and, if required, the provision by the supplier or contractor of a security for the performance of the contract, notice of the procurement contract shall be given to other suppliers or contractors, specifying the name and address of the supplier or contractor that has entered into the contract and the contract price.

CHAPTER IV. PRINCIPAL METHOD FOR PROCUREMENT OF SERVICES

Article 37. Notice of solicitation of proposals

(1) A procuring entity shall solicit proposals for services or, where applicable, applications to prequalify by causing a notice seeking expression of interest in submitting a proposal or in prequalifying, as the case may be, to be published in ... (the enacting State specifies the official gazette or other official publication in which the notice is to be published). The notice shall contain, at a minimum, the name and address of the procuring entity, a brief description of the services to be procured, the means of obtaining the request for proposals or prequalification documents and the price, if any, charged for the request for proposals or for the prequalification documents.

(2) The notice shall also be published, in a language customarily used in international trade, in a newspaper of wide international circulation or in a relevant trade or professional publication of wide international circulation except where participation is limited solely to domestic suppliers or contractors pursuant to article 8 (1) or where, in view of the low value of the services to be procured, the procuring entity decides that only domestic suppliers or contractors are likely to be interested in submitting proposals.

(3) (Subject to approval by ... (the enacting State designates an organ to issue the approval),) where direct solicitation is necessary for reasons of economy and efficiency, the procuring entity need not apply the provisions of paragraphs (1) and (2) of this article in a case where:

> (a) The services to be procured are available only from a limited number of suppliers or contractors, provided that it solicits proposals from all those suppliers or contractors; or
>
> (b) The time and cost required to examine and evaluate a large number of proposals would be disproportionate to the value of the services to be procured, provided that it solicits proposals from a sufficient number of suppliers or contractors to ensure effective competition; or
>
> (c) Direct solicitation is the only means of ensuring confidentiality or is required by reason of the national interest, provided that it solicits proposals from a sufficient number of suppliers or contractors to ensure effective competition.

(4) The procuring entity shall provide the request for proposals, or the prequalification documents, to suppliers or contractors in accordance with the procedures and requirements specified in the notice or, in cases in which paragraph (3) applies, directly to participating suppliers or contractors. The price that the procuring entity may charge for the request for proposals or the prequalification documents shall reflect

only the cost of printing and providing them to suppliers or contractors. If prequalification proceedings have been engaged in, the procuring entity shall provide the request for proposals to each supplier or contractor that has been prequalified and that pays the price charged, if any.

Article 38. Contents of requests for proposals for services

The request for proposals shall include, at a minimum, the following information:

(a) The name and address of the procuring entity;

(b) The language or languages in which proposals are to be prepared;

(c) The manner, place and deadline for the submission of proposals;

(d) If the procuring entity reserves the right to reject all proposals, a statement to that effect;

(e) The criteria and procedures, in conformity with the provisions of article 6, relative to the evaluation of the qualifications of suppliers or contractors and relative to the further demonstration of qualifications pursuant to article 7 (8);

(f) The requirements as to documentary evidence or other information that must be submitted by suppliers or contractors to demonstrate their qualifications;

(g) The nature and required characteristics of the services to be procured to the extent known, including, but not limited to, the location where the services are to be provided and the desired or required time, if any, when the services are to be provided;

(h) Whether the procuring entity is seeking proposals as to various possible ways of meeting its needs;

(i) If suppliers or contractors are permitted to submit proposals for only a portion of the services to be procured, a description of the portion or portions for which proposals may be submitted;

(j) The currency or currencies in which the proposal price is to be formulated or expressed, unless the price is not a relevant criterion;

(k) The manner in which the proposal price is to be formulated or expressed, including a

statement as to whether the price is to cover elements other than the cost of the services, such as reimbursement for transportation, lodging, insurance, use of equipment, duties or taxes, unless the price is not a relevant criterion;

(l) The procedure selected pursuant to article 41 (1) for ascertaining the successful proposal;

(m) The criteria to be used in determining the successful proposal, including any margin of preference to be used pursuant to article 39 (2), and the relative weight of such criteria;

(n) The currency that will be used for the purpose of evaluating and comparing proposals, and either the exchange rate that will be used for the conversion of proposal prices into that currency or a statement that the rate published by a specified financial institution prevailing on a specified date will be used;

(o) If alternatives to the characteristics of the services, contractual terms and conditions or other requirements set forth in the request for proposals are permitted, a statement to that effect and a description of the manner in which alternative proposals are to be evaluated and compared;

(p) The name, functional title and address of one or more officers or employees of the procuring entity who are authorized to communicate directly with and to receive communications directly from suppliers or contractors in connection with the procurement proceedings, without the intervention of an intermediary;

(q) The means by which, pursuant to article 40, suppliers or contractors may seek clarifications of the request for proposals, and a statement as to whether the procuring entity intends, at this stage, to convene a meeting of suppliers or contractors;

(r) The terms and conditions of the procurement contract, to the extent that they are already known to the procuring entity, and the contract form, if any, to be signed by the parties;

(s) References to this Law, the procurement regulations and other laws and regulations directly pertinent to the procurement proceedings, provided, however, that the omission of any such reference shall not constitute grounds for review under article 52 or give rise to liability on the part of the procuring entity;

(t) Notice of the right provided under article 52 to seek review of an unlawful act or decision of, or procedure followed by, the procuring entity in relation to the procurement proceedings;

(u) Any formalities that will be required once the proposal has been accepted for a procurement contract to enter into force, including, where applicable, the execution of a written procurement contract, and approval by a higher authority or the Government and the estimated period of time following dispatch of the notice of acceptance that will be required to obtain the approval;

(v) Any other requirements established by the procuring entity in conformity with this Law and the procurement regulations relating to the preparation and submission of proposals and to other aspects of the procurement proceedings.

Article 39. Criteria for the evaluation of proposals

(1) The procuring entity shall establish criteria for evaluating the proposals and determine the relative weight to be accorded to each such criterion and the manner in which they are to be applied in the evaluation of proposals. Those criteria shall be notified to suppliers or contractors in the request for proposals and may concern only the following:

(a) The qualifications, experience, reputation, reliability and professional and managerial competence of the supplier or contractor and of the personnel to be involved in providing the services;

(b) The effectiveness of the proposal submitted by the supplier or contractor in meeting the needs of the procuring entity;

(c) The proposal price, subject to any margin of preference applied pursuant to paragraph (2), including any ancillary or related costs;

(d) The effect that the acceptance of a proposal will have on the balance of payments position and foreign exchange reserves of [this State], the extent of participation by local suppliers and contractors, the economic development potential offered by the proposal, including domestic investment or other business activity, the encouragement of employment, the transfer of technology, the development of managerial, scientific and operational skills and the countertrade arrangements offered by suppliers or contractors (... (the enacting State may expand subparagraph (d) by including additional criteria));

(e) National defence and security considerations.

(2) If authorized by the procurement regulations (and subject to approval by ... (each State designates an organ to issue the approval),) in evaluating and comparing the proposals, a procuring entity may grant a margin of preference for the benefit of domestic suppliers of services, which shall be calculated in

accordance with the procurement regulations and reflected in the record of the procurement proceedings.

Article 40. Clarification and modification of requests for proposals

(1) A supplier or contractor may request a clarification of the request for proposals from the procuring entity. The procuring entity shall respond to any request by a supplier or contractor for clarification of the request for proposals that is received by the procuring entity within a reasonable time prior to the deadline for the submission of proposals. The procuring entity shall respond within a reasonable time so as to enable the supplier or contractor to make a timely submission of its proposal and shall, without identifying the source of the request, communicate the clarification to all suppliers or contractors to which the procuring entity has provided the request for proposals.

(2) At any time prior to the deadline for submission of proposals, the procuring entity may, for any reason, whether on its own initiative or as a result of a request for clarification by a supplier or contractor, modify the request for proposals by issuing an addendum. The addendum shall be communicated promptly to all suppliers or contractors to which the procuring entity has provided the request for proposals and shall be binding on those suppliers or contractors.

(3) If the procuring entity convenes a meeting of suppliers or contractors, it shall prepare minutes of the meeting containing the requests submitted at the meeting for clarification of the request for proposals, and its responses to those requests, without identifying the sources of the requests. The minutes shall be provided promptly to all suppliers or contractors participating in the procurement proceedings, so as to enable those suppliers or contractors to take the minutes into account in preparing their proposals.

Article 41. Choice of selection procedure

(1) The procuring entity, in ascertaining the successful proposal, shall use the procedure provided for in article 42 (2) (a), 42 (2) (b), 43 or 44 that has been notified to suppliers or contractors in the request for proposals.

(2) The procuring entity shall include in the record required under article 11 a statement of the grounds and circumstances on which it relied to justify the use of a selection procedure pursuant to paragraph (1) of this article.

(3) Nothing in this chapter shall prevent the procuring entity from resorting to an impartial panel of external experts in the selection procedure.

Article 42. Selection procedure without negotiation

(1) Where the procuring entity, in accordance with article 41 (1), uses the procedure provided for in this article, it shall establish a threshold with respect to quality and technical aspects of the proposals in accordance with the criteria other than price as set out in the request for proposals and rate each proposal in accordance with such criteria and the relative weight and manner of application of those criteria as set forth in the request for proposals. The procuring entity shall then compare the prices of the proposals that have attained a rating at or above the threshold.

(2) The successful proposal shall then be:

> (a) The proposal with the lowest price; or
>
> (b) The proposal with the best combined evaluation in terms of the criteria other than price referred to in paragraph (1) of this article and the price.

Article 43. Selection procedure with simultaneous negotiations

(1) Where the procuring entity, in accordance with article 41 (1), uses the procedure provided for in this article, it shall engage in negotiations with suppliers or contractors that have submitted acceptable proposals and may seek or permit revisions of such proposals, provided that the opportunity to participate in negotiations is extended to all such suppliers or contractors.

(2) Following completion of negotiations, the procuring entity shall request all suppliers or contractors remaining in the proceedings to submit, by a specified date, a best and final offer with respect to all aspects of their proposals.

(3) In the evaluation of proposals, the price of a proposal shall be considered separately and only after completion of the technical evaluation.

(4) Any award by the procuring entity shall be made to the supplier or contractor whose proposal best meets the needs of the procuring entity as determined in accordance with the criteria for evaluating the proposals as well as with the relative weight and manner of application of those criteria as set forth in the request for proposals.

Article 44. Selection procedure with consecutive negotiations

Where the procuring entity, in accordance with article 41 (1), uses the procedure provided for in this article, it shall engage in negotiations with suppliers and contractors in accordance with the following procedure:

(a) Establish a threshold in accordance with article 42 (1);

(b) Invite for negotiations on the price of its proposal the supplier or contractor that has attained the best rating in accordance with article 42 (1);

(c) Inform the suppliers or contractors that attained ratings above the threshold that they may be considered for negotiation if the negotiations with the suppliers or contractors with better ratings do not result in a procurement contract;

(d) Inform the other suppliers or contractors that they did not attain the required threshold;

(e) If it becomes apparent to the procuring entity that the negotiations with the supplier or contractor invited pursuant to subparagraph (b) of this article will not result in a procurement contract, inform that supplier or contractor that it is terminating the negotiations;

(f) The procuring entity shall then invite for negotiations the supplier or contractor that attained the second best rating; if the negotiations with that supplier or contractor do not result in a procurement contract, the procuring entity shall invite the other suppliers or contractors for negotiations on the basis of their ranking until it arrives at a procurement contract or rejects all remaining proposals.

Article 45. Confidentiality

The procuring entity shall treat proposals in such a manner as to avoid the disclosure of their contents to competing suppliers or contractors. Any negotiations pursuant to article 43 or 44 shall be confidential and, subject to article 11, one party to the negotiations shall not reveal to any other person any technical, price or other information relating to the negotiations without the consent of the other party.

CHAPTER V. PROCEDURES FOR ALTERNATIVE METHODS OF PROCUREMENT

Article 46. Two-stage tendering

(1) The provisions of chapter III of this Law shall apply to two-stage tendering proceedings except to the extent those provisions are derogated from in this article.

(2) The solicitation documents shall call upon suppliers or contractors to submit, in the first stage of the two-stage tendering proceedings, initial tenders containing their proposals without a tender price. The solicitation documents may solicit proposals relating to the technical, quality or other characteristics of the goods, construction or services as well as to contractual terms and conditions of supply, and, where relevant, the professional and technical competence and qualifications of the suppliers or contractors.

(3) The procuring entity may, in the first stage, engage in negotiations with any supplier or contractor whose tender has not been rejected pursuant to articles 12, 15 or 34 (3) concerning any aspect of its tender.

(4) In the second stage of the two-stage tendering proceedings, the procuring entity shall invite suppliers or contractors whose tenders have not been rejected to submit final tenders with prices with respect to a single set of specifications. In formulating those specifications, the procuring entity may delete or modify any aspect, originally set forth in the solicitation documents, of the technical or quality characteristics of the goods, construction or services to be procured, and any criterion originally set forth in those documents for evaluating and comparing tenders and for ascertaining the successful tender, and may add new characteristics or criteria that conform with this Law. Any such deletion, modification or addition shall be communicated to suppliers or contractors in the invitation to submit final tenders. A supplier or contractor not wishing to submit a final tender may withdraw from the tendering proceedings without forfeiting any tender security that the supplier or contractor may have been required to provide. The final tenders shall be evaluated and compared in order to ascertain the successful tender as defined in article 34 (4) (b).

Article 47. Restricted tendering

(1) (a) When the procuring entity engages in restricted tendering on the grounds referred to in article 20 (a), it shall solicit tenders from all suppliers and contractors from whom the goods, construction or services to be procured are available;

> (b) When the procuring entity engages in restricted tendering on the grounds referred to in article 20 (b), it shall select suppliers or contractors from whom to solicit tenders in a non-discriminatory manner and it shall select a sufficient number of suppliers or contractors to ensure effective competition.

(2) When the procuring entity engages in restricted tendering, it shall cause a notice of the restricted-

tendering proceeding to be published in ... (each enacting State specifies the official gazette or other official publication in which the notice is to be published).

(3) The provisions of chapter III of this Law, except article 24, shall apply to restricted-tendering proceedings, except to the extent that those provisions are derogated from in this article.

Article 48. Request for proposals

(1) Requests for proposals shall be addressed to as many suppliers or contractors as practicable, but to at least three, if possible.

(2) The procuring entity shall publish in a newspaper of wide international circulation or in a relevant trade publication or technical or professional journal of wide international circulation a notice seeking expressions of interest in submitting a proposal, unless for reasons of economy or efficiency the procuring entity considers it undesirable to publish such a notice; the notice shall not confer any rights on suppliers or contractors, including any right to have a proposal evaluated.

(3) The procuring entity shall establish the criteria for evaluating the proposals and determine the relative weight to be accorded to each such criterion and the manner in which they are to be applied in the evaluation of the proposals. The criteria shall concern:

(a) The relative managerial and technical competence of the supplier or contractor;

(b) The effectiveness of the proposal submitted by the supplier or contractor in meeting the needs of the procuring entity; and

(c) The price submitted by the supplier or contractor for carrying out its proposal and the cost of operating, maintaining and repairing the proposed goods or construction.

(4) A request for proposals issued by a procuring entity shall include at least the following information:

(a) The name and address of the procuring entity;

(b) A description of the procurement need including the technical and other parameters to which the proposal must conform, as well as, in the case of procurement of construction, the location of any construction to be effected and, in the case of services, the location where they are to be provided;

(c) The criteria for evaluating the proposal, expressed in monetary terms to the extent

practicable, the relative weight to be given to each such criterion and the manner in which they will be applied in the evaluation of the proposal; and

(d) The desired format and any instructions, including any relevant timetables applicable in respect of the proposal.

(5) Any modification or clarification of the request for proposals, including modification of the criteria for evaluating proposals referred to in paragraph (3) of this article, shall be communicated to all suppliers or contractors participating in the request-for-proposals proceedings.

(6) The procuring entity shall treat proposals in such a manner so as to avoid the disclosure of their contents to competing suppliers or contractors.

(7) The procuring entity may engage in negotiations with suppliers or contractors with respect to their proposals and may seek or permit revisions of such proposals, provided that the following conditions are satisfied:

(a) Any negotiations between the procuring entity and a supplier or contractor shall be confidential;

(b) Subject to article 11, one party to the negotiations shall not reveal to any other person any technical, price or other market information relating to the negotiations without the consent of the other party;

(c) The opportunity to participate in negotiations is extended to all suppliers or contractors that have submitted proposals and whose proposals have not been rejected.

(8) Following completion of negotiations, the procuring entity shall request all suppliers or contractors remaining in the proceedings to submit, by a specified date, a best and final offer with respect to all aspects of their proposals.

(9) The procuring entity shall employ the following procedures in the evaluation of proposals:

(a) Only the criteria referred to in paragraph (3) of this article as set forth in the request for proposals shall be considered;

(b) The effectiveness of a proposal in meeting the needs of the procuring entity shall be evaluated separately from the price;

(c) The price of a proposal shall be considered by the procuring entity only after completion of the technical evaluation.

(10) Any award by the procuring entity shall be made to the supplier or contractor whose proposal best meets the needs of the procuring entity as determined in accordance with the criteria for evaluating the proposals set forth in the request for proposals, as well as with the relative weight and manner of application of those criteria indicated in the request for proposals.

Article 49. Competitive negotiation

(1) In competitive negotiation proceedings, the procuring entity shall engage in negotiations with a sufficient number of suppliers or contractors to ensure effective competition.

(2) Any requirements, guidelines, documents, clarifications or other information relative to the negotiations that are communicated by the procuring entity to a supplier or contractor shall be communicated on an equal basis to all other suppliers or contractors engaging in negotiations with the procuring entity relative to the procurement.

(3) Negotiations between the procuring entity and a supplier or contractor shall be confidential, and, except as provided in article 11, one party to those negotiations shall not reveal to any other person any technical, price or other market information relating to the negotiations without the consent of the other party.

(4) Following completion of negotiations, the procuring entity shall request all suppliers or contractors remaining in the proceedings to submit, by a specified date, a best and final offer with respect to all aspects of their proposals. The procuring entity shall select the successful offer on the basis of such best and final offers.

Article 50. Request for quotations

(1) The procuring entity shall request quotations from as many suppliers or contractors as practicable, but from at least three, if possible. Each supplier or contractor from whom a quotation is requested shall be informed whether any elements other than the charges for the goods or services themselves, such as any applicable transportation and insurance charges, customs duties and taxes, are to be included in the price.

(2) Each supplier or contractor is permitted to give only one price quotation and is not permitted to change its quotation. No negotiations shall take place between the procuring entity and a supplier or contractor with respect to a quotation submitted by the supplier or contractor.

(3) The procurement contract shall be awarded to the supplier or contractor that gave the lowest-priced quotation meeting the needs of the procuring entity.

Article 51. Single-source procurement

In the circumstances set forth in article 22 the procuring entity may procure the goods, construction or services by soliciting a proposal or price quotation from a single supplier or contractor.

CHAPTER VI. REVIEW*

Article 52. Right to review

(1) Subject to paragraph (2) of this article, any supplier or contractor that claims to have suffered, or that may suffer, loss or injury due to a breach of a duty imposed on the procuring entity by this Law may seek review in accordance with articles 53 to [57].

(2) The following shall not be subject to the review provided for in paragraph (1) of this article:

(a) The selection of a method of procurement pursuant to articles 18 to 22;

(b) The choice of a selection procedure pursuant to article 41 (1);

(c) The limitation of procurement proceedings in accordance with article 8 on the basis of nationality;

(d) A decision by the procuring entity under article 12 to reject all tenders, proposals, offers or quotations;

(e) A refusal by the procuring entity to respond to an expression of interest in participating in request-for-proposals proceedings pursuant to article 48 (2);

(f) An omission referred to in article 27 (t) or article 38 (s).

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* States enacting the Model Law may wish to incorporate the articles on review without change or with only such minimal changes as are necessary to meet particular important needs. However, because of

constitutional or other considerations, States might not, to one degree or another, see fit to incorporate those articles. In such cases, the articles on review may be used to measure the adequacy of existing review procedures.

Article 53. Review by procuring entity (or by approving authority)

(1) Unless the procurement contract has already entered into force, a complaint shall, in the first instance, be submitted in writing to the head of the procuring entity. (However, if the complaint is based on an act or decision of, or procedure followed by, the procuring entity, and that act, decision or procedure was approved by an authority pursuant to this Law, the complaint shall instead be submitted to the head of the authority that approved the act, as the case may be.)

(2) The head of the procuring entity (or of the approving authority) shall not entertain a complaint, unless it was submitted within 20 days of when the supplier or contractor submitting it became aware of the circumstances giving rise to the complaint or of when that supplier or contractor should have become aware of those circumstances, whichever is earlier.

(3) The head of the procuring entity (or of the approving authority) need not entertain a complaint, or continue to entertain a complaint, after the procurement contract has entered into force.

(4) Unless the complaint is resolved by mutual agreement of the supplier or contractor that submitted it and the procuring entity, the head of the procuring entity (or of the approving authority) shall, within 30 days after the submission of the complaint, issue a written decision. The decision shall:

(a) State the reasons for the decision; and

(b) If the complaint is upheld in whole or in part, indicate the corrective measures that are to be taken.

(5) If the head of the procuring entity (or of the approving authority) does not issue a decision by the time specified in paragraph (4) of this article, the supplier or contractor submitting the complaint (or the procuring entity) is entitled immediately thereafter to institute proceedings under article [54 or 57]. Upon the institution of such proceedings, the competence of the head of the procuring entity (or of the approving authority) to entertain the complaint ceases.

(6) The decision of the head of the procuring entity (or of the approving authority) shall be final unless proceedings are instituted under article [54 or 57].

Article 54. Administrative review*

(1) A supplier or contractor entitled under article 52 to seek review may submit a complaint to [insert name of administrative body]:

(a) If the complaint cannot be submitted or entertained under article 53 because of the entry into force of the procurement contract, and provided that the complaint is submitted within 20 days after the earlier of the time when the supplier or contractor submitting it became aware of the circumstances giving rise to the complaint or the time when that supplier or contractor should have become aware of those circumstances;

(b) If the head of the procuring entity does not entertain the complaint because the procurement contract has entered into force, provided that the complaint is submitted within 20 days after the issuance of the decision not to entertain the complaint;

(c) Pursuant to article 53 (5), provided that the complaint is submitted within 20 days after the expiry of the period referred to in article 53 (4); or

(d) If the supplier or contractor claims to be adversely affected by a decision of the head of the procuring entity (or of the approving authority) under article 53, provided that the complaint is submitted within 20 days after the issuance of the decision.

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* States where hierarchical administrative review of administrative actions, decisions and procedures is not a feature of the legal system may omit article 54 and provide only for judicial review (article 57).

(2) Upon receipt of a complaint, the [insert name of administrative body] shall give notice of the complaint promptly to the procuring entity (or to the approving authority).

(3) The [insert name of administrative body] may [grant] [recommend]** one or more of the following remedies, unless it dismisses the complaint:

(a) Declare the legal rules or principles that govern the subject-matter of the complaint;

(b) Prohibit the procuring entity from acting or deciding unlawfully or from following an unlawful procedure;

(c) Require the procuring entity that has acted or proceeded in an unlawful manner, or that

has reached an unlawful decision, to act or to proceed in a lawful manner or to reach a lawful decision;

(d) Annul in whole or in part an unlawful act or decision of the procuring entity, other than any act or decision bringing the procurement contract into force;

(e) Revise an unlawful decision by the procuring entity or substitute its own decision for such a decision, other than any decision bringing the procurement contract into force;

(f) Require the payment of compensation for

Option I

Any reasonable costs incurred by the supplier or contractor submitting the complaint in connection with the procurement proceedings as a result of an unlawful act or decision of, or procedure followed by, the procuring entity;

Option II

Loss or injury suffered by the supplier or contractor submitting the complaint in connection with the procurement proceedings;

(g) Order that the procurement proceedings be terminated.

(4) The [insert name of administrative body] shall within 30 days issue a written decision concerning the complaint, stating the reasons for the decision and the remedies granted, if any.

(5) The decision shall be final unless an action is commenced under article 57.

** Optional language is presented in order to accommodate those States where review bodies do not have the power to grant the remedies listed below but can make recommendations.

Article 55. Certain rules applicable to review proceedings under article 53 [and article 54]

(1) Promptly after the submission of a complaint under article 53 [or article 54], the head of the procuring entity (or of the approving authority) [, or the [insert name of administrative body], as the case may be,] shall notify all suppliers or contractors participating in the procurement proceedings to which

the complaint relates of the submission of the complaint and of its substance.

(2) Any such supplier or contractor or any governmental authority whose interests are or could be affected by the review proceedings has a right to participate in the review proceedings. A supplier or contractor that fails to participate in the review proceedings is barred from subsequently making the same type of claim.

(3) A copy of the decision of the head of the procuring entity (or of the approving authority) [, or of the [insert name of administrative body], as the case may be,] shall be furnished within five days after the issuance of the decision to the supplier or contractor submitting the complaint, to the procuring entity and to any other supplier or contractor or governmental authority that has participated in the review proceedings. In addition, after the decision has been issued, the complaint and the decision shall be promptly made available for inspection by the general public, provided, however, that no information shall be disclosed if its disclosure would be contrary to law, would impede law enforcement, would not be in the public interest, would prejudice legitimate commercial interests of the parties or would inhibit fair competition.

Article 56. Suspension of procurement proceedings

(1) The timely submission of a complaint under article 53 [or article 54] suspends the procurement proceedings for a period of seven days, provided that the complaint is not frivolous and contains a declaration the contents of which, if proven, demonstrate that the supplier or contractor will suffer irreparable injury in the absence of a suspension, it is probable that the complaint will succeed and the granting of the suspension would not cause disproportionate harm to the procuring entity or to other suppliers or contractors.

(2) When the procurement contract enters into force, the timely submission of a complaint under article 54 shall suspend performance of the procurement contract for a period of seven days, provided the complaint meets the requirements set forth in paragraph (1) of this article.

(3) The head of the procuring entity (or of the approving authority) [, or the [insert name of administrative body],] may extend the suspension provided for in paragraph (1) of this article, [and the [insert name of administrative body] may extend the suspension provided for in paragraph (2) of this article,] in order to preserve the rights of the supplier or contractor submitting the complaint or commencing the action pending the disposition of the review proceedings, provided that the total period of suspension shall not exceed 30 days.

(4) The suspension provided for by this article shall not apply if the procuring entity certifies that urgent public interest considerations require the procurement to proceed. The certification, which shall state the grounds for the finding that such urgent considerations exist and which shall be made a part of the

record of the procurement proceedings, is conclusive with respect to all levels of review except judicial review.

(5) Any decision by the procuring entity under this article and the grounds and circumstances therefor shall be made part of the record of the procurement proceedings.

Article 57. Judicial review

The [insert name of court or courts] has jurisdiction over actions pursuant to article 52 and petitions for judicial review of decisions made by review bodies, or of the failure of those bodies to make a decision within the prescribed time-limit, under article 53 [or 54].

Guide to Enactment

of

UNCITRAL Model Law on Procurement of Goods, Construction and Services

INTRODUCTION

History and purpose of UNCITRAL Model Law on Procurement of Goods, Construction and Services

1. At its nineteenth session, in 1986, the United Nations Commission on International Trade Law (UNCITRAL) decided to undertake work in the area of procurement. The UNCITRAL Model Law on Procurement of Goods and Construction, and its accompanying Guide to Enactment, were adopted by the Commission at its twenty-sixth session (Vienna, 5-23 July 1993). The Model Law on Procurement of Goods and Construction is intended to serve as a model for States for the evaluation and modernization of their procurement laws and practices and the establishment of procurement legislation where none presently exists. The text of the Model Law on Procurement of Goods and Construction is set forth in annex I to the report of UNCITRAL on the work of its twenty-sixth session (*Official Records of the General Assembly, Forty-eighth Session, Supplement No. 17 (A/48/17)*).

2. On the understanding that certain aspects of the procurement of services were governed by different considerations from those that governed the procurement of goods or construction, a decision had been made to limit the work at the initial stage to the formulation of model legislative provisions on the procurement of goods and construction. At the twenty-sixth session, having completed work on model statutory provisions on procurement of goods and construction, the Commission decided to proceed with the elaboration of model statutory provisions on procurement of services. Accordingly, at the twenty-seventh session (New York, 31 May-17 June 1994), the Commission discussed additions and changes to the Model Law on Procurement of Goods and Construction that would need to be made so as to encompass procurement of services and adopted the UNCITRAL Model Law on Procurement of Goods, Construction and Services (hereinafter referred to as the "Model Law"), without thereby superseding the earlier text, whose scope is limited to goods and construction. The text of the Model Law is set forth in annex I to the report of UNCITRAL on the work of its twenty-seventh session (*Official Records of the General Assembly, Forty-ninth Session, Supplement No. 17* (A/49/17)). At the same session, the Commission also adopted the present Guide as a companion to the Model Law.

3. The decision by UNCITRAL to formulate model legislation on procurement was taken in response to the fact that in a number of countries the existing legislation governing procurement is inadequate or outdated. This results in inefficiency and ineffectiveness in the procurement process, patterns of abuse, and the failure of the public purchaser to obtain adequate value in return for the expenditure of public funds. While sound laws and practices for public sector procurement are necessary in all countries, this need is particularly felt in many developing countries, as well as in countries whose economies are in transition. In those countries, a substantial portion of all procurement is engaged in by the public sector. Much of such procurement is in connection with projects that are part of the essential process of economic and social development. Those countries in particular suffer from a shortage of public funds to be used for procurement. It is thus critical that procurement be carried out in the most advantageous way possible. The utility of the Model Law is enhanced in States whose economic systems are in transition, since reform of the public procurement system is a cornerstone of the law reforms being undertaken to increase the market orientation of the economy.

4. Furthermore, the Model Law may help to remedy disadvantages that stem from the fact that inadequate procurement legislation at the national level creates obstacles to international trade, a significant amount of which is linked to procurement. Disparities among and uncertainty about national legal regimes governing procurement may contribute to limiting the extent to which Governments can access the competitive price and quality benefits available through procurement on an international basis. At the same time, the ability and willingness of suppliers and contractors to sell to foreign Governments is hampered by the inadequate or divergent state of national procurement legislation in many countries.

5. UNCITRAL is an organ of the United Nations General Assembly established to promote the harmonization and unification of international trade law, so as to remove unnecessary obstacles to international trade caused by inadequacies and divergences in the law affecting trade. Over the past quarter of a century, UNCITRAL, whose membership consists of States from all regions and of all levels of economic development, has implemented its mandate by formulating international conventions

(the United Nations Conventions on Contracts for the International Sale of Goods, on the Limitation Period in the International Sale of Goods, on Carriage of Goods by Sea ("Hamburg Rules"), on Liability of Terminal Operators in International Trade, and on International Bills of Exchange and International Promissory Notes), model laws (in addition to the UNCITRAL Model Law on Procurement of Goods, Construction and Services, the UNCITRAL Model Laws on International Commercial Arbitration and International Credit Transfers), the UNCITRAL Arbitration Rules, the UNCITRAL Conciliation Rules, and legal guides (on construction contracts, countertrade transactions and electronic funds transfers).

Purpose of this Guide

6. In preparing and adopting the Model Law, the Commission was mindful that the Model Law would be a more effective tool for States modernizing their procurement legislation if background and explanatory information would be provided to executive branches of Governments and to parliaments to assist them in using the Model Law. The Commission was also aware of the likelihood that the Model Law would be used in a number of States with limited familiarity with the type of procurement procedures in the Model Law.

7. The information presented in the Guide is intended to explain why the provisions in the Model Law have been included as essential minimum features of a modern procurement law designed to achieve the objectives set forth in the Preamble to the Model Law. Such information might assist States also in exercising the options provided for in the Model Law and in considering which, if any, of the provisions of the Model Law might have to be varied to take into account particular national circumstances. For example, options have been included on issues that were expected in particular to be treated differently from State to State such as: the definition of the term "procuring entity", which involves the scope of application of the Model Law; imposition of the requirement of a higher approval for certain key decisions and actions in the procurement proceedings; methods of procurement other than tendering for exceptional cases in the case of goods or construction, or, in the case of services, methods other than the principal method for procurement of services; and the form of and remedies available under review procedures. Furthermore, taking into account that the Model Law is a "framework" law providing only a minimum skeleton of essential provisions and envisaging the issuance of procurement regulations, the Guide identifies and discusses possible areas to be addressed by regulation rather than by statute.

I. MAIN FEATURES OF THE MODEL LAW

A. Objectives

8. The objectives of the Model Law, which include maximizing competition, according fair treatment to suppliers and contractors bidding to do Government work, and enhancing transparency and objectivity, are essential for fostering economy and efficiency in procurement and for curbing abuses. With the procedures prescribed in the Model Law incorporated in its national legislation, an enacting State may create an environment in which the public is assured that the Government purchaser is likely to spend public funds with responsibility and accountability and thus to obtain fair value, and an environment in

which parties offering to sell to the Government are confident of obtaining fair treatment.

B. Scope of the Model Law

9. The Model Law as adopted by UNCITRAL at its twenty-seventh session is designed to be applicable to the procurement of goods, construction and services. Within that basic scope of application, the objectives of the Model Law are best served by the widest possible application of the Model Law. Thus, although there is provision made in the Model Law for exclusion of defence and security related procurement, as well as other sectors that might be indicated by the enacting State in the law or its implementing procurement regulations, an enacting State might decide not to enact in its legislation substantial restrictions on the scope of application of the Model Law. In order to facilitate the widest possible application of the Model Law, it is provided in article 1(3) that, even in the excluded sectors, it is possible, at the discretion of the procuring entity, to apply the Model Law. It is also important to note that article 3 gives deference to the international obligations of the enacting State at the intergovernmental level. It provides that such international obligations (e.g., loan or grant agreements with multilateral and bilateral aid agencies containing specific procedural requirements for the funds involved; procurement directives of regional economic integration groupings) prevail over the Model Law to the extent of any inconsistent requirements.

10. The Model Law sets forth procedures to be used by procuring entities in selecting the supplier or contractor with whom to enter into a given procurement contract. The Model Law does not purport to address the contract performance or implementation phase. Accordingly, one will not find in the Model Law provisions on issues arising in the contract implementation phase, issues such as contract administration, resolution of performance disputes or contract termination. The enacting State would have to ensure that adequate laws and structures are available to deal with the implementation phase of the procurement process.

11. To take account of certain differences between the procurement of goods and construction and the procurement of services, the Model Law sets forth in chapter IV a set of procedures especially designed for the procurement of services. The main differences referred to above in paragraph 2 arise from the fact that, unlike the procurement of goods and construction, procurement of services typically involves the supply of an intangible object whose quality and exact content may be difficult to quantify. The precise quality of the services provided may be largely dependent on the skill and expertise of the suppliers or contractors. Thus, unlike procurement of goods and construction where price is the predominant criterion in the evaluation process, the price of services is often not considered as important a criterion in the evaluation and selection process as the quality and competence of the suppliers or contractors. Chapter IV is intended to provide procedures that reflect these differences.

C. A "framework" law to be supplemented by procurement regulations

12. The Model Law is intended to provide all the essential procedures and principles for conducting procurement proceedings in the various types of circumstances likely to be encountered by procuring

entities. However, it is a "framework" law that does not itself set forth all the rules and regulations that may be necessary to implement those procedures in an enacting State. Accordingly, the Model Law envisages the issuance by enacting States of "procurement regulations" to fill in the procedural details for procedures authorized by the Model Law and to take account of the specific, possibly changing circumstances at play in the enacting State -- without compromising the objectives of the Model Law.

13. It should be noted that the procurement proceedings in the Model Law, beyond raising matters of procedure to be addressed in the implementing procurement regulations, may raise certain legal questions the answers to which will not necessarily be found in the Model Law, but rather in other bodies of law. Such other bodies of law may include, for example, the applicable administrative, contract, criminal and judicial-procedure law.

D. Procurement methods in the Model Law

14. The Model Law presents several procurement methods to enable the procuring entity to deal with the varying circumstances that it might encounter, as well as to take account of the multiplicity of methods that are used in practice in different States. This enables an enacting State to aim for as broad an application of the Model Law as possible. As the rule for normal circumstances in procurement of goods or construction, the Model Law mandates the use of tendering, the method of procurement widely recognized as generally most effective in promoting competition, economy and efficiency in procurement, as well as the other objectives set forth in the Preamble. For normal circumstances in the procurement of services, the Model Law prescribes the use of the "principal method for procurement of services" (chapter IV), which is designed to give due weight in the evaluation process to the qualifications and expertise of the service providers. For the exceptional circumstances in which tendering is not appropriate or feasible for procurement of goods or construction, the Model Law offers alternative methods of procurement; it also does so for the circumstances in which resort to the principal method for procurement of services is not appropriate or feasible.

15. However, as mentioned in the footnote to article 18 of the Model Law, States may choose not to incorporate all of the alternative methods of procurement into their national law. While an enacting State would wish to retain request for quotations and single-source procurement, it need not incorporate all of the methods set forth in article 19. Furthermore, since the procedures for the methods in article 19 are in many respects similar to the procedures in the principal method for procurement of services (chapter IV), the enacting State may choose not to extend to procurement of services a method in article 19 that it has incorporated for use in procurement of goods and construction.

Tendering

16. Some of the key features of tendering as provided for in the Model Law include: as a general rule, unrestricted solicitation of participation by suppliers or contractors; comprehensive description and specification in solicitation documents of the goods, construction or services to be procured, thus providing a common basis on which suppliers and contractors are to prepare their tenders; full disclosure

to suppliers or contractors of the criteria to be used in evaluating and comparing tenders and in selecting the successful tender (i.e., price alone, or a combination of price and some other technical or economic criteria); strict prohibition against negotiations between the procuring entity and suppliers or contractors as to the substance of their tenders; public opening of tenders at the deadline for submission of tenders; and disclosure of any formalities required for entry into force of the procurement contract.

Principal method for procurement of services

17. Since the principal method for procurement of services (chapter IV) is the method of procurement to be used in typical circumstances in the procurement of services, chapter IV contains procedures that promote competition, objectivity and transparency, while taking account of the predominant weight accorded to the qualifications and expertise of the service providers in the evaluation process. The main features of the principal method for procurement of services include, for example, unrestricted solicitation of suppliers and contractors as the general rule, and predisclosure in the request for proposals of the criteria for evaluation of proposals and predisclosure of the selection procedure, among the three options available, to be used in the selection process. According to the first selection procedure, which is set forth in article 42, the procuring entity subjects proposals that obtain a technical rating above a set threshold to a straightforward price competition. The second selection procedure (article 43) provides a method by which the procuring entity negotiates with suppliers and contractors, after which they submit their best and final offers, a process akin to the request for proposals procedure in article 48. Under the third selection procedure (article 44), the procuring entity holds negotiations solely on price with the supplier or contractor who obtained the highest technical rating. Under this procedure, the procuring entity may negotiate with the other suppliers or contractors in a sequential fashion, one by one, on the basis of their rating, but only after terminating negotiations with the previous, higher-ranked supplier or contractor, which negotiations, once terminated, may not be reopened.

Two-stage tendering, request for proposals, competitive negotiation

18. For cases in the procurement of goods and construction in which it is not feasible for the procuring entity to formulate specifications to the degree of precision or finality required for tendering proceedings, as well as for a number of other special circumstances referred to in article 19(1), the Model Law offers three options for incorporation into national law. These include two-stage tendering, request for proposals, and competitive negotiation. Whichever of those three procurement methods have been included by the enacting State in its law might also be used for procurement of services. However, for one of these other methods to be used, the condition for its use would have to be present. All three of those methods of procurement have been included for consideration by enacting States because practice varies as to the method used in circumstances of the type in question. A situation in which it is not feasible for the procuring entity to formulate precise or final specifications may arise in two types of cases. The first is when the procuring entity has not determined the exact manner in which to meet a particular need and therefore seeks proposals as to various possible solutions (e.g., it has not decided upon the type of material to be used for building a bridge). The second case is the procurement of high technology items such as large passenger aircraft or sophisticated computer equipment. In the latter type of exceptional case, because of the technical sophistication and complexity of the goods, it might be

considered undesirable, from the standpoint of obtaining the best value, for the procuring entity to proceed on the basis of specifications it has drawn up in the absence of negotiations with suppliers and contractors as to the exact capabilities and possible variations of what is being offered.

19. No hierarchy has been assigned to the three methods set forth in article 19, and an enacting State, though it should incorporate at least one of those methods, may choose not to incorporate all of them into its procurement law. While each of those three methods shares the common feature of providing the procuring entity with an opportunity to negotiate with suppliers and contractors with a view to settling upon technical specifications and contractual terms, they employ different procedures for selecting a supplier or contractor.

20. Two-stage tendering, in its first stage, provides an opportunity for the procuring entity to solicit various proposals relating to the technical, quality or other characteristics of the procurement as well as to the contractual terms and conditions of its supply. Upon the conclusion of that first stage, the procuring entity finalizes the specifications and, on the basis of those specifications, in the second stage, conducts a regular tendering proceeding subject to the rules set forth in chapter III of the Model Law. Request for proposals is a procedure in which the procuring entity typically approaches a limited number of suppliers or contractors and solicits various proposals, negotiates with them as to possible changes in the substance of their proposals, requests "best and final offers" from them and then assesses and compares those best and final offers in accordance with the predisclosed evaluation criteria, the relative weight and manner of application of which have also been predisclosed to the suppliers or contractors. By contrast to two-stage tendering, at no stage in request-for-proposals proceedings does a procuring entity conduct a tendering proceeding. Competitive negotiation differs from both two-stage tendering and request for proposals in that it is by its nature a relatively unstructured method of procurement, for which the Model Law therefore provides few specific procedures and rules, beyond those found in the applicable general provisions. The Model Law also provides, in article 19(2), that competitive negotiation may be used in cases of urgency as an alternative to single-source procurement (see comment 4 on article 19).

Restricted tendering

21. For two types of exceptional cases, the Model Law offers restricted tendering, a method of procurement that differs from tendering only in that it permits the procuring entity to extend the invitation to tender to a limited number of suppliers or contractors. These are the case of technically complex or specialized goods, construction or services available from only a limited number of suppliers and the case of procurement of such a low value that economy and efficiency is served by restricting the number of tenders that would have to be considered by the procuring entity.

Request-for-quotations, single-source procurement

22. For cases of low-value procurement of standardized goods or services, the Model Law offers the request-for-quotations method, which involves a simplified, accelerated procedure fitting the relatively

low value involved. Under this method, which is sometimes referred to in practice as "shopping", the procuring entity solicits quotations from a small number of suppliers and selects the lowest-priced, responsive offer. Lastly, for exceptional circumstances such as urgency due to catastrophic events and the availability of goods, construction or services from only one supplier or contractor, the Model Law offers single-source procurement.

E. Qualifications of suppliers and contractors

23. The Model Law includes provisions designed to ensure that the suppliers and contractors with whom the procuring entity contracts are qualified to perform the procurement contracts awarded to them and that create a procedural climate conducive to fairness and participation by qualified suppliers and contractors in procurement proceedings. Article 6, in addition to requiring that, no matter which method of procurement is utilized, suppliers and contractors must be qualified in order to enter into a procurement contract, specifies the criteria and procedures that the procuring entity may use to assess the qualifications of suppliers and contractors, requires the pre-disclosure to suppliers and contractors of the criteria to be used for the evaluation of their qualifications, and requires the application of the same criteria to all suppliers or contractors participating in the procurement proceedings. While those provisions aim at equal treatment and prevention of arbitrariness, the procuring entity is afforded sufficient flexibility to determine the exact extent to which it is appropriate to examine qualifications in a given procurement proceeding. In addition to those basic provisions on qualifications, the Model Law provides procedures for pre-qualification of suppliers and contractors at early stages of procurement proceedings, as well as on re-confirmation at later stages of the qualifications of suppliers and contractors that had been pre-qualified.

F. Provisions on international participation in procurement proceedings

24. In line with the mandate of UNCITRAL to promote international trade, and with the notion underlying the Model Law that the wider the degree of competition the better the value received for expenditures from the public purse, the Model Law provides that, as a general rule, suppliers and contractors are to be permitted to participate in procurement proceedings without regard to nationality and that foreign suppliers and contractors should not otherwise be subject to discrimination. In the contexts of tendering proceedings and the principal method for procurement of services, that general rule is given effect by a number of procedures designed, for example, to ensure that invitations to tender or to submit proposals and invitations to prequalify are issued in such a manner that they will reach and be understood by an international audience of suppliers and contractors.

25. At the same time, the Model Law recognizes that enacting States may wish in some cases to restrict foreign participation with a view in particular to protecting certain vital economic sectors of their national industrial capacity against deleterious effects of unbridled foreign competition. Such restrictions are subject to the requirement in article 8(1) that the imposition of the restriction by the procuring entity should be based only on grounds specified in the procurement regulations or should be pursuant to other provisions of law. That requirement is meant to promote transparency and to prevent arbitrary and

excessive resort to restriction of foreign participation. The reference in article 8 to exclusions of suppliers or contractors on the basis of nationality pursuant to provisions in the procurement regulations or other provisions of law, supported also by article 3 on the primacy of international obligations of the enacting State, also permits the Model Law to take account of cases in which the funds being used are derived from a bilateral tied-aid arrangement. Such an arrangement would require that procurement with the funds should be from suppliers and contractors in the donor country. Similarly, recognition is thereby given to restrictions on the basis of nationality that may result, for example, from regional economic integration groupings that accord national treatment to suppliers and contractors from other States members of the regional economic grouping, as well as to restrictions arising from economic sanctions imposed by the United Nations Security Council.

26. It may be noted that the Model Law provides in article 34(4)(d) and 39(2) for the use of the technique referred to as the "margin of preference" in favour of local suppliers and contractors. By way of this technique, the Model Law provides the enacting State with a mechanism for balancing the objectives of international participation in procurement proceedings and fostering national industrial capacity, without resorting to purely domestic procurement. The margin of preference permits the procuring entity to select the lowest-priced tender or, in the case of services, the proposal of a local supplier or contractor when the difference in price between that tender or proposal and the overall lowest-priced tender or proposal falls within the range of the margin of preference. It allows the procuring entity to favour local suppliers and contractors that are capable of approaching internationally competitive prices, and it does so without simply excluding foreign competition. It is important not to allow total insulation from foreign competition so as not to perpetuate lower levels of economy, efficiency and competitiveness of the concerned sectors of national industry. Accordingly, the margin of preference could be a preferable means of fostering the competitiveness of local suppliers and contractors, not only as effective and economic providers for the procurement needs of the procuring entity, but also as a source of competitive exports.

27. Aside from cases of domestic procurement that result from requirements of law referred to above in paragraph 25, in which the procuring entity may dispense with the special measures in the Model Law designed to facilitate international participation, the Model Law also permits the procuring entity engaging in tendering proceedings or using the principal method for procurement of services to forgo those procedures in the case of low-value procurement in which there is unlikely to be interest on the part of foreign suppliers or contractors. At the same time, the Model Law recognizes that in such cases of low-value procurement the procuring entity would not have any legal or economic interest in precluding the participation of foreign suppliers and contractors, since a blanket exclusion of foreign suppliers and contractors in such cases might unnecessarily deprive it of the possibility of obtaining a better price. It may be noted that for the purposes of determining what is a low-value procurement contract, the threshold level as regards procurement of goods and construction might be higher than that for procurement of services.

G. Prior-approval requirement for use of exceptional procedures

28. The Model Law provides that certain important actions and decisions by the procuring entity, in

particular those involving the use of exceptional procedures (e.g., use of a procurement method other than tendering for the procurement of goods and construction or, in the case of services, a method other than the principal method for procurement of services or other than tendering), should be subject to prior approval by a higher authority. The advantage of a prior-approval system is that it fosters the detection of errors and problems before certain actions and final decisions are taken. In addition, it may provide an added measure of uniformity in a national procurement system, particularly where the enacting State has an otherwise decentralized procurement system. However, the prior-approval requirement is presented in the Model Law as an option. This is because a prior-approval system is not traditionally applied in all countries, in particular where control over the procurement practices is exercised primarily through audit.

29. The references in the Model Law to approval requirements leave it up to the enacting State to designate the organ or organs responsible for issuing the various approvals. The authority exercised as well as the organ exercising the approval function may differ. An approval function may be vested in an organ or authority that is wholly autonomous of the procuring entity (e.g., ministry of finance or of commerce, or central procurement board) or, alternatively, it may be vested in a separate supervisory organ of the procuring entity itself. In the case of procuring entities that are autonomous of the governmental or administrative structure of the State, such as some State-owned commercial enterprises, States may find it preferable for the approval function to be exercised by an organ or authority that is part of the governmental or administrative apparatus in order to ensure that the public policies sought to be advanced by the Model Law are given due effect. In any case, it is important that the organ or authority be able to exercise its functions impartially and effectively and be sufficiently independent of the persons or department involved in the procurement proceedings. It may be preferable for the approval function to be exercised by a committee of persons, rather than by one single person.

H. Review procedures

30. An important safeguard of proper adherence to procurement rules is that suppliers and contractors have the right to seek review of actions by the procuring entity in violation of those rules. Such a review process, which is set forth in chapter VI, helps to make the Model Law to an important degree self-policing and self-enforcing, since it provides an avenue for review to suppliers and contractors, who have a natural interest in monitoring compliance by procuring entities with the provisions of the Model Law.

31. The Model Law recognizes that, because of considerations relating to the nature and structure of legal systems and systems of administration, which are closely linked to the question of review of governmental actions, States might, to one degree or another, see fit to adapt the articles in chapter VI in line with those considerations. Because of this special circumstance, the provisions on review are of a more skeletal nature than other portions of the Model Law. What is crucial is that, whatever the exact form of review procedures, an adequate opportunity and effective procedures for review should be provided. Furthermore, it is recognized that the articles in the Model Law on review may be used by the enacting State merely to measure the adequacy of existing review procedures.

32. As to their content, the provisions establish in the first place that suppliers and contractors have a right to seek review. In the first instance, that review is to be sought from the procuring entity itself, in particular where the procurement contract is yet to be awarded. That initial step has been included so as to facilitate economy and efficiency, since in many cases, in particular prior to the awarding of the procurement contract, the procuring entity may be quite willing to correct procedural errors, of which it may even not have been aware. The Model Law also provides for review by higher administrative organs of Government, where such a procedure would be consistent with constitutional, administrative and judicial structures. Finally, the Model Law affirms the right to judicial review, but does not go beyond that to address matters of judicial-procedure law, which are left to the applicable national law.

33. In order to strike a workable balance between, on the one hand, the need to preserve the rights of suppliers and contractors and the integrity of the procurement process and, on the other hand, the need to limit disruption of the procurement process, chapter VI includes a number of restrictions on the review procedures that it establishes. These include: limitation of the right to review under the Model Law to suppliers and contractors; time limits for filing of applications for review and for disposition of cases, including any suspension of the procurement proceedings that may apply at the level of administrative review; exclusion from the review procedures of a number of decisions that are left to the discretion of the procuring entity and that do not directly involve questions of the fairness of treatment accorded suppliers and contractors (e.g., selection of a method of procurement; the limitation of participation in procurement proceedings on the basis of nationality in accordance with article 8).

I. Record requirement

34. One of the principal mechanisms for promoting adherence to the procedures set forth in the Model Law and for facilitating the accountability of the procuring entity to supervisory bodies in Government, to suppliers and contractors, and to the public at large is the requirement set forth in article 11 that the procuring entity maintain a record of the key decisions and actions taken by the procuring entity during the course of the procurement proceedings. Article 11 provides rules as to which specific actions and decisions are to be reflected in the record. It also establishes rules as to which portions of the record are, at least under the Model Law, to be made available to the general public, and which portions of the record are to be disclosed only to suppliers and contractors.

J. Other provisions

35. The Model Law also includes a variety of other provisions designed to support the objectives and procedures of the Model Law. These include provisions on: public accessibility of laws and regulations relating to procurement; form of communications between the procuring entity and suppliers and contractors; documentary evidence provided by suppliers and contractors concerning their qualifications; public notification of procurement-contract awards; mandatory rejection of a tender or offer in case of improper inducements from suppliers and contractors; manner of formulating specifications for goods or construction to be procured; language of documents for solicitation of tenders, proposals, offers or quotations; procedures to be followed in the various procurement methods

available under the Model Law (e.g., for tendering proceedings: provision on contents of solicitation documents; tender securities; opening of tenders; examination, evaluation and comparison of tenders; rejection of all tenders; and entry into force of the procurement contract).

K. Proper administrative structure for implementation of the Model Law

36. The Model Law sets forth only the procedures to be followed in selecting the supplier or contractor with whom the contract will be concluded. The Model Law assumes that the enacting State has in place, or will put into place, the proper institutional and bureaucratic structures and human resources necessary to operate and administer the type of procurement procedures provided for in the Model Law.

37. In addition to designating the organ or authority to perform the approval function referred to above in paragraphs 28 and 29, an enacting State may find it desirable to provide for the overall supervision of and control over procurement to which the Model Law applies. An enacting State may vest all of those functions in a single organ or authority (e.g., ministry of finance or of commerce, or central procurement board), or they may be allocated among two or more organs or authorities. The functions might include, for example, some or all of those mentioned here:

(a) **Supervising overall implementation of procurement law and regulations.** This may include, for example, issuance of procurement regulations, monitoring implementation of the procurement law and regulations, making recommendations for their improvement, and issuing interpretations of those laws. In some cases, e.g., in the case of high-value procurement contracts, the organ might be empowered to review the procurement proceedings to ensure that they have conformed to the Model Law and to the procurement regulations, before the contract can enter into existence.

(b) **Rationalization and standardization of procurement and of procurement practices**. This may include, for example, co-ordinating procurement by procuring entities, and preparing standardized procurement documents, specifications and conditions of contract.

(c) **Monitoring procurement and the functioning of the procurement law and regulations from the standpoint of broader Government policies.** This may include, for example, examining the impact of procurement on the national economy, rendering advice on the effect of particular procurement on prices and other economic factors, and verifying that a particular procurement falls within the programmes and policies of the Government. The organ or authority may be charged with issuance of approvals for particular procurement prior to the commencement of the procurement proceedings.

(d) **Training of procurement officers.** The organ or authority could also be responsible for training the procurement officers and other civil servants involved in operating the procurement system.

38. The organ or authority to exercise administrative and oversight functions in a particular enacting State, and the precise functions that the organ or authority is to exercise, will depend, for example, on the governmental, administrative and legal systems in the State, which vary widely from country to country. The system of administrative control over procurement should be structured with the objectives of economy and efficiency in mind, since systems that are excessively costly or burdensome either to the procuring entity or to participants in procurement proceedings, or that result in undue delays in procurement, will be counterproductive. In addition, excessive control over decision-making by officials who carry out the procurement proceedings could in some cases stifle their ability to act effectively.

39. It may be noted that a State enacting the Model Law does not thereby commit itself to any particular administrative structure; neither does the adoption of such legislation necessarily commit the enacting State to increased Government expenditures.

40. It may be noted that a variety of the institutional, staff development and training, and policy issues affecting public procurement, in particular in developing countries, are discussed in Improving Public Procurement Systems, Guide No. 23 issued by the International Trade Centre UNCTAD/GATT (Geneva).

L. Assistance from UNCITRAL Secretariat

41. In line with its training and assistance activities, the UNCITRAL secretariat may provide technical consultations for Governments preparing legislation based on the UNCITRAL Model Law on Procurement of Goods, Construction and Services, as it may for Governments considering legislation based on other UNCITRAL model laws, or considering adhesion to one of the international trade law conventions prepared by UNCITRAL.

42. Further information concerning the Model Law, as well as the Guide, and other model laws and conventions developed by UNCITRAL, may be obtained from the secretariat at the address below. The secretariat welcomes comments concerning the Model Law and the Guide, as well as information concerning enactment of legislation based on the Model Law.

International Trade Law Branch
Office of Legal Affairs, United Nations
Vienna International Centre, P. O. Box 500
A-1400, Vienna, Austria
Fax: (43-1) 21345 5813
Phone: (43-1) 21345-4060

II. ARTICLE-BY-ARTICLE REMARKS

PREAMBLE

The reason for including in the Model Law a statement of objectives is to provide guidance in the interpretation and application of the Model Law. Such a statement of objectives does not itself create substantive rights or obligations for procuring entities or for contractors or suppliers. It is recommended that, in States in which it is not the practice to include preambles, the statement of objectives should be incorporated in the body of the provisions of the Law.

CHAPTER I. GENERAL PROVISIONS

Article 1. Scope of application

1. The purpose of article 1 is to delineate the scope of application of the Model Law. The approach used in the Model Law is to provide in principle for the coverage of all types of procurement, but at the same time to recognize that an enacting State may wish to exempt certain types of procurement from coverage. The provision limits exclusions of the Model Law to cases provided for either by the Law itself or by regulation. This is done so that exclusions would not be made in a secretive or informal manner. In order to expand as far as possible the application of the Model Law, article 1(3) provides for complete or partial application of the Model Law even to excluded sectors. It may be further noted that, despite the exclusion in article 1(2)(a) of procurement involving national defence or security, it is not the intent of the Model Law to suggest that an enacting State that was prepared as a general rule to apply the Model Law to such procurement should not do so.

2. It is recommended that application of the Model Law be made as wide as possible. Particular caution should be used in excluding the application of the Model Law by way of the procurement regulations, since such exclusions by means of administrative rather than legislative action may be seen as negatively affecting the objectives of the Model Law. Furthermore, the broad variety of procedures available under the Model Law to deal with the different types of situations that may arise in procurement may make it less necessary to exclude the procedures provided in the Model Law. States excluding the application of the Model Law by way of procurement regulations should take note of article 5.

Article 2. Definitions

1. The Model Law is intended to cover primarily procurement by governmental units and other entities and enterprises within the public sector. Which exactly those entities are will differ from State to State due to differences in the allocation of legislative competence among different levels of Government. Accordingly, subparagraph (b)(i), defining the term "procuring entity", presents options as to the levels of Government to be covered. Option I brings within the scope of the Model Law all governmental departments, agencies, organs and other units within the enacting State, pertaining to the central Government as well as to provincial, local or other governmental subdivisions of the enacting State. This

Option would be adopted by non-federal States, and by federal States that could legislate for their subdivisions. Option II would be adopted by States that enact the Model Law only with respect to organs of the national Government.

2. In subparagraph (b)(ii), the enacting State may extend application of the Model Law to certain entities or enterprises that are not considered part of the Government, if it has an interest in requiring those entities to conduct procurement in accordance with the Model Law. In deciding which, if any, entities to cover, the enacting State may consider factors such as the following:

> (a) whether the Government provides substantial public funds to the entity, provides a guarantee or other security to secure payment by the entity in connection with its procurement contract, or otherwise supports the obligations of the procuring entity under the contract;
>
> (b) whether the entity is managed or controlled by the Government or whether the Government participates in the management or control of the entity;
>
> (c) whether the Government grants to the entity an exclusive licence, monopoly or quasi-monopoly for the sale of the goods that the entity sells or the services that it provides;
>
> (d) whether the entity is accountable to the Government or to the public treasury in respect of the profitability of the entity;
>
> (e) whether an international agreement or other international obligation of the State applies to procurement engaged in by the entity;
>
> (f) whether the entity has been created by special legislative action in order to perform activities in the furtherance of a legally-mandated public purpose and whether the public law applicable to Government contracts applies to procurement contracts entered into by the entity.

3. Editorial language has been included at the end of the definitions of "goods" and of "services" in subparagraphs (c) and (e) indicating that a State may wish to refer specifically in those definitions to categories of items that would be treated as goods or services, as the case may be, and whose classification might otherwise be unclear. The intent of this technique is to provide clarity with respect to what is and what is not to be treated as "goods" or "services" and it is therefore not meant to be used to limit the scope of application of the Model Law, which can be done by way of article 1(2)(b). Such an added degree of specificity might be considered desirable by the enacting State, in particular in view of the open-ended definition of services. For example, the enacting state may wish to specify the definition under which printing would fall, or the classification of other items, such as real estate, that might be made subject to the procurement law but whose classification would not be readily apparent.

Article 3. International obligations of this State relating to procurement [and intergovernmental agreements within (this State)]

1. An enacting State may be subject to international agreements or obligations with respect to procurement. For example, a number of States are parties to the GATT Agreement on Government Procurement, and the members of the European Union are bound by directives on procurement applicable throughout the geographic region. Similarly, the members of regional economic groupings in other parts of the world may be subject to procurement directives applied by their regional groupings. In addition, many international lending institutions and national development funding agencies have established guidelines or rules governing procurement with funds provided by them. In their loan or funding agreements with those institutions and agencies, borrowing or recipient countries undertake that proceedings for procurement with those funds will conform to the respective guidelines or rules. The purpose of subparagraphs (a) and (b) is to provide that the requirements of the international agreement, or other international obligation at the intergovernmental level, are to be applied; but in all other respects the procurement is to be governed by the Model Law.

2. Optional subparagraph (c) permits a federal State enacting the Model Law to give precedence over the Model Law to intergovernmental agreements concerning matters covered by the Model Law concluded between the national Government and one or more subdivisions of the State, or between any two or more such subdivisions. Such a clause might be used in enacting States in which the national Government does not possess the power to legislate for its subdivisions with respect to matters covered by the Model Law.

Article 4. Procurement regulations

1. As noted in paragraphs 7 and 12 of section I of the Guide, the Model Law is a "framework law", setting forth basic legal rules governing procurement that are intended to be supplemented by regulations promulgated by the appropriate organ or authority of the enacting State. The "framework law" technique enables an enacting State to tailor its detailed rules governing procurement procedures to its own particular needs and circumstances within the overall framework established by the Law. Thus, various provisions of the Model Law expressly provide for supplementation by procurement regulations. Furthermore, the enacting State may decide to supplement other provisions of the Model Law even though they do not expressly refer to the procurement regulations. In both cases, the regulations should be consistent with the Model Law.

2. Examples of procedures for which the elaboration of more detailed rules in the procurement regulations may be useful include: application of the Model Law to excluded sectors (article 1(2)); prequalification proceedings (article 7(3)(v)); the manner of publication of the notice of procurement-contract awards (article 14); limitation of the quantity of procurement carried out in cases of urgency using a procurement method other than tendering (to the quantity that is required to deal with the urgent circumstances); details concerning the procedures for soliciting tenders or applications to prequalify (article 24); requirements relating to the preparation and submission of tenders (article 27(z)); and, in

procurement of services, rules to guard against conflicts of interest in a determination to use single source procurement for reasons of compatibility with previous services.

3. In some cases failure to issue procurement regulations when the regulations are referred to in the Model Law may deprive the procuring entity of authority to take the particular actions in question. These cases include: limitation of participation in procurement proceedings on the ground of nationality (article 8(1)); use of the request-for-quotations method of procurement, since that method may be used only below threshold levels set in the procurement regulations (article 21); and authority and procedures for application of a margin of preference in favour of national suppliers or contractors (article 34(4)(d) and 39(2)).

Article 5. Public accessibility of legal texts

1. This article is intended to promote transparency in the laws, regulations and other legal texts relating to procurement by requiring public accessibility to those legal texts. Inclusion of this article may be considered important not only in States in which such a requirement is not already found in its existing administrative law, but even in States in which such a requirement was already found in the existing applicable law. In the latter case, the legislature may consider that a provision in the procurement law itself would help to focus the attention of both procuring entities and suppliers and contractors on the requirement of adequate public disclosure of legal texts concerned with procurement procedures.

2. In many countries there exist official publications in which laws, regulations and administrative rulings and directives are routinely published. The texts referred to in the present article could be published in those publications. Where there do not exist publications for one or more of those categories of texts, the texts should be promptly made accessible to the public, including foreign suppliers and contractors, in another appropriate manner.

Article 6. Qualifications of suppliers and contractors

The function and broad outlines of article 6 have been noted in paragraph 23 of section I of the Guide. Paragraph (1)(b)(v) of article 6 refers to disqualification of suppliers and contractors pursuant to administrative suspension or disbarment proceedings. Such administrative proceedings -- in which alleged wrongdoers should be given some procedural rights such as an opportunity to disprove the charges -- are commonly used to suspend or disbar suppliers and contractors found guilty of wrongdoing such as faulty accounting, default in contractual performance, or fraud. It may be noted that the Model Law leaves it to the enacting State to determine the period of time for which a criminal offence of the type referred to in paragraph (1)(b)(v) should disqualify a supplier or contractor from being considered for a procurement contract.

Article 7. Prequalification proceedings

1. Prequalification proceedings are intended to eliminate, early in the procurement proceedings,

suppliers or contractors that are not suitably qualified to perform the contract. Such a procedure may be particularly useful for the purchase of complex or high-value goods, construction or services, and may even be advisable for purchases that are of a relatively low value but involve a very specialized nature. The reason for this is that the evaluation and comparison of tenders, proposals and offers in those cases is much more complicated, costly and time-consuming. The use of prequalification proceedings may narrow down the number of tenders, proposals or offers that the procuring entity must evaluate and compare. In addition, competent suppliers and contractors are sometimes reluctant to participate in procurement proceedings for high-value contracts, where the cost of preparing the tender, proposal or offer may be high, if the competitive field is too large and where they run the risk of having to compete with unrealistic tenders, proposals or offers submitted by unqualified or disreputable suppliers or contractors.

2. The prequalification procedures set forth in article 7 are made subject to a number of important safeguards. These safeguards include the subjugation of prequalification procedures to the limitations contained in article 6, in particular as to assessment of qualifications, and the procedures found in paragraphs (2) through (7) of article 7. This set of procedural safeguards is included to ensure that prequalification procedures are conducted only on non-discriminatory terms and conditions that are fully disclosed to participating suppliers or contractors, and that otherwise ensure at least a required minimum level of transparency and facilitate the exercise by a supplier or contractor that has not been prequalified of its right to review.

3. The purpose of article 7(8) is to provide for reconfirmation, at a later stage of the procurement proceedings, of the qualifications of suppliers or contractors that had been prequalified. Such "post-qualification proceedings" are intended to permit the procuring entity to ascertain whether the qualification information submitted by a supplier or a contractor at the time of pre-qualification remains valid and accurate. The procedural requirements for post-qualification are designed to safeguard both the interests of suppliers and contractors in receiving fair treatment and the interest of the procuring entity in entering into procurement contracts only with qualified suppliers and contractors.

Article 8. Participation by suppliers or contractors

As noted in paragraphs 24 to 27 of section I of the Guide, making provision for international procurement proceedings has important advantages. Therein is found a description of the general approach and rationale of the provisions in the Model Law on international participation of suppliers and contractors in procurement proceedings, including the manner in which the general principle of international participation may be limited to take into account differing applicable legal obligations and the margin of preference in favour of local suppliers and contractors.

Article 9. Form of communications

1. Article 9 is intended to provide certainty as to the required form of communications between the procuring entity and suppliers and contractors provided for under the Model Law. The essential

requirement, subject to other provisions of the Model Law, is that a communication must be in a form that provides a record of its content. This approach is designed not to tie communication to the use of paper, taking into account that communications are increasingly carried out through means such as electronic data interchange ("EDI"). In view in particular of the as yet uneven availability and use of non-traditional means of communication such as EDI, paragraph (3) has been included as a safeguard against discrimination against or among suppliers and contractors on the basis of the form of communication that they use.

2. Obviously, article 9 does not purport to answer all the technical and legal questions that may be raised by the use of EDI or other non-traditional methods of communication in the context of procurement proceedings, and different areas of the law would apply to ancillary questions such as the electronic issuance of a tender security and other matters that are beyond the sphere of "communications" under the Model Law.

3. In order to permit the procuring entity and suppliers and contractors to avoid unnecessary delays, paragraph (2) permits certain specified types of communications to be made on a preliminary basis through means, in particular telephone, that do not leave a record of the content of the communication, provided that the preliminary communication is immediately followed by a confirming communication in a form that leaves a record of the content of the confirming communication.

Article 10. Rules concerning documentary evidence provided by suppliers or contractors

1. In order to facilitate participation by foreign suppliers and contractors, article 10 bars the imposition of any requirements as to the legalization of documentary evidence provided by suppliers and contractors as to their qualifications other than those provided for in the laws of the enacting State relating to the legalization of documents of the type in question. The article does not require that all documents provided by contractors and suppliers are to be legalized. Rather, it recognizes that States have laws concerning the legalization of documents and establishes the principle that no additional formalities specific to procurement proceedings should be imposed.

2. It may be noted that the expression "the laws of this State" is meant to refer not only to the statutes, but also to the implementing regulations as well as to the treaty obligations of the enacting State. In some States such a general reference to "laws" would suffice to indicate that all of the above-mentioned sources of law were being referred to. However, in other States a more detailed reference to the various sources of law would be warranted in order to make it clear that reference was being made not merely to statutes.

Article 11. Record of procurement proceedings

1. One of the most important ways to promote transparency and accountability is to include provisions requiring that the procuring entity maintain a record of the procurement proceedings. A record summarizes key information concerning the procurement proceedings. It facilitates the exercise of the

right of aggrieved suppliers and contractors to seek review. That in turn will help to ensure that the procurement law is, to the extent possible, self-policing and self-enforcing. Furthermore, adequate record requirements in the procurement law will facilitate the work of Government bodies exercising an audit or control function and promote the accountability of procuring entities to the public at large as regards the disbursement of public funds. The rationale behind limiting disclosure of information required to be disclosed under article 11 (1)(d) to that which is known to the procuring entity is that there may be procurement proceedings in which not all proposals would be fully developed or finalized by the proponents, in particular where some of the proposals did not survive to the final stages of the procurement proceedings. The reference in this paragraph to "a basis for determining the price" is meant to reflect the possibility that in some instances, particularly in procurement of services, the tenders, proposals, offers or quotations would contain a formula by which the price could be determined rather than an actual price quotation.

2. An aspect of enacting record requirements is to specify the extent and the recipients of the disclosure. Setting the parameters of disclosure involves balancing factors such as: the general desirability, from the standpoint of the accountability of procuring entities, of broad disclosure; the need to provide suppliers and contractors with information necessary to permit them to assess their performance in the proceedings and to detect instances in which there are legitimate grounds for seeking review; and the need to protect the confidential trade information of suppliers and contractors. In view of these considerations, article 11 provides two levels of disclosure. It mandates disclosure to any member of the general public of the information referred to in article 11(1)(a) and (b) -- basic information geared to the accountability of the procuring entity to the general public. Disclosure of more detailed information concerning the conduct of the procurement proceedings is mandated for the benefit of suppliers and contractors, since that information is necessary to enable them to monitor their relative performance in the procurement proceedings and to monitor the conduct of the procuring entity in implementing the requirements of the Model Law.

3. As mentioned above, among the necessary objectives of disclosure provisions is to avoid the disclosure of confidential trade information of suppliers and contractors. That is true in particular with respect to what is disclosed concerning the evaluation and comparison of tenders, proposals, offers and quotations, as excessive disclosure of such information may be prejudicial to the legitimate commercial interests of suppliers and contractors. Accordingly, the information referred to in paragraph (1)(e) involves only a summary of the evaluation and comparison of tenders, proposals, offers or quotations, while paragraph (3)(b) restricts the disclosure of more detailed information that exceeds what would be disclosed in such a summary.

4. The purpose of requiring disclosure to the suppliers or contractors at the time when the decision is made to accept a particular tender, proposal or offer is to give efficacy to the right to review under article 52. Delaying disclosure until entry into force of the procurement contract might deprive aggrieved suppliers and contractors of a meaningful remedy.

5. The limited disclosure scheme in paragraphs (2) and (3) does not preclude the applicability to certain parts of the record of other statutes in the enacting State that confer on the public at large a general right

to obtain access to Government records. Disclosure of the information in the record to legislative or parliamentary oversight bodies may be mandated pursuant to the law applicable in the enacting State.

Article 12. Rejection of all tenders, proposals, offers or quotations

1. The purpose of article 12 is to enable the procuring entity to reject all tenders, proposals, offers or quotations. Inclusion of this provision is important because a procuring entity may need to do so for reasons of public interest, such as where there appears to have been a lack of competition or to have been collusion in the procurement proceedings, where the procuring entity's need for the goods, construction or services ceases, or where the procurement can no longer take place due to a change in Government policy or a withdrawal of funding. Public law in some countries may restrict the exercise of this right, e.g., by prohibiting actions constituting an abuse of discretion or a violation of fundamental principles of justice.

2. The requirement in paragraph (3) that notice of the rejection of all tenders, proposals, offers or quotations be given to suppliers or contractors that submitted them, together with the requirement in paragraph (1) that the grounds for the rejection be communicated upon request to those suppliers or contractors, is designed to foster transparency and accountability. Paragraph (1) does not require the procuring entity to justify the grounds that it cites for the rejection. This approach is based on the premise that the procuring entity should be free to abandon the procurement proceedings on economic, social or political grounds which it need not justify. The protection of this power is further buttressed by the fact that the decision of the procuring entity to reject all tenders, proposals, offers or quotations is not subject, in accordance with article 52(2)(d), to the right to review provided by the Model Law; it is also supported by paragraph (2), which provides that the procuring entity is to incur no liability towards suppliers or contractors, such as compensation for their costs of preparing and submitting tenders, proposals, offers or quotations, solely by virtue of its invoking paragraph (1). The potentially harsh effects of article 12 are mitigated by permitting the procuring entity to reject all tenders, proposals, offers or quotations only if the right to do so has been reserved in the solicitation documents.

Article 13. Entry into force of the procurement contract

Article 13 is included because, from the standpoint of transparency, it is important for suppliers and contractors to know in advance the manner of entry into force of the procurement contract. In the context of tendering, article 36 sets forth detailed rules applicable to the entry into force of the procurement contract, which is reflected in paragraph (1). However, no rules on entry into force of the procurement contract are provided for the other methods of procurement in view of the varying circumstances that may surround the use of other procurement methods and the procedurally less detailed treatment of them in the Model Law. It is expected that, in most instances, entry into force of the procurement contract for the other methods of procurement will be determined in accordance with other bodies of law, such as the contract or administrative law of the enacting State. In order to ensure an adequate degree of transparency, however, it is provided for those other methods that the procuring entity predisclose to the suppliers and contractors the rules that will be applicable to the entry into force

of the procurement contract.

Article 14. Public notice of procurement contract awards

1. In order to promote transparency in the procurement process, and the accountability of the procuring entity to the public at large for its use of public funds, article 14 requires publication of a notice of award of the procurement contract. This obligation is separate from the notice of award required to be given pursuant to article 36(6) to suppliers and contractors that have participated in tendering proceedings, and independent from the requirement that information of that nature in the record should be made available to the general public under article 11(2). The Model Law does not specify the manner of publication of the notice, which is left to the enacting State and which paragraph (2) suggests may be dealt with in the procurement regulations.

2. In order to avoid the disproportionately onerous effects that such a publication requirement might have on the procuring entity were the notice requirement to apply to all procurement contracts no matter how low their value, the enacting State is given the option in paragraph (3) of setting a monetary-value threshold below which the publication requirement would not apply. However, since the monetary-value threshold might be subject to periodic changes, for example, due to inflation, it might be preferable to set out the threshold in the procurement regulations, the amendment of which would presumably be less complicated than an amendment of the statute.

Article 15. Inducements from suppliers or contractors

1. Article 15 contains an important safeguard against corruption: the requirement of rejection of a tender, proposal, offer or quotation if the supplier or contractor in question attempts to improperly influence the procuring entity. A procurement law cannot be expected to eradicate completely such abusive practices. However, the procedures and safeguards in the Model Law are designed to promote transparency and objectivity in the procurement proceedings and thereby to reduce corruption. In addition, the enacting State should have in place generally an effective system of sanctions against corruption by Government officials, including employees of procuring entities, and by suppliers and contractors, which would apply also to the procurement process.

2. To guard against abusive application of article 15, rejection is made subject to approval, to a record requirement and to a duty of prompt disclosure to the alleged wrongdoer. The latter is designed to permit exercise of the right to review.

Article 16. Rules concerning description of goods, construction or services

The purpose of including article 16 is to make clear the importance of the principle of clarity, completeness and objectivity in the description of the goods, construction or services to be procured in prequalification documents, solicitation documents and other documents for solicitation of proposals, offers or quotations. Descriptions with those characteristics encourage participation by suppliers and

contractors in procurement proceedings, enable suppliers and contractors to formulate tenders, proposals, offers and quotations that meet the needs of the procuring entity, and enable suppliers and contractors to forecast the risks and costs of their participation in procurement proceedings and of the performance of the contracts to be concluded, and thus to offer their most advantageous prices and other terms and conditions. Furthermore, properly prepared descriptions in solicitation documents enable tenders to be evaluated and compared on a common basis, which is one of the essential requirements of the tendering method. They also contribute to transparency and reduce possibilities of erroneous, arbitrary or abusive actions or decisions by the procuring entity. Furthermore, application of the rule that specifications should be written so as not to favour particular contractors or suppliers will make it more likely that the procurement needs of the procuring entity may be filled by a greater number of suppliers or contractors, thereby facilitating the use of as competitive a method of procurement as is feasible under the circumstances and in particular helping to limit abusive resort to single-source procurement.

Article 17. Language

1. The function of the bracketed language at the end of the chapeau is to facilitate participation in procurement proceedings by helping to make the prequalification documents, solicitation documents and other documents for solicitation of proposals, offers or quotations understandable to foreign suppliers and contractors. The reference to a language customarily used in international trade need not be adopted by an enacting State whose official language is one customarily used in international trade. Subparagraphs (a) and (b) have been incorporated in order to provide the procuring entity with the flexibility needed to waive application of the foreign language requirement in cases in which participation is restricted to domestic suppliers or contractors and in cases in which, while there is no such restriction imposed, foreign suppliers or contractors are not expected to be interested in participating.

2. In States in which solicitation documents are issued in more than one language, it would be advisable to include in the procurement law, or in the procurement regulations, a rule to the effect that a supplier or contractor should be able to base its rights and obligations on either language version. The procuring entity might also be called upon to make it clear in the solicitation documents that both language versions are of equal weight.

CHAPTER II. METHODS OF PROCUREMENT AND THEIR CONDITIONS FOR USE

Article 18. Methods of procurement

1. Article 18 establishes the rule, already discussed in paragraph 14 of section I of the Guide, that, for the procurement of goods or construction, tendering is the method of procurement to be used normally, while the principal method for procurement of services, as set out in chapter IV, is the method to be used normally for procurement of services. For those exceptional cases of procurement of goods or

construction in which tendering, even if feasible, is not judged by the procuring entity to be the method most apt to provide the best value, the Model Law provides a number of other methods of procurement. In the case of services, the procuring entity may use tendering where it is feasible to formulate detailed specifications and the nature of the services allows for tendering (for example, general building management services); furthermore, it may use one of the other methods of procurement available under the Model Law if the conditions for its use are met.

2. Article 18(4) sets forth the requirement that a decision to use a method of procurement other than tendering in the case of goods or construction, or, in the case of services, a method of procurement other than the principal method for procurement of services, should be supported in the record by a statement of the grounds and circumstances underlying that decision. That requirement is included because the decision to use an exceptional method of procurement, rather than the method that is normally required (i.e., tendering for goods or construction, or the principal method for procurement of services) should not be made secretly or informally.

Article 19. Conditions for use of two-stage tendering, request for proposals or competitive negotiation

1. As noted in paragraph 18 of section I of the Guide, for the circumstances specified in article 19(1), the Model Law provides the enacting State with a choice among three different methods of procurement other than tendering or the principal method for procurement of services -- two-stage tendering, request for proposals, and competitive negotiation. As further noted in paragraph 19 of section I of the Guide, an enacting State need not necessarily enact each of the three methods for the common circumstances referred to in article 19 or even enact more than one of them. An enacting State might decide not to enact more than one of the methods in view of the uncertainty likely to be encountered by procuring entities in trying to discern the most appropriate method from among two or three similar methods. In deciding which of the three methods to enact, a decisive criterion for the enacting State might be that, from the standpoint of transparency, competition and objectivity in the selection process, two-stage tendering and request for proposals are likely to offer more than competitive negotiation, with its high degree of flexibility and possibly higher risk of corruption. At least one of the three methods should be enacted, since the cases in question might otherwise only be dealt with through the least competitive of the procurement methods, single-source procurement.

2. The enacting State also might decide not to extend to procurement of services the methods of procurement set forth in article 19. The rationale behind such a decision could be a determination that the principal method for procurement of services (chapter IV) already contains procedures that are in many respects similar to the procedures for the methods of procurement set forth in article 19.

3. It may be noted that in the cases referred to in article 19(1)(a), in which it is not feasible for the procuring entity to formulate specifications for the goods or construction or, in the case of services, to identify their characteristics, the procuring entity, before deciding to use a method of procurement other than tendering, might wish to consider whether the specifications could be prepared with the assistance

of consultants.

4. Subparagraphs (b) and (c) of article 22(1) (single-source procurement), referring, respectively, to cases of non-catastrophic and catastrophic urgency, are identical to subparagraphs (a) and (b) of article 19(2), which permit the use of competitive negotiation in such cases of urgency. The purpose of this overlap is to permit the procuring entity to decide which of the two methods best suits the circumstances at hand. For both procurement methods, the urgency cases contemplated are intended to be truly exceptional, and not merely cases of convenience. In the application of the Model Law to procurement involving national defence or national security and in cases of research contracts for the procurement of a prototype, the procuring entity is, for similar reasons, given a choice between the methods of procurement provided for in article 19 and single-source procurement. Thus, an enacting State may, even if it does not enact competitive negotiation for the circumstances referred to in paragraph (1), enact competitive negotiation for the circumstances referred to in paragraph (2).

Article 20. Conditions for use of restricted tendering

1. Article 20 has been included in order to enable the procuring entity, in exceptional cases, to solicit participation only from a limited number of suppliers or contractors. Inclusion of this method in the Model Law is not intended to encourage its use. On the contrary, strict and narrow conditions for use have been included for restricted tendering since the unjustified resort to that method of procurement would impair fundamentally the objectives of the Model Law.

2. In order to give effect to the purpose of article 20 to limit the use of restrictive tendering to truly exceptional cases while maintaining the appropriate degree of competition, minimum solicitation requirements are set forth in article 47(1) that are tailored specifically to each of the two types of cases reflected in the conditions for use in article 20. When resort is made to restricted tendering on the ground, referred to in article 20(a), of a limited number of suppliers or contractors being available, all the suppliers or contractors that could provide the goods, construction or services are required to be invited to participate; when the ground is the low value of the procurement contract, the case referred to in article 20(b), suppliers or contractors should be invited in a non-discriminatory manner and in a sufficient number to ensure effective competition.

Article 21. Conditions for use of request for quotations

1. The request-for-quotations method of procurement provides a method of procurement appropriate for low-value purchases of standardized goods or services. In such cases, engaging in tendering proceedings, which can be costly and time-consuming, may not be justified. Article 21(2), however, strictly limits the use of this method to procurement of a value below the threshold set in the procurement regulations. In enacting article 21, it should be made clear that use of request for quotations is not mandatory for procurement below the threshold value. It may indeed be advisable in certain cases that fall below the threshold to use tendering or one of the other methods of procurement. This may be the case, for example, when an initial low-value procurement would have the long- term consequence of

committing the procuring entity to a particular type of technological system.

2. Paragraph (2) gives added and important effect to the intended limited scope for the use of request for quotations. It does so by prohibiting the artificial division of packages of goods or services for the purpose of circumventing the value limit on the use of request for quotations with a view to avoiding use of the more competitive methods of procurement, a prohibition that is essential to the objectives of the Model Law.

Article 22. Conditions for use of single-source procurement

1. In view of the non-competitive character of single-source procurement, its use is strictly limited to the exceptional circumstances set forth in article 22.

2. Paragraph (2) has been included in order to permit the use of single-source procurement in cases of serious economic emergency in which such procurement would avert serious harm. A case of this type may be, for example, where an enterprise employing most of the labor force in a particular region or city is threatened with closure unless it obtains a procurement contract.

3. Paragraph (2) contains safeguards to ensure that it does not give rise to more than a very exceptional use of single-source procurement. As regards the approval requirement mentioned in paragraph (2), it may be noted that enacting States that incorporate the over-all approval requirement for the use of single-source procurement might not necessarily have to incorporate the approval requirement referred to in paragraph (2). At the same time, however, it would have to be recognized that the decision to use single-source procurement in the economic emergency type of circumstance referred to would and should ordinarily be taken at the highest levels of Government.

CHAPTER III. TENDERING PROCEEDINGS

SECTION I. SOLICITATION OF TENDERS AND OF APPLICATIONS TO PREQUALIFY

Article 23. Domestic tendering

As pointed out in paragraph 27 of section I of the Guide, article 23 has been included in order to specify the exceptional cases in which application of various procedures in the Model Law to solicit foreign participation in the tendering proceedings would not be required.

Article 24. Procedures for soliciting tenders or applications to prequalify

1. In order to promote transparency and competition, article 24 sets forth the minimum publicity procedures to be followed for soliciting tenders and applications to prequalify from an audience wide enough to provide an effective level of competition. Including these procedures in the procurement law enables interested suppliers and contractors to identify, simply by reading the procurement law, publications they may monitor in order to stay abreast of procurement opportunities in the enacting State. In view of the objective of the Model Law of fostering participation in procurement proceedings without regard to nationality and maximizing competition, article 24(2) requires publication of the invitations also in a publication of international circulation. One possible medium of such publication is Development Business, published by the United Nations Department of Public Information.

2. The publicity requirements in the Model Law are only minimum requirements. The procurement regulations may require procuring entities to publicize the invitation to tender or the invitation to prequalify by additional means that would promote widespread awareness by suppliers and contractors of procurement proceedings. These might include, for example, posting the invitation on official notice boards, and circulating it to chambers of commerce, to foreign trade missions in the country of the procuring entity and to trade missions abroad of the country of the procuring entity.

Article 25. Contents of invitation to tender and invitation to prequalify

In order to promote efficiency and transparency, article 25 requires that invitations to tender as well as invitations to prequalify contain the information required for suppliers or contractors to be able to ascertain whether the goods, construction or services being procured are of a type that they can provide and, if so, how they can participate in the tendering proceedings. The specified information requirements are only the required minimum so as not to preclude the procuring entity from including additional information that it considers appropriate.

Article 26. Provision of solicitation documents

Solicitation documents are intended to provide suppliers or contractors with the information they need to prepare their tenders and to inform them of the rules and procedures according to which the tendering proceedings will be conducted. Article 26 has been included in order to ensure that all suppliers or contractors that have expressed an interest in participating in the tendering proceedings and that comply with the procedures set forth by the procuring entity are provided with solicitation documents. The purpose of including a provision concerning the price to be charged for the solicitation documents is to enable the procuring entity to recover its costs of printing and providing those documents, but to avoid excessively high charges that could inhibit qualified suppliers or contractors from participating in the tendering proceedings.

Article 27. Contents of solicitation documents

1. Article 27 contains a listing of the information required to be included in the solicitation documents. An indication in the procurement law of those requirements is useful to ensure that the solicitation

documents include the information necessary to provide a basis for enabling suppliers and contractors to submit tenders that meet the needs of the procuring entity and that the procuring entity can compare in an objective and fair manner. Many of the items listed in article 27 are regulated or dealt with in other provisions of the Model Law. The enumeration in this article of items that are required to be in the solicitation documents, including all items the inclusion of which is expressly provided for elsewhere in the Model Law, is useful because it enables procuring entities to use the article as a "check-list" in preparing the solicitation documents.

2. One category of items listed in article 27 concerns instructions for preparing and submitting tenders (subparagraphs (a), (i) through (r), and (t); issues such as the form, and manner of signature, of tenders and the manner of formulation of the tender price). The purpose of including these provisions is to limit the possibility that qualified suppliers or contractors would be placed at a disadvantage or even rejected due to lack of clarity as to how the tenders should be prepared. Other items in article 27 concern in particular the manner in which the tenders will be evaluated; their disclosure is required to achieve transparency and fairness in the tendering proceedings.

3. The Model Law recognizes that, for procurement actions that are separable into two or more distinct elements (e.g., the procurement of different types of laboratory apparatus; the procurement of a hydroelectric plant consisting of the construction of a dam and the supply of a generator), a procuring entity may wish to permit suppliers or contractors to submit tenders either for the entirety of the procurement or for one or more portions thereof. That approach might enable the procuring entity to maximize economy by procuring either from a single supplier or contractor or from a combination of them, depending on which approach the tenders revealed to be more cost effective. Permitting partial tenders may also facilitate participation by smaller suppliers or contractors, who may have the capacity to submit tenders only for certain portions of the procurement. Article 27(h) is included to make the tender evaluation stage as objective, transparent and efficient as possible, since the procuring entity should not be permitted to divide the entirety of the procurement into separate contracts merely as it sees fit after tenders are submitted.

Article 28. Clarifications and modifications of solicitation documents

1. The purpose of article 28 is to establish procedures for clarification and modification of the solicitation documents in a manner that will foster efficient, fair and successful conduct of tendering proceedings. The right of the procuring entity to modify the solicitation documents is important in order to enable the procuring entity to obtain what is required to meet its needs. Article 28 provides that clarifications, together with the questions that gave rise to the clarifications, and modifications must be communicated by the procuring entity to all suppliers or contractors to whom the procuring entity provided solicitation documents. It would not be sufficient to simply permit them to have access to clarifications upon request since they would have no independent way of finding out that a clarification had been made.

2. The rule governing clarifications is meant to ensure that the procuring entity responds to a timely

request for clarification in time for the clarification to be taken into account in the preparation and submission of tenders. Prompt communication of clarifications and modifications also enables suppliers or contractors to exercise their right under article 31(3) to modify or withdraw their tenders prior to the deadline for submission of tenders, unless that right has been superseded by a stipulation in the solicitation documents. Similarly, minutes of meetings of suppliers or contractors convened by the procuring entity must be communicated to them promptly so that those minutes too can be taken into account in the preparation of tenders.

SECTION II. SUBMISSION OF TENDERS

Article 29. Language of tenders

Article 29 provides that tenders may be formulated in any language in which the solicitation documents have been formulated or in any other language specified in the solicitation documents. This rule, which is linked to the general language rule in article 17, has been included in order to facilitate participation by foreign suppliers and contractors.

Article 30. Submission of tenders

1. An important element in fostering participation and competition is the granting to suppliers and contractors of a sufficient period of time to prepare their tenders. Article 30 recognizes that the length of that period of time may vary from case to case, depending upon a variety of factors such as the complexity of the procurement, the extent of subcontracting anticipated, and the time needed for transmitting tenders. Thus, it is left up to the procuring entity to fix the deadline by which tenders must be submitted, taking into account the circumstances of the given procurement. An enacting State may wish to establish in the procurement regulations minimum periods of time that the procuring entity must allow for the submission of tenders.

2. In order to promote competition and fairness, paragraph (2) requires the procuring entity to extend the deadline in the exceptional case of late issuance of clarifications or modifications of the solicitation documents, or of late issuance of minutes of a meeting of suppliers or contractors. Paragraph (3) permits, but does not compel, the procuring entity to extend the deadline for submission of tenders in other cases, i.e., when one or more suppliers or contractors are unable to submit their tenders on time due to any circumstances beyond their control. This is designed to protect the level of competition when a potentially important element of that competition would otherwise be precluded from participation. It may be noted that an extension of the deadline in the circumstances referred to in paragraph (2) is required rather than discretionary, and would thus be subject to the right to review. By contrast, an extension under paragraph (3) is, as indicated in paragraph (3), absolutely discretionary and therefore intended to be beyond the right to review provided for in article 52.

3. The requirement in paragraph (5)(a) that tenders are to be submitted in writing is subject to the exception in subparagraph (b) permitting the use of a form of communication other than writing, such as electronic data interchange (EDI), provided that the form used is one that provides a record of the content of the communication. Additional safeguards are included to protect the integrity of the procurement proceedings, as well as the particular interests of the procuring entity and of suppliers and contractors: that the use of a form other than writing must be permitted by the solicitation documents; that suppliers and contractors must always be given the right to submit tenders in writing, an important safeguard against discrimination in view of the uneven availability of non-traditional means of communication such as EDI; and that the alternative form must be one that provides at least a similar degree of authenticity, security and confidentiality. It may be further noted that the implementation of paragraph (5) to accommodate the submission of tenders in non-traditional forms would necessitate elaboration of special rules and techniques to guard the confidentiality of tenders and to prevent "opening" of the tenders prior to the deadline for submission of tenders, and to deal with other issues that might arise when a tender is submitted other than in writing (e.g., the form that the tender security would take).

4. The rule in paragraph (6) prohibiting the consideration of late tenders is intended to promote economy and efficiency in procurement and the integrity of and confidence in the procurement process. Permitting the consideration of late tenders after the commencement of the opening might enable suppliers or contractors to learn of the contents of other tenders before submitting their own tenders. This could lead to higher prices and could facilitate collusion between suppliers or contractors. It would also be unfair to the other suppliers or contractors. In addition, it could interfere with the orderly and efficient process of opening tenders.

Article 31. Period of effectiveness of tenders; modification and withdrawal of tenders

1. Article 31 has been included to make it clear that the procuring entity should stipulate in the solicitation documents the period of time that tenders are to remain in effect.

2. It is of obvious importance that the length of the period of effectiveness of tenders should be stipulated in the solicitation documents, taking into account the circumstances peculiar to the particular tendering proceeding. It would not be a viable solution to fix in a procurement law a generally applicable long period of effectiveness hoping to cover the needs of most if not all tendering proceedings. This would be inefficient since for many cases the period would be longer than necessary. Excessively long periods of effectiveness may result in higher tender prices since suppliers or contractors would have to include in their prices an increment to compensate for the costs and risks to which they would be exposed during such a period (e.g., tied capacity and inability to tender elsewhere; the risks of higher manufacturing or construction costs).

3. Paragraph (2)(b) has been included to enable the procuring entity to deal with delays in the tendering proceedings by requesting extensions of the tender validity period. The procedure is not compulsory on suppliers and contractors, so as not to force them to remain bound to their tenders for unexpectedly long

durations -- a risk that would discourage suppliers and contractors from participating or drive up their tender prices. In order to prolong, where necessary, also the protection afforded by tender securities, it is provided that a supplier or contractor failing to obtain a security to cover the extended validity period of the tender is considered as having refused to extend the validity period of its tender.

4. Paragraph (3) is an essential companion of the provisions in article 28 concerning clarifications and modifications of the solicitation documents. This is because it permits suppliers and contractors to respond to clarifications and modifications of solicitation documents, or to other circumstances, either by modifying their tenders, if necessary, or by withdrawing them if they so choose. Such a rule facilitates participation, while protecting the interests of the procuring entity by permitting forfeiture of the tender security for modification or withdrawal following the deadline for submission of tenders. However, in order to take account of a contrary approach found in the existing law and practice of some States, paragraph (3) permits the procuring entity to depart from the general rule and to impose forfeiture of the tender security for modifications and withdrawals prior to the deadline for submission of tenders, but only if so stipulated in the solicitation documents. (See also the remarks under article 46.)

Article 32. Tender securities

1. The procuring entity may suffer losses if suppliers or contractors withdraw tenders or if a procurement contract with the supplier or contractor whose tender had been accepted is not concluded due to the fault of that supplier or contractor (e.g., the costs of new procurement proceedings and losses due to delays in procurement). Article 32 authorizes the procuring entity to require the suppliers or contractors participating in the tendering proceedings to post a tender security so as to cover such losses and to discourage them from defaulting. Procuring entities are not required to impose tender security requirements in all tendering proceedings. Tender securities are usually important when the procurement is of high-value goods or construction. In the procurement of low-value items, though it may be of importance to require a tender security in some cases, the risks faced by the procuring entity and its potential losses are generally low, and the cost of providing a tender security -- which will normally be reflected in the contract price -- will be less justified.

2. Safeguards have been included to ensure that a tender-security requirement is only imposed fairly and for the intended purpose. That purpose is to secure the obligation of suppliers or contractors to enter into a procurement contract on the basis of the tenders they have submitted and to post a security for performance of the procurement contract, if required to do so.

3. Paragraph (1)(c) has been included to remove unnecessary obstacles to the participation of foreign suppliers and contractors that could arise if they were restricted to providing securities issued by institutions in the enacting State. However, there is optional language at the end of paragraph (1)(c) providing flexibility on this point for procuring entities in States in which acceptance of tender securities not issued in the enacting State would be a violation of law.

4. The reference to confirmation of the tender security is intended to take account of the practice in some

States of requiring local confirmation of a tender security issued abroad. The reference, however, is not intended to encourage such a practice, in particular since the requirement of local confirmation could constitute an obstacle to participation by foreign suppliers and contractors in tendering proceedings (e.g., difficulties in obtaining the local confirmation prior to the deadline for submission of tenders and added costs for foreign suppliers and contractors).

5. Paragraph (2) has been included in order to provide clarity and certainty as to the point of time after which the procuring entity may not make a claim under the tender security. While the retention by the beneficiary of a guarantee instrument beyond the expiry date of the guarantee should not be regarded as extending the validity period of the guarantee, the requirement that the security be returned is of particular importance in the case of a security in the form of a deposit of cash or in some other similar form. The clarification is also useful since there remain some national laws in which, contrary to what is generally expected, a demand for payment is timely even though made after the expiry of the security, as long as the contingency covered by the security occurred prior to the expiry. As does article 31(3), paragraph (2)(d) reflects that the procuring entity may avail itself, by way of a stipulation in the solicitation documents, of an exception to the general rule that withdrawal or modification of a tender prior to the deadline for submission of tenders is not subject to forfeiture of the tender security.

SECTION III. EVALUATION AND COMPARISON OF TENDERS

Article 33. Opening of tenders

1. The rule in paragraph (1) is intended to prevent time gaps between the deadline for submission of tenders and the opening of tenders. Such gaps may create opportunities for misconduct (e.g., disclosure of the contents of tenders prior to the designated opening time) and deprive suppliers and contractors of an opportunity to minimize that risk by submitting a tender at the last minute, immediately prior to the opening of tenders.

2. Paragraph (2) sets forth the rule that the procuring entity must permit all suppliers or contractors that have submitted tenders, or their representatives, to be present at the opening of tenders. This rule contributes to transparency of the tendering proceedings. It enables suppliers and contractors to observe that the procurement laws and regulations are being complied with and helps to promote confidence that decisions will not be taken on an arbitrary or improper basis. For similar reasons, paragraph (3) requires that at such an opening the names of suppliers or contractors that have submitted tenders, as well as the prices of their tenders, are to be announced to those present. With the same objectives in view, provision is also made for the communication of that information to participating suppliers or contractors that were not present or represented at the opening of tenders.

Article 34. Examination, evaluation and comparison of tenders

1. The purpose of paragraph (1) is to enable the procuring entity to seek from suppliers or contractors clarifications of their tenders in order to assist in the examination, evaluation and comparison of tenders, while making it clear that this should not involve changes in the substance of tenders. Paragraph (1)(b), which refers to the correction of purely arithmetical errors, is not intended to refer to abnormally low tender prices that are suspected to result from misunderstandings or to other errors not apparent on the face of the tender. Enactment of the related notice requirement is important since, in paragraph (3)(b), provision is made for the mandatory rejection of the tender if the correction is not accepted.

2. Paragraph (2) sets forth the rule to be followed in determining whether tenders are responsive and permits a tender to be regarded as responsive even if it contains minor deviations. Permitting the procuring entity to consider tenders with minor deviations promotes participation and competition in tendering proceedings. Quantification of such minor deviations is required so that tenders may be compared objectively in a way that reflects positively on tenders that do comply to a full degree.

3. Although ascertaining the successful tender on the basis of the tender price alone provides the greatest objectivity and predictability, in some tendering proceedings the procuring entity may wish to select a tender not purely on the basis of the price factor. Accordingly, the Model Law enables the procuring entity to select the "lowest evaluated tender", i.e., one that is selected on the basis of criteria in addition to price. Paragraph (4)(c)(ii) and (iii) list such criteria. The criteria in paragraph (4)(c)(iii) related to economic-development objectives have been included because, in some countries, particularly developing countries and countries whose economies are in transition, it is important for procuring entities to be able to take into account criteria that permit the evaluation and comparison of tenders in the context of economic development objectives. It is envisaged in the Model Law that some enacting States may wish to list additional such criteria. However, caution is advisable in expanding the list of non-price criteria set forth in paragraph (4)(c)(iii) in view of the risk that such other criteria may pose to the objectives of good procurement practice. Criteria of this type are sometimes less objective and more discretionary than those referred to in paragraph (4)(c)(i) and (ii), and therefore their use in evaluating and comparing tenders could impair competition and economy in procurement, and reduce confidence in the procurement process.

4. Requiring that the non-price criteria should be objective and quantifiable to the extent practicable, and that they be given a relative weight in the evaluation procedure or be expressed in monetary terms, is aimed at enabling tenders to be evaluated objectively and compared on a common basis. This reduces the scope for discretionary or arbitrary decisions. The enacting State may wish to spell out in the procurement regulations how such factors are to be formulated and applied. One possible method is to quantify in monetary terms the various aspects of each tender in relation to the criteria set forth in the solicitation documents and to combine that quantification with the tender price. The tender resulting in the lowest evaluated price would be regarded as the successful tender.

Another method may be to assign relative weightings (e.g., "coefficients" or "merit points") to the various aspects of each tender in relation to the criteria set forth in the solicitation documents. The tender with the most favourable aggregate weighting would be the lowest evaluated tender.

5. Paragraph (4)(d) permits a procuring entity to grant a margin of preference to domestic tenders, but makes its availability contingent upon rules for calculation to be set forth in the procurement regulations. (See paragraph 26 of section I of the Guide concerning the reasons for using a margin of preference as a technique for achieving national economic objectives while still preserving competition.) It should be noted, however, that States that are parties to the GATT Agreement on Government Procurement and member States of regional economic integration groupings such as the European Union may be restricted in their ability to accord such preferential treatment. In order to promote transparency, resort to the margin of preference may be made only if authorized by the procurement regulations and approved by the approving authority. Furthermore, the use of the margin of preference is required to be predisclosed in the solicitation documents and reflected in the record of the procurement proceedings.

6. The envisaged procurement regulations setting forth rules concerning the calculation and application of a margin of preference could also establish criteria for qualifying as a "domestic" contractor or supplier and for qualifying goods as "domestically produced" (e.g., that they contain a minimum domestic content or value added) and fix the amount of the margin of preference, which might be different for goods and for construction. As to the mechanics of applying the margin of preference, this may be done, for example, by deducting from the tender prices of all tenders import duties and taxes levied in connection with the supply of the goods or construction, and adding to the resulting tender prices, other than those that are to benefit from the margin of preference, the amount of the margin of preference or the actual import duty, whichever is less.

7. The rule in paragraph (5) on conversion of tender prices to a single currency for the purposes of comparison and evaluation of tenders is included to promote accuracy and objectivity in the decision of the procuring entity (see article 27(s)).

8. Paragraph (6) has been included in order to enable procuring entities to require the supplier or contractor submitting the successful tender to reconfirm its qualifications. This may be of particular utility in procurement proceedings of a long duration, in which the procuring entity may wish to verify whether qualification information submitted at an earlier stage remains valid. Use of reconfirmation is left discretionary since the need for it depends on the circumstances of each tendering proceeding. In order to make the reconfirmation procedure effective and transparent, paragraph (7) mandates the rejection of a tender upon failure of the supplier or contractor to reconfirm and establishes the procedures to be followed by the procuring entity to select a successful tender in such a case.

Article 35. Prohibition of negotiations with suppliers or contractors

Article 35 contains a clear prohibition against negotiations between the procuring entity and a supplier or contractor concerning a tender submitted by the supplier or contractor. This rule has been included because such negotiations might result in an "auction", in which a tender offered by one supplier or contractor is used to apply pressure on another supplier or contractor to offer a lower price or an otherwise more favourable tender. Many suppliers and contractors refrain from participating in tendering proceedings where such techniques are used or, if they do participate, they raise their tender prices in

anticipation of the negotiations.

Article 36. Acceptance of tender and entry into force of procurement contract

1. The purpose of paragraph (1) is to state clearly the rule that the tender ascertained to be the successful one pursuant to article 34(4)(b) is to be accepted and that notice of the acceptance is to be given promptly to the supplier or contractor that submitted the tender. Absent the provision in paragraph (4) on entry into force of the procurement contract, the entry into force of the procurement contract would be governed by general legal rules, which in many cases might not provide solutions appropriate for the procurement context.

2. The Model Law provides for different methods of entry into force of the procurement contract in the context of tendering proceedings, in recognition that enacting States may differ as to the preferred method and that, even within a single enacting State, different entry-into-force methods may be employed in different circumstances. Depending upon its preferences and traditions, an enacting State may wish to incorporate one or more of these methods.

3. Under one method (set forth in paragraph (4)), absent a contrary indication in the solicitation documents, the procurement contract enters into force upon dispatch of the notice of acceptance to the supplier or contractor that submitted the successful tender. The second method (set forth in paragraph (2)), ties the entry into force of the procurement contract to the signature by the supplier or contractor submitting the successful tender of a written procurement contract conforming to the tender. Paragraph (2) contains an optional reference to "the requesting ministry" as a signatory to the procurement contract in order to take into account that in some States the procurement contract is signed on behalf of the Government by the ministry for whose use the goods, construction or services were destined, but which did not itself conduct the procurement proceedings nor act as the procuring entity within the meaning of the Model Law. In States with such a procurement practice, procurement proceedings may be conducted by a central entity such as a central procurement or tendering board.

4. A third method of entry into force (set forth in paragraph (3)), provides for entry into force upon approval of the procurement contract by a higher authority. In States in which this provision is enacted, further details may be provided in the procurement regulations as to the type of circumstances in which the approval would be required (e.g., only for procurement contracts above a specified value). The reference in paragraph (3) to stipulation of the approval requirement in the solicitation documents is included to give a clear statement of the role of the solicitation documents in giving notice to suppliers or contractors of formalities required for entry into force of the procurement contract. The requirement that the solicitation documents disclose the estimated period of time required to obtain the approval and the provision that a failure to obtain the approval within the estimated time should not be deemed to extend the validity period of the successful tender or of any tender security are designed to establish a balance taking into account the rights and obligations of suppliers and contractors. They are designed in particular to exclude the possibility that a selected supplier or contractor would remain committed to the procuring entity for a potentially indefinite period of time with no assurance of the eventual entry into

force of the procurement contract.

5. The rationale behind linking entry into force of the procurement contract to dispatch rather than to receipt of the notice of acceptance is that the former approach is more appropriate to the particular circumstances of tendering proceedings. In order to bind the supplier or contractor to a procurement contract, including to obligate it to sign any written procurement contract, the procuring entity has to give notice of acceptance while the tender is in force. Under the "receipt" approach, if the notice was properly transmitted, but the transmission was delayed, lost or misdirected owing to no fault of the procuring entity, so that the notice was not received before the expiry of the period of effectiveness of the tender, the procuring entity would lose its right to bind the supplier or contractor. Under the "dispatch" approach, that right of the procuring entity is preserved. In the event of a delay, loss or misdirection of the notice, the supplier or contractor might not learn before the expiration of the validity period of its tender that the tender had been accepted; but in most cases that consequence would be less severe than the loss of the right of the procuring entity to bind the supplier or contractor.

6. In order to promote the objectives of good procurement practice, paragraph (5) makes it clear that, in the event that the supplier or contractor whose tender the procuring entity has selected fails to sign a procurement contract in accordance with paragraph (2), the selection of another tender from among the remaining tenders must be in accordance with the provisions normally applicable to the selection of tenders, subject to the right of the procuring entity to reject all tenders.

CHAPTER IV. PRINCIPAL METHOD FOR PROCUREMENT OF SERVICES

This chapter presents the procurement method normally to be used in procurement of services. Since, as noted in paragraph 11 of section I of the Guide, the main difference between procurement of goods and construction and procurement of services is in the evaluation and selection process, the features of chapter IV that differ most markedly from tendering are to be found in articles 42, 43 and 44 on the selection procedures. Otherwise, the articles in this chapter, for example on solicitation of proposals and on contents of the request for proposals, generally parallel provisions on analogous points in chapter III, on tendering proceedings. This is because tendering and the principal method for procurement of services are the methods to be used in the bulk of procurement and, as such, are designed to maximize economy and efficiency in procurement and promote the other objectives set forth in the Preamble.

Article 37. Notice of solicitation of proposals

1. In line with the objective of the Model Law of fostering competition in procurement, and since the principal method for procurement of services is the one typically to be used, article 37 is aimed at ensuring that as many suppliers and contractors as possible get the opportunity to become aware of the procurement proceedings and to express their interest in participating. As is the case also in tendering proceedings, this is achieved by providing that the notice seeking expressions of interest should be

publicized widely.

2. However, recognizing that in certain instances generally parallel to those reflected in the conditions for use of restricted tendering (article 20), the requirement of open solicitation might be unwarranted or might defeat the objectives of economy and efficiency, paragraph (3) sets out those cases where the procuring entity may engage in direct solicitation. The enacting State may wish to establish in the procurement regulations the value threshold below which procuring entities need not, in accordance with paragraphs (2) and (3) of the article, resort to open solicitation. The level at which the threshold would be set for services might be lower than the level at which it would be set for goods and construction. In deciding to engage in direct solicitation, the procuring entity should give consideration as to whether it will reject any unsolicited proposals or as to the manner in which it would consider any such proposals.

Article 38. Contents of requests for proposals for services

1. Article 38 contains a list of the minimum information that should be contained in the request for proposals in order to assist the suppliers or contractors in preparing their proposals and to enable the procuring entity to compare the proposals on an equal basis. In view of the predominant role of the principal method for procurement of services, article 38 is largely parallel in level of detail and in substance to the provisions on the required contents of solicitation documents in tendering proceedings (article 27).

2. Paragraphs (g) and (h) reflect the fact that, in many instances of procurement of services, the full nature and characteristics of the services to be procured might not be known to the procuring entity. Since, as discussed in paragraph 11 of section I of the Guide, the proposal price might not always be a relevant criterion in the procurement of services, paragraphs (j) and (k) are only applicable if price is a relevant criterion in the selection process.

Article 39. Criteria for the evaluation of proposals

1. Article 39 sets out the permissible range of criteria that the procuring entity may apply in evaluating the proposals. As is the case elsewhere in the Model Law where such types of criteria are listed, for example, article 48(3), the procuring entity is not required necessarily to apply each of the criteria in every instance of procurement. In the interests of transparency, however, the procuring entity is to apply the same criteria to all proposals in a given procurement proceeding and it is precluded from applying criteria that have not been predisclosed to the suppliers or contractors in the request for proposals.

2. In reflecting the importance of the skill and expertise of the suppliers and contractors in the bulk of the cases of procurement of services, paragraph (1)(a) lists as one of the criteria the qualifications and abilities of the personnel who will be involved in providing the services. This criterion would be particularly relevant in the procurement of those services that require a high degree of personal skill and knowledge on the part of the service providers, for example, in an engineering consultancy contract. By establishing the effectiveness of the proposal in meeting the needs of the procuring entity as one of the

possible criteria, paragraph (1)(b) enables the procuring entity to disregard a proposal that has been inflated with regard to technical and quality aspects beyond what is required by the procuring entity in an attempt to obtain a high ranking in the selection process, thereby artificially attempting to put the procuring entity in the position of having to negotiate with the proponent of the inflated proposal.

3. Paragraphs (1) (d) and (e), and (2), are similar to provisions applicable to tendering by way of article 34(4)(c)(iii) and (iv), and (d). The comments in the Guide on those provisions in the context of tendering (see paragraphs 3 to 6 of the comments on article 34) are therefore relevant to article 39.

Article 40. Clarification and modification of requests for proposals

Article 40 mirrors the provisions of article 28 on the analogous matter in the context of tendering and the comments in the Guide on article 28 are thus relevant to article 40.

Article 41. Choice of selection procedure

1. In articles 42, 43 and 44, three procedures for selecting the successful proposal are provided so as to enable the procuring entity, within the context of a proceeding under chapter IV, to utilize a procedure that best suits the particular requirements and circumstances of each given case. The choice of a particular selection procedure is largely dependent on the type of service being procured and the main factors that will be taken into account in the selection process, in particular, whether the procuring entity wishes to hold negotiations with suppliers and contractors, and if so, at which stage in the selection process. For example, if the services to be procured are of fairly standard nature where no great personal skill and expertise is required, the procuring entity may wish to resort to the selection procedure under article 42, which is more price oriented and which, like tendering, does not involve negotiations. On the other hand, in particular for services of a complex nature in which the personal skill and expertise of the supplier or contractor are crucial considerations, the procuring entity may wish to resort to one of the procedures in articles 43 or 44, since they permit greater emphasis to be placed on those selection criteria and provide for negotiation.

2. Paragraph (3) makes allowance for the use of an external and impartial panel of experts in the selection process, a procedure that is sometimes used by procuring entities, particularly in the adjudication of design contests or in procurement of services with a high artistic or aesthetic content. Enacting States using such panels may wish to provide further rules in the procurement regulations, with regard, for example, to any distinctions that would have to be drawn between panels whose role was merely advisory, panels whose role was limited to the aesthetic and artistic aspects of the proposals and panels empowered to make decisions that would bind the procuring entity.

Article 42. Selection procedure without negotiation

As mentioned above, the procedure provided for under this article may be more compatible with the procurement of services that are of a relatively non-complex nature where the price rather than the

personal skill and expertise of the suppliers or contractors is the dominant consideration and the procuring entity does not wish to negotiate. However, to ensure that the suppliers and contractors possess sufficient competence and expertise to perform the procurement contract, the Model Law provides that the procuring entity should establish a threshold level by which to measure the non-price aspects of the proposals. If this threshold is set at a sufficiently high level, then all the suppliers or contractors whose proposals attain a rating at or above the threshold can in all probability provide the services at a more or less equivalent level of competence. This allows the procuring entity to be more secure in selecting the winning proposal on the basis of price alone in accordance with paragraph (2)(a), or, in accordance with paragraph (2)(b), on the basis of the best combined evaluation of price and non-price aspects.

Article 43. Selection procedure with simultaneous negotiations

Article 43 sets forth a selection procedure that is akin to the evaluation procedures for the request for proposals method under article 48. It is therefore best suited in those circumstances where the procuring entity seeks various proposals on how best to meet its procurement needs. By allowing for early negotiations with all suppliers or contractors, the procuring entity is able to clarify better what its needs are, which can be taken into account by suppliers or contractors when preparing their "best and final offers". Paragraph (3) has been included in order to ensure that the price of the proposal is not given undue weight in the evaluation process to the detriment of the evaluation of the technical and other aspects of the proposal, including the evaluation of the competence of those who will be involved in providing the services.

Article 44. Selection procedure with consecutive negotiations

A third procedure for selecting the successful proposal, one that also involves negotiations, and which traditionally has been widely used in particular in procurement of intellectual services, is set forth in article 44. In this procedure, the procuring entity sets a threshold on the basis of the quality and technical aspects of the proposals, and then ranks those proposals that are rated above the threshold, ensuring that the suppliers or contractors with whom it will negotiate are capable of providing the services required. The procuring entity then holds negotiations with those suppliers or contractors, one at a time, starting with the supplier or contractor that was ranked highest, proceeding on the basis of their ranking until it concludes a procurement contract with one of them. These negotiations are aimed at ensuring that the procuring entity obtains a fair and reasonable price for the services to be provided. The rationale for not providing the procuring entity with the ability to reopen negotiations with suppliers or contractors with whom it had already terminated negotiations is to avoid open-ended negotiations which could lead to abuse and cause unnecessary delay. However, although this has the benefit of imposing a measure of discipline in the procurement, it denies the procuring entity the opportunity to reconsider a proposal that subsequent negotiations with suppliers or contractors at a later stage would show to have been more favourable. Nevertheless, the procuring entity may find such a negotiation procedure, although it does not emphasize price competition, appealing in some cases, such as the procurement of architectural and engineering services where considerations of technical quality are particularly important.

Article 45. Confidentiality

Article 45 is included because, in order to prevent abuse of the selection procedures and to promote confidence in the procurement process, it is important that confidentiality be observed by all parties, especially where negotiations are involved. Such confidentiality is important in particular to protect any trade or other information that suppliers or contractors might include in their proposals and that they would not wish to be made known to their competitors.

CHAPTER V. PROCEDURES FOR ALTERNATIVE METHODS OF PROCUREMENT

1. Articles 46 to 51 present procedures to be used for the methods of procurement other than tendering or other than the principal method for procurement of services. As noted in paragraphs 18 and 19 of section I of the Guide, as well as in comment 1 on article 19, there is an overlap in the conditions for use of two-stage tendering, request for proposals and competitive negotiation, and enacting States might not wish to enact in their procurement laws each of those three methods. The decision as to which of those methods to enact will therefore determine which of articles 46 (procedures for two-stage tendering), 48 (procedures for request for proposals) and 49 (procedures for competitive negotiation) will be retained.

2. With respect to request for proposals, competitive negotiation, request for quotations and single-source procurement, chapter V does not provide as full a procedural framework as chapter III does with respect to tendering proceedings (as well as two-stage tendering and restricted tendering), and as chapter IV does with respect to the principal method for procurement of services. This is mainly because the methods of procurement in chapter V involve more procedural flexibility than do tendering or the principal method of procurement of services. Some of the questions that for tendering, as well as for two-stage tendering and restricted tendering, are answered definitively in the Model Law (e.g., entry into force of the procurement contract) may be answered for those other methods of procurement in other bodies of the applicable law, which procuring entities will generally want to be the law of the State of the procuring entity. Where the applicable law is the United Nations Convention on Contracts for the International Sale of Goods, matters such as the formation of contract will be subject to the internationally uniform rules contained in the Convention. An enacting State may consider it useful to incorporate into the procurement law some of those solutions from other bodies of applicable law, as well as to supplement chapter V with rules in the procurement regulations. It should also be noted that chapters I and VI are generally applicable to all the methods of procurement.

Article 46. Two-stage tendering

The rationale behind the two-stage procedure used in this method of procurement is to combine two elements: the flexibility afforded to the procuring entity in the first stage by the ability to negotiate with suppliers or contractors in order to arrive at a final set of specifications for what is to be procured, and, in the second stage, the high degree of objectivity and competition provided by tendering proceedings

under chapter III. The general thrust of the provisions of article 46, which establish the specific procedures that distinguish two-stage tendering from ordinary tendering proceedings, has been noted in paragraph 20 of section I of the Guide. They include the requirement in paragraph (4) that the procuring entity should notify all suppliers or contractors remaining for the second stage of any changes made to the original specifications and should permit suppliers or contractors to forgo submitting a final tender without forfeiture of any tender security that may have been required for entry into the first stage. The latter provision is necessary to make the two-stage procedure hospitable to participation by suppliers or contractors since, upon the deadline for submission of tenders in the first stage, the suppliers or contractors cannot be expected to know what the specifications will be for the second stage.

Article 47. Restricted tendering

1. As noted in comment 2 on article 20, article 47 sets forth solicitation requirements designed to ensure that, in the case of resort to restricted tendering on the grounds referred to in article 20(a), tenders are solicited from all suppliers or contractors from whom the goods, construction or services to be procured are available, and, in the case of resort to restricted tendering on the grounds referred to in article 20(b), from a sufficient number of suppliers or contractors to ensure effective competition. Incorporation of those solicitation requirements is an important safeguard to ensure that the use of restricted tendering does not subvert the objective of the Model Law of promoting competition.

2. Paragraph (2) promotes transparency and accountability as regards the decision to use restricted tendering by requiring publication of a notice of the restricted tendering in a publication to be specified by the enacting State in its procurement law. Also relevant in this regard is the generally applicable rule in article 18(4) that the procuring entity include in the record of procurement proceedings a statement of the grounds and circumstances relied upon to justify the selection of one of the alternative methods of procurement provided for under chapter V.

3. The function of paragraph (3) is to provide that, beyond the specific procedures set forth in paragraphs (1) and (2), the procedures to be applied in restricted tendering are those normally applied to tendering proceedings, with the exception of article 24.

Article 48. Request for proposals

1. While request for proposals is a method in which the procuring entity typically solicits proposals from a limited number of suppliers or contractors, article 48 contains provisions designed to ensure that a sufficient number of suppliers or contractors have an opportunity to express their interest in participating in the proceedings and that a sufficient number actually do participate so as to foster adequate competition. In that regard, paragraph (1) requires the procuring entity to solicit proposals from as many suppliers or contractors as practicable, but from a minimum of three if possible. The companion provision in paragraph (2) is designed to potentially widen participation by requiring the procuring entity, unless this is not desirable on the grounds of economy and efficiency, to publish in a publication of international circulation a notice seeking expressions of interest in participating in the request-for-

proposals proceedings. In order to protect the procurement proceedings from inordinate delays that might result if the procuring entity were obligated to admit all suppliers or contractors that responded to such a notice, publication of the notice does not confer any rights on suppliers or contractors.

2. The procurement regulations may set forth further rules for the procuring entity in this type of a notice procedure. For example, the practice in some countries is that a request for proposals is sent as a general rule to all suppliers or contractors that respond to the notice, unless the procuring entity decides that it wishes to send the request for proposals only to a limited number of suppliers or contractors. The rationale behind such an approach is that those suppliers or contractors that expressed an interest should be given an opportunity to submit proposals and that the number asked to submit proposals should be limited only when important administrative reasons can be established. A countervailing consideration is that, while the wider notification procedure should not be foregone casually, such a procedure might create an extra burden for the procuring entity at a time when it is already busy.

3. The remainder of article 48 sets forth the essential elements of request-for-proposals proceedings as regards the evaluation and comparison of proposals and the selection of the winning proposal. They are designed to maximize transparency and fairness in competition, and objectivity in the comparison and evaluation of proposals.

4. The relative managerial and technical competence of the supplier or contractor is included in paragraph 3(a) as a possible evaluation factor since the procuring entity might feel more, or less, confident in the ability of one particular supplier or contractor than in that of another to implement the proposal. This provision should be distinguished from the authority granted to the procuring entity by virtue of article 6 not to evaluate or pursue the proposals of suppliers or contractors deemed unreliable or incompetent.

5. The "best and final offer" procedure required by paragraph (8) is intended to maximize competition and transparency by providing for a culminating date by which suppliers or contractors are to make their best and final offers. That procedure puts an end to the negotiations and freezes all the specifications and contract terms offered by suppliers and contractors so as to restrict the undesirable situation in which the procuring entity uses the price offer made by one supplier or contractor to pressure another supplier or contractor to lower its price. Otherwise, in anticipation of such pressure, suppliers or contractors may be led to raise their initial prices.

Article 49. Competitive negotiation

1. Article 49 is a relatively short provision since, subject to the applicable general provisions and rules set forth in the Model Law and in the procurement regulations, and subject to any rules of other bodies of applicable law, the procuring entity may organize and conduct the negotiations as it sees fit. Those rules that are set forth in the present article are intended to allow that freedom to the procuring entity while attempting to foster competition in the proceedings and objectivity in the selection and evaluation process, in particular by providing in paragraph (4) that the procuring entity should, at the end of the

negotiations, request suppliers or contractors to submit best and final offers, on the basis of which the successful offer is to be selected.

2. The enacting State may wish to require in the procurement regulations that the procuring entity take steps such as the following: establish basic rules and procedures relating to the conduct of the negotiations in order to help ensure that they proceed in an efficient manner; prepare various documents to serve as a basis for the negotiations, including documents setting forth the desired technical characteristics of the goods or construction to be procured, or a description of the nature of services to be procured, and the desired contractual terms and conditions; and request the suppliers or contractors with whom it negotiates to itemize their prices so as to assist the procuring entity in comparing what is being offered by one supplier or contractor during the negotiations with offers from the other suppliers or contractors.

Article 50. Request for quotations

It is important to include in a procurement law minimum procedural requirements for request for quotations of the type set forth in the Model Law. They are designed to foster an adequate level and quality of competition. With respect to the requirement in paragraph (1) that suppliers from whom quotations are requested should be informed as to the charges to be included in the quotation, the procuring entity may wish to consider using recognized trade terms, in particular INCOTERMS.

Article 51. Single-source procurement

The Model Law does not prescribe procedures to be followed specifically in single-source procurement. This is because single-source procurement is subject to very exceptional conditions of use and involves a sole supplier or contractor, thus making the procedure essentially a contract negotiation which it would not be appropriate for the Model Law to specifically regulate. It may be noted, however, that the provisions of chapter I would be generally applicable to single-source procurement, including article 11 on record requirements and article 14 on publication of notices of procurement contract awards.

CHAPTER VI. REVIEW

1. An effective means to review acts and decisions of the procuring entity and procedures followed by the procuring entity is essential to ensure the proper functioning of the procurement system and to promote confidence in that system. Chapter VI of the Model Law sets forth provisions establishing a right to review and governing its exercise.

2. It is recognized that there exist in most States mechanisms and procedures for review of acts of administrative organs and other public entities. In some States, review mechanisms and procedures have been established specifically for disputes arising in the context of procurement by those organs and

entities. In other States, those disputes are dealt with by means of the general mechanisms and procedures for review of administrative acts. Certain important aspects of proceedings for review, such as the forum where review may be sought and the remedies that may be granted, are related to fundamental conceptual and structural aspects of the legal system and system of State administration in every country. Many legal systems provide for review of acts of administrative organs and other public entities before an administrative body that exercises hierarchical authority or control over the organ or entity (hereinafter referred to as "hierarchical administrative review"). In legal systems that provide for hierarchical administrative review, the question of which body or bodies are to exercise that function in respect of acts of particular organs or entities depends largely on the structure of the State administration. In the context of procurement, for example, some States provide for review by a body that exercises overall supervision and control over procurement in the State (e.g., a central procurement board); in other States the review function is performed by the body that exercises financial control and oversight over operations of the Government and of the public administration. Some States provide for review by the Head of State in certain cases.

3. In some States, the review function in respect of particular types of cases involving administrative organs or other public entities is performed by specialized independent administrative bodies whose competence is sometimes referred to as "quasi-judicial". Those bodies are not, however, considered in those States to be courts within the judicial system.

4. Many national legal systems provide for judicial review of acts of administrative organs and public entities. In several of those legal systems judicial review is provided in addition to administrative review, while in other systems only judicial review is provided. Some legal systems provide only administrative review, and not judicial review. In some legal systems where both administrative and judicial review is provided, judicial review may be sought only after opportunities for administrative review have been exhausted; in other systems the two means of review are available as options.

5. In view of the above, and in order to avoid impinging upon fundamental conceptual and structural aspects of legal systems and systems of State administration, the provisions in chapter VI are of a more skeletal nature than other sections of the Model Law. As indicated in the asterisk footnote in the Model Law at the head of chapter VI, some States may wish to incorporate the articles on review without change or with only minimal changes, while other States might not see fit, to one degree or another, to incorporate those articles. In the latter cases, the articles on review may be used to measure the adequacy of existing review procedures.

6. In order to enable the provisions to be accommodated within the widely differing conceptual and structural frameworks of legal systems throughout the world, only basic features of the right of review and its exercise are dealt with. Procurement regulations to be formulated by an enacting State might include more detailed rules concerning matters that are not dealt with by the Model Law or by other legal rules in the State. In some cases, alternative approaches to the treatment of particular issues have been presented.

7. Chapter VI does not deal with the possibility of dispute resolution through arbitration, since the use of arbitration in the context of procurement proceedings is relatively infrequent. Nevertheless, the Model Law does not intend to suggest that the procuring entity and the supplier or contractor are precluded from submitting to arbitration, in appropriate circumstances, a dispute relating to the procedures in the Model Law.

Article 52. Right to review

1. The purpose of article 52 is to establish the basic right to obtain review. Under paragraph (1), the right to review appertains only to suppliers and contractors, and not to members of the general public. Subcontractors have been intentionally omitted from the ambit of the right to review provided for in the Model Law. This limitation is designed to avoid an excessive degree of disruption, which might impact negatively on the economy and efficiency of public purchasing. The article does not deal with the capacity of the supplier or contractor to seek review or with the nature or degree of interest or detriment that is required to be claimed for a supplier or contractor to be able to seek review. Those and other issues are left to be resolved in accordance with the relevant legal rules in the enacting State.

2. The reference in paragraph (1) to article 57 has been placed within square brackets because the article number will depend on whether or not the enacting State provides for hierarchical administrative review (see comment 1 on article 54).

3. Not all of the provisions of the Model Law impose obligations which, if unfulfilled by the procuring entity, give rise under the Model Law to a right to review. Paragraph (2) provides that certain types of actions and decisions by the procuring entity which involve an exercise of discretion are not subject to the right of review provided for in paragraph (1). The exemption of certain acts and decisions is based on a distinction between, on the one hand, requirements and duties imposed on the procuring entity that are directed to its relationship with suppliers and contractors and that are intended to constitute legal obligations towards suppliers and contractors, and, on the other hand, other requirements that are regarded as being only "internal" to the administration, that are aimed at the general public interest, or that for other reasons are not intended to constitute legal obligations of the procuring entity towards suppliers and contractors. The right to review is generally restricted to cases where the first type of requirement is violated by the procuring entity. (See also comment 2 on article 30.)

Article 53. Review by procuring entity (or by approving authority)

1. The purpose of providing for first-instance review by the head of the procuring entity (or of the approving authority) is essentially to enable that officer to correct defective acts, decisions or procedures. Such an approach can avoid unnecessarily burdening higher levels of review and the judiciary with cases that might have been resolved by the parties at an earlier, less disruptive stage. References to the approving authority in paragraph (1), as well as elsewhere in article 53 and the other articles on review, have been placed in parentheses since they may not be relevant to all enacting States (see paragraph 28 of section I of the Guide).

2. The policy rationale behind requiring initiation of review before the procuring entity or the approving authority only if the procurement contract has not yet entered into force is that, once the procurement contract has entered into force, there are limited corrective measures that the head of the procuring entity or of the approving authority could usefully require. The latter cases might better fall within the purview of hierarchical administrative review or judicial review.

3. The purpose of the time limit in paragraph (2) is to ensure that grievances are promptly filed so as to avoid unnecessary delays and disruption in the procurement proceedings at a later stage. Paragraph (2) does not define the notion of "days" (i.e., whether calendar or working days) since most States have enacted interpretation acts that would provide a definition.

4. Paragraph (3) is a companion provision to paragraph (1), providing that, for the reasons referred to in comment 2 on the present article, the head of the procuring entity or of the approving authority need not entertain a complaint, or continue to entertain a complaint, once the procurement contract has entered into force.

5. Paragraph (4)(b) leaves it to the head of the procuring entity or of the approving authority to determine what corrective measures would be appropriate in each case (subject to any rules on that matter contained in the procurement regulations; see also comment 7 on the present article). Possible corrective measures might include the following: requiring the procuring entity to rectify the procurement proceedings so as to be in conformity with the procurement law, the procurement regulations or other applicable rule of law; if a decision has been made to accept a particular tender and it is shown that another tender should be accepted, requiring the procuring entity not to issue the notice of acceptance to the initially chosen supplier or contractor, but instead to accept that other tender; or terminating the procurement proceedings and ordering new proceedings to be commenced.

6. An enacting State should take the following action with respect to the references within square brackets in paragraphs (5) and (6) to article "54 or 57". If the enacting State provides judicial review but not hierarchical administrative review (see comment 1 on article 54), the reference should be only to the article appearing in this Model Law as article 57. If the enacting State provides both forms of review but requires the supplier or contractor submitting the complaint to exhaust the right to hierarchical administrative review before seeking judicial review, the reference should be only to article 54. If the enacting State provides both forms of review but does not require the right to hierarchical administrative review to be exhausted before seeking judicial review, the reference should be to "article 54 or 57".

7. Certain additional rules applicable to review proceedings under this article are set forth in article 55. Furthermore, the enacting State may include in the procurement regulations detailed rules concerning the procedural requirements to be met by a supplier or contractor in order to initiate the review proceedings. For example, such regulations could clarify whether a succinct statement made by telex, with evidence to be submitted later, would be regarded as sufficient. The procurement regulations may also include detailed rules concerning the conduct of review proceedings under this article (e.g., concerning the right of suppliers or contractors participating in the procurement proceedings, other than

the party submitting the complaint, to participate in the review proceedings (see article 55); the submission of evidence; the conduct of the review proceedings; and the corrective measures that the head of the procuring entity or of the approving authority may require the procuring entity to take).

8. Review proceedings under this article should be designed to provide an expeditious disposition of the complaint. If the complaint cannot be disposed of expeditiously, the proceedings should not unduly delay the institution of proceedings for hierarchical administrative review or judicial review. To that end, paragraph (4) provides a thirty-day deadline for the issuance by the procuring entity (or by the approving authority) of a decision on the complaint; in the absence of a decision, paragraph (5) entitles the supplier or contractor that submitted the complaint to initiate administrative review under article 54 or, if such review is not available in the enacting State, judicial review under article 57.

Article 54. Administrative review

1. States where hierarchical administrative review of administrative actions, decisions and procedures is not a feature of the legal system might choose to omit this article and provide only for judicial review (article 57).

2. In some legal systems that provide for both hierarchical administrative review and judicial review, proceedings for judicial review may be instituted while administrative review proceedings are still pending, or vice versa, and rules are provided as to whether or not, or the extent to which, the judicial review proceedings supplant the administrative review proceedings. If the legal system of an enacting State that provides both means of review does not have such rules, the State may wish to establish them by law or by regulation.

3. An enacting State that wishes to provide for hierarchical administrative review but that does not already have a mechanism for such review in procurement matters should vest the review function in a relevant administrative body. The function may be vested in an appropriate existing body or in a new body created by the enacting State. The body may, for example, be one that exercises overall supervision and control over procurement in the State (e.g., a central procurement board), a relevant body whose competence is not restricted to procurement matters (e.g., the body that exercises financial control and oversight over the operations of the Government and of the public administration (the scope of the review should not, however, be restricted to financial control and oversight)), or a special administrative body whose competence is exclusively to resolve disputes in procurement matters, such as a "procurement review board". It is important that the body exercising the review function be independent of the procuring entity. In addition, if the administrative body is one that, under the Model Law as enacted in the State, is to approve certain actions or decisions of, or procedures followed by, the procuring entity, care should be taken to ensure that the section of the body that is to exercise the review function is independent of the section that is to exercise the approval function.

4. While paragraph (1)(a) establishes time limits for the commencement of administrative review actions with reference to the point of time when the complainant became aware of the circumstances in

question, the Model Law leaves to the applicable law the question of any absolute limitation period for the commencement of review.

5. The suppliers and contractors entitled to institute proceedings under paragraph (1)(d) are not restricted to suppliers or contractors who participated in the proceedings before the head of the procuring entity or of the approving authority (see article 54(2)), but include any other suppliers or contractors claiming to be adversely affected by a decision of the head of the procuring entity or of the approving authority.

6. The requirement in paragraph (2) is included so as to enable the procuring entity or the approving authority to carry out its obligation under article 55(1) to notify all suppliers or contractors of the filing of a petition for review.

7. With respect to paragraph (3), the means by which the supplier or contractor submitting the complaint establishes its entitlement to a remedy depends upon the substantive and procedural law applicable in the review proceedings.

8. Differences exist among national legal systems with respect to the nature of the remedies that bodies exercising hierarchical administrative review are competent to grant. In enacting the Model Law, a State may include all of the remedies listed in paragraph (3), or only those remedies that an administrative body would normally be competent to grant in the legal system of that State. If in a particular legal system an administrative body can grant certain remedies that are not already set forth in paragraph (3), those remedies may be added to the paragraph. The paragraph should list all of the remedies that the administrative body may grant. The approach of the present article, which specifies the remedies that the hierarchical administrative body may grant, contrasts with the more flexible approach taken with respect to the corrective measures that the head of the procuring entity or of the approving authority may require (article 53(4)(b)). The policy underlying the approach in article 53(4)(b) is that the head of the procuring entity or of the approving authority should be able to take whatever steps are necessary in order to correct an irregularity committed by the procuring entity itself or approved by the approving authority. Hierarchical administrative authorities exercising review functions are, in some legal systems, subject to more formalistic and restrictive rules with respect to the remedies that they can grant, and the approach taken in article 54(3) seeks to avoid impinging on those rules.

9. Optional language is included in the chapeau of paragraph (3) in order to accommodate those States where review bodies do not have the power to grant the remedies listed in paragraph (3) but can make recommendations.

10. With respect to the types of losses in respect of which compensation may be required, paragraph (3)(f) sets forth two alternatives for the consideration of the enacting State. Under Option I, compensation may be required in respect of any reasonable costs incurred by the supplier or contractor submitting the complaint in connection with the procurement proceedings as a result of the unlawful act, decision or procedure. Those costs do not include profit lost because of non-acceptance of a tender, proposal, offer or quotation of the supplier or contractor submitting the complaint. The types of losses that are

compensable under Option II are broader than those under Option I, and might include lost profit in appropriate cases.

11. If the procurement proceedings are terminated pursuant to paragraph (3)(g), the procuring entity may institute new procurement proceedings.

12. There may be cases in which it would be appropriate for a procurement contract that has entered into force to be annulled. This might be the case, for example, where a contract was awarded to a particular supplier or contractor as a result of fraud. However, as annulment of procurement contracts may be particularly disruptive of the procurement process and might not be in the public interest, it has not been provided for in the Model Law itself. Nevertheless, the lack of provisions on annulment in the Model Law does not preclude the availability of annulment under other bodies of law. Instances in which annulment would be appropriate are likely to be adequately dealt with by the applicable contract, administrative or criminal law.

13. If detailed rules concerning proceedings for hierarchical administrative review do not already exist in the enacting State, the State may provide such rules by law or in the procurement regulations. Rules may be provided, for example, concerning: the right of suppliers and contractors, other than the one instituting the review proceedings, to participate in the review proceedings (see article 55(2)); the burden of proof; the submission of evidence; and the conduct of the review proceedings.

14. The overall period of 30 days imposed by paragraph (4) may have to be adjusted in countries in which administrative proceedings take the form of quasi-judicial proceedings involving hearings or other lengthy procedures. In such countries the difficulties raised by the limitation can be treated in the light of the optional character of article 54.

Article 55. Certain rules applicable to review proceedings under article 53 [and 54]

1. This article applies only to review proceedings before the head of the procuring entity or of the approving authority, and before a hierarchical administrative body, but not to judicial review proceedings. There exist in many States rules concerning the matters addressed in this article.

2. References within square brackets in the heading and text of this article to article 54 and to the administrative body should be omitted by enacting States that do not provide for hierarchical administrative review.

3. The purpose of paragraphs (1) and (2) of this article is to make suppliers or contractors aware that a complaint has been submitted concerning procurement proceedings in which they have participated or are participating and to enable them to take steps to protect their interests. Those steps may include intervention in the review proceedings under paragraph (2), and other steps that may be provided for under applicable legal rules. The possibility of broader participation in the review proceedings is provided since it is in the interest of the procuring entity to have complaints aired and information

brought to its attention as early as possible.

4. While paragraph (2) establishes a fairly broad right of suppliers and contractors to participate in review proceedings that they have not themselves generated, the Model Law does not provide detailed guidance as to the extent of the participation to be allowed to such third parties (e.g., whether the participation of such third parties would be at a full level, including the right to submit statements). Enacting States may have to ascertain whether there is a need in their jurisdictions for establishing rules to govern such issues.

5. In paragraph (3), the words "any other supplier or contractor or governmental authority that has participated in the review proceedings" refer to suppliers or contractors participating pursuant to paragraph (2) and to governmental authorities such as approving authorities.

Article 56. Suspension of procurement proceedings

1. An automatic suspension approach (i.e., suspension of the procurement proceedings triggered by the mere filing of a complaint) is followed in the procurement laws of some countries. The purpose of suspension is to enable the rights of the supplier or contractor instituting review proceedings to be preserved pending the disposition of those proceedings. Without a suspension, a supplier or contractor submitting a complaint might not have sufficient time to seek and obtain interim relief. In particular, it will usually be important for the supplier or contractor to avoid the entry into force of the procurement contract pending disposition of the review proceedings and, if an entitlement to interim relief would have to be established, there might not be sufficient time to do so and still avoid entry into force of the contract (e.g., where the procurement proceedings are in their final stages). With an automatic suspension approach, there is a greater possibility of settlement of complaints at a lower level, short of judicial intervention, thus fostering more economical and efficient dispute settlement. At the same time, the disadvantage of an automatic suspension approach is that it would increase the extent to which the review procedures would result in disruption and delay in the procurement process, thus affecting the operations of the procuring entity.

2. The approach taken in article 56 with regard to suspension is designed to strike a balance between the right of the supplier or contractor to have a complaint reviewed and the need of the procuring entity to conclude a contract in an economic and efficient way, without undue disruption and delay of the procurement process. In the first place, in order to limit the unnecessary triggering of a suspension, the suspension provided for in article 56 is not automatic, but is subject to the fulfillment of the conditions set forth in paragraph (1). The requirements set forth in paragraph (1) as to the declaration to be made by a supplier or contractor in applying for a suspension are not intended to involve an adversarial or evidentiary process as this would run counter to the objective of a swift triggering of a suspension upon timely filing of a complaint. Rather, what is involved is an ex parte process based on the affirmation by the complainant of the existence of certain circumstances, circumstances of the type that must be alleged in many legal systems in order to obtain preliminary relief. The requirement that the complaint not be frivolous is included since, even in the context of ex parte proceedings, the reviewing body should be

enabled to look on the face of the complaint to reject frivolous complaints.

3. In order to mitigate the potentially disruptive effect of a suspension, only a short initial suspension of seven days may be triggered through the fairly simple procedure envisaged in article 56. This short initial suspension is intended to permit the procuring entity or other reviewing administrative body to assess the merits of the complaint and to determine whether a prolongation of the initial suspension under paragraph (3) would be warranted. The potential for disruption is further limited by the overall thirty-day cap on the total length of the suspension in accordance with paragraph (3). Furthermore, paragraph (4) allows avoidance of the suspension in exceptional circumstances if the procuring entity certifies that urgent public interest considerations require the procurement to proceed without delay, for example, when the procurement involves goods needed urgently at the site of a natural disaster.

4. Paragraph (2) provides for the suspension for a period of seven days of a procurement contract that has already entered into force in the event that a complaint is submitted in accordance with article 54 and meets the requirements of paragraph (1). This suspension can also be avoided under paragraph (4) and, as noted above, is subject to extension up to a thirty-day total period under paragraph (3).

5. Since, beyond what is contained in article 57, the Model Law does not deal with judicial review, article 56 does not purport to address the question of court-ordered suspension, which may be available under the applicable law.

Article 57. Judicial review

The purpose of this article is not to limit or to displace the right to judicial review that might be available under other applicable law. Rather, its purpose is merely to confirm the right and to confer jurisdiction on the specified court or courts over petitions for review commenced pursuant to article 52. This includes appeals against decisions of review bodies pursuant to articles 53 and 54, as well as against failures by those review bodies to act. The procedural and other aspects of the judicial proceedings, including the remedies that may be granted, will be governed by the law applicable to the proceedings. The law applicable to the judicial proceedings will govern the question of whether, in the case of an appeal of a review decision made pursuant to article 53 or 54, the court is to examine de novo the aspect of the procurement proceedings complained of, or is only to examine the legality or propriety of the decision reached in the review proceeding. The minimal approach in article 57 has been adopted so as to avoid impinging on national laws and procedures relating to judicial proceedings.

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UNCITRAL

United Nations Commission on International Trade Law

Status

1994 - UNCITRAL Model Law on Procurement of Goods, Construction and Services

This page is updated whenever the UNCITRAL Secretariat is informed of changes in enactment of the Model Law.

The UNCITRAL Secretariat also prepares yearly a document containing the Status of Conventions and Enactments of UNCITRAL Model Laws, which is available on the web page of the corresponding UNCITRAL Commission Session.

Legislative texts based on or largely inspired by the UNCITRAL Model Law on Procurement of Goods, Construction and Services have been adopted in various countries including:

Afghanistan	2006
Albania	*
Armenia	2005
Azerbaijan	*
Bangladesh	*
Croatia	*
Estonia	*
Gambia	2001
Georgia	1999
Ghana	*
Guyana	*
Kazakhstan	*
Kenya	*
Kyrgyzstan	*
Madagascar	*
Malawi	2003

Sear

Mauritius	*
Mongolia	*
Nepal	*
Nigeria	2007
Poland	*
Republic of Moldova	*
Romania	*
Rwanda	*
Slovakia	*
Uganda	*
United Republic of Tanzania	*
Uzbekistan	*
Zambia	*

* = date unrecorded

Disclaimer: A model law is created as a suggested pattern for law-makers to consider adopting as part of their domestic legislation. Since States enacting legislation based upon a model law have the flexibility to depart from the text, the above list is only indicative of the enactments that were made known to the UNCITRAL Secretariat. The legislation of each State should be considered in order to identify the exact nature of any possible deviation from the model in the legislative text that was adopted. The year of enactment indicated above is the year the legislation was passed by the relevant legislative body, as indicated to the UNCITRAL Secretariat; it does not address the date of entry into force of that piece of legislation, the procedures for which vary from State to State, and could result in entry into force some time after enactment.

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Travaux préparatoires

1994 - UNCITRAL Model Law on Procurement of Goods, Construction and Services, with Guide to Enactment

Related documents are available from:

- the tenth, eleventh, twelfth, thirteenth, fourteenth, fifteenth, sixteenth and seventeenth of the Working Group V
- and from the nineteenth, twentieth, twenty-first, twenty-second, twenty-third, twenty-fourth, twenty-fifth session, twenty-sixth session and twenty-seventh sessions of the Commission.

Summary Records

of the United Nations Commission on International Trade Law for meetings devoted to the preparation of the UNCITRAL Model Law on Procurement of Goods, Construction and Services and Guide to Enactment

520 th Meeting [A/CN.9/SR.520]- Consideration of a draft UNCITRAL model law on procurement of goods, construction and services: introduction of chapter IV bis on procurement of services (A/CN.9/392), general discussion, Article 1, Article 2(a), Article 2(b)

521 st Meeting [A/CN.9/SR.521] - Article 2(c), Article 2(d), Article 2(d bis), Article 2(e), Article 2(f), Article 2(g), Article 2(h), Article 3, Article 4, Article 5, Article 6, Article 7, Article 8, Article 9, Article 10, Article 11, Article 11 bis, Article 11 ter, Article 12

522 nd Meeting [A/CN.9/SR.522] - Article 12 (continued), Article 13, Article 14, Article 15, Article 16

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523 rd Meeting [A/CN.9/SR.523] - Article 16 (continued), Article 17, Article 18, Article 19, Article 20, Articles 21 to 35, Chapter IV, Articles 37 to 41, Chapter IV bis

524 th Meeting [A/CN.9/SR.524] - Article 41 bis

525 th Meeting [A/CN.9/SR.525] - Article 41 bis (continued)

526 th Meeting [A/CN.9/SR.526] - Article 41 bis (continued)

527 th Meeting [A/CN.9/SR.527] - Article 41 bis (continued), Article 41 ter, Article 41 quater, Article 41 quinquies, Article 41 sexies

528 th Meeting [A/CN.9/SR.528] - Article 41 sexies (continued)

529 th Meeting [A/CN.9/SR.529] - Article 41 sexies (continued), Article 41 septies

530 th Meeting [A/CN.9/SR.530] - Chapter II (Methods of procurement and their conditions for use), Article 16, Chapter V (Review), Articles 42 to 47; Consideration of draft amendments to the Guide to Enactment of the UNCITRAL Model Law on Procurement of Goods and Construction (A/CN.9/393 and A/CN.9/394): Chapter I (General Provisions), Chapter II (Methods of procurement and their conditions for use), Chapter IV bis (Request for proposals for services)

535 th Meeting [A/CN.9/SR.535] - finalization of the text of the draft UNCITRAL model law on procurement of goods, construction and services (A/CN.9/XXVII/CRP.2 and Add. 1-3): Preamble, Chapter I, Chapter II, Chapter III, Chapter III bis and Chapter IV

536 th Meeting [A/CN.9/SR.536] - Chapter III bis (continued) and Chapter V

540 th Meeting [A/CN.9/SR.540] - consideration of the report of the drafting group on the draft UNCITRAL model law on procurement of goods, construction and services (A/CN.9/XXVII/CRP.2/Add.4); Adoption of the Model Law and recommendation (A/CN.9/XXVII/CRP.5); Adoption of draft paragraphs for the Guide to Enactment of the UNCITRAL Model Law on Procurement of Goods, Construction and Services (A/CN.9/XXVII/CRP.3)

Other Related Summary Records

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United Nations Commission on International Trade Law

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1993 - UNCITRAL Model Law on Procurement of Goods and Construction with Guide to Enactment

Adopted by UNCITRAL on 16 July 1993, the Model Law is designed to assist States in reforming and modernizing their laws on procurement procedures. The Model Law contains procedures aimed at achieving the objectives of competition, transparency, fairness and objectivity in the procurement process, and thereby increasing economy and efficiency in procurement. The Model Law is available for use by States who wish to enact procurement legislation with a scope limited to procurement of goods and construction.

General Assembly resolution

Text - Guide to enactment

Travaux préparatoires

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UNITED NATIONS

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General Assembly

Distr.
GENERAL

A/RES/48/33
1 February 1994

Forty-eighth session
Agenda item 144

RESOLUTION ADOPTED BY THE GENERAL ASSEMBLY

[on the report of the Sixth Committee (A/48/613)]

48/33. Model Law on Procurement of Goods and Construction of the United Nations Commission on International Trade Law

The General Assembly,

Recalling its resolution 2205 (XXI) of 17 December 1966, by which it created the United Nations Commission on International Trade Law with a mandate to further the progressive harmonization and unification of the law of international trade and in that respect to bear in mind the interests of all peoples, in particular those of developing countries, in the extensive development of international trade,

Noting that procurement constitutes a large portion of public expenditure of most States,

Noting also that a model law on procurement establishing procedures designed to foster integrity, confidence, fairness and transparency in the procurement process will also promote economy, efficiency and competition in procurement and thus lead to increased economic development,

Being of the opinion that the establishment of a model law on procurement that is acceptable to States with different legal, social and economic systems contributes to the development of harmonious international economic relations,

Being convinced that the Model Law on Procurement of Goods and Construction of the United Nations Commission on International Trade Law 1/ will significantly assist all States, including developing countries and States whose economies are in transition, in enhancing their existing procurement laws and formulating procurement laws where none presently exist,

1. *Takes note with satisfaction* of the completion and adoption by the United Nations Commission on International Trade Law of the Model Law on Procurement of Goods and Construction together with the Guide to Enactment of the Model Law; 2/

2. *Recommends* that, in view of the desirability of improvement and uniformity of the laws of procurement, States give favourable consideration to the Model Law when they enact or revise their procurement laws;

3. *Recommends also* that all efforts be made to ensure that the Model Law together with the Guide become generally known and available.

73rd plenary meeting
9 December 1993

1/ *Official Records of the General Assembly, Forty-eighth Session, Supplement No. 17* (A/48/17), chap. II.

2/ Ibid., paras. 218-258.

UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW (UNCITRAL)

UNCITRAL Model Law on Procurement of Goods and Construction (1993)

Preamble

WHEREAS the [Government] [Parliament] of ... considers it desirable to regulate procurement of goods and of construction so as to promote the objectives of:

(a) maximizing economy and efficiency in procurement;

(b) fostering and encouraging participation in procurement proceedings by suppliers and contractors, especially where appropriate, participation by suppliers and contractors regardless of nationality, and thereby promoting international trade;

(c) promoting competition among suppliers and contractors for the supply of the goods or construction to be procured;

(d) providing for the fair and equitable treatment of all suppliers and contractors;

(e) promoting the integrity of, and fairness and public confidence in, the procurement process; and

(f) achieving transparency in the procedures relating to procurement,

Be it therefore enacted as follows.

CHAPTER I. GENERAL PROVISIONS

Article 1. Scope of application

(1) This Law applies to all procurement by procuring entities, except as otherwise provided by paragraph (2) of this article.

(2) Subject to the provisions of paragraph (3) of this article, this Law does not apply to:

(a) procurement involving national defence or national security;

(b) ... (the enacting State may specify in this Law additional types of procurement to be excluded); or

(c) procurement of a type excluded by the procurement regulations.

(3) This Law applies to the types of procurement referred to in paragraph (2) of this article where and to the extent that the procuring entity expressly so declares to suppliers or contractors when first soliciting their participation in the procurement proceedings.

Article 2. Definitions

For the purposes of this Law:

(a) "procurement" means the acquisition by any means, including by purchase, rental, lease or hire-purchase, of goods or of construction, including services incidental to the supply of the goods or to the construction if the value of those incidental services does not exceed that of the goods or construction themselves;

(b) "procuring entity" means:

Option I for subparagraph (i)

any governmental department, agency, organ or other unit, or any subdivision thereof, in this State that engages in procurement, except ...; (and)

Option II for subparagraph (i)

any department, agency, organ or other unit, or any subdivision thereof, of

the ("Government" or other term used to refer to the national Government of the enacting State) that engages in procurement, except ...; (and)

(ii) (the enacting State may insert in this subparagraph and, if necessary, in subsequent subparagraphs, other entities or enterprises, or categories thereof, to be included in the definition of "procuring entity");

(c) "goods" includes raw materials, products, equipment and other physical objects of every kind and description, whether in solid, liquid or gaseous form, and electricity; (the enacting State may include additional categories of goods)

(d) "construction" means all work associated with the construction, reconstruction, demolition, repair or renovation of a building, structure or works, such as site preparation, excavation, erection, building, installation of equipment or materials, decoration and finishing, as well as drilling, mapping, satellite photography, seismic investigations and similar activities incidental to such work if they are provided pursuant to the procurement contract;

(e) "supplier or contractor" means, according to the context, any potential party or the party to a procurement contract with the procuring entity;

(f) "procurement contract" means a contract between the procuring entity and a supplier or contractor resulting from procurement proceedings;

(g) "tender security" means a security provided to the procuring entity to secure the fulfilment of any obligation referred to in article 30 (1) (f) and includes such arrangements as bank guarantees, surety bonds, stand-by letters of credit, cheques on which a bank is primarily liable, cash deposits, promissory notes and bills of exchange;

(h) "currency" includes monetary unit of account.

Article 3. International obligations of this State relating to procurement [and intergovernmental agreements within (this State)]

To the extent that this Law conflicts with an obligation of this State under or arising out of any

(a) treaty or other form of agreement to which it is a party with one or more other States,

(b) agreement entered into by this State with an intergovernmental international financing institution, or

(c) agreement between the federal Government of [name of federal State] and any

subdivision or subdivisions of [name of federal State], or between any two or more such subdivisions, the requirements of the treaty or agreement shall prevail; but in all other respects, the procurement shall be governed by this Law.

Article 4. Procurement regulations

The ... (the enacting State specifies the organ or authority authorized to promulgate the procurement regulations) is authorized to promulgate procurement regulations to fulfil the objectives and to carry out the provisions of this Law.

Article 5. Public accessibility of legal texts

The text of this Law, procurement regulations and all administrative rulings and directives of general application in connection with procurement covered by this Law, and all amendments thereof, shall be promptly made accessible to the public and systematically maintained.

Article 6. Qualifications of suppliers and contractors

(1) (a) This article applies to the ascertainment by the procuring entity of the qualifications of suppliers or contractors at any stage of the procurement proceedings.

(b) In order to participate in procurement proceedings, suppliers or contractors must qualify by meeting such of the following criteria as the procuring entity considers appropriate in the particular procurement proceedings:

(i) that they possess the technical competence, financial resources, equipment and other physical facilities, managerial capability, reliability, experience, and reputation, and the personnel, to perform the procurement contract;

(ii) that they have legal capacity to enter into the procurement contract;

(iii) that they are not insolvent, in receivership, bankrupt or being wound up, their affairs are not being administered by a court or a judicial officer, their business activities have not been suspended, and they are not the subject of legal proceedings for any of the foregoing;

(iv) that they have fulfilled their obligations to pay taxes and social security contributions in this State;

(v) that they have not, and their directors or officers have not, been

convicted of any criminal offence related to their professional conduct or the making of false statements or misrepresentations as to their qualifications to enter into a procurement contract within a period of ... years (the enacting State specifies the period of time) preceding the commencement of the procurement proceedings, or have not been otherwise disqualified pursuant to administrative suspension or disbarment proceedings.

(2) Subject to the right of suppliers or contractors to protect their intellectual property or trade secrets, the procuring entity may require suppliers or contractors participating in procurement proceedings to provide such appropriate documentary evidence or other information as it may deem useful to satisfy itself that the suppliers or contractors are qualified in accordance with the criteria referred to in paragraph (1) (b).

(3) Any requirement established pursuant to this article shall be set forth in the prequalification documents, if any, and in the solicitation documents or other documents for solicitation of proposals, offers or quotations, and shall apply equally to all suppliers or contractors. A procuring entity shall impose no criterion, requirement or procedure with respect to the qualifications of suppliers or contractors other than those provided for in this article.

(4) The procuring entity shall evaluate the qualifications of suppliers or contractors in accordance with the qualification criteria and procedures set forth in the prequalification documents, if any, and in the solicitation documents or other documents for solicitation of proposals, offers or quotations.

(5) Subject to articles 8 (1) and 32 (4) (d), the procuring entity shall establish no criterion, requirement or procedure with respect to the qualifications of suppliers or contractors that discriminates against or among suppliers or contractors or against categories thereof on the basis of nationality.

(6) (a) The procuring entity shall disqualify a supplier or contractor if it finds at any time that the information submitted concerning the qualifications of the supplier or contractor was false.

(b) A procuring entity may disqualify a supplier or contractor if it finds at any time that the information submitted concerning the qualifications of the supplier or contractor was materially inaccurate or materially incomplete.

(c) Other than in a case to which subparagraph (a) of this paragraph applies, a procuring entity may not disqualify a supplier or contractor on the ground that information submitted concerning the qualifications of the supplier or contractor was inaccurate or incomplete in a non-material respect. The supplier or contractor may be disqualified if it fails to remedy such deficiencies promptly upon request by the procuring entity.

Article 7. Prequalification proceedings

(1) The procuring entity may engage in prequalification proceedings with a view towards identifying, prior to the submission of tenders, proposals or offers in procurement proceedings conducted pursuant to chapter III or IV, suppliers and contractors that are qualified. The provisions of article 6 shall apply to prequalification proceedings.

(2) If the procuring entity engages in prequalification proceedings, it shall provide a set of prequalification documents to each supplier or contractor that requests them in accordance with the invitation to prequalify and that pays the price, if any, charged for those documents. The price that the procuring entity may charge for the prequalification documents shall reflect only the cost of printing them and providing them to suppliers or contractors.

(3) The prequalification documents shall include, at a minimum, the information required to be specified in the invitation to tender by article 23 (1) (a) to (e), (h) and, if already known, (j), as well as the following information:

(a) instructions for preparing and submitting prequalification applications;

(b) a summary of the principal required terms and conditions of the procurement contract to be entered into as a result of the procurement proceedings;

(c) any documentary evidence or other information that must be submitted by suppliers or contractors to demonstrate their qualifications;

(d) the manner and place for the submission of applications to prequalify and the deadline for the submission, expressed as a specific date and time and allowing sufficient time for suppliers or contractors to prepare and submit their applications, taking into account the reasonable needs of the procuring entity;

(e) any other requirements that may be established by the procuring entity in conformity with this Law and the procurement regulations relating to the preparation and submission of applications to prequalify and to the prequalification proceedings.

(4) The procuring entity shall respond to any request by a supplier or contractor for clarification of the prequalification documents that is received by the procuring entity within a reasonable time prior to the deadline for the submission of applications to prequalify. The response by the procuring entity shall be given within a reasonable time so as to enable the supplier or contractor to make a timely submission of its application to prequalify. The response to any request that might reasonably be expected to be of interest to other suppliers or contractors shall, without identifying the source of the request, be communicated to all suppliers or contractors to which the procuring entity provided the prequalification documents.

(5) The procuring entity shall make a decision with respect to the qualifications of each supplier or contractor submitting an application to prequalify. In reaching that decision, the procuring entity shall apply only the criteria set forth in the prequalification documents.

(6) The procuring entity shall promptly notify each supplier or contractor submitting an application to prequalify whether or not it has been prequalified and shall make available to any member of the general public, upon request, the names of all suppliers or contractors that have been prequalified. Only suppliers or contractors that have been prequalified are entitled to participate further in the procurement proceedings.

(7) The procuring entity shall upon request communicate to suppliers or contractors that have not been prequalified the grounds therefor, but the procuring entity is not required to specify the evidence or give the reasons for its finding that those grounds were present.

(8) The procuring entity may require a supplier or contractor that has been prequalified to demonstrate again its qualifications in accordance with the same criteria used to prequalify such supplier or contractor. The procuring entity shall disqualify any supplier or contractor that fails to demonstrate again its qualifications if requested to do so. The procuring entity shall promptly notify each supplier or contractor requested to demonstrate again its qualifications as to whether or not the supplier or contractor has done so to the satisfaction of the procuring entity.

Article 8. Participation by suppliers or contractors

(1) Suppliers or contractors are permitted to participate in procurement proceedings without regard to nationality, except in cases in which the procuring entity decides, on grounds specified in the procurement regulations or according to other provisions of law, to limit participation in procurement proceedings on the basis of nationality.

(2) A procuring entity that limits participation on the basis of nationality pursuant to paragraph (1) of this article shall include in the record of the procurement proceedings a statement of the grounds and circumstances on which it relied.

(3) The procuring entity, when first soliciting the participation of suppliers or contractors in the procurement proceedings, shall declare to them that they may participate in the procurement proceedings regardless of nationality, a declaration which may not later be altered. However, if it decides to limit participation pursuant to paragraph (1) of this article, it shall so declare to them.

Article 9. Form of communications

(1) Subject to other provisions of this Law and any requirement of form specified by the procuring entity when first soliciting the participation of suppliers or contractors in the procurement proceedings, documents, notifications, decisions and other communications referred to in this Law to be submitted by

the procuring entity or administrative authority to a supplier or contractor or by a supplier or contractor to the procuring entity shall be in a form that provides a record of the content of the communication.

(2) Communications between suppliers or contractors and the procuring entity referred to in articles 7 (4) and (6), 29 (2) (a), 30 (1) (d), 32 (1), 33 (3), 35 (1) and 37 (1) may be made by a means of communication that does not provide a record of the content of the communication provided that, immediately thereafter, confirmation of the communication is given to the recipient of the communication in a form which provides a record of the confirmation.

(3) The procuring entity shall not discriminate against or among suppliers or contractors on the basis of the form in which they transmit or receive documents, notifications, decisions or other communications.

Article 10. Rules concerning documentary evidence provided by suppliers or contractors

If the procuring entity requires the legalization of documentary evidence provided by suppliers or contractors to demonstrate their qualifications in procurement proceedings, the procuring entity shall not impose any requirements as to the legalization of the documentary evidence other than those provided for in the laws of this State relating to the legalization of documents of the type in question.

Article 11. Record of procurement proceedings

(1) The procuring entity shall maintain a record of the procurement proceedings containing, at a minimum, the following information:

(a) a brief description of the goods or construction to be procured, or of the procurement need for which the procuring entity requested proposals or offers;

(b) the names and addresses of suppliers or contractors that submitted tenders, proposals, offers or quotations, and the name and address of the supplier or contractor with whom the procurement contract is entered into and the contract price;

(c) information relative to the qualifications, or lack thereof, of suppliers or contractors that submitted tenders, proposals, offers or quotations;

(d) the price and a summary of the other principal terms and conditions of each tender, proposal, offer or quotation and of the procurement contract;

(e) a summary of the evaluation and comparison of tenders, proposals, offers or quotations, including the application of any margin of preference pursuant to article 32 (4) (d);

(f) if all tenders were rejected pursuant to article 33, a statement to that effect and the

grounds therefor, in accordance with article 33 (1);

(g) if, in procurement proceedings involving methods of procurement other than tendering, those proceedings did not result in a procurement contract, a statement to that effect and of the grounds therefor;

(h) the information required by article 13, if a tender, proposal, offer or quotation was rejected pursuant to that provision;

(i) in procurement proceedings involving methods of procurement other than tendering, the statement required under article 16 (2) of the grounds and circumstances on which the procuring entity relied to justify the selection of the method of procurement used;

(j) in procurement proceedings in which the procuring entity, in accordance with article 8 (1), limits participation on the basis of nationality, a statement of the grounds and circumstances relied upon by the procuring entity for imposing the limitation;

(k) a summary of any requests for clarification of the prequalification or solicitation documents, the responses thereto, as well as a summary of any modification of those documents.

(2) Subject to article 31 (3), the portion of the record referred to in subparagraphs (a) and (b) of paragraph (1) of this article shall, on request, be made available to any person after a tender, proposal, offer or quotation, as the case may be, has been accepted or after procurement proceedings have been terminated without resulting in a procurement contract.

(3) Subject to article 31 (3), the portion of the record referred to in subparagraphs (c) to (g), and (k), of paragraph (1) of this article shall, on request, be made available to suppliers or contractors that submitted tenders, proposals, offers or quotations, or applied for prequalification, after a tender, proposal, offer or quotation has been accepted or procurement proceedings have been terminated without resulting in a procurement contract. Disclosure of the portion of the record referred to in subparagraphs (c) to (e), and (k), may be ordered at an earlier stage by a competent court. However, except when ordered to do so by a competent court, and subject to the conditions of such an order, the procuring entity shall not disclose:

(a) information if its disclosure would be contrary to law, would impede law enforcement, would not be in the public interest, would prejudice legitimate commercial interests of the parties or would inhibit fair competition;

(b) information relating to the examination, evaluation and comparison of tenders, proposals, offers or quotations, and tender, proposal, offer or quotation prices, other than the summary referred to in paragraph (1) (e).

(4) The procuring entity shall not be liable to suppliers or contractors for damages owing solely to a failure to maintain a record of the procurement proceedings in accordance with the present article.

Article 12. Public notice of procurement contract awards

(1) The procuring entity shall promptly publish notice of procurement contract awards.

(2) The procurement regulations may provide for the manner of publication of the notice required by paragraph (1).

(3) Paragraph (1) is not applicable to awards where the contract price is less than [...].

Article 13. Inducements from suppliers or contractors

(Subject to approval by ... (the enacting State designates an organ to issue the approval),) a procuring entity shall reject a tender, proposal, offer or quotation if the supplier or contractor that submitted it offers, gives or agrees to give, directly or indirectly, to any current or former officer or employee of the procuring entity or other governmental authority a gratuity in any form, an offer of employment or any other thing of service or value, as an inducement with respect to an act or decision of, or procedure followed by, the procuring entity in connection with the procurement proceedings. Such rejection of the tender, proposal, offer or quotation and the reasons therefor shall be recorded in the record of the procurement proceedings and promptly communicated to the supplier or contractor.

Article 14. Rules concerning description of goods or construction

(1) Any specifications, plans, drawings and designs setting forth the technical or quality characteristics of the goods or construction to be procured, and requirements concerning testing and test methods, packaging, marking or labelling or conformity certification, and symbols and terminology, that create obstacles to participation, including obstacles based on nationality, by suppliers or contractors in the procurement proceedings shall not be included or used in the prequalification documents, solicitation documents or other documents for solicitation of proposals, offers or quotations.

(2) To the extent possible, any specifications, plans, drawings, designs and requirements shall be based on the relevant objective technical and quality characteristics of the goods or construction to be procured. There shall be no requirement of or reference to a particular trade mark, name, patent, design, type, specific origin or producer unless there is no other sufficiently precise or intelligible way of describing the characteristics of the goods or construction to be procured and provided that words such as "or equivalent" are included.

(3) (a) Standardized features, requirements, symbols and terminology relating to the technical and quality characteristics of the goods or construction to be procured shall be used, where available, in

formulating any specifications, plans, drawings and designs to be included in the prequalification documents, solicitation documents or other documents for solicitation or proposals, offers or quotations;

(b) due regard shall be had for the use of standardized trade terms, where available, in formulating the terms and conditions of the procurement contract to be entered into as a result of the procurement proceedings and in formulating other relevant aspects of the prequalification documents, solicitation documents or other documents for solicitation of proposals, offers or quotations.

Article 15. Language

The prequalification documents, solicitation documents and other documents for solicitation of proposals, offers or quotations shall be formulated in ... (the enacting State specifies its official language or languages) (and in a language customarily used in international trade except where:

> (a) the procurement proceedings are limited solely to domestic suppliers or contractors pursuant to article 8 (1), or
>
> (b) the procuring entity decides, in view of the low value of the goods or construction to be procured, that only domestic suppliers or contractors are likely to be interested).

CHAPTER II. METHODS OF PROCUREMENT AND THEIR CONDITIONS FOR USE

Article 16. Methods of procurement

(1) Except as otherwise provided by this chapter, a procuring entity engaging in procurement shall do so by means of tendering proceedings.

(2) A procuring entity may use a method of procurement other than tendering proceedings only pursuant to article 17, 18, 19 or 20, and, if it does, it shall include in the record required under article 11 a statement of the grounds and circumstances on which it relied to justify the use of that particular method of procurement.

Article 17. Conditions for use of two-stage tendering, request for proposals or competitive negotiation

(1) (Subject to approval by ... (the enacting State designates an organ to issue the approval),) a procuring entity may engage in procurement by means of two-stage tendering in accordance with article 36, or request for proposals in accordance with article 38, or competitive negotiation in accordance with article 39, in the following circumstances:

(a) it is not feasible for the procuring entity to formulate detailed specifications for the goods or construction and, in order to obtain the most satisfactory solution to its procurement needs,

(i) it seeks proposals as to various possible means of meeting its needs; or,

(ii) because of the technical character of the goods or construction, it is necessary for the procuring entity to negotiate with suppliers or contractors;

(b) when the procuring entity seeks to enter into a contract for the purpose of research, experiment, study or development leading to the procurement of a prototype, except where the contract includes the production of goods in quantities sufficient to establish their commercial viability or to recover research and development costs;

(c) when the procuring entity applies this Law, pursuant to article 1 (3), to procurement involving national defence or national security and determines that the selected method is the most appropriate method of procurement; or

(d) when tendering proceedings have been engaged in but no tenders were submitted or all tenders were rejected by the procuring entity pursuant to articles 13, 32 (3) or 33, and when, in the judgement of the procuring entity, engaging in new tendering proceedings would be unlikely to result in a procurement contract.

(2) (Subject to approval by ... (the enacting State designates an organ to issue the approval),) the procuring entity may engage in procurement by means of competitive negotiation also when:

(a) there is an urgent need for the goods or construction, and engaging in tendering proceedings would therefore be impractical, provided that the circumstances giving rise to the urgency were neither foreseeable by the procuring entity nor the result of dilatory conduct on its part; or,

(b) owing to a catastrophic event, there is an urgent need for the goods or construction, making it impractical to use other methods of procurement because of the time involved in using those methods.

Article 18. Conditions for use of restricted tendering

(Subject to approval by ... (the enacting State designates an organ to issue the approval),) the procuring entity may, where necessary for reasons of economy and efficiency, engage in procurement by means of restricted tendering in accordance with article 37, when:

(a) the goods or construction, by reason of their highly complex or specialized nature, are

available only from a limited number of suppliers or contractors; or

(b) the time and cost required to examine and evaluate a large number of tenders would be disproportionate to the value of the goods or construction to be procured.

Article 19. Conditions for use of request for quotations

(1) (Subject to approval by ... (the enacting State designates an organ to issue the approval),) a procuring entity may engage in procurement by means of a request for quotations in accordance with article 40 for the procurement of readily available goods that are not specially produced to the particular specifications of the procuring entity and for which there is an established market, provided that the estimated value of the procurement contract is less than the amount set forth in the procurement regulations.

(2) A procuring entity shall not divide its procurement into separate contracts for the purpose of invoking paragraph (1) of this article.

Article 20. Conditions for use of single-source procurement

(1) (Subject to approval by ... (the enacting State designates an organ to issue the approval),) a procuring entity may engage in single-source procurement in accordance with article 41 when:

(a) the goods or construction are available only from a particular supplier or contractor, or a particular supplier or contractor has exclusive rights in respect of the goods or construction, and no reasonable alternative or substitute exists;

(b) there is an urgent need for the goods or construction, and engaging in tendering proceedings would therefore be impractical, provided that the circumstances giving rise to the urgency were neither foreseeable by the procuring entity nor the result of dilatory conduct on its part;

(c) owing to a catastrophic event, there is an urgent need for the goods or construction, making it impractical to use other methods of procurement because of the time involved in using those methods;

(d) the procuring entity, having procured goods, equipment or technology from a supplier or contractor, determines that additional supplies must be procured from that supplier or contractor for reasons of standardization or because of the need for compatibility with existing goods, equipment or technology, taking into account the effectiveness of the original procurement in meeting the needs of the procuring entity, the limited size of the proposed procurement in relation to the original procurement, the reasonableness of the price and the unsuitability of alternatives to the goods in question;

(e) the procuring entity seeks to enter into a contract with the supplier or contractor for the purpose of research, experiment, study or development leading to the procurement of a prototype, except where the contract includes the production of goods in quantities to establish their commercial viability or to recover research and development costs; or

(f) the procuring entity applies this Law, pursuant to article 1 (3), to procurement involving national defence or national security and determines that single-source procurement is the most appropriate method of procurement.

(2) Subject to approval by ... (the enacting State designates an organ to issue the approval), and following public notice and adequate opportunity to comment, a procuring entity may engage in single-source procurement when procurement from a particular supplier or contractor is necessary in order to promote a policy specified in article 32 (4) (c) (iii), provided that procurement from no other supplier or contractor is capable of promoting that policy.

CHAPTER III. TENDERING PROCEEDINGS

SECTION I. SOLICITATION OF TENDERS AND OF APPLICATIONS TO PREQUALIFY

Article 21. Domestic tendering

In procurement proceedings in which

(a) participation is limited solely to domestic suppliers or contractors pursuant to article 8 (1), or

(b) the procuring entity decides, in view of the low value of the goods or construction to be procured, that only domestic suppliers or contractors are likely to be interested in submitting tenders, the procuring entity shall not be required to employ the procedures set out in articles 22 (2), 23 (1) (h), 23 (1) (i), 23 (2) (c), 23 (2) (d), 25 (j), 25 (k), 25 (s) and 30 (1) (c) of this Law.

Article 22. Procedures for soliciting tenders or applications to prequalify

(1) A procuring entity shall solicit tenders or, where applicable, applications to prequalify by causing an invitation to tender or an invitation to prequalify, as the case may be, to be published in ... (the enacting State specifies the official gazette or other official publication in which the invitation to tender or to prequalify is to be published).

(2) The invitation to tender or invitation to prequalify shall also be published, in a language customarily used in international trade, in a newspaper of wide international circulation or in a relevant trade publication or technical journal of wide international circulation.

Article 23. Contents of invitation to tender and invitation to prequalify

(1) The invitation to tender shall contain, at a minimum, the following information:

(a) the name and address of the procuring entity;

(b) the nature and quantity, and place of delivery, of the goods to be supplied or the nature and location of the construction to be effected;

(c) the desired or required time for the supply of the goods or for the completion of the construction;

(d) the criteria and procedures to be used for evaluating the qualifications of suppliers or contractors, in conformity with article 6 (1) (b);

(e) a declaration, which may not later be altered, that suppliers or contractors may participate in the procurement proceedings regardless of nationality, or a declaration that participation is limited on the basis of nationality pursuant to article 8 (1), as the case may be;

(f) the means of obtaining the solicitation documents and the place from which they may be obtained;

(g) the price, if any, charged by the procuring entity for the solicitation documents;

(h) the currency and means of payment for the solicitation documents;

(i) the language or languages in which the solicitation documents are available;

(j) the place and deadline for the submission of tenders.

(2) An invitation to prequalify shall contain, at a minimum, the information referred to in paragraph (1) (a) to (e), (g), (h) and, if it is already known, (j), as well as the following information:

(a) the means of obtaining the prequalification documents and the place from which they may be obtained;

(b) the price, if any, charged by the procuring entity for the prequalification documents;

(c) the currency and terms of payment for the prequalification documents;

(d) the language or languages in which the prequalification documents are available;

(e) the place and deadline for the submission of applications to prequalify.

Article 24. Provision of solicitation documents

The procuring entity shall provide the solicitation documents to suppliers or contractors in accordance with the procedures and requirements specified in the invitation to tender. If prequalification proceedings have been engaged in, the procuring entity shall provide a set of solicitation documents to each supplier or contractor that has been prequalified and that pays the price, if any, charged for those documents. The price that the procuring entity may charge for the solicitation documents shall reflect only the cost of printing them and providing them to suppliers or contractors.

Article 25. Contents of solicitation documents

The solicitation documents shall include, at a minimum, the following information:

(a) instructions for preparing tenders;

(b) the criteria and procedures, in conformity with the provisions of article 6, relative to the evaluation of the qualifications of suppliers or contractors and relative to the further demonstration of qualifications pursuant to article 32 (6);

(c) the requirements as to documentary evidence or other information that must be submitted by suppliers or contractors to demonstrate their qualifications;

(d) the nature and required technical and quality characteristics, in conformity with article 14, of the goods or construction to be procured, including, but not limited to, technical specifications, plans, drawings and designs as appropriate; the quantity of the goods; the location where the construction is to be effected; any incidental services to be performed; and the desired or required time, if any, when the goods are to be delivered or the construction is to be effected;

(e) the factors to be used by the procuring entity in determining the successful tender, including any margin of preference and any factors other than price to be used pursuant to article 32 (4) (b), (c) or (d) and the relative weight of such factors;

(f) the terms and conditions of the procurement contract, to the extent they are already known to the procuring entity, and the contract form, if any, to be signed by the parties;

(g) if alternatives to the characteristics of the goods, construction, contractual terms and conditions or other requirements set forth in the solicitation documents are permitted, a statement to that effect, and a description of the manner in which alternative tenders are to be evaluated and compared;

(h) if suppliers or contractors are permitted to submit tenders for only a portion of the goods or construction to be procured, a description of the portion or portions for which tenders may be submitted;

(i) the manner in which the tender price is to be formulated and expressed, including a statement as to whether the price is to cover elements other than the cost of the goods or construction themselves, such as transportation and insurance charges, customs duties and taxes;

(j) the currency or currencies in which the tender price is to be formulated and expressed;

(k) the language or languages, in conformity with article 27, in which tenders are to be prepared;

(l) any requirements of the procuring entity with respect to the issuer and the nature, form, amount and other principal terms and conditions of any tender security to be provided by suppliers or contractors submitting tenders, and any such requirements for any security for the performance of the procurement contract to be provided by the supplier or contractor that enters into the procurement contract, including securities such as labour and materials bonds;

(m) if a supplier or contractor may not modify or withdraw its tender prior to the deadline for the submission of tenders without forfeiting its tender security, a statement to that effect;

(n) the manner, place and deadline for the submission of tenders, in conformity with article 28;

(o) the means by which, pursuant to article 26, suppliers or contractors may seek clarifications of the solicitation documents, and a statement as to whether the procuring entity intends, at this stage, to convene a meeting of suppliers or contractors;

(p) the period of time during which tenders shall be in effect, in conformity with article 29;

(q) the place, date and time for the opening of tenders, in conformity with article 31;

(r) the procedures to be followed for opening and examining tenders;

(s) the currency that will be used for the purpose of evaluating and comparing tenders pursuant to article 32 (5) and either the exchange rate that will be used for the conversion of tenders into that currency or a statement that the rate published by a specified financial institution prevailing on a specified date will be used;

(t) references to this Law, the procurement regulations and other laws and regulations directly pertinent to the procurement proceedings, provided, however, that the omission of any such reference shall not constitute grounds for review under article 42 or give rise to liability on the part of the procuring entity;

(u) the name, functional title and address of one or more officers or employees of the procuring entity who are authorized to communicate directly with and to receive communications directly from suppliers or contractors in connection with the procurement proceedings, without the intervention of an intermediary;

(v) any commitments to be made by the supplier or contractor outside of the procurement contract, such as commitments relating to countertrade or to the transfer of technology;

(w) notice of the right provided under article 42 of this Law to seek review of an unlawful act or decision of, or procedure followed by, the procuring entity in relation to the procurement proceedings;

(x) if the procuring entity reserves the right to reject all tenders pursuant to article 33, a statement to that effect;

(y) any formalities that will be required once a tender has been accepted for a procurement contract to enter into force, including, where applicable, the execution of a written procurement contract pursuant to article 35, and approval by a higher authority or the Government and the estimated period of time following the dispatch of the notice of acceptance that will be required to obtain the approval;

(z) any other requirements established by the procuring entity in conformity with this Law and the procurement regulations relating to the preparation and submission of tenders and to other aspects of the procurement proceedings.

Article 26. Clarifications and modifications of solicitation documents

(1) A supplier or contractor may request a clarification of the solicitation documents from the procuring

entity. The procuring entity shall respond to any request by a supplier or contractor for clarification of the solicitation documents that is received by the procuring entity within a reasonable time prior to the deadline for the submission of tenders. The procuring entity shall respond within a reasonable time so as to enable the supplier or contractor to make a timely submission of its tender and shall, without identifying the source of the request, communicate the clarification to all suppliers or contractors to which the procuring entity has provided the solicitation documents.

(2) At any time prior to the deadline for submission of tenders, the procuring entity may, for any reason, whether on its own initiative or as a result of a request for clarification by a supplier or contractor, modify the solicitation documents by issuing an addendum. The addendum shall be communicated promptly to all suppliers or contractors to which the procuring entity has provided the solicitation documents and shall be binding on those suppliers or contractors.

(3) If the procuring entity convenes a meeting of suppliers or contractors, it shall prepare minutes of the meeting containing the requests submitted at the meeting for clarification of the solicitation documents, and its responses to those requests, without identifying the sources of the requests. The minutes shall be provided promptly to all suppliers or contractors to which the procuring entity provided the solicitation documents, so as to enable those suppliers or contractors to take the minutes into account in preparing their tenders.

SECTION II. SUBMISSION OF TENDERS

Article 27. Language of tenders

Tenders may be formulated and submitted in any language in which the solicitation documents have been issued or in any other language that the procuring entity specifies in the solicitation documents.

Article 28. Submission of tenders

(1) The procuring entity shall fix the place for, and a specific date and time as the deadline for, the submission of tenders.

(2) If, pursuant to article 26, the procuring entity issues a clarification or modification of the solicitation documents, or if a meeting of suppliers or contractors is held, it shall, prior to the deadline for the submission of tenders, extend the deadline if necessary to afford suppliers or contractors reasonable time to take the clarification or modification, or the minutes of the meeting, into account in their tenders.

(3) The procuring entity may, in its absolute discretion, prior to the deadline for the submission of tenders, extend the deadline if it is not possible for one or more suppliers or contractors to submit their tenders by the deadline owing to any circumstance beyond their control.

(4) Notice of any extension of the deadline shall be given promptly to each supplier or contractor to which the procuring entity provided the solicitation documents.

(5) (a) Subject to subparagraph (b), a tender shall be submitted in writing, signed and in a sealed envelope.

(b) Without prejudice to the right of a supplier or contractor to submit a tender in the form referred to in subparagraph (a), a tender may alternatively be submitted in any other form specified in the solicitation documents that provides a record of the content of the tender and at least a similar degree of authenticity, security and confidentiality.

(c) The procuring entity shall, on request, provide to the supplier or contractor a receipt showing the date and time when its tender was received.

(6) A tender received by the procuring entity after the deadline for the submission of tenders shall not be opened and shall be returned to the supplier or contractor that submitted it.

Article 29. Period of effectiveness of tenders; modification and withdrawal of tenders

(1) Tenders shall be in effect during the period of time specified in the solicitation documents.

(2) (a) Prior to the expiry of the period of effectiveness of tenders, the procuring entity may request suppliers or contractors to extend the period for an additional specified period of time. A supplier or contractor may refuse the request without forfeiting its tender security, and the effectiveness of its tender will terminate upon the expiry of the unextended period of effectiveness;

(b) Suppliers or contractors that agree to an extension of the period of effectiveness of their tenders shall extend or procure an extension of the period of effectiveness of tender securities provided by them or provide new tender securities to cover the extended period of effectiveness of their tenders. A supplier or contractor whose tender security is not extended, or that has not provided a new tender security, is considered to have refused the request to extend the period of effectiveness of its tender.

(3) Unless otherwise stipulated in the solicitation documents, a supplier or contractor may modify or withdraw its tender prior to the deadline for the submission of tenders without forfeiting its tender security. The modification or notice of withdrawal is effective if it is received by the procuring entity prior to the deadline for the submission of tenders.

Article 30. Tender securities

(1) When the procuring entity requires suppliers or contractors submitting tenders to provide a tender

security:

(a) the requirement shall apply to all such suppliers or contractors;

(b) the solicitation documents may stipulate that the issuer of the tender security and the confirmer, if any, of the tender security, as well as the form and terms of the tender security, must be acceptable to the procuring entity;

(c) notwithstanding the provisions of subparagraph (b) of this paragraph, a tender security shall not be rejected by the procuring entity on the grounds that the tender security was not issued by an issuer in this State if the tender security and the issuer otherwise conform to requirements set forth in the solicitation documents (, unless the acceptance by the procuring entity of such a tender security would be in violation of a law of this State);

(d) prior to submitting a tender, a supplier or contractor may request the procuring entity to confirm the acceptability of a proposed issuer of a tender security, or of a proposed confirmer, if required; the procuring entity shall respond promptly to such a request;

(e) confirmation of the acceptability of a proposed issuer or of any proposed confirmer does not preclude the procuring entity from rejecting the tender security on the ground that the issuer or the confirmer, as the case may be, has become insolvent or otherwise lacks creditworthiness;

(f) the procuring entity shall specify in the solicitation documents any requirements with respect to the issuer and the nature, form, amount and other principal terms and conditions of the required tender security; any requirement that refers directly or indirectly to conduct by the supplier or contractor submitting the tender shall not relate to conduct other than:

(i) withdrawal or modification of the tender after the deadline for submission of tenders, or before the deadline if so stipulated in the solicitation documents;

(ii) failure to sign the procurement contract if required by the procuring entity to do so;

(iii) failure to provide a required security for the performance of the contract after the tender has been accepted or to comply with any other condition precedent to signing the procurement contract specified in the solicitation documents.

(2) The procuring entity shall make no claim to the amount of the tender security, and shall promptly return, or procure the return of, the tender security document, after whichever of the following that

occurs earliest:

(a) the expiry of the tender security;

(b) the entry into force of a procurement contract and the provision of a security for the performance of the contract, if such a security is required by the solicitation documents;

(c) the termination of the tendering proceedings without the entry into force of a procurement contract;

(d) the withdrawal of the tender prior to the deadline for the submission of tenders, unless the solicitation documents stipulate that no such withdrawal is permitted.

SECTION III. EVALUATION AND COMPARISON OF TENDERS

Article 31. Opening of tenders

(1) Tenders shall be opened at the time specified in the solicitation documents as the deadline for the submission of tenders, or at the deadline specified in any extension of the deadline, at the place and in accordance with the procedures specified in the solicitation documents.

(2) All suppliers or contractors that have submitted tenders, or their representatives, shall be permitted by the procuring entity to be present at the opening of tenders.

(3) The name and address of each supplier or contractor whose tender is opened and the tender price shall be announced to those persons present at the opening of tenders, communicated on request to suppliers or contractors that have submitted tenders but that are not present or represented at the opening of tenders, and recorded immediately in the record of the tendering proceedings required by article 11.

Article 32. Examination, evaluation and comparison of tenders

(1) (a) The procuring entity may ask suppliers or contractors for clarifications of their tenders in order to assist in the examination, evaluation and comparison of tenders. No change in a matter of substance in the tender, including changes in price and changes aimed at making an unresponsive tender responsive, shall be sought, offered or permitted.

(b) Notwithstanding subparagraph (a) of this paragraph, the procuring entity shall correct purely arithmetical errors that are discovered during the examination of tenders. The procuring entity shall give prompt notice of any such correction to the supplier or

contractor that submitted the tender.

(2) (a) Subject to subparagraph (b) of this paragraph, the procuring entity may regard a tender as responsive only if it conforms to all requirements set forth in the tender solicitation documents.

(b) The procuring entity may regard a tender as responsive even if it contains minor deviations that do not materially alter or depart from the characteristics, terms, conditions and other requirements set forth in the solicitation documents or if it contains errors or oversights that are capable of being corrected without touching on the substance of the tender. Any such deviations shall be quantified, to the extent possible, and appropriately taken account of in the evaluation and comparison of tenders.

(3) The procuring entity shall not accept a tender:

(a) if the supplier or contractor that submitted the tender is not qualified;

(b) if the supplier or contractor that submitted the tender does not accept a correction of an arithmetical error made pursuant to paragraph (1) (b) of this article;

(c) if the tender is not responsive;

(d) in the circumstances referred to in article 13.

(4) (a) The procuring entity shall evaluate and compare the tenders that have been accepted in order to ascertain the successful tender, as defined in subparagraph (b) of this paragraph, in accordance with the procedures and criteria set forth in the solicitation documents. No criterion shall be used that has not been set forth in the solicitation documents.

(b) The successful tender shall be:

(i) the tender with the lowest tender price, subject to any margin of preference applied pursuant to subparagraph (d) of this paragraph; or

(ii) if the procuring entity has so stipulated in the solicitation documents, the lowest evaluated tender ascertained on the basis of factors specified in the solicitation documents, which factors shall, to the extent practicable, be objective and quantifiable, and shall be given a relative weight in the evaluation procedure or be expressed in monetary terms wherever practicable.

(c) In determining the lowest evaluated tender in accordance with subparagraph (b) (ii) of this paragraph, the procuring entity may consider only the following:

(i) the tender price, subject to any margin of preference applied pursuant to subparagraph (d) of this paragraph;

(ii) the cost of operating, maintaining and repairing the goods or construction, the time for delivery of the goods or completion of construction, the functional characteristics of the goods or construction, the terms of payment and of guarantees in respect of the goods or construction;

(iii) the effect that acceptance of a tender would have on the balance of payments position and foreign exchange reserves of [this State], the countertrade arrangements offered by suppliers or contractors, the extent of local content, including manufacture, labour and materials, in goods being offered by suppliers or contractors, the economic development potential offered by tenders, including domestic investment or other business activity, the encouragement of employment, the reservation of certain production for domestic suppliers, the transfer of technology and the development of managerial, scientific and operational skills [... (the enacting State may expand subparagraph (iii) by including additional factors)]; and

(iv) national defence and security considerations.

(d) If authorized by the procurement regulations, (and subject to approval by ... (the enacting State designates an organ to issue the approval),) in evaluating and comparing tenders a procuring entity may grant a margin of preference for the benefit of tenders for construction by domestic contractors or for the benefit of tenders for domestically produced goods. The margin of preference shall be calculated in accordance with the procurement regulations and reflected in the record of the procurement proceedings.

(5) When tender prices are expressed in two or more currencies, the tender prices of all tenders shall be converted to the same currency, and according to the rate specified in the solicitation documents pursuant to article 25 (s), for the purpose of evaluating and comparing tenders.

(6) Whether or not it has engaged in prequalification proceedings pursuant to article 7, the procuring entity may require the supplier or contractor submitting the tender that has been found to be the successful tender pursuant to paragraph (4) (b) of this article to demonstrate again its qualifications in accordance with criteria and procedures conforming to the provisions of article 6. The criteria and procedures to be used for such further demonstration shall be set forth in the solicitation documents. Where prequalification proceedings have been engaged in, the criteria shall be the same as those used in the prequalification proceedings.

(7) If the supplier or contractor submitting the successful tender is requested to demonstrate again its

qualifications in accordance with paragraph (6) of this article but fails to do so, the procuring entity shall reject that tender and shall select a successful tender, in accordance with paragraph (4) of this article, from among the remaining tenders, subject to the right of the procuring entity, in accordance with article 33 (1), to reject all remaining tenders.

(8) Information relating to the examination, clarification, evaluation and comparison of tenders shall not be disclosed to suppliers or contractors or to any other person not involved officially in the examination, evaluation or comparison of tenders or in the decision on which tender should be accepted, except as provided in article 11.

Article 33. Rejection of all tenders

(1) (Subject to approval by ... (the enacting State designates an organ to issue the approval), and) if so specified in the solicitation documents, the procuring entity may reject all tenders at any time prior to the acceptance of a tender. The procuring entity shall upon request communicate to any supplier or contractor that submitted a tender the grounds for its rejection of all tenders, but is not required to justify those grounds.

(2) The procuring entity shall incur no liability, solely by virtue of its invoking paragraph (1) of this article, towards suppliers or contractors that have submitted tenders.

(3) Notice of the rejection of all tenders shall be given promptly to all suppliers or contractors that submitted tenders.

Article 34. Prohibition of negotiations with suppliers or contractors

No negotiations shall take place between the procuring entity and a supplier or contractor with respect to a tender submitted by the supplier or contractor.

Article 35. Acceptance of tender and entry into force of procurement contract

(1) Subject to articles 32 (7) and 33, the tender that has been ascertained to be the successful tender pursuant to article 32 (4) (b) shall be accepted. Notice of acceptance of the tender shall be given promptly to the supplier or contractor submitting the tender.

(2) (a) Notwithstanding the provisions of paragraph (4) of this article, the solicitation documents may require the supplier or contractor whose tender has been accepted to sign a written procurement contract conforming to the tender. In such cases, the procuring entity (the requesting ministry) and the supplier or contractor shall sign the procurement contract within a reasonable period of time after the notice referred to in paragraph (1) of this article is dispatched to the supplier or contractor;

(b) Subject to paragraph (3) of this article, where a written procurement contract is required to be signed

pursuant to subparagraph (a) of this paragraph, the procurement contract enters into force when the contract is signed by the supplier or contractor and by the procuring entity. Between the time when the notice referred to in paragraph (1) of this article is dispatched to the supplier or contractor and the entry into force of the procurement contract, neither the procuring entity nor the supplier or contractor shall take any action that interferes with the entry into force of the procurement contract or with its performance.

(3) Where the solicitation documents stipulate that the procurement contract is subject to approval by a higher authority, the procurement contract shall not enter into force before the approval is given. The solicitation documents shall specify the estimated period of time following dispatch of the notice of acceptance of the tender that will be required to obtain the approval. A failure to obtain the approval within the time specified in the solicitation documents shall not extend the period of effectiveness of tenders specified in the solicitation documents pursuant to article 29 (1) or the period of effectiveness of tender securities that may be required pursuant to article 30 (1).

(4) Except as provided in paragraphs (2) (b) and (3) of this article, a procurement contract in accordance with the terms and conditions of the accepted tender enters into force when the notice referred to in paragraph (1) of this article is dispatched to the supplier or contractor that submitted the tender, provided that it is dispatched while the tender is in force. The notice is dispatched when it is properly addressed or otherwise directed and transmitted to the supplier or contractor, or conveyed to an appropriate authority for transmission to the supplier or contractor, by a mode authorized by article 9.

(5) If the supplier or contractor whose tender has been accepted fails to sign a written procurement contract, if required to do so, or fails to provide any required security for the performance of the contract, the procuring entity shall select a successful tender in accordance with article 32 (4) from among the remaining tenders that are in force, subject to the right of the procuring entity, in accordance with article 33 (1), to reject all remaining tenders. The notice provided for in paragraph (1) of this article shall be given to the supplier or contractor that submitted that tender.

(6) Upon the entry into force of the procurement contract and, if required, the provision by the supplier or contractor of a security for the performance of the contract, notice of the procurement contract shall be given to other suppliers or contractors, specifying the name and address of the supplier or contractor that has entered into the contract and the contract price.

CHAPTER IV. PROCEDURES FOR PROCUREMENT METHODS OTHER THAN TENDERING

Article 36. Two-stage tendering

(1) The provisions of chapter III of this Law shall apply to two-stage tendering proceedings except to the extent those provisions are derogated from in this article.

(2) The solicitation documents shall call upon suppliers or contractors to submit, in the first stage of the two-stage tendering proceedings, initial tenders containing their proposals without a tender price. The solicitation documents may solicit proposals relating to the technical, quality or other characteristics of the goods or construction as well as to contractual terms and conditions of their supply.

(3) The procuring entity may engage in negotiations with any supplier or contractor whose tender has not been rejected pursuant to articles 13, 32 (3) or 33 concerning any aspect of its tender.

(4) In the second stage of the two-stage tendering proceedings, the procuring entity shall invite suppliers or contractors whose tenders have not been rejected to submit final tenders with prices with respect to a single set of specifications. In formulating those specifications, the procuring entity may delete or modify any aspect, originally set forth in the solicitation documents, of the technical or quality characteristics of the goods or construction to be procured, and any criterion originally set forth in those documents for evaluating and comparing tenders and for ascertaining the successful tender, and may add new characteristics or criteria that conform with this Law. Any such deletion, modification or addition shall be communicated to suppliers or contractors in the invitation to submit final tenders. A supplier or contractor not wishing to submit a final tender may withdraw from the tendering proceedings without forfeiting any tender security that the supplier or contractor may have been required to provide. The final tenders shall be evaluated and compared in order to ascertain the successful tender as defined in article 32 (4) (b).

Article 37. Restricted tendering

(1) (a) When the procuring entity engages in restricted tendering on the grounds referred to in article 18 (a), it shall solicit tenders from all suppliers and contractors from whom the goods or construction to be procured are available.

(b) When the procuring entity engages in restricted tendering on the grounds referred to in article 18 (b), it shall select suppliers or contractors from whom to solicit tenders in a non-discriminatory manner and it shall select a sufficient number of suppliers or contractors to ensure effective competition.

(2) When the procuring entity engages in restricted tendering, it shall cause a notice of the restricted-tendering proceeding to be published in ... (each enacting State specifies the official gazette or other official publication in which the notice is to be published).

(3) The provisions of chapter III of this Law, except article 22, shall apply to restricted-tendering proceedings, except to the extent that those provisions are derogated from in this article.

Article 38. Request for proposals

(1) Requests for proposals shall be addressed to as many suppliers or contractors as practicable, but to at least three, if possible.

(2) The procuring entity shall publish in a newspaper of wide international circulation or in a relevant trade publication or technical journal of wide international circulation a notice seeking expression of interest in submitting a proposal, unless for reasons of economy or efficiency the procuring entity considers it undesirable to publish such a notice; the notice shall not confer any rights on suppliers or contractors, including any right to have a proposal evaluated.

(3) The procuring entity shall establish the criteria for evaluating the proposals and determine the relative weight to be accorded to each such criterion and the manner in which they are to be applied in the evaluation of the proposals. The criteria shall concern:

(a) the relative managerial and technical competence of the supplier or contractor;

(b) the effectiveness of the proposal submitted by the supplier or contractor in meeting the needs of the procuring entity; and

(c) the price submitted by the supplier or contractor for carrying out its proposal and the cost of operating, maintaining and repairing the proposed goods or construction.

(4) A request for proposals issued by a procuring entity shall include at least the following information:

(a) the name and address of the procuring entity;

(b) a description of the procurement need including the technical and other parameters to which the proposal must conform, as well as, in the case of procurement of construction, the location of any construction to be effected;

(c) the criteria for evaluating the proposal, expressed in monetary terms to the extent practicable, the relative weight to be given to each such criterion, and the manner in which they will be applied in the evaluation of the proposal; and

(d) the desired format and any instructions, including any relevant time-frames, applicable in respect of the proposal.

(5) Any modification or clarification of the request for proposals, including modification of the criteria for evaluating proposals referred to in paragraph (3) of this article, shall be communicated to all suppliers or contractors participating in the request-for-proposals proceedings.

(6) The procuring entity shall treat proposals in such a manner so as to avoid the disclosure of their contents to competing suppliers or contractors.

(7) The procuring entity may engage in negotiations with suppliers or contractors with respect to their proposals and may seek or permit revisions of such proposals, provided that the following conditions are satisfied:

(a) any negotiations between the procuring entity and a supplier or contractor shall be confidential;

(b) subject to article 11, one party to the negotiations shall not reveal to any other person any technical, price or other market information relating to the negotiations without the consent of the other party;

(c) the opportunity to participate in negotiations is extended to all suppliers or contractors that have submitted proposals and whose proposals have not been rejected.

(8) Following completion of negotiations, the procuring entity shall request all suppliers or contractors remaining in the proceedings to submit, by a specified date, a best and final offer with respect to all aspects of their proposals.

(9) The procuring entity shall employ the following procedures in the evaluation of proposals:

(a) only the criteria referred to in paragraph (3) of this article as set forth in the request for proposals shall be considered;

(b) the effectiveness of a proposal in meeting the needs of the procuring entity shall be evaluated separately from the price;

(c) the price of a proposal shall be considered by the procuring entity only after completion of the technical evaluation.

(10) Any award by the procuring entity shall be made to the supplier or contractor whose proposal best meets the needs of the procuring entity as determined in accordance with the criteria for evaluating the proposals set forth in the request for proposals, as well as with the relative weight and manner of application of those criteria indicated in the request for proposals.

Article 39. Competitive negotiation

(1) In competitive negotiation proceedings, the procuring entity shall engage in negotiations with a sufficient number of suppliers or contractors to ensure effective competition.

(2) Any requirements, guidelines, documents, clarifications or other information relative to the

negotiations that are communicated by the procuring entity to a supplier or contractor shall be communicated on an equal basis to all other suppliers or contractors engaging in negotiations with the procuring entity relative to the procurement.

(3) Negotiations between the procuring entity and a supplier or contractor shall be confidential, and, except as provided in article 11, one party to those negotiations shall not reveal to any other person any technical, price or other market information relating to the negotiations without the consent of the other party.

(4) Following completion of negotiations, the procuring entity shall request all suppliers or contractors remaining in the proceedings to submit, by a specified date, a best and final offer with respect to all aspects of their proposals. The procuring entity shall select the successful offer on the basis of such best and final offers.

Article 40. Request for quotations

(1) The procuring entity shall request quotations from as many suppliers or contractors as practicable, but from at least three, if possible. Each supplier or contractor from whom a quotation is requested shall be informed whether any elements other than the charges for the goods themselves, such as transportation and insurance charges, customs duties and taxes, are to be included in the price.

(2) Each supplier or contractor is permitted to give only one price quotation and is not permitted to change its quotation. No negotiations shall take place between the procuring entity and a supplier or contractor with respect to a quotation submitted by the supplier or contractor.

(3) The procurement contract shall be awarded to the supplier or contractor that gave the lowest-priced quotation meeting the needs of the procuring entity.

Article 41. Single-source procurement

In the circumstances set forth in article 20 the procuring entity may procure the goods or construction by soliciting a proposal or price quotation from a single supplier or contractor.

CHAPTER V. REVIEW*

Article 42. Right to review

(1) Subject to paragraph (2) of this article, any supplier or contractor that claims to have suffered, or that may suffer, loss or injury due to a breach of a duty imposed on the procuring entity by this Law may seek review in accordance with articles 43 to [47].

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* States enacting the Model Law may wish to incorporate the articles on review without change or with only such minimal changes as are necessary to meet particular important needs. However, because of constitutional or other considerations, States might not, to one degree or another, see fit to incorporate those articles. In such cases, the articles on review may be used to measure the adequacy of existing review procedures.

* * *

(2) The following shall not be subject to the review provided for in paragraph (1) of this article:

(a) the selection of a method of procurement pursuant to articles 16 to 20;

(b) the limitation of procurement proceedings in accordance with article 8 on the basis of nationality;

(c) a decision by the procuring entity under article 33 (1) to reject all tenders;

(d) a refusal by the procuring entity to respond to an expression of interest in participating in request-for-proposals proceedings pursuant to article 38 (2);

(e) an omission referred to in article 25 (t).

Article 43. Review by procuring entity (or by approving authority)

(1) Unless the procurement contract has already entered into force, a complaint shall, in the first instance, be submitted in writing to the head of the procuring entity. (However, if the complaint is based on an act or decision of, or procedure followed by, the procuring entity, and that act, decision or procedure was approved by an authority pursuant to this Law, the complaint shall instead be submitted to the head of the authority that approved the act, decision or procedure.) A reference in this Law to the head of the procuring entity (or the head of the approving authority) includes any person designated by the head of the procuring entity (or by the head of the approving authority, as the case may be).

(2) The head of the procuring entity (or of the approving authority) shall not entertain a complaint, unless it was submitted within 20 days of when the supplier or contractor submitting it became aware of the circumstances giving rise to the complaint or of when that supplier or contractor should have become aware of those circumstances, whichever is earlier.

(3) The head of the procuring entity (or of the approving authority) need not entertain a complaint, or

continue to entertain a complaint, after the procurement contract has entered into force.

(4) Unless the complaint is resolved by mutual agreement of the supplier or contractor that submitted it and the procuring entity, the head of the procuring entity (or of the approving authority) shall, within 30 days after the submission of the complaint, issue a written decision. The decision shall:

> (a) state the reasons for the decision; and
>
> (b) if the complaint is upheld in whole or in part, indicate the corrective measures that are to be taken.

(5) If the head of the procuring entity (or of the approving authority) does not issue a decision by the time specified in paragraph (4) of this article, the supplier or contractor submitting the complaint (or the procuring entity) is entitled immediately thereafter to institute proceedings under article [44 or 47]. Upon the institution of such proceedings, the competence of the head of the procuring entity (or of the approving authority) to entertain the complaint ceases.

(6) The decision of the head of the procuring entity (or of the approving authority) shall be final unless proceedings are instituted under article [44 or 47].

Article 44. Administrative review*

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* States where hierarchical administrative review of administrative actions, decisions and procedures is not a feature of the legal system may omit article 44 and provide only for judicial review (article 47).

* * *

(1) A supplier or contractor entitled under article 42 to seek review may submit a complaint to [insert name of administrative body]:

> (a) if the complaint cannot be submitted or entertained under article 43 because of the entry into force of the procurement contract, and provided that the complaint is submitted within 20 days after the earlier of the time when the supplier or contractor submitting it became aware of the circumstances giving rise to the complaint or the time when that supplier or contractor should have become aware of those circumstances;
>
> (b) if the head of the procuring entity does not entertain the complaint because the procurement contract has entered into force, provided that the complaint is submitted within 20 days after the issuance of the decision not to entertain the complaint;

(c) pursuant to article 43 (5), provided that the complaint is submitted within 20 days after the expiry of the period referred to in article 43 (4); or

(d) if the supplier or contractor claims to be adversely affected by a decision of the head of the procuring entity (or of the approving authority) under article 43, provided that the complaint is submitted within 20 days after the issuance of the decision.

(2) Upon receipt of a complaint, the [insert name of administrative body] shall give notice of the complaint promptly to the procuring entity (or to the approving authority).

(3) The [insert name of administrative body] may [grant] [recommend]** one or more of the following remedies, unless it dismisses the complaint:

** Optional language is presented in order to accommodate those States where review bodies do not have the power to grant the remedies listed below but can make recommendations.

* * *

(a) declare the legal rules or principles that govern the subject-matter of the complaint;

(b) prohibit the procuring entity from acting or deciding unlawfully or from following an unlawful procedure;

(c) require the procuring entity that has acted or proceeded in an unlawful manner, or that has reached an unlawful decision, to act or to proceed in a lawful manner or to reach a lawful decision;

(d) annul in whole or in part an unlawful act or decision of the procuring entity, other than any act or decision bringing the procurement contract into force;

(e) revise an unlawful decision by the procuring entity or substitute its own decision for such a decision, other than any decision bringing the procurement contract into force;

(f) require the payment of compensation for

<u>Option I</u>

any reasonable costs incurred by the supplier or contractor submitting the complaint in connection with the procurement

proceedings

Option II

loss or injury suffered by the supplier or contractor
submitting the complaint in connection with the procurement
proceedings

as a result of an unlawful act or decision of, or procedure followed by, the procuring entity;

(g) order that the procurement proceedings be terminated.

(4) The [insert name of administrative body] shall within 30 days issue a written decision concerning the complaint, stating the reasons for the decision and the remedies granted, if any.

(5) The decision shall be final unless an action is commenced under article 47.

Article 45. Certain rules applicable to review proceedings under article 43 [and article 44]

(1) Promptly after the submission of a complaint under article 43 [or article 44], the head of the procuring entity (or of the approving authority) [, or the [insert name of administrative body], as the case may be,] shall notify all suppliers or contractors participating in the procurement proceedings to which the complaint relates of the submission of the complaint and of its substance.

(2) Any such supplier or contractor or any governmental authority whose interests are or could be affected by the review proceedings has a right to participate in the review proceedings. A supplier or contractor that fails to participate in the review proceedings is barred from subsequently making the same type of claim.

(3) A copy of the decision of the head of the procuring entity (or of the approving authority) [, or of the [insert name of administrative body], as the case may be,] shall be furnished within five days after the issuance of the decision to the supplier or contractor submitting the complaint, to the procuring entity and to any other supplier or contractor or governmental authority that has participated in the review proceedings. In addition, after the decision has been issued, the complaint and the decision shall be promptly made available for inspection by the general public, provided, however, that no information shall be disclosed if its disclosure would be contrary to law, would impede law enforcement, would not be in the public interest, would prejudice legitimate commercial interests of the parties or would inhibit fair competition.

Article 46. Suspension of procurement proceedings

(1) The timely submission of a complaint under article 43 [or article 44] suspends the procurement

proceedings for a period of seven days, provided that the complaint is not frivolous and contains a declaration the contents of which, if proven, demonstrate that the supplier or contractor will suffer irreparable injury in the absence of a suspension, it is probable that the complaint will succeed and the granting of the suspension would not cause disproportionate harm to the procuring entity or to other suppliers or contractors.

(2) When the procurement contract enters into force, the timely submission of a complaint under article 44 shall suspend performance of the procurement contract for a period of seven days, provided the complaint meets the requirements set forth in paragraph (1) of this article.

(3) The head of the procuring entity (or of the approving authority) [, or the [insert name of administrative body],] may extend the suspension provided for in paragraph (1) of this article, [and the [insert name of administrative body] may extend the suspension provided for in paragraph (2) of this article,] in order to preserve the rights of the supplier or contractor submitting the complaint or commencing the action pending the disposition of the review proceedings, provided that the total period of suspension shall not exceed 30 days.

(4) The suspension provided for by this article shall not apply if the procuring entity certifies that urgent public interest considerations require the procurement to proceed. The certification, which shall state the grounds for the finding that such urgent considerations exist and which shall be made a part of the record of the procurement proceedings, is conclusive with respect to all levels of review except judicial review.

(5) Any decision by the procuring entity under this article and the grounds and circumstances therefor shall be made part of the record of the procurement proceedings.

Article 47. Judicial review

The [insert name of court or courts] has jurisdiction over actions pursuant to article 42 and petitions for judicial review of decisions made by review bodies, or of the failure of those bodies to make a decision within the prescribed time-limit, under article 43 [or 44].

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United Nations Commission on International Trade Law

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1993 - UNCITRAL Model Law on Procurement of Goods and Construction with Guide to Enactment

Related documents are available from:

- the tenth, eleventh, twelfth, thirteenth, fourteenth and fiftheenth sessions of Working Group V
- and from the nineteenth, twentieth, twenty-first, twenty-second, twenty-third, twenty-fourth, twenty-fifth session and twenty-sixth session sessions of the Commission.

Summary Records

of the United Nations Commission on International Trade Law for meetings devoted to the preparation of the UNCITRAL Model Law on Procurement of Goods and Construction and Guide to Enactment

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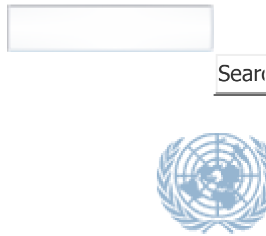

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509 th Meeting [A/CN.9/SR.509] - Article 11 *bis*: Consideration of draft Guide to Enactment (A/CN.9/375): introduction to the draft Guide and commentary on the Preamble, commentaries on Articles 1 - 8, commentary on Article 9

510 th Meeting [A/CN.9/SR.510] - Consideration of draft Guide to Enactment (continued): commentary on the Preamble, commentary on Article 1, commentary on Article 2, commentary on Article 3, commentary on Article 4, commentary on Articles 5 - 10

511 th Meeting [A/CN.9/SR.511] - Consideration of draft UNCITRAL model law on procurement of goods and construction (continued). Report of the drafting group (A/CN.9/XXVI/CRP.4): consideration of changes to Title, Preamble, Article 1, Article 2, Article 3, Article 6

512 th Meeting [A/CN.9/SR.512] - Consideration of draft UNCITRAL model law on procurement of goods and construction (continued). Report of the drafting group (continued): consideration of changes to commentary on Article 7, commentary on Article 9; Consideration of the draft Guide to Enactment (continued): commentary on Articles 11 to 37, introduction to the commentary on chapter V, articles 38 to 43, introduction to the draft Guide

513 th Meeting [A/CN.9/SR.513] - Consideration of the draft Guide to Enactment (continued): Consideration of draft UNCITRAL model law on procurement of goods and construction (continued). Report of the drafting group (A/CN.9/XXVI/CRP.4/Add.1-4) (continued): consideration of changes to Articles 11 to 17, 19, 21, 22, 6, 18, 25,

26, 27, 29, 31, 32, 34, 35, 36, 38; Arrangements for publication of the Model Law and Guide to Enactment

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United Nations Commission on International Trade Law

1987 - UNCITRAL Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works

Adopted by UNCITRAL on 14 August 1987, the Legal Guide discusses the many legal issues that arise in connection with the construction of industrial works, covering the pre-contractual, construction and post-construction phases, and suggests possible ways in which the parties may deal with these issues in their contracts.

General Assembly resolution

Text

Travaux préparatoires

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Considering that the question of the peaceful settlement of disputes should represent one of the central concerns for States and for the United Nations and that efforts for strengthening the process of peaceful settlement of disputes should be continued,

1. *Again urges* all States to observe and promote in good faith the provisions of the Manila Declaration on the Peaceful Settlement of International Disputes in the settlement of their international disputes;

2. *Stresses* the need to continue efforts to strengthen the process of the peaceful settlement of disputes through progressive development and codification of international law and through enhancing the effectiveness of the United Nations in this field;

3. *Calls upon* Member States to make full use, in accordance with the Charter, of the framework provided by the United Nations for the peaceful settlement of disputes and international problems;

4. *Requests* the Secretary-General to submit to the General Assembly at its forty-third session a report containing the replies of Member States, relevant United Nations bodies and specialized agencies, regional intergovernmental organizations and interested international legal bodies on the implementation of the Manila Declaration on the Peaceful Settlement of International Disputes and on ways and means of increasing the effectiveness of this instrument;

5. *Decides* that the question of the peaceful settlement of disputes between States shall be considered at its forty-third session as a separate agenda item, in conjunction with the item of the provisional agenda entitled "Report of the Special Committee on the Charter of the United Nations and on the Strengthening of the Role of the Organization".

94th plenary meeting
7 December 1987

42/151. Draft Code of Crimes against the Peace and Security of Mankind

The General Assembly,

Mindful of Article 13, paragraph 1 *a*, of the Charter of the United Nations, which provides that the General Assembly shall initiate studies and make recommendations for the purpose of encouraging the progressive development of international law and its codification,

Recalling its resolution 177 (II) of 21 November 1947, by which it directed the International Law Commission to prepare a draft code of offences against the peace and security of mankind,

Having considered the draft Code of Offences against the Peace and Security of Mankind prepared by the International Law Commission and submitted to the General Assembly in 1954,[11]

Recalling its belief that the elaboration of a code of offences against the peace and security of mankind could contribute to strengthening international peace and security and thus to promoting and implementing the purposes and principles set forth in the Charter,

Recalling also its resolution 36/106 of 10 December 1981, in which it invited the International Law Commission to resume its work with a view to elaborating the draft Code and to examine it with the required priority in order to review it, taking into account the results achieved by the process of the progressive development of international law,

Bearing in mind that the International Law Commission should fulfil its task on the basis of early elaboration of draft articles thereof,

Having considered chapter II of the report of the International Law Commission on the work of its thirty-ninth session,[12]

Taking note of the report of the Secretary-General on the subject,[13]

Taking into account the views expressed during the debate on this item at the forty-second session,[14]

Recognizing the importance and urgency of the subject,

1. *Agrees* with the recommendation in paragraph 65 of the report of the International Law Commission to amend the title of this topic in English, in order to achieve greater uniformity and equivalence between different language versions;

2. *Invites* the Commission to continue its work on the elaboration of the draft Code of Crimes against the Peace and Security of Mankind including the elaboration of a list of crimes, taking into account the progress made at its thirty-ninth session,[12] as well as the views expressed during the forty-second session of the General Assembly;[14]

3. *Requests* the Secretary-General to seek the views of Member States regarding the conclusions contained in paragraph 69 (*c*) (i) of the Commission's report on the work of its thirty-fifth session;[15]

4. *Further requests* the Secretary-General to include the views received from Member States in accordance with paragraph 3 above in a report to be submitted to the General Assembly at its forty-third session;

5. *Decides* to include in the provisional agenda of its forty-third session the item entitled "Draft Code of Crimes against the Peace and Security of Mankind", to be considered in conjunction with the examination of the report of the International Law Commission.

94th plenary meeting
7 December 1987

42/152. Report of the United Nations Commission on International Trade Law on the work of its twentieth session

The General Assembly,

Recalling its resolution 2205 (XXI) of 17 December 1966, by which it created the United Nations Commission on International Trade Law with a mandate to further the progressive harmonization and unification of the law of international trade and in that respect to bear in mind the interests of all peoples, in particular those of developing countries, in the extensive development of international trade,

Recalling also its resolutions 3201 (S-VI) of 1 May 1974, 3281 (XXIX) of 12 December 1974 and 3362 (S-VII) of 16 September 1975,

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[11] *Official Records of the General Assembly, Ninth Session, Supplement No. 9* (A/2693), para. 54.

[12] *Ibid., Forty-second Session, Supplement No. 10* (A/42/10).

[13] A/42/484 and Add.1 and 2.

[14] See *Official Records of the General Assembly, Forty-second Session, Sixth Committee*, 35th to 49th and 58th meetings, and corrigendum.

[15] *Ibid., Thirty-eighth Session, Supplement No. 10* (A/38/10).

Reaffirming its conviction that the progressive harmonization and unification of international trade law, in reducing or removing legal obstacles to the flow of international trade, especially those affecting the developing countries, would significantly contribute to universal economic co-operation among all States on a basis of equality, equity and common interest and to the elimination of discrimination in international trade and, thereby, to the well-being of all peoples,

Having regard for the need to take into account the different social and legal systems in harmonizing and unifying international trade law,

Stressing the value of participation by States at all levels of economic development, including developing countries, in the process of harmonizing and unifying international trade law,

Having considered the report of the United Nations Commission on International Trade Law on the work of its twentieth session,[16]

Considering that legally sound, balanced and equitable international contracts for the construction of industrial works are important for all countries,

Being of the opinion that the Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works adopted by the Commission at its twentieth session,[17] which identifies the legal issues to be dealt with in such contracts and suggests solutions to those issues, will be helpful to all parties in concluding such contracts,

Noting that the Convention on the Limitation Period in the International Sale of Goods, of 14 June 1974,[18] will come into force upon the deposit of one additional ratification or accession,

Being aware that the United Nations Convention on the Carriage of Goods by Sea, of 31 March 1978,[19] was prepared at the request of developing countries,

Being convinced that widespread adherence to the conventions emanating from the work of the Commission would benefit the peoples of all States,

1. *Takes note with appreciation* of the report of the United Nations Commission on International Trade Law on the work of its twentieth session;

2. *Commends* the Commission for the progress made in its work and for having reached decisions by consensus;

3. *Calls upon* the Commission to continue to take account of the relevant provisions of the resolutions concerning the new international economic order, as adopted by the General Assembly at its sixth[20] and seventh[21] special sessions;

4. *Reaffirms* the mandate of the Commission, as the core legal body within the United Nations system in the field of international trade law, to co-ordinate legal activities in this field in order to avoid duplication of effort and to promote efficiency, consistency and coherence in the unification and harmonization of international trade law, and, in this connection, recommends that the Commission, through its secretariat, should continue to maintain close co-operation with the other international organs and organizations, including regional organizations, active in the field of international trade law;

5. *Reaffirms also* the importance, in particular for developing countries, of the work of the Commission concerned with training and assistance in the field of international trade law and the desirability for it to sponsor seminars and symposia, in particular those organized on a regional basis, to promote such training and assistance, and, in this connection:

(*a*) Expresses its appreciation to those regional organizations and institutions which have collaborated with the secretariat of the Commission in organizing regional seminars and symposia in the field of international trade law;

(*b*) Welcomes the initiatives being undertaken by the Commission and its secretariat to collaborate with other organizations and institutions in the organization of regional seminars;

(*c*) Invites Governments, international organizations and institutions to assist the secretariat of the Commission in financing and organizing regional seminars and symposia, in particular in developing countries;

(*d*) Invites Governments, the relevant United Nations organs, organizations, institutions and individuals to make voluntary contributions to allow the resumption of the programme of the Commission for the award of fellowships on a regular basis to candidates from developing countries to enable them to participate in such seminars and symposia;

6. *Takes note with appreciation* of the completion by the Commission of the draft Convention on International Bills of Exchange and International Promissory Notes;[22]

7. *Notes with particular satisfaction* the completion and adoption by the Commission of the Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works;

8. *Recommends* that all efforts should be made so that the Legal Guide becomes generally known and available;

9. *Invites* those States which have not yet done so to consider ratifying or acceding to the following conventions:

(*a*) Convention on the Limitation Period in the International Sale of Goods, of 14 June 1974;[18]

(*b*) Protocol amending the Convention on the Limitation Period in the International Sale of Goods, of 11 April 1980;[23]

(*c*) United Nations Convention on the Carriage of Goods by Sea, of 31 March 1978;[19]

(*d*) United Nations Convention on Contracts for the International Sale of Goods, of 11 April 1980;[24]

10. *Requests* the Secretary-General to make increased efforts to promote the adoption and use of the texts emanating from the work of the Commission and to submit to the General Assembly at its forty-fourth session a report concerning the status of the conventions;

11. *Recommends* that the Commission should continue its work on the topics included in its programme of work;

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[16] *Ibid., Forty-second Session, Supplement No. 17* (A/42/17).

[17] *Ibid.*, chap. III, sect. A. The Legal Guide was subsequently issued as United Nations publication, Sales No. E.87.V.10.

[18] *Official Records of the United Nations Conference on Prescription (Limitation) in the International Sale of Goods, New York, 20 May-14 June 1974* (United Nations publication, Sales No. E.74.V.8), p. 101.

[19] *Official Records of the United Nations Conference on the Carriage of Goods by Sea, Hamburg, 6-31 March 1978* (United Nations publication, Sales No. E.80.VIII.1), document A/CONF.89/13, annex I.

[20] Resolutions 3201 (S-VI) and 3202 (S-VI).

[21] Resolution 3362 (S-VII).

[22] *Official Records of the General Assembly, Forty-second Session, Supplement No. 17* (A/42/17), annex I.

[23] *Official Records of the United Nations Conference on Contracts for the International Sale of Goods, Vienna, 10 March-11 April 1980* (United Nations publication, Sales No. E.82.V.5), p. 191.

[24] *Ibid.*, p. 178.

12. *Expresses its appreciation* for the important role played by the International Trade Law Branch of the Office of Legal Affairs of the Secretariat, as the substantive secretariat of the Commission, in assisting in the structuring and implementation of the work programme of the Commission, and invites the Secretary-General to consider taking whatever measures may be necessary, within existing resources, to provide the Commission with adequate substantive secretariat support.

94th plenary meeting
7 December 1987

42/153. Draft Convention on International Bills of Exchange and International Promissory Notes

The General Assembly,

Recalling its resolution 2205 (XXI) of 17 December 1966, by which it created the United Nations Commission on International Trade Law with the object of promoting the progressive harmonization and unification of the law of international trade,

Reaffirming its conviction that divergencies arising from the laws of different States in matters relating to international trade constitute one of the obstacles to the development of world trade,

Being aware that the Commission, at its fourth session in 1971, decided to proceed with work directed towards the preparation of uniform rules applicable to a special negotiable instrument for optional use in international transactions in order to overcome the divergencies arising out of the existence of two main systems of law governing negotiable instruments,[25]

Recalling that, in its resolution 41/77 of 3 December 1986, it requested the Commission to complete, at its twentieth session, the work on the draft Convention on International Bills of Exchange and International Promissory Notes[26] and decided to consider the draft Convention during its forty-second session with a view to its adoption or other appropriate action,

Taking note of the draft Convention adopted by the Commission at its twentieth session,[22]

Recognizing that Governments should be given sufficient time to study the draft Convention,

1. *Expresses its appreciation* for the work achieved by the United Nations Commission on International Trade Law in the preparation of the draft Convention on International Bills of Exchange and International Promissory Notes;

2. *Requests* the Secretary-General to draw the attention of all States to the draft Convention, to ask them to submit the observations and proposals they wish to make on the draft Convention before 30 April 1988 and to circulate these observations and proposals to all Member States before 30 June 1988;

3. *Decides* to consider, at its forty-third session, the draft Convention on International Bills of Exchange and International Promissory Notes, with a view to its adoption at that session, and to create to this end, in the framework of the Sixth Committee, a working group that will meet for a maximum period of two weeks at the beginning of the session, in order to consider the observations and proposals made by States.

94th plenary meeting
7 December 1987

[25] See *Official Records of the General Assembly, Twenty-sixth Session, Supplement No. 17* (A/8417), chap. III, sect. A.

[26] *Ibid., Forty-first Session, Supplement No. 17* (A/41/17), annex I.

42/154. Consideration of effective measures to enhance the protection, security and safety of diplomatic and consular missions and representatives

The General Assembly,

Having considered the report of the Secretary-General,[27]

Emphasizing the important role of diplomatic and consular missions and representatives, as well as of missions and representatives to international intergovernmental organizations and officials of such organizations, in the maintenance of international peace and the promotion of friendly relations among States, and also the need for enhancing global understanding thereof,

Convinced that respect for the principles and rules of international law governing diplomatic and consular relations, in particular those aimed at ensuring the inviolability of diplomatic and consular missions and representatives, is a basic prerequisite for the normal conduct of relations among States and for the fulfilment of the purposes and principles of the Charter of the United Nations,

Concerned at the continued failure to respect the inviolability of diplomatic and consular missions and representatives, and at the serious threat presented by such violations to the maintenance of normal and peaceful international relations, which are necessary for co-operation among States,

Also concerned at the abuse of diplomatic or consular privileges and immunities, particularly if acts of violence are involved,

Alarmed by the acts of violence against diplomatic and consular representatives, as well as against representatives to international intergovernmental organizations and officials of such organizations, which endanger or take innocent lives and seriously impede the normal work of such representatives and officials,

Expressing its sympathy for the victims of such illegal acts,

Emphasizing the duty of States to take all appropriate steps, as required by international law:

(*a*) To protect the premises of diplomatic and consular missions, as well as of missions to international intergovernmental organizations,

(*b*) To prevent any attacks on diplomatic and consular representatives, as well as on representatives to international intergovernmental organizations and officials of such organizations,

(*c*) To apprehend the offenders and to bring them to justice,

Noting that, in spite of the call by the General Assembly at its previous sessions, not all States have yet become parties to the relevant conventions concerning the inviolability of diplomatic and consular missions and representatives,

Welcoming the measures already taken by States in conformity with their international obligations to enhance the

[27] A/42/485 and Add.1-5 and Add.5/Corr.1.

UNCITRAL

Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works

Prepared by
the United Nations Commission on International Trade Law
(UNCITRAL)

UNITED NATIONS
New York, 1988

NOTE

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Foreword

This *Guide* was drafted within the Working Group on the New International Economic Order of the United Nations Commission on International Trade Law (UNCITRAL), which is composed of all 36 member States of UNCITRAL. Representatives of many other States and international organizations attended sessions of the Working Group as observers and participated actively in the work on the *Guide*. Mr. Leif Sevon of Finland served as chairman of all sessions of the Working Group devoted to the drafting of the *Guide*. In drafting chapters for consideration by the Working Group, the Secretariat consulted with practioners and other experts in the field of international works contracts. In addition, it consulted numerous sources, including publications, articles and other textual materials, as well as model forms of contract, general conditions of contract and actual contracts between parties. Such sources are too numerous to be able to acknowledge them individually; however, recognition is hereby given to their contribution in the preparation of the *Guide*.

After being approved by the Working Group, the *Guide* was finalized and adopted by UNCITRAL at its twentieth session in August 1987 by the following resolution:

"*The United Nations Commission on International Trade Law,*

"*Recalling* its mandate under General Assembly resolution 2205 (XXI) of 17 December 1966 to further the progressive harmonization and unification of the law of international trade, and in that respect to bear in mind the interests of all peoples, and in particular those of developing countries, in the extensive development of international trade,

"*Taking into consideration* the resolutions adopted by the General Assembly on economic development and the establishment of the new international economic order,

"*Considering* that legally sound, balanced and equitable international contracts for the construction of industrial works are important for all countries, and in particular for developing countries,

"*Being of the opinion* that a legal guide on drawing up international contracts for the construction of industrial works, identifying the legal issues to be dealt with in such contracts and suggesting solutions of those issues, will be helpful to all parties, in particular those from developing countries, in concluding such contracts,

"1. *Adopts* the UNCITRAL Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works;

"2. *Invites* the General Assembly to recommend the use of the Legal Guide by persons involved in drawing up international contracts for the construction of industrial works;

"3. *Requests* the Secretary-General to take effective measures for the widespread distribution and promotion of the use of the Legal Guide."*

Readers may wish to communicate to the Secretariat, at the address below, their comments on the use of the *Guide*, and suggestions as to matters to be taken into consideration when the *Guide* is reissued at an appropriate time in the future.

UNCITRAL Secretariat
Vienna International Centre
P. O. Box 500
A-1400 Vienna, Austria

*Report of the United Nations Commission on International Trade Law on the work of its twentieth session, *Official Records of the General Assembly, Forty-second Session, Supplement No. 17* (A/42/17), para. 315.

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Introduction

A. Origin, purpose and approach of the *Guide*

1. In 1974 and 1975, the United Nations General Assembly adopted a number of resolutions dealing with economic development and the establishment of a new international economic order.[1] As one of the organs of the United Nations, UNCITRAL was called upon by the General Assembly to take account of the relevant provisions of those resolutions. It responded by including in its programme of work the topic of the legal implications of the new international economic order,[2] and considered how, having regard to its special expertise, and within the context of its mandate, it could most effectively advance the objectives set forth in the General Assembly resolutions. In doing so, it also took into account a recommendation of the Asian-African Legal Consultative Committee (AALCC) that the Commission should deal with the topic.[3]

2. To assist it in defining the nature and scope of possible work in this area, in 1978 the Commission established a Working Group on the New International Economic Order and charged it with the task of making recommendations as to specific topics which could appropriately form part of the programme of work of the Commission.[4] The Working Group reported to the Commission its conclusion that a study of contractual provisions commonly occurring in international industrial development contracts would be of special importance to developing countries, in view of the role of industrialization in the process of economic development.[5] Based upon the discussions and conclusions of the Working Group, the Commission decided in 1980 to accord priority to work related to contracts in the field of industrial development. In 1981 it instructed the Working Group to prepare a *Legal Guide on Drawing up International Contracts for the Construction of Industrial Works*.[6]

3. Contracts for the construction of industrial works are typically of great complexity, with respect both to the technical aspects of the construction and to the legal relationships between the parties. The obligations to be performed by contractors under these contracts normally extend over a relatively long period of time, often several years. In these and other ways, contracts for the construction of industrial works differ in important respects from traditional contracts for the sale of goods or the supply of services. Consequently, rules of law drafted to govern sales or services contracts may not settle in an appropriate manner many issues arising in contracts for the construction of industrial works. It may be desirable or advisable for the parties to settle these issues through contract provisions.

4. The preparation of the *Guide* was largely motivated by an awareness that the complexities and technical nature of this field often make it difficult for purchasers of industrial works, particularly those from developing countries, to acquire the necessary information and expertise required to draw up

appropriate contracts. The *Guide* has therefore been designed to be of particular benefit to those purchasers, while seeking at the same time to take account of the legitimate interests of contractors.

5. The *Guide* seeks to assist parties in negotiating and drawing up international contracts for the construction of industrial works by identifying the legal issues involved in those contracts, discussing possible approaches to the solution of the issues, and, where appropriate, suggesting solutions which the parties may wish to incorporate in their contract. The discussion in the *Guide* and the suggested solutions are written in the light of the differences between the various legal systems in the world. It is hoped that one result of the *Guide* will be to promote the development of an international common understanding as to the identification and resolution of issues arising in connection with those contracts.

6. As conceived in the *Guide*, an industrial works is an installation which incorporates one or more major pieces of equipment and a technological process to produce an output. Examples of industrial works include petrochemical plants, fertilizer plants and hydroelectric plants. The *Guide* deals with contracts in which the contractor assumes the obligation to supply to the purchaser equipment and materials to be incorporated in the works, and either to install the equipment or to supervise such installation by others. For brevity, these contracts are referred to in the *Guide* as "works contracts". In addition to the obligations just mentioned, which are the essence of a works contract, a contractor often assumes other important obligations, such as the design of the works, the transfer of technology, and the training of the purchaser's personnel. Works contracts may therefore be distinguished from other types of contracts from which one or more of the elements mentioned above are absent, for example, contracts exclusively for building or for civil engineering.

7. The term "works contract" is used in the *Guide* merely to indicate the type of contract to which the discussion in the *Guide* is directed, rather than to delimit precisely the scope of application of the *Guide*. Although certain parts of the discussion in the *Guide* may be irrelevant to or inappropriate for contracts other than works contracts (for example, the discussion of performance tests in chapter XII, "Inspections and tests during manufacture and construction", may be irrelevant for contracts exclusively for building), persons involved in the negotiation and drafting of contracts other than works contracts may also derive some assistance from the *Guide*.

8. The *Guide* has been designed to be of use to persons involved at various levels in negotiating and drawing up works contracts. It is intended for use by lawyers representing the parties, as well as non-legal staff of and advisers to the parties (e.g., engineers) who participate in the negotiation and drawing up of the contracts. The *Guide* is also intended to be of assistance to persons who have overall managerial responsibility for the conclusion of works contracts, and who require a broad awareness of the structure of those contracts and the principal legal issues to be covered by them. Such persons may include, for example, high-level officials of a Government ministry under the auspices of which the works is being constructed. It is emphasized, however, that the *Guide* should not be regarded by the parties as a substitute for obtaining legal and technical advice and services from competent professional advisers.

9. The *Guide* does not have an independent juridical status; it is intended merely to assist parties in negotiating and drafting their contract. The various

solutions to issues discussed in the *Guide* will not govern the relationship between the parties unless they expressly agree upon such solutions and provide for them in the contract, or unless the solutions result from legal rules under the applicable system of law. In addition, the *Guide* is intended only to assist the parties in negotiating and drafting their contract; it is not intended to be used for interpreting contracts entered into before or after its publication.

B. Arrangement of the *Guide*

10. The *Guide* is arranged in two parts. Part one deals with certain matters arising prior to the time when the contract is drawn up. These include the identification of the project and its parameters through pre-contract studies (chapter I); the various contracting approaches which the parties may adopt (chapter II); the possible procedures for concluding the contract (i.e., tendering, or negotiation without prior tendering), and the form and validity of the contract (chapter III). The discussion of these subjects has two aims: to direct the attention of the parties to important matters which they should consider prior to commencing to negotiate and draw up a works contract, and to provide a setting for the discussion of the legal issues involved in the contract.

11. Particular notice may be taken of the discussion in chapter II, "Choice of contracting approach". The settlement of certain issues in the contract may depend upon the contracting approach which is adopted by the parties. Throughout the *Guide*, whenever appropriate, the discussion points out that different situations or solutions may apply under different contracting approaches.

12. Part two of the *Guide* deals with the drawing up of specific provisions of a works contract. It discusses the issues to be addressed in those provisions and in many cases suggests approaches to the treatment of those issues (see paragraph 16, below). Part two is thus the core of the *Guide*. Each chapter in part two deals with a particular issue which may be addressed in a works contract. To the extent possible, the chapters have been arranged in the order in which the issues dealt with in those chapters are frequently addressed in works contracts.

13. An analytical index is included at the end of the *Guide*. This, in addition to serving the usual functions of an index, has been designed in particular to enable the reader to locate the meanings of terminology used in the *Guide*. Where terms are expressly defined in chapters of the *Guide*, the index refers the reader to those definitions. In some cases, however, terms do not lend themselves to concise definitions; rather, the significance and scope of the terms must be gained from the entire chapters in which they are discussed. In those cases, the reader will be assisted by the index in locating the various aspects of the discussions relating to the terms.

C. Chapter summaries

14. Each chapter of the *Guide* is preceded by a summary. The summaries are designed to serve the needs of non-legal management or other personnel who need to be aware of the principal issues covered by a particular type of contract

clause, but who do not require a discussion of the issues in the depth or detail contained in the main text of a chapter. Those readers might obtain information which they require about the settlement of issues arising in the contract as a whole or in particular types of clauses by reading the summaries alone. To assist such readers who find that they would like further information on particular points, cross-references are provided to paragraphs in the main text of the chapter where points referred to in the summary are discussed. Persons directly involved in drawing up works contracts, for whom the main text of each chapter is principally designed, might find that reading the summaries provides a useful overview of the subject-matter and issues covered by each chapter. They might also use the summaries as a check-list of issues to be addressed in negotiating and drawing up contractual provisions.

D. "General remarks"

15. The main text of each chapter begins with a section entitled "General remarks". This is intended to serve as an introduction to the subject-matter of the chapter, and to cover certain matters which are applicable to the chapter as a whole so as to avoid repeating them in each section of the chapter where they are relevant. In some cases, the section also deals with points which do not easily fit elsewhere within the structure of the chapter. The section often refers readers to the other chapters where related issues are discussed.

E. Recommendations made in the *Guide*

16. Where appropriate, the *Guide* contains suggestions as to ways in which certain issues in a works contract might be settled. Three levels of suggestion are used. The highest level is indicated by a statement to the effect that the parties "should" take a particular course of action. It is used only when that course of action is a logical necessity or is legally mandated. This level is used sparingly in the *Guide*. An intermediate level is used when it is "advisable" or "desirable", but not logically or legally required, that the parties adopt a particular course of action. A formulation such as "the parties may wish to provide", "the parties may wish to consider", or the contract "might" contain a particular provision, is used for the lowest level of suggestion. Occasionally, the wording used to denote a particular level of suggestion is, for editorial reasons, varied somewhat from that just indicated; however, it should be clear from that wording which level is intended.

F. Illustrative provisions

17. Some chapters contain one or more "illustrative provisions" set forth in footnotes. They are included in order to make issues discussed in the text of a chapter easier to understand. They also serve to illustrate how certain solutions discussed in the text might be structured, particularly those that are complex or may otherwise present difficulties in drafting. It is emphasized, however, that illustrative provisions should not necessarily be regarded as models of provisions that should be included in particular contracts. The precise content of a clause and language to be used in it may vary with each contract. In

addition, there is usually more than one possible solution to an issue, even though only one of those possible solutions is presented in an illustrative provision. The illustrative provisions have been designed to fit within the overall scheme followed and approaches taken in the *Guide*. It is therefore important that parties who draft a provision for their contract based upon an illustrative provision carefully consider whether the provision fits harmoniously within their own contract. In general, illustrative provisions have not been included where an understanding of an issue and guidance to drafting is clearly obtainable from the text of the chapter, or where a provision dealing with an issue cannot be drafted in isolation from the particular contract in which it is to appear.

Footnotes to Introduction

[1]See Charter of Economic Rights and Duties of States, General Assembly resolution 3281 (XXIX), *Official Records of the General Assembly, Twenty-ninth Session, Supplement No. 31* (A/9631); also, Resolutions adopted by the General Assembly during its sixth special session, *Official Records of the General Assembly, Sixth Special Session, Supplement No. 1* (A/9559); Resolutions adopted by the General Assembly during its seventh special session, *Official Records of the General Assembly, Seventh Special Session, Supplement No. 1* (A/10301).

[2]Report of the United Nations Commission on International Trade Law on the work of its eleventh session, *Official Records of the General Assembly, Thirty-third Session, Supplement No. 17* (A/33/17), paras. 67(c)(vi), 68, 69 (*Yearbook of the United Nations Commission on International Trade Law* (hereinafter referred to as *UNCITRAL Yearbook*), Volume IX: 1978, Part One, II, A, paras. 67(c)(vi), 68, 69 (United Nations publication, Sales No. E.80.V.8)).

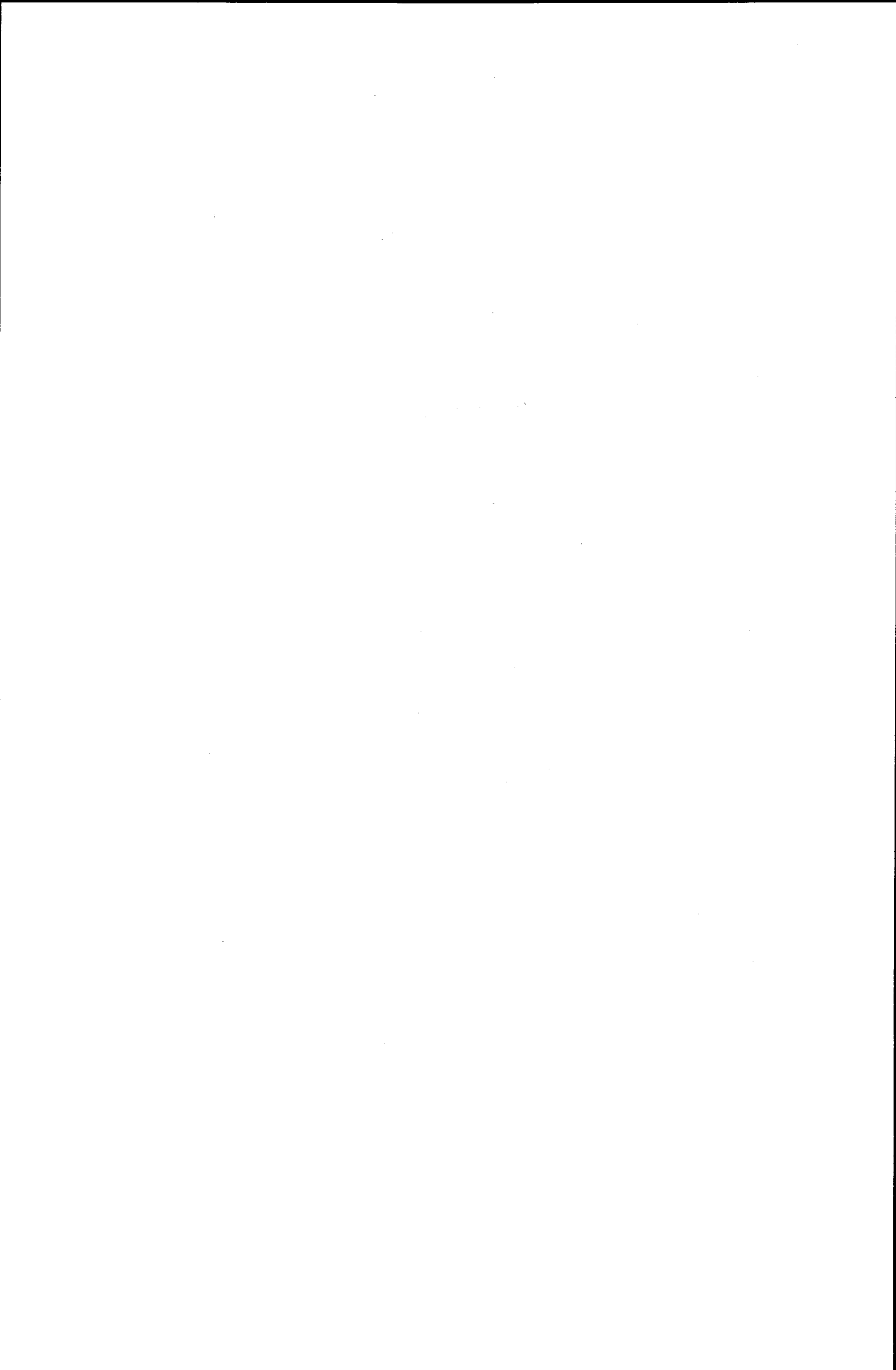
[3]This recommendation is set forth in Recommendations of the Asian-African Legal Consultative Committee: note by the Secretary-General, A/CN.9/155, Annex (*UNCITRAL Yearbook*, Volume IX: 1978, Part Two, IV, B); see, also, *Legal Implications of the New International Economic Order: Note by the Secretariat*, A/CN.9/194 (*UNCITRAL Yearbook*, Volume XI: 1980, Part Two, V, D (United Nations publication, Sales No. E.81.V.8)).

[4]Report of the United Nations Commission on International Trade Law on the work of its eleventh session, fn. 3, above, para. 71; Report of the United Nations Commission on International Trade Law on the work of its twelfth session, *Official Records of the General Assembly, Thirty-fourth Session, Supplement No. 17* (A/34/17), para. 100 (*UNCITRAL Yearbook*, Volume X: 1979, Part One, II, A, para. 100 (United Nations publication, Sales No. E.81.V.2)).

[5]Report of the Working Group on the New International Economic Order on the work of its session, A/CN.9/176, paras. 31 and 32 (*UNCITRAL Yearbook*, Volume XI: 1980, Part Two, V, A, paras. 31 and 32).

[6]Report of the United Nations Commission on International Trade Law on the work of its fourteenth session *Official Records of the General Assembly, Thirty-sixth Session, Supplement No. 17* (A/36/17), para. 84 (*UNCITRAL Yearbook*, Volume XII: 1981, Part One, A, para. 84 (United Nations publication, Sales No. E.82.V.6)).

Part One



Chapter I. Pre-contract studies

SUMMARY

Pre-contract studies assist the purchaser in deciding whether to proceed with an industrial works project and in determining the nature and scope of the works. They are in most cases carried out by or on behalf of the purchaser (paragraphs 1 to 5).

Pre-contract studies may include opportunity studies (paragraph 6), preliminary feasibility studies (paragraphs 7 and 8), feasibility studies (paragraphs 9 to 11) and detailed studies (paragraph 12).

If the purchaser does not have within his own staff the expertise necessary to perform the pre-contract studies, he may wish to consider engaging an outside consulting firm in which he has confidence. The consulting firm may be selected by means of selection procedures designed to promote competition among prospective consulting firms (paragraph 13).

As a general proposition, the pre-contract studies should not be conducted by a firm which may be engaged as a contractor to construct the works, due to the potential of a conflict of interest; although in some highly specialized fields it may be necessary for the studies to be conducted by a potential contractor. However, it may be acceptable to the purchaser for the firm which conducted the pre-contract studies merely to supervise the construction of the works by other firms (paragraphs 14 and 15).

On the other hand, in some cases it may be advantageous to the purchaser for the firm which performs the pre-contract studies to be engaged subsequently to supply the design or to serve as the consulting engineer in connection with the construction. However, the purchaser may wish to consider the possibility of a conflict of interest in that case (paragraph 16).

A. General remarks

1. A purchaser contemplating investment in an industrial works will have to acquire and analyse a large amount of technical, commercial, financial and other information in order to be able to decide whether to proceed with the investment, and to determine the nature and scope of the works. That information is acquired and analysed in the context of one or more studies, referred to in the *Guide* as "pre-contract studies".[1] Pre-contract studies are in most cases carried out by or on behalf of the purchaser. Sometimes, however, they are carried out by the contractor (see paragraph 15, below). In some countries, particularly those in the process of industrialization, pre-contract studies may also constitute an element of the country's overall planning process by enabling the authorities to compare and evaluate various potential industrial projects in order to determine national investment priorities.

2. Pre-contract studies are not only essential decision-making tools for the purchaser, they are often required by lending institutions which provide financing for the construction of industrial works. Those institutions sometimes even participate in or carry out pre-contract studies themselves.

3. A party who performs or procures pre-contract studies should make available to the other party information derived from those studies. The works contract may deal with the responsibility of the party who makes the information available for the accuracy and sufficiency of that information. Contractual provisions in this regard are discussed in chapter VII, "Price and payment conditions", paragraph 43.

4. Purchasers may note that it is not necessarily desirable to reduce costs by restricting the scope of pre-contract studies. To do so could result in insufficient or misleading information, and contribute to an unwise investment decision, or necessitate varying the design of the works or construction methods during construction in order to conform to circumstances which were not known or were erroneously forecast. This could ultimately result in greater cost to the purchaser.

5. Pre-contract studies are often carried out in stages, the results of the study in one stage providing the basis for a decision whether to proceed to the study in the next stage and serving as the foundation for that study. The nature and sequence of those studies are typically as set forth in the following paragraphs.

B. Opportunity studies

6. Opportunity studies are often carried out by or on behalf of countries in the process of industrialization, and are a valuable source of information to purchasers. They are designed to identify potential investment opportunities within the country to be pursued either by the Government itself or to be proposed to potential independent investors in investment promotion programmes. The studies may explore, for example, various possibilities for constructing works to manufacture a particular product which the Government is interested in producing locally, and the potential market for the product. They may explore possibilities for constructing works to make use of locally available resources or to promote industrialization in a particular region. Opportunity studies usually deal only with the principal economic and technical aspects of various potential investment opportunities, without attempting to define the parameters of a particular project in detail. Certain international organizations will assist countries in the performance or procurement of opportunity studies; in some countries they are performed by governmental organs.

C. Preliminary feasibility studies

7. When the purchaser has begun to focus upon a particular project, he will engage in studies aimed at ascertaining the technical and financial viability of the project. Full-scale feasibility studies (discussed in paragraphs 9 to 11, below) are often costly; in some cases, therefore, the purchaser may wish to engage in a preliminary feasibility study in order to determine whether a full-scale feasibility study is warranted.

8. The preliminary feasibility study should enable the purchaser to determine on a general basis the viability of the project. It will often investigate many of the same matters and address many of the same issues as does the feasibility study (see paragraph 10, below), although in less detail. The preliminary feasibility study will often enable the purchaser to evaluate various options concerning the scope and the manner of execution of the project. It may also point out particular matters requiring more detailed investigation and help to determine the nature of investigations and tests to be conducted within the context of the feasibility study. On the basis of the findings of the preliminary feasibility study the purchaser might approach potential sources of financing for the project. The purchaser may wish to do so at that stage, and prior to the full-scale feasibility study, because some lenders wish to have their terms of reference incorporated in the feasibility study, and sometimes to have their own experts involved in that study.

D. Feasibility studies

9. The feasibility study should be designed so as to provide the purchaser with the information which he needs in order to decide whether to invest in the project and, if he decides to do so, to settle upon the parameters of the works to be constructed (e.g., its size, location, cost, production capacity, and perhaps the possible technologies which may be used), the source and method of financing, the contracting approach to be used (see chapter II, "Choice of contracting approach"), and the method of obtaining offers from contractors (e.g., by tender or by negotiation: see chapter III, "Selection of contractor and conclusion of contract"). The lending institution which is to finance the construction of the works may collaborate in the making of these decisions on the basis of the feasibility study.

10. The exact scope and contents of the feasibility study will depend on the project concerned. However, feasibility studies typically cover the following matters and issues: the potential market size and potential market price for the product to be produced by the works; the capacity of the works; raw materials, power and other inputs for the manufacturing process; the location and site of the works; transport and other elements of infrastructure; civil, mechanical and electrical engineering; technology; organization of the works and overhead costs; kinds and amount of manpower needed to construct the works; and legal constraints (e.g., land-use requirements and environmental controls). It is advisable for the feasibility study to contain an analysis of the financial viability of the works, including the total investment required, possibilities concerning the financing of construction and the commercial profitability of the works. It may also evaluate the project in relation to the national economy. The feasibility study will usually also include an investigation of the site to determine its topography and geological characteristics and climatic conditions.

11. Feasibility studies typically assume the existence of certain situations or facts, and therefore incorporate an element of uncertainty. The purchaser should be able to ascertain from the study the assumptions which have been made and the extent of the uncertainty. Sometimes feasibility studies include "sensitivity studies", which vary some of the assumptions on which the feasibility study is based to determine the effect of those changes in assumptions on the feasibility of the project.

E. Detailed studies

12. Once the feasibility of a project has been confirmed, a detailed study is sometimes conducted to provide more refined and detailed information needed for the design of the works and to settle other aspects of the project (e.g., the nature and number of contracts to be entered into, and the construction methods to be used).

F. Specialists performing pre-contract studies

13. In many cases, it may be desirable for pre-contract studies to be made by a team of specialists in various relevant disciplines, e.g., economists, financial experts, geologists, engineers and industrial management experts. The purchaser may wish to consider whether there exists within his own staff the expertise necessary to perform the studies. If not, he may wish to consider engaging an outside consulting firm in which he has confidence to perform the studies. In choosing such a firm, it would be desirable for the purchaser to consider not only the price to be charged by it (bearing in mind that the least expensive firm is not always the best choice), but also such other factors as its reputation and expertise. The purchaser may wish to consider selecting a consulting firm by means of selection procedures designed to promote competition among prospective consulting firms with respect to the services to be performed and the price to be charged. A purchaser who is unable to identify a suitable firm or firms may obtain assistance in doing so from sources such as lending institutions, international organizations and professional bodies.[2]

14. The purchaser may wish to consider whether the pre-contract studies should be conducted by a firm which is eligible to be engaged subsequently as the contractor under the works contract, or either to perform limited services, such as supplying the design for the works or serving as the consulting engineer in connection with the construction (see chapter X, "Consulting engineer"). The purchaser may view these two possibilities differently.

15. As a general proposition, the pre-contract studies should not be conducted by a firm which may be engaged as a contractor to construct the works. Such a firm might be tempted to produce studies which are more encouraging to the purchaser to proceed with the project than is justified. Some lending institutions will not allow the entity which conducted the pre-contract studies to be engaged subsequently to construct the works. However, in some highly specialized fields, it may be necessary for the pre-contract studies to be conducted by a potential contractor, since there may exist no independent consultants with the required expertise in the field to perform the studies. It may be noted that while the pre-contract studies should not be conducted by a firm which may be engaged as a contractor to construct the works, it may be acceptable to the purchaser for the firm which conducted the pre-contract studies merely to supervise the construction of the works by other firms.

16. On the other hand, in some cases, it may be advantageous to the purchaser for the firm which performed the pre-contract studies to be engaged subsequently to supply the design or to serve as the consulting engineer. When these functions are performed by different firms, the supplier of the design or the consulting engineer may have to spend time examining the pre-contract

studies in detail, and perhaps even to duplicate some investigations made for the studies, resulting in higher cost to the purchaser. However, in considering whether the same firm should be eligible to serve in both capacities, the purchaser may wish to consider the possibility of a conflict of interest similar to that discussed in paragraph 15, above.

Footnotes to chapter I

[1]For a discussion of the content and methodology of pre-contract studies, see United Nations Industrial Development Organization, *Manual for the Preparation of Industrial Feasibility Studies* (United Nations publication, Sales No. E.78.II.B.5).

[2]See United Nations Industrial Development Organization, *Manual on the Use of Consultants in Developing Countries* (United Nations publication, Sales No. E.72.II.B.10).

Chapter II. Choice of contracting approach

SUMMARY

A purchaser who intends to contract for the construction of industrial works has a choice of entering into a single contract with a single enterprise or a group of enterprises, which will be responsible for performing all obligations needed for the completion of the construction, or dividing the obligations among several parties entering into an individual contract with each party. In addition, the purchaser may construct a portion of the works. Which technique he adopts may depend on several factors (e.g., whether the technology to be used in the works is the exclusive property of a single supplier, or whether the purchaser has the capability to co-ordinate the performances of several parties). Within each of these techniques, there are different possible approaches to contracting (paragraphs 1 to 3).

The contractual approach whereby a single contractor is engaged to perfom all obligations needed for the completion of the entire works is referred to in the *Guide* as the "turnkey contract approach". Where competitive tenders to construct the works are solicited from potential turnkey contractors, each tender will be based on the individual design of the tendering contractor, and the purchaser will be able to choose the design which is most responsive to his requirements. However, comparison of the different designs may sometimes be difficult. A turnkey contractor may sometimes be motivated more by a desire to offer an attractive price than by the need to ensure the durability, reliability and ease of maintenance of the works. On the other hand he usually has no incentive to over-design the works (paragraphs 4 to 6).

In some cases, a single contractor, in addition to assuming the obligations of a turnkey contractor, may undertake to ensure that after the works is completed it can be operated and achieve agreed production targets by the purchaser's own personnel, using raw materials and other inputs specified in the contract. This approach is referred to in this *Guide* as the "product-in-hand contract approach" (paragraph 7).

Since a single contractor bears a high degree of risk in performing all the obligations needed for the completion of the works, and must incur costs to guard against this risk, the total price of the works may be lower if several contractors are engaged than if a single contractor is engaged (paragraph 8).

The construction of a large-scale industrial works may be beyond the technical or financial means of a single enterprise. Accordingly, the purchaser may contemplate entering a contract with a group of enterprises able, jointly, to provide the necessary resources and expertise with which to construct the works. One means of doing so is for the purchaser to enter a contract with a single enterprise which subcontracts for the performance of certain of its obligations under the works contract (paragraphs 9 and 10). Another approach is for the purchaser to enter a

contract with a group of enterprises which has combined to perform the obligations of the contractor. It may be advisable for the contract to describe the responsibilities and liabilities undertaken by such a group or its members in a clear manner to avoid implying certain legal consequences which may arise under the applicable law by the use of a particular term (paragraph 11).

Depending on whether or not the group takes the form of an independent legal entity, different considerations will apply. If the group has not integrated into an independent entity, it is desirable for the contract to resolve the question of whether each member of the group is to be liable for the performance of the obligations of all of the members or only of those which that member is to perform. It may also be desirable for the contract to deal with other issues arising in the use of such an arrangement (paragraphs 12 to 16).

Where the purchaser divides all the obligations needed for the completion of the works among two or more parties, he must co-ordinate the scope and the time of the performances under each contract so as to achieve his construction targets. An approach involving several contracts may facilitate the use by a purchaser of local contractors to construct portions of the works. The way in which the construction is to be apportioned among the various parties will depend upon the nature and size of the works and the national policy followed by the country of the purchaser (paragraphs 17 to 20).

The risks borne by the purchaser in connection with the co-ordination of several contracts could be considerably reduced by employing a consulting engineer to advise the purchaser on how to achieve a proper co-ordination. Alternatively, the purchaser may engage a construction manager with a wider scope of responsibility. Another technique is to have one of the contractors assume responsibility for some part of the co-ordination (paragraphs 21 to 23).

The purchaser may also reduce the risks connected with engaging more than one contractor by providing that one of the contractors is to be responsible for the transfer of the technology, the supply of the design for the entire works and the construction of a vital portion of the works. This contractor may also be responsible for handing over to the purchaser at an agreed time completed works which are capable of operating in accordance with the contract, unless he is prevented from doing so by the failure of another party engaged by the purchaser (paragraph 24). Another approach available to the purchaser is to enter into a works contract with a single contractor for the construction of the entire works in accordance with technology and a design supplied to that contractor (paragraph 25).

The construction of the works may be effected in the context of a joint venture entered into between the contractor and the purchaser. A joint venture has certain advantages and disadvantages for each party (paragraphs 26 to 29). The joint venture may be based on a variety of legal relationships. When creating a joint venture, the parties should take into account the relevant rules of the applicable law, which are often mandatory (paragraphs 30 and 31).

A. General remarks

1. A purchaser who intends to contract for the construction of industrial works has a choice of entering into a single contract with a single enterprise or a group of enterprises, which will be responsible for performing all the obligations needed for the completion of the construction (see section B,

below), or dividing the obligations among several parties, entering into an individual contract with each party (see section C, below). In addition, the purchaser may construct a portion of the works. Within each of these two techniques there are different possible approaches to contracting, as discussed below. These approaches differ in important respects, for example, as to the extent of the responsibility of the contractor, the extent to which the purchaser must co-ordinate construction, and, in many cases, the total cost to the purchaser.

2. Whether it is advisable for the purchaser to enter into a single contract or several contracts may depend upon several factors. Entering into a single contract places the responsibility for the entire construction on a single party; if several contracts are entered into, and the works upon completion is defective, it may sometimes be difficult to determine which contractor is liable. If the technology is highly specialized or is the exclusive property of a single supplier, the entire works may have to be designed and constructed by the supplier of the technology. The purchaser may wish to enter into different contracts for, e.g., the transfer of technology, the supply of the design, and construction of different portions of the works only if he has the ability to co-ordinate and evaluate the performance by several contractors of their obligations.

3. Mandatory legal regulations in the country of the purchaser may require that a certain contracting approach be used by the purchaser. For example, those regulations may require that enterprises in the purchaser's country be engaged for certain aspects of the construction (e.g., civil engineering) in order to develop the technological capability of the country and to conserve foreign exchange. In such cases, the purchaser will have either to contract with a single contractor who is prepared to engage the local enterprises as subcontractors, or to enter into several contracts, including contracts with the local enterprises. In addition, the extent of the contractor's liability to taxation may influence the contracting approach to be chosen by the parties. The parties may wish to obtain expert advice on the issue of taxation.

B. Approaches involving single contract

4. The contractual approach whereby a single contractor is engaged to perform all obligations needed for the completion of the entire works, i.e., the transfer of the technology, the supply of the design, the supply of equipment and materials, the installation of the equipment and the performance of the other construction obligations (such as civil engineering and building), is referred to in this *Guide* as the "turnkey contract approach". This approach requires the contractor to co-ordinate the entire construction process, and, in principle, results in the contractor's liability for any delay in completion of the construction or for defects in the works.

1. *General considerations*

5. Where the purchaser chooses the turnkey contract approach, and decides to solicit competitive tenders to construct the works from potential contractors (see chapter III, "Selection of contractor and conclusion of contract"), each tender made by a potential turnkey contractor will be based (within the

parameters set in the invitation to tender) on an individual design. The purchaser will thus be able to choose the design which is most responsive to his requirements. In addition, since the turnkey contractor is himself to supply equipment and to construct pursuant to the specifications contained in the design included in his tender, that design may reflect manufacturing and construction economies and techniques available to the contractor, and thus result in construction which is economical and efficient. On the other hand, it may sometimes be difficult for the purchaser to evaluate and compare the different designs and different combinations of construction elements and methods contained in offers by different potential turnkey contractors. It is therefore advisable for the purchaser, when soliciting competitive offers, to invite all potential contractors to set forth the specific advantages of the design, methods and construction elements of their offers.

6. In preparing his design and construction methods and selecting his subcontractors, a turnkey contractor may sometimes be motivated more by a desire to offer an attractive price than by the need to ensure the durability, reliability and ease of maintenance of the works. However, a turnkey contractor usually has no incentive to over-design the works (i.e., to include in the design unnecessary features and technical safeguards to ensure that the works performs in accordance with the contract), since over-designing would make a turnkey contractor's offer uncompetitive. If the design is supplied by a separate designer, there may exist some incentive to over-design.

7. In some cases, a single contractor, in addition to assuming the obligations mentioned in paragraph 4, above, may undertake to ensure that after the works is completed, it can be operated and achieve agreed production targets using the purchaser's own personnel, and the raw materials and other inputs specified in the contract. This approach is referred to in the *Guide* as the "product-in-hand contract approach". It may be used by the purchaser as a means of making the contractor responsible, not only for the completion of the entire works, but also for an effective transfer to the purchaser's personnel of the technical and managerial skills and knowledge required by the purchaser's personnel for the successful operation of the works. In contrast to the case where the contractor merely undertakes to train the purchaser's personnel in the operation of the works (see chapter VI, "Transfer of technology", paragraphs 26 to 32), this approach requires the contractor to ensure that his training is successful. Accordingly, the contract should specify the results which the contractor is obligated to achieve through his training. The contract may provide that the training must enable the purchaser's personnel to operate the works during an agreed test period under the guidance of the contractor's managerial personnel. The contract might impose greater responsibility on the contractor by providing that the training must enable the purchaser's personnel to operate and manage the works independently during the test period. The product-in-hand contract approach is to be distinguished from cases where the contractor undertakes in the contract to assist with his own personnel in the operation of the works after its completion (see chapter XXVI, "Supplies of spare parts and services after construction", paragraphs 3 and 37 to 39).

8. A single contractor bears a high degree of risk in performing all the obligations needed for the completion of the works. He may insure against this risk, or provide some financial reserves to cover the risk. The cost of adopting these measures is usually reflected in the calculation of the price. The total price

of the works may be lower if several contractors are engaged than if a single contractor is engaged, since, under the approach involving several contracts, the purchaser himself effects the co-ordination of the construction process which under the single contract approach is effected by the contractor. Since, under the product-in-hand contract approach, the contractor not only assumes extensive training obligations but also bears the risk of failing to achieve the agreed training results, the price charged by him under that approach is likely to be higher than that charged under the turnkey contract approach. The final choice by the purchaser among the various approaches may be guided by considerations that go beyond simply the financial costs of the construction. Alternatives to both the turnkey and production-in-hand approaches may add to the staffing needs and the risk costs of the purchaser.

2. *Contracting with group of enterprises*

9. A purchaser may contemplate entering into a contract with a group of enterprises, rather than with only one enterprise. This *Guide* does not deal in depth with the legal issues connected with arrangements of that type.[1] The purpose of the discussion of these arrangements in the present section is to bring them to the attention of the parties and to point out some of the principal issues associated with them which the parties may wish to consider.

10. The construction of complex and large-scale industrial works may be beyond the technical or financial means or the experience of a single enterprise. This may be the case, in particular, where all or a substantial part of the works is to be constructed under a single contract, such as in a product-in-hand contract or a turnkey contract (see paragraphs 4 to 8, above). In such instances one possibility may be for a single enterprise to enter into the contract as the contractor, and to engage subcontractors to perform those obligations which it cannot itself perform (see chapter XI, "Subcontracting"). Another possibility may be for a group of enterprises to combine to perform the obligations of a contractor. A group of enterprises may be created not only for the purpose of pooling the experience and the technical and financial means of the members of the group but also to satisfy eligibility requirements (e.g., those concerning the nationality of the contractor) which may be imposed by law, by the purchaser or by a financing institution, or in order to take advantage of financial or fiscal benefits available to contractors meeting certain requirements.

11. The terminology used to describe a group of enterprises which has combined to perform the obligations of a contractor is not uniform in all legal systems. For example, the terms "joint venture" and "consortium" may sometimes describe the same types of arrangements, while at other times different types of arrangements are implied by the terms. Furthermore, the use of a term in a contract may carry with it certain legal consequences under some legal systems. Accordingly, where the purchaser is entering into a contract with a group of enterprises, it may be advisable for the contract to describe clearly the responsibilities and liabilities undertaken by the group or its members.

12. In some cases, the members of a group of enterprises which have combined to perform the obligations of the contractor under a works contract may form an independent legal entity. In such cases, the contractual provisions of the works contract will be the same as those in a contract between the

purchaser and a single enterprise. The entity itself will be fully responsible for the performance of all the obligations of the contractor under the works contract. Whether the individual members of the group will be responsible for the performance of those obligations, and if so, to what extent they will be individually responsible, will depend upon the nature of the legal entity. Some legal systems may have mandatory rules governing contracts entered into by a purchaser with a group of enterprises integrated into an independent legal entity and the parties may need to take those rules into account in negotiating the contract.

13. In other cases, and these are the more common, the members of the group do not integrate into an independent legal entity. In such instances there are matters which it would be advisable for the works contract to address which do not arise in contracts with a single enterprise or with a group of enterprises integrated into an independent legal entity. Firstly, it would be advisable for all members of the group to become parties to the works contract. Secondly, it would be advisable for the works contract to set out the responsibilities and liabilities of the members of the group to the purchaser in the performance of the contractor's obligations. Under one approach, the works contract may allocate specific obligations to each member of the group and make him liable for the performance only of the obligations allocated to him. In this case, the legal positions of the parties will be similar to those connected with an approach involving several contracts (see paragraphs 17 to 25, below). Under a second approach, the works contract may allocate specific obligations to each member of the group, but make the members of the group jointly and severally liable to the purchaser for the performance of all the obligations of the contractor under the contract.

14. From the purchaser's point of view, it may be desirable for each of the members of the group to assume joint and several liability for the performance of all the obligations of the members, instead of each member assuming liability only for obligations to be performed by him. With joint and several liability, the purchaser would be able to claim performance against any one or a combination of the members of the group without having to attribute the failure of performance to a particular member, and each member would be personally liable for any such failure. In the event of a successful claim, the purchaser would be able to execute his award against the combined assets of the members against whom he claimed. It may be noted that the purchaser may protect himself against the effects of a failure of performance by obtaining performance guarantees from the members of the group (see chapter XVII, "Security for performance", paragraphs 10 to 12).

15. It may be advisable for a purchaser who is contemplating entering into a single contract with a group of contractors who have not integrated into an independent legal entity to obtain legal advice in respect of the possible consequences or difficulties which may arise by the use of such an arrangement. In addition to the matters mentioned in paragraphs 13 and 14, above, there are a number of other issues which the purchaser may wish to consider when entering into a contract with a non-integrated group of enterprises:

(*a*) How the difficulty of bringing a claim against enterprises from different countries, should a dispute arise, may be overcome;

(*b*) How the settlement of disputes clause may be formulated so as to enable any dispute between the purchaser and several or all the members of the group to be settled in the same arbitral or judicial proceedings (see chapter XXIX, "Settlement of disputes", paragraph 4);

(*c*) How guarantees to be given by third parties as security for performance and quality guarantees to be given by members of the group are to be structured;

(*d*) How the financial arrangements between the purchaser and the group may be settled, including such questions as the manner of payment of portions of the price to members of the group;

(*e*) What ancillary agreements may have to be entered into by the purchaser;

(*f*) Whether there are any mandatory rules of the applicable law governing contracts of this type.

16. Should the group not be integrated into an independent legal entity, it may be to the advantage of all the parties for the purchaser not to have to deal with each member of the group in matters arising during the course of performance of the contract. The members of the group may therefore designate one of their number to be spokesman for the group in their dealings with the purchaser. Thus, notices to be exchanged between the parties could be exchanged between the purchaser and the designated spokesman. It may be advisable for the authority of such a spokesman to be specified in the contract. The purchaser will need to know whether the spokesman is acting merely as a means of passing information between the purchaser and the group or whether he has any authority to take decisions binding on all the members of the group. The group of enterprises may extend the spokesman's authority so as to enable him to act on behalf of the group, as for instance, in defending a claim by the purchaser.

C. Approaches involving several contracts

17. Where the purchaser divides all the obligations needed for the completion of the works among two or more parties, he may adopt different approaches to contracting. The approach chosen by the purchaser will affect the extent of the risk borne by him in connection with the construction.

18. The purchaser may divide the construction of the works among two or more contractors. The transfer of technology and the supply of the design may also be effected by one or more of these contractors, or may be effected by other enterprises. The purchaser must co-ordinate the scope and the time of the obligations to be performed under each contract so as to achieve his construction targets. The purchaser may bear the risk of delay in construction or defects in the works resulting from his failure to determine appropriately in each contract the equipment, materials and construction services to be supplied by the different contractors, and the time-schedules to be observed by them (see, however, paragraphs 21 to 25, below).

19. In addition to resulting in a lower price (see paragraph 8, above), the engagement of several contractors for construction could facilitate the use by purchasers from developing countries of local contractors to construct portions of the works, perhaps under the supervision of an experienced foreign

contractor. The use of local contractors in this manner may save foreign exchange and facilitate the transfer of technical and managerial skills to enterprises in the purchaser's country.

20. When several contracts are entered into for construction, the supply and installation of equipment and the supply of materials are often effected under one or more contracts, and building and civil engineering under other contracts. The equipment may in some cases be installed by the purchaser's personnel or by a local enterprise under the supervision of the contractor (see chapter IX, "Construction on site", paragraphs 27 to 30). However, the way in which the construction is to be apportioned among the various contractors will depend upon the nature and the size of the works, and the national policy followed by the country of the purchaser. In general, the less complex the works, the smaller the number of contractors required and the easier it is for the purchaser to co-ordinate the scope and the time of the construction obligations under the different contracts. The risks connected with co-ordination increase when a large number of parties participate in the construction.

21. The risks borne by the purchaser in co-ordinating the scope and the time of the performance of the obligations of several contractors could be considerably reduced by employing a consulting engineer to advise the purchaser as to how to achieve proper co-ordination. A consulting engineer may be employed even if the single-contract approach is used, though his function in such cases may be primarily to check the quality and the progress of the construction to be effected by the single contractor. The possible role of a consulting engineer is discussed in chapter X, "Consulting engineer".

22. The purchaser may, as is increasingly the practice, engage a construction manager (sometimes called a managing contractor) with a wider scope of responsibility instead of, or in addition to, a consulting engineer. The construction manager might be the designer of the works, or an expert with management capabilities. The responsibility of the construction manager need not be limited to giving advice, but may include integrated construction management (e.g., inviting tenders or negotiating and concluding different contracts for the various portions of the works for and on behalf of the purchaser, co-ordinating all site activities and controlling the construction process). If the construction manager is not the designer, the contract may obligate him to check the design and to assume responsibility for design defects which he could reasonably have discovered. He might also be obligated to advise the purchaser on the selection of contractors. The fee paid for the services of a construction manager is usually higher than the fee of a consulting engineer because of the wider scope of the construction manager's responsibility. The parties might agree that the fee is to be reduced according to a specified formula if the works is completed late or if the cost of the construction is higher than a target cost, and increased if the works is completed early or the cost is less than the target cost (see chapter VII, "Price and payment conditions", paragraph 15).

23. Another technique which the purchaser might wish to adopt in order to reduce his risks in co-ordination is to have one of the contractors assume responsibility for some part of the co-ordination. This contractor may, for example, be obligated to define the scope of the construction to be effected by other contractors to be engaged by the purchaser, and to provide a time-

schedule for that work. He may also be obligated to check the construction effected by the other contractors and to notify the purchaser of defects in the construction which he could reasonably have discovered. However, in considering this approach, the purchaser should take into account the possible conflict of interest which it might create for the co-ordinating contractor, since he has to evaluate the performances of fellow contractors who might be participating closely with him in the construction. Accordingly, the purchaser may wish to adopt this technique only in exceptional circumstances.

24. A further approach which the purchaser might wish to adopt in order to reduce his risks in co-ordination is to provide that one of the contractors is to be responsible for the transfer of the technology, the supply of the design for the entire works and the construction of a vital portion of the works. This contractor may also be obligated to define the scope of the construction to be effected by other contractors to be engaged by the purchaser, and to provide a time-schedule for that work. The contractor may be obligated to hand over to the purchaser at an agreed time a completed works capable of operation in accordance with the contract, unless he is prevented from doing so by the failure of another party engaged by the purchaser to perform his construction obligations in accordance with the design, specifications or time-schedule provided by the contractor to the purchaser. An advantage of this approach for the purchaser is that the responsibility for the transfer of the technology, the supply of the design and the construction of a vital portion of the works is concentrated in one contractor.

25. Another approach available to the purchaser is to conclude a works contract with a single contractor for the construction of the entire works in accordance with technology and a design to be supplied to that contractor, and to engage one or more enterprises other than the contractor to transfer the technology and supply the design for the works. The design is usually obtained by the purchaser before the tendering procedure or negotiations in respect of the works contract commence, in order that tenders to construct may be solicited on the basis of the design. Since the contractor under this approach is responsible for the construction of the entire works in accordance with the design supplied by the purchaser, his responsibilities for co-ordinating the construction process and constructing the entire works are the same as those of a turnkey contractor. The contract may obligate the contractor to notify the purchaser of inherent defects in the design of which he is aware.

D. Joint venture between contractor and purchaser

26. The contracts drawn up under the different contracting approaches described above have as their principal objective the construction of the works in return for the payment of the price. The legal relationship between the contractor and the purchaser essentially comes to an end with the completion of construction by the contractor and the acceptance of the works and the payment of the price by the purchaser, except, for example, as to the rights and obligations of the parties under a quality guarantee (see chapter V, "Description of works and quality guarantee", paragraph 26), and other obligations which are to take effect after that time (e.g., with respect to the supply of spare parts or certain services after acceptance of the works (see chapter XXVI, "Supplies of spare parts and services after construction"). In general, the commercial

risks connected with the management and operation of the works (e.g., a decrease in the market price of the products of the works) will, after that time, be borne solely by the purchaser.

27. In contrast, the construction of the works may be effected in the context of a joint venture, i.e., an association between the contractor and the purchaser whose objectives may include, in varying degrees, the transfer of technology, the pooling of financial resources or other assets, the sharing of the costs, control and management of the operation of the works, the marketing of the products of the works, and the sharing of the profits and losses resulting from the operation of the works. The contractor and the purchaser may agree to form a joint venture for the construction of works; but, more often, they may enter into a contract for the construction of the works with the understanding that they will form a joint venture for the operation of the works or for distribution of the products upon completion of the construction.

28. A joint venture between the contractor and the purchaser may offer certain advantages to the purchaser. When the construction is effected by the contractor in the context of a joint venture which includes the marketing of the output of the works, the contractor has an economic interest in the timely completion of construction of the works and its proper functioning which goes beyond that which arises under a works contract. The joint venture would create an incentive in the contractor to impart to the purchaser technology, including improvements in the technology and the technology used in the industrial process, and managerial skills possessed by the contractor; in addition, the output of the works might be sold in markets to which the contractor has access. Furthermore, the losses resulting from the joint venture would be borne by both the purchaser and the contractor. The disadvantages to the purchaser of a joint venture may lie in the need to share the profits resulting from the operation of the works, and the fact that the purchaser loses to some degree managerial control over the operation of the works.

29. To the contractor, a joint venture with the purchaser may present the advantages of, for example, facilitating access to the markets in the country or region of the purchaser, or to markets which favour purchasing from the country of the purchaser, and the opportunity to participate in the profits obtained from the operation of the works. The costs to the contractor of these advantages arise principally from his sharing of the risks associated with the joint venture.

30. The joint venture may be based on a variety of legal relationships. The parties may wish to establish for the purposes of the joint venture a corporate body with independent legal personality which is owned and controlled by both parties (this is usually called an equity joint venture). The works may be operated by this corporate body. Alternatively, the parties may wish to agree on a joint venture without creating a body with independent legal personality, the association between the parties being based purely on contractual arrangements between them (this is usually called a contractual joint venture). The works may be jointly operated by both parties, and be either owned jointly by them or solely by the purchaser.

31. When creating a joint venture, the parties should take into account the rules of the applicable law, which are often mandatory, dealing specifically with the creation of joint ventures, and with the rules regulating the creation of

corporate bodies with independent legal personality. The contractual arrangements entered into between the parties for creating and implementing the joint venture will be distinct from those entered into for constructing the works. The contractual arrangements for creating joint ventures are outside the scope of the *Guide,* and accordingly are not dealt with herein.[2]

Footnotes to chapter II

[1]Issues relating to groups of firms acting as contractors are discussed in Economic Commission for Europe, *Guide for Drawing up International Contracts between Parties Associated for the Purpose of Executing a Specific Project* (United Nations publication, Sales No. E.79.II.E.22) and in Economic Commission for Europe, *Guide on Drawing up Contracts for Large Industrial Works* (United Nations publication, Sales No. E.73.II.E.13).

[2]The creation of joint ventures between contractors and purchasers is discussed in *Manual on the Establishment of Industrial Joint-Venture Agreements in Developing Countries* (United Nations publication, Sales No. E.71.II.B.23).

Chapter III. Selection of contractor and conclusion of contract

SUMMARY

There are two basic approaches to the conclusion of a works contract. Under the first approach, the purchaser invites tenders from enterprises to construct the works, and the contract is concluded on the basis of the tender selected by the purchaser through formal tender procedures. Under the second approach, the purchaser negotiates the contract with enterprises selected by him without formal tender procedures. The purchaser may not have complete freedom to choose the approach he wishes to adopt in concluding the contract (paragraphs 1 to 3).

The tendering approach may be implemented through the open tendering system or the limited tendering system. Tenders may be restricted to those of enterprises which have been qualified by the purchaser in accordance with pre-qualification procedures. The open tendering system, under which all interested enterprises are invited to submit tenders for the construction of the works, provides competition among enterprises but may also be the most formal and costly of the procedures for the conclusion of a works contract. The limited tendering system, where only certain enterprises are invited to submit tenders, allows for some competition, but usually less than under the open tendering system. Negotiation of the works contract with a number of potential contractors or with only one such contractor may avoid the need to adopt the formalities of the tender procedures (paragraphs 5 to 9).

The legal rights and obligations of parties engaging in tendering procedures may be regulated by mandatory rules of the applicable law or by the rules of a lending institution financing the project (paragraph 10).

When the open tendering approach is adopted, it may be appropriate to require potential tenderers to pre-qualify in order to limit the number of tenders to be considered. An enterprise applying to be pre-qualified may be required to complete a questionnaire which seeks to elicit relevant information about the enterprise. On the basis of the replies to the questionnaire, the purchaser may select enterprises in accordance with criteria for pre-qualification which have been established by him (paragraphs 11 to 14).

When the purchaser has sufficient information about the works to be constructed, he may invite tenders from those enterprises whose tenders are solicited. Under the open tendering system, the invitation is communicated by means of an advertisement, which may be circulated internationally or more restrictedly. Under the limited tendering system, the invitation to tender is sent individually to enterprises selected by the purchaser, accompanied by a full set of documents to be provided to prospective tenderers (paragraphs 15 to 18).

The documents to be provided to prospective tenderers usually include instructions to tenderers conveying information with respect to the preparation, contents, submission and evaluation of tenders, and model

forms of the documents which are to be submitted by the tenderer with his tender (paragraph 19). The instructions may specify all the purchaser's requirements in respect of the tenders, including the criteria they must meet to be successful. Where model forms of the tender documents are not supplied by the purchaser to tenderers, the purchaser's requirements in their regard may be set out in the instructions. It is desirable for the purchaser to prepare the contractual terms that are to form the basis of the works contract and to supply them to tenderers. The purchaser may wish to consider requiring tenderers to submit a tender guarantee meeting specified criteria (paragraphs 20 to 30).

Tenders are usually opened in the presence of the tenderers or their representatives or in public. A private opening, without the tenderers being present, may be justified by exceptional circumstances. After tenders are opened, they are compared and evaluated with a view to identifying the tender which complies with the purchaser's requirements and is most acceptable to him. The purchaser then proceeds to select the successful tenderer. The purchaser may, in certain circumstances, reject all tenders (paragraphs 31 to 43).

Under the negotiation approach, the purchaser contacts one or more enterprises which he judges to be capable of constructing the works, informs them of his requirements, and requests offers. Documents describing the scope of the construction and main technical characteristics of the works required and containing the contractual terms required by the purchaser may be submitted to the enterprises. No formalities are usually required for making or evaluating the offers, or for negotiating the contract. In certain circumstances the purchaser may be able to combine the tendering and negotiation approaches (paragraphs 44 to 47).

The parties may find it advisable to reduce their agreement to writing. The parties may also wish to agree on when contractual obligations between them are to arise, either on their entering into the contract or as from the date when a specified condition is fulfilled (paragraphs 49 and 50).

A. General remarks

1. There are, in practice, two basic approaches that may be used for concluding a works contract. Under the first approach, the purchaser may, through formal tender procedures, invite enterprises to submit tenders to construct the works, evaluate the tenders and enter into a contract with the tenderer selected by him in accordance with the tender procedures. Tenders are usually based upon contractual terms and technical factors stipulated by the purchaser. One aspect of the formality of tender procedures, especially when the purchaser is a public entity, is that the purchaser and the tenderers may be subject to certain legal obligations and liabilities, for example, concerning the submission, withdrawal and selection of tenders.

2. Under the second approach, the purchaser enters into negotiations with one or more enterprises with a view to entering into a contract with one of those enterprises. This approach does not involve formal tender procedures and participants in negotiations are not subject to the strict obligations and liabilities to which participants in tender procedures are subject. However, it requires the purchaser to do certain preparatory work and it may be necessary for the parties to the negotiations to agree upon certain rules to be followed in the negotiations (see paragraphs 44 to 46, below).

3. The purchaser may not have complete freedom of choice with respect to the approach to be used in concluding the contract. Procurement laws and regulations in the country of the purchaser will often limit the purchaser's choice of the approach to be adopted and the detailed procedures to be followed. Such laws and regulations may apply to all purchasers in that country, or they may be directed only to State or public enterprises, giving private enterprises greater freedom to choose the approach and procedures they wish to adopt. The procurement laws may require that preference be given to tenders received from local enterprises or enterprises from a particular region. A purchaser may also have to conform to the requirements of international lending or other institutions financing the project concerning the approach and procedures to be followed. Those requirements are usually designed to achieve efficiency, economy and fairness in the procurement process. In many cases, these institutions require equipment, materials and services financed by them to be procured on the basis of international competitive tendering, in order to promote competition among a wide range of enterprises. They may also require that enterprises from all the member countries of the institution be given an opportunity to participate in the tendering procedures on the basis of equality of opportunity. In other cases, these institutions may allow the purchaser to employ more restrictive procedures than international competitive tendering. In particular, they often recognize the desirability of allowing a margin of preference for enterprises from the country or region of the borrower. The parties may also note that, where a contracting approach involving several contracts is adopted (see chapter II, "Choice of contracting approach", paragraphs 17 to 25), different approaches to concluding the contract or different procedures may be used in respect of each contract.

4. Where the applicable law or a financing institution does not require any particular approach or procedure to be followed, the purchaser is free to adopt the approach or procedure most suitable to his needs. He may, for example, choose to adopt the formal procedures under the tendering approach or he may adopt the negotiation approach, or he may combine various features of both these approaches (see paragraph 47, below).

5. Within the tender approach, there are two basic systems: the open tendering system, under which all interested enterprises are invited, by means of an advertised notice, to submit tenders for the construction of the works, and the limited tendering system, under which only certain selected enterprises are invited by the purchaser to submit tenders. Different features of the two basic systems may be combined as required by the applicable law or the rules of a financing institution or to satisfy the needs of the purchaser.

6. The principal advantage of the open tendering system is that it enables a broader range of enterprises to compete in tendering for the construction of the works. The purchaser may benefit from this extensive competition by obtaining a lower price, a better design, or other more favourable conditions relevant to the construction of the works. On the other hand, the open tendering system may be the most formal and costly of the procedures for the conclusion of a works contract. It usually involves the preparation of a number of formal tender documents, international or other wide advertisement of the invitation to tender, public opening of tenders and evaluation of the sometimes numerous tenders which may be submitted. It also demands strict adherence to time-limits and other procedural requirements. In addition, the open tendering system sometimes

attracts tenders from unqualified enterprises that submit unrealistically low tenders in order to be awarded the contract, and that later seek variations of the contract resulting in an increase of the contract price (see chapter XXIII, "Variation clauses", paragraphs 20 to 22). In such cases the purchaser faces the difficulty and expense of investigating and eliminating such tenders.

7. Under a variant of the open tendering system, the opportunity to submit tenders may be restricted to enterprises which have qualified in accordance with pre-qualification procedures (see paragraphs 11 to 14, below). The opportunity to pre-qualify may be given to all interested enterprises worldwide, or may be restricted to those from a particular region. The use of pre-qualification enables the purchaser to limit participation in tendering to reputable enterprises that are technically and financially capable of constructing the works. It may also enable the purchaser to assess, prior to the commencement of tendering procedures, the degree of real interest in the project that exists among contractors.

8. In contrast to the open tendering system, the limited tendering system confines the tender process to enterprises which the purchaser invites to tender. This system may be particularly suitable where the technology to be incorporated in the works can be supplied, or the construction can be effected, only by a limited number of enterprises. While the limited tendering system offers competition among the tendering enterprises that are given the opportunity to participate in the tendering process, it usually offers less competition than under the open tendering system. To the extent that the purchaser informally discusses with prospective tendering enterprises the scope of the construction and the technical characteristics of the works to be constructed, the documents to be provided to prospective tenderers (see section B. 3, below) may be simplified as compared with those required under the open tendering system. However, the limited tendering system also entails certain formalities, although they may be somewhat less onerous than under the open tendering system. It should be noted that international financing institutions may not permit the use of the limited tendering system in some cases.

9. Under the negotiation approach, the purchaser negotiates the works contract with a number of potential contractors or with only one such contractor without the formalities of tender procedures. The negotiation approach may be used when the applicable law or an institution financing the project does not require tender procedures. It may be appropriate, for instance, where a limited number of potential contractors have a satisfactory record of constructing works similar to the works to be constructed for the purchaser, and where no advantages are to be gained by inviting tenders from other enterprises. The approach may also be appropriate where the equipment or technology to be incorporated in the works can be obtained only from certain enterprises. The extent to which the purchaser will benefit from competition in respect of the price, design and other key factors relating to the construction will depend in part on whether he negotiates with more than one enterprise. Occasionally, the need for early completion of the works may make it preferable for the purchaser to engage a contractor without prior tendering, as the conclusion of the contract under tendering procedures would in most cases take longer than under the negotiation approach. In certain exceptional cases the purchaser may find it appropriate to negotiate the contract with only one enterprise. For example, when an existing works is to be extended or modified in conformity with the technological process or equipment already in use, it may be appropriate to negotiate only with the contractor who constructed the works.

B. Tendering

10. A purchaser wishing to adopt tender procedures and tenderers participating in such procedures should consider whether they must conform to any rules regarding the invitation, submission and acceptance of tenders imposed by mandatory rules of the applicable law or by the rules of a lending institution financing the project (see paragraphs 3 and 4, above). Such rules may provide, for example, that neither an invitation to tender, nor a tender, may be withdrawn unless certain conditions are fulfilled. Furthermore, they may compel the purchaser to accept a tender so long as the criteria specified in his invitation to tender are satisfied (see paragraph 43, below). Other legal systems, however, may view the invitation to tender as a mere solicitation of offers to construct the works and the tender itself may be regarded only as an offer, capable of being withdrawn or modified by the tenderer unless it is accepted by the purchaser.

1. *Pre-qualification*

11. The purpose of pre-qualification is to eliminate at the outset those potential tenderers who would not be suitable contractors and to narrow down the number of tenders which must ultimately be evaluated by the purchaser. In order to be pre-qualified, an enterprise may be required to demonstrate its capacity to perform the contract. In assessing that capacity, the purchaser may consider, for example, the enterprise's experience and past record of performance, its ability to supply the necessary technology, equipment, materials and services, its financial status and existing construction commitments, and its capability to meet the purchaser's safety requirements. State enterprises or financing institutions may keep a list of enterprises which are pre-qualified for all contracts of a particular type. They may up-date this list regularly, requiring enterprises to furnish information or reply to a questionnaire (see paragraphs 13 and 14, below) at stated intervals. Where the purchaser does not already have a list of pre-qualified tenderers he may wish enterprises to pre-qualify before accepting tenders for the works contract.

12. The first step in the pre-qualification process is the advertisement of an invitation to apply for pre-qualification. The factors to be considered in respect of the advertisement are similar to those to be considered in respect of the advertisement of an invitation to tender (see paragraphs 15 and 18, below).[1]

13. To enable the purchaser to decide whether to pre-qualify an enterprise it is desirable for him to require enterprises applying for pre-qualification to complete a questionnaire. Such a questionnaire may be sent by the purchaser to enterprises applying to be pre-qualified, and may be so formulated as to elicit information relevant to the considerations referred to in paragraph 11, above.[2] The questionnaire sent to enterprises may be accompanied by instructions for its completion, including directions as to the language to be used in completing the questionnaire, the currency in which financial information is to be expressed, and the date by which the completed questionnaire must be submitted, as well as by information about the project.

14. The replies to the questionnaire submitted by enterprises should then be evaluated by the purchaser in accordance with criteria for pre-qualification established by him. Such criteria may have to conform to the applicable law or

to the requirements of a financing institution. Thus, the purchaser may be prohibited from denying pre-qualification to an enterprise for reasons unrelated to the capacity of the enterprise to perform the contract. After evaluating the replies to the questionnaire, the purchaser should notify non-successful enterprises that they have not pre-qualified, and may send all enterprises which have pre-qualified notices informing them of their pre-qualification and inviting them to submit tenders. At the same time, the purchaser may send to enterprises which have pre-qualified a full set of the documents for prospective tenderers (see paragraph 19, below).

2. *Invitation to tender*

15. Once the purchaser has sufficient information about the works to be constructed (e.g., in the case of a turnkey contract, when the output requirements and other performance parameters are known or, in other cases, when the design of the works is completed or almost completed), he will be in a position to formulate the terms of the invitation to tender. The purpose of the invitation to tender is to provide potential tenderers with basic information about the proposed works and to solicit from enterprises offers to construct the works in accordance with the tender documents. The information to be provided by the purchaser in the invitation may include, for example, a general description of the works, specifying the scope of the construction and the technical characteristics of the required equipment, materials and construction services, the date for completion of construction, the date for submission of tenders, the date and place of opening of tenders, the address to which requests for tender documents and other information should be sent, and the cost of tender documents. It may also state any eligibility requirements for tenderers (e.g., a requirement of a financing institution that participation in the tendering process is restricted to enterprises from member States of that institution).[3] Where this information has been provided in the invitation for pre-qualification it may be unnecessary to issue a formal invitation to tender. In many cases, the invitation to tender may be prepared with the assistance of the purchaser's consulting engineer.

16. Under the open tendering system, the invitation to tender may be required to be advertised internationally in such a manner as to give an opportunity to all potentially interested and eligible enterprises to participate in the tender process. With respect to the media in which the advertisement is to appear, the applicable law may require advertisement in certain media (e.g., the official gazette of a country). The purchaser may also consider advertising in local newspapers, foreign newspapers circulating in the major commercial centres of the world, technical journals and trade publications. If the construction is being financed by a financing institution, the purchaser may have to comply with the advertisement requirements, if any, of that institution, which may include advertisement in a specified periodical, such as the business edition of *Development Forum*.[4]

17. Under the limited tendering system, the invitation to tender is sent individually to the enterprises selected by the purchaser. Where pre-qualification procedures have been used, the invitation may be sent only to enterprises which have pre-qualified. In some cases, the invitation may be accompanied by a full set of the documents needed by prospective tenderers in order to

formulate and submit a tender (see section B, 3, below). In other cases, it may only indicate the address to which requests for the tender documents and other information should be sent.

18. It is advisable for the invitation to tender to specify clearly the date by which enterprises must submit their tenders to the purchaser, since tenders may be invalid under the tender procedures if they are submitted late. The amount of time after the advertisement of the invitation to tender, or its delivery to enterprises, allowed for the submission of tenders, may depend upon the accessibility of the site for inspection by prospective tenderers, the scope and complexity of the construction to be effected, and whether there was pre-qualification. In order for all enterprises to have approximately the same amount of time to obtain the documents to be provided to prospective tenderers and to prepare and submit their tenders, it is desirable for the timing of the advertisement of the invitation to tender or the delivery of the invitation to enterprises to be carefully co-ordinated. Thus, the timing of the advertisement in the various media may take into account the fact that different media may publish at different intervals (e.g., daily, monthly, quarterly), and the timing may be such that the advertisement appears at approximately the same time in all the media.

3. *Documents to be provided to prospective tenderers*

19. In many cases, it will be desirable for the documents to be provided to prospective tenderers to be prepared by an engineer on the purchaser's staff or by a consulting engineer engaged by the purchaser (see chapter X, "Consulting engineer"). The documents may consist, *inter alia*, of the following: the instructions to tenderers (see paragraphs 20 to 25, below); a model form of tender (see paragraph 26, below); the contractual terms required by the purchaser (see paragraph 27, below); the technical specifications and drawings (see chapter V, "Description of works and quality guarantee", paragraphs 10 to 19); a model form of tender guarantee (if such guarantee is required by the purchaser; see paragraphs 28 to 30, below); if a performance guarantee is to be required of the contractor (see chapter XVII, "Security for performance", paragraphs 10 to 12), a model form of that guarantee; and evidence of authority (certifying that persons signing the tender have the necessary authority to do so; see paragraph 22, below). The technical specifications which the purchaser may be required to provide (depending on the contractual approach adopted) will be of particular importance to prospective tenderers. The provision of model forms of the documents which are to be completed and submitted by the tenderer with his tender will assist the purchaser in comparing and evaluating tenders. Where there have been no pre-qualification procedures, the purchaser may also supply prospective tenderers with a questionnaire, similar to a pre-qualification questionnaire (see paragraph 13, above), for completion by the tenderer and submission with his tender. It may be advisable for the documents to be made available in at least one language customarily used in international commercial transactions.

(a) *Instructions to tenderers*

20. The purpose of the instructions is to provide guidance for the preparation of tenders and to convey information on matters relating to the evaluation of tenders. It is advisable for the instructions to inform tenderers of the purchaser's requirements in regard to the preparation, contents and submission

of tenders. Where model forms of the tender, of the contractual terms and of any required tender and performance guarantees are not supplied by the purchaser to the tenderer, it is advisable for the purchaser's requirements in regard to the tender and guarantees to be fully set out in the instructions (see paragraphs 26 to 30, below). The instructions may list the documents which are to be submitted with a tender (these should include, among others, all documents, duly completed, of which model forms were provided to tenderers). The instructions may indicate whether an enterprise may submit a tender with alternative offers and, if so, the item or items in respect of which alternatives are acceptable (e.g., transportation arrangements, insurance, or the design of less important items of equipment). The instructions may also specify whether tenders in respect of only portions of the construction are acceptable. In addition, the instructions may set out the general criteria by which the purchaser will evaluate the tenders (e.g., the weight to be given to the tender price and to other factors). The instructions may state that the purchaser reserves the right not to select any tender (see paragraph 43, below).

21. The instructions may inform the tenderers of the date or the time within which tenders are to be submitted, and the place for submission, as well as the number of copies of the tender documents to be submitted. They may inform tenderers of any particular requirements concerning the manner in which tenders are to be submitted. For example, the purchaser may wish to require tenderers to prepare their tenders in accordance with the "two-envelope" system whereby two documents are submitted. The first document details the technical elements proposed for the construction by the tenderer, but does not mention the price. The second document contains the tender price (see paragraph 35, below).

22. The instructions may specify the language or languages that may be used in completing the tender documents. They may also set out any requirements of the purchaser as to how the tender price or, in the case of cost-reimbursable contracts, the costs, are to be expressed. For example, they may specify the currency in which the costs and price are to be quoted, and may specify that portions of the price that are allocated to certain aspects of the construction must be shown separately. The purchaser may wish to require in the instructions that all documents submitted with the tender are to be typed or written in indelible ink and that all erasures in a document are to be signed or initialled by the persons signing the document. Further, he may wish to require that all signatures on the tender documents are to be those of persons who are authorized to sign on behalf of the tenderer, and that their authority is to be evidenced in the manner required by rules of the applicable law.

23. The procedures according to which the tenders will be opened and the tenderers notified of the outcome of the evaluation of tenders may be specified in the instructions. So, too, may the procedure envisaged for entering into the contract (see section D, below). The instructions may set out the purchaser's requirements regarding the eligibility of tenderers. They may also require a tenderer who has been pre-qualified (see section B,1, above) to update the information contained in the questionnaire previously completed by him in connection with his pre-qualification. The purchaser may wish to specify that the costs of preparing and submitting tenders are to be borne by the tenderers.

24. The instructions may specify a date up to which the tender must remain in effect after the date for submission of tenders has passed. In this regard, the purchaser may wish to ensure that sufficient time is allowed to permit the tenders to be evaluated, for the successful tenderer to be selected and notified, for any necessary discussions between the purchaser and the successful tenderer to take place prior to the conclusion of the contract, for any required approvals or licences to be obtained from the purchaser's Government or from a lending institution, and for the submission of a performance guarantee by the successful tenderer. The purchaser may wish to reserve the right, if necessary, to extend the validity period of the tender by notifying all the tenderers of the extension and its length. The instructions may provide that tenderers who agree to such an extension must prolong their tender guarantees, if any, to cover the period of the extension, and that tenderers who do not so agree will be deemed to have withdrawn their tenders, but without forfeiting their tender guarantees. The instructions may provide that tenderers are not permitted to change the terms of their tenders or withdraw their tenders after they have been submitted, including any period of extension. Alternatively, they may specify the circumstances in which tenders may be modified or withdrawn.

25. The instructions may set out the means by which a prospective tenderer can inspect the site. The instructions may also set out the procedures by which a prospective tenderer may obtain clarification of the documents provided to him. The instructions may describe the circumstances, if any, in which the purchaser may be permitted to alter the tendering procedure, and the rights of prospective tenderers consequent upon such alteration.

(b) *Model form of tender*

26. The model form of tender may require the offer of the tenderer to construct the works, as expressed in his tender, to conform to the contractual terms, technical specifications and drawings supplied by the purchaser. Furthermore, it may contain a consent by the tenderer to be bound by all the requirements, terms and conditions set out in the instructions to tenderers. It may also require the tenderer to detail in his offer all matters in respect of which the tenderer's offer is solicited. These may include, for example, the price and details of the conditions of payment (see chapter VII, "Price and payment conditions"); factors such as the anticipated costs of operating and maintaining the works; a time-schedule for the completion of the construction; and details of the services after construction which the contractor is prepared to supply (see chapter XXVI, "Supplies of spare parts and services after construction").

(c) *Contractual terms*

27. It is desirable for the purchaser to draft the contractual terms on the basis of which a works contract is to be entered into with the successful tenderer and to supply these terms to prospective tenderers with the other tender documents (see paragraph 19, above). Unless this is done, it will be difficult for the purchaser to compare and evaluate tenders, as each tender may be submitted on the basis of different contractual terms. Many aspects of the contractual terms prepared by the purchaser are not usually the subject of

negotiations between the purchaser and a tenderer (although the purchaser may allow certain details to be discussed); rather, in determining his tender price, the tenderer will take into account the terms proposed and the allocation of costs, risks and liabilities reflected in them. Part two of this *Guide* makes recommendations as to the various issues which may be addressed in these contractual terms, and the ways in which these issues may be dealt with.

(d) *Tender guarantee*

28. The purchaser may wish to consider requiring a tenderer to submit with his tender a tender guarantee in a specified amount. A tender guarantee may be required by the applicable law. The guarantee may provide that the amount of the guarantee is recoverable by the purchaser without proof of loss if, within the validity period of the guarantee, the tenderer withdraws his tender before the purchaser has selected a tenderer with whom to enter into a contract or if, having been selected as the successful tenderer, he fails to enter into a works contract with the purchaser in accordance with his tender or fails to provide the required performance guarantee. The tender guarantee should indicate whether it is payable on demand or whether the purchaser will need to prove the tenderer's liability before being entitled to payment.

29. In determining the required amount of the tender guarantee, the purchaser may consider such questions as what amount would constitute an adequate deterrent to the tenderer from withdrawing his tender or from failing to enter into a works contract in accordance with his tender or to provide the required performance guarantee and what amount would be sufficient to compensate the purchaser for the loss which he may suffer upon such a withdrawal or failures. For example, the purchaser may wish to be compensated for the cost of any new tender procedures that may be necessary and for the difference between the defaulting tenderer's price and the often higher price of a tender selected by the purchaser in the same or in new tender procedures, as well as for losses arising from any postponement in the commencement of construction due to the necessity of enagaging in new tender procedures. The amount of the tender guarantee may be set forth as a specific amount or as a percentage of the tender price.

30. The purchaser may require the tender guarantee to remain in force for a specified period beyond the date to which the tender is to remain in effect (see paragraph 24, above) in order to permit the purchaser to claim against the guarantor. The purchaser may require the tenderer who is chosen as the contractor, or with whom a contract is concluded, to extend the validity of the tender guarantee until the required performance guarantee is provided. He may require the guarantee to be of a particular type and may require the guarantee amount to be payable in a particular currency. Possible types of tender guarantee may include a standby letter of credit, a bank guarantee, or a guarantee issued by an insurance or bonding company. The purchaser may wish to specify the institutions acceptable to him for the purposes of issuing a guarantee (see, also, chapter XVII, "Security for performance", paragraphs 14 to 16). To ensure that the tender guarantee submitted is acceptable, the purchaser may wish to provide prospective tenderers with a model form of a tender guarantee.

4. *Opening of tenders and selection of contractor*

(a) *Opening of tenders*

31. The purchaser should determine whether he must conform to any procedures for the opening of tenders required by mandatory rules of the applicable law or by an international institution financing the project. For example, tenders are often required by the laws or regulations in the country of the purchaser, and by international financing institutions, to be opened in the presence of the tenderers or their representatives. If the purchaser so wishes, even persons who have not tendered may be permitted to be present at a public opening (cf. paragraph 35, below).

32. There may be exceptional circumstances in which the private opening of tenders, without tenderers being present, may be justified, such as when the works to be constructed is related to national security. As this procedure can lead to abuses, many lending institutions will not permit it. However, when tenders are to be opened in private, confidence in the opening procedures might be enhanced if individuals of recognized integrity (e.g., auditors or senior civil servants) were asked to participate in them.

(b) *Evaluation of tenders*

33. The purpose of tender evaluation is to compare the tenders submitted to the purchaser in order to identify the one which most closely complies with the purchaser's requirements, taking into account all relevant factors. The criteria for evaluating tenders may be governed by mandatory rules of the applicable law or the rules of an institution financing the project. The evaluation procedure, unlike the opening of tenders, is usually conducted without the tenderers being present. It is not necessary for the same persons to both open and evaluate the tenders.

34. In evaluating the tenders, the purchaser will need to compare the terms proposed in the tenders with his own requirements and consider how well these coincide. The tender price need not necessarily be the most important criterion in choosing amongst the tenderers. For example, the purchaser will need to be satisfied that, if chosen, a particular tenderer will be able to fulfil all his obligations within a certain time limit. The purchaser may, during the evaluation period, seek from a tenderer any clarification needed to evaluate a tender.

35. When the "two-envelope" system of tendering is used (see paragraph 21, above), the envelopes containing the technical elements are opened first, often in private, without the tenderers or their representatives being present, and the technical elements compared and evaluated to determine whether they comply with the purchaser's requirements. Thereafter, the envelopes containing the tender prices submitted by those tenderers whose technical proposals comply with the purchaser's requirements are opened in the presence of the tenderers or their representatives or at a public session, and the tenders in their entirety are evaluated in greater detail. This procedure may lead to a more objective evaluation of the technical elements, because these elements are assessed on their merits without a consideration of the tender price. On the other hand, the system may have the disadvantage that a tender which departs from the technical requirements set forth by the purchaser in the tender documents but

which could result in significant cost savings and could be otherwise acceptable to the purchaser would be rejected before the second envelope (containing the tender price) is opened. Accordingly, where the purchaser's technical requirements are flexible, this system may not be appropriate.

36. The process of evaluating tenders may take place in stages: preliminary screening, detailed evaluation, and discussions with the most acceptable tenderer.

(i) Preliminary screening

37. A preliminary screening of tenders may be used to determine whether the tender complies with the purchaser's requirements as to the tender itself and the accompanying documents. This may involve examining:

(*a*) Whether all the required documents, including any model forms supplied, have been submitted duly completed;

(*b*) Whether the tenderer has met any eligibility requirements, e.g., whether he is on the list of qualified contractors (if pre-qualification procedures were used) or whether he meets the requirements, if any, laid down by a financing institution;

(*c*) Whether the tender substantially complies with the contractual terms and technical requirements set out in the invitation to tender and the instructions to tenderers;

(*d*) Whether the tender has been signed by an authorized representative of the tenderer.

38. The documents may also be checked for arithmetical or clerical errors at this stage, and tenderers who have submitted tenders which appear to contain such errors may be contacted and given an opportunity to correct them. The process of screening may enable the purchaser to place the tenders in different categories. Some tenders may contain substantial deviations from the requirements of the purchaser, and will not need to be considered further. Others may contain deviations which appear to be inadvertent (e.g., omission of required documents). In such cases the purchaser may contact the tenderer to inquire whether he wishes to rectify the deviation. Yet other tenders may contain minor deviations or alternatives which the purchaser is prepared to consider, but which have to be quantified in financial terms and assessed when a detailed evaluation is being made of the tenders. Tenders may also contain reservations and qualifications to particular contractual terms proposed by the purchaser in the tender documents. The purchaser may decide to accept some of these, and may wish to discuss others with the tenderer (see paragraph 40, below). Any reservations or qualifications accepted by the purchaser will have to be quantified and assessed during the evaluation of the tenders.

(ii) Detailed evaluation

39. The general criteria to be considered in the detailed evaluation and comparison of tenders will usually have been set out in the instructions to tenderers. As has been mentioned, the tender with the lowest price need not necessarily be the most acceptable (see paragraph 34, above). The purchaser may also take into account other contractual obligations concerning which offers were solicited by the purchaser (see paragraph 27, above), as well as the

likelihood of the tenderer being able to fulfil his obligations (taking into account, for example, the tenderer's financial status, his past record, and his other contract commitments). Depending on the nature of the contract, further criteria (e.g., the extent of the transfer of technology to the purchaser, the nature of the skilled personnel allocated by the tenderer to the performance of the contract, the scope of the training of the purchaser's personnel proposed, the extent to which work is to be sub-contracted) may be considered in assessing the tenders. In the detailed evaluation, any deviations, qualifications or alternatives (see paragraph 38, above) stated by a tenderer must be evaluated in terms of their direct and indirect costs and benefits to the purchaser in order to determine which is the most acceptable tender.

(iii) Discussions with most acceptable tenderer

40. The purchaser may hold discussions with the most acceptable tenderer in order to consider any deviations in the tender from the purchaser's design or specifications, or alternatives in the tender to the contractual terms accompanying the invitation to tender (see paragraph 38, above). Through these discussions the parties may seek to resolve any differences there may be between the purchaser's requirements and the terms of the tenderer's offer. Mandatory rules of the applicable law or of a lending institution financing the construction may permit only details and qualifications or alternatives in respect of minor matters to be open to alteration once the tender has been received or opened by the purchaser. In that case, the purchaser's discussion with the most acceptable tenderer will be limited to those minor issues or details. But where the law of the purchaser's country and the rules of any relevant lending institution so permit, the discussions the purchaser may have with the most acceptable tenderer may be of a broader scope (see, also, paragraph 47, below).

(c) Post-qualification and selection of successful tenderer

41. The purchaser must be satisfied that the most acceptable tenderer is able to perform the contract. If a pre-qualification procedure has been used or a questionnaire as to his qualifications has been completed by the tenderer, the purchaser may need only to make certain that the tenderer's ability to perform has not deteriorated between the time of pre-qualification or the completion of the questionnaire and the time of the decision to select him. If these procedures have not been used, the purchaser may wish to require the tenderer to complete a questionnaire such as the one described in relation to pre-qualification (see paragraph 13, above).

42. Once the purchaser is satisfied that the most acceptable tenderer is able to perform the contract, he will notify the successful tenderer of his selection. The purchaser's written acceptance of the tender may of itself be sufficient to convert the tender into a concluded contract. Usually, however, the terms contained in the tender are incorporated in a formal, detailed contract entered into by the parties. The parties, or one of them, must prepare the contract incorporating all the terms of the tender and any changes or additions to which they may have agreed in their discussions (as to the drafting of the contract, see chapter IV, "General remarks on drafting"). Once the successful tenderer has entered into a contract and has furnished the required performance guarantee,

the tender guarantees of unsuccessful tenderers may be returned, unless they have already expired (see paragraph 30, above; cf. chapter XVII, "Security for performance", paragraph 37).

(d) *Rejection of all tenders*

43. If, under the applicable tender laws or regulations he is permitted to do so, the purchaser may reject all tenders received by him. Some international financing institutions, however, may require purchasers borrowing from them to conform to guidelines which limit the right of the purchaser to reject all tenders. Furthermore, the applicable law may contain mandatory rules requiring the purchaser to accept a tender which meets certain conditions.

C. Negotiation

44. Under this approach, the purchaser contacts one or more enterprises which he judges to be capable of constructing the works and negotiates with them with a view to concluding a contract with the enterprise which offers the best terms. The negotiations need not take place within a formal procedural framework. Nevertheless, it may be advisable for the negotiating parties to agree upon a certain basic framework for the negotiations. For example, at the outset of the negotiations, the parties may wish to agree, where there is no general obligation of confidentiality, that certain types of information (e.g., in respect of technological processes) disclosed by a party during the course of negotiations are to be kept confidential by the other party. In addition, they may wish to stipulate that no contractual obligations exist between the parties until such time as a written contract has been entered into between them (see paragraph 49, below).

45. It is desirable for the purchaser to furnish the enterprise or enterprises with which he is negotiating with documents describing the scope of the construction to be effected and the main technical characteristics of the works required and also containing the contractual terms proposed by the purchaser. Those documents may serve as a basis for the negotiations between the parties, and may contribute to the smooth progress of the negotiations. It may be useful to keep minutes of the negotiations as they progress, and those minutes may be authenticated on behalf of each party.

46. Where the purchaser negotiates with only one enterprise he may wish to require the tenderer in his offer to itemize the price in such a way as will enable the purchaser to compare the prices for different items and services with those he knows to have been paid for similar items or services. The absence of competition when the purchaser is negotiating with one enterprise means that only by such a comparison will the purchaser be able to evaluate the reasonableness of the price sought by the potential contractor.

47. In certain circumstances (see paragraph 4, above), the purchaser may be able to combine the tendering approach with the negotiating approach. For example, the purchaser may invite enterprises to submit tenders and, on receipt of their tenders, negotiate with the more acceptable tenderers. However, there may be reasons why the purchaser, even though he is free to do so, may not wish to employ such a combined approach. For instance, under this approach

tenderers may submit a higher tender price than they would if strict tendering were adopted in order to allow themselves a margin by which to reduce their tender price during negotiations to that which they would have submitted under strict tendering.

D. Entering into contract

48. In drafting and entering into the contract, the parties should take account of the applicable legal rules governing the formation and validity of the contract. Some of these rules may be of a mandatory nature.

1. *Form of contract*

49. Whichever approach to concluding the contract is adopted, the law governing the formation of the contract may require a works contract to be in a written form. Even where such a requirement does not exist it is advisable for the parties to reduce their agreement to writing to avoid later disputes as to what terms were actually agreed upon. It is also advisable for the contract to provide that it may be modified or terminated only by agreement in writing. Recommendations as to the drafting of the contract are contained in chapter IV, "General remarks on drafting".

2. *Validity and entry into force of contract*

50. In some cases, the parties may wish to provide that contractual obligations between them are to arise from the date the contract is entered into. In other cases, however, the parties may wish to provide that the contract is to enter into force on a date subsequent to the date on which the contract is entered into. For example, the parties may wish to agree that contractual obligations are to arise only from the date when a specified pre-condition is fulfilled (e.g., the date on which a required licence is obtained).

Footnotes to chapter III

[1]*Illustrative sample of invitation to apply for pre-qualification*

"The purchaser is a [ ] having its principal office at [ ] and carries on the business of [ ]. The purchaser proposes to construct works for the manufacture of [ ]. The works to be constructed should comply with the following requirements: [here insert technical description of the works]. The purchaser intends entering into a contract with a contractor for the supply of the technology, equipment, materials, civil engineering, building and other construction services [here state the purchaser's requirements in the construction of the works], necessary for the construction of the aforementioned works. It is desired to have these works completed by the [ ] day of [ ] or within [ ] days of the conclusion of the tendering procedures. The anticipated date for the entering into of the contract is [ ] day of [ ].

"Tenders for the supply of the aforementioned technology, equipment, materials and civil engineering, building and other construction services will be considered only if they are submitted by parties considered qualified to tender on the basis of their replies to the pre-qualification questionnaire prepared in respect of this project.

"Copies of this questionnaire can be obtained from [ ]. Completed questionnaires should be submitted to the purchaser at the address given above on or before the [ ] day of [ ]."

[2] *Illustrative questionnaire to be given to enterprises that wish to be pre-qualified*

"The purchaser requires information regarding the following matters from enterprises that desire to be pre-qualified to tender for the construction of the works described in the invitation to pre-qualify. On the basis of the information supplied in response to this questionnaire, the purchaser will determine which parties are qualified to tender for the construction.

"The information required is as follows:

"1. A description of the enterprise applying for pre-qualification, including details of its structure and organization and the extent of its experience as a contractor;

"2. A financial statement certified by a qualified, independent person showing the assets and liabilities of the enterprise, and its working capital;

"3. Bankers' references;

"4. Details of the numbers, categories and, where available, the names and *curricula vitae* of supervisory staff and other key personnel proposed to be employed in the construction and their experience in the construction of industrial works;

"5. A description of the source and nature of the main items of equipment and materials proposed to be used in the construction, the names of the principal subcontractors proposed to be employed in the construction, and the aspects of the construction for which they will be used;

"6. A list of projects of comparable size and complexity which the enterprise has completed in the previous five years; the identities of the purchasers and the consulting engineers in those projects; the final contract price and the final costs for each of those projects; if the final contract price for a project was higher than the original contract price, the reasons therefor; whether each project was completed satisfactorily; and similar information on the performance record of the principal subcontractors proposed to be employed;

"7. Information regarding the failure, if any, of the enterprise to complete work under a construction contract to which it was a party;

"8. The enterprise's existing and anticipated work commitments;

"9. The nature and amount of the enterprise's existing insurance coverage;

"10. The name and address of the enterprise's performance bonding company for the past five years and, if different, the name of the bonding company from which the enterprise intends to secure performance bonds for future work;

"11. Any types of business other than construction in which the enterprise is financially interested;

"12. Any other information which the enterprise believes will be relevant to a decision to engage it for the construction."

[3] *Illustrative invitation to tender*

"The purchaser is a [ ] having its principal office at [ ] and carries on the business of [ ]. The purchaser proposes to construct works for the manufacture of [ ]. The works to be constructed should comply with the following requirements: [here insert technical description of the works]. The purchaser intends entering into a contract with a contractor for the supply of the technology, equipment, materials, civil engineering, building and other construction services [here state the purchaser's requirements in the construction of the works] necessary for the construction of the aforementioned works.

"Any enterprises interested in tendering for the supply of all or any of the aforementioned technology, equipment, materials and civil engineering, building and other construction services should complete the tender documents which are available from [ ] and submit them in sealed envelopes. The fee for the supply of these documents is [ ]. The tender documents must be delivered to the purchaser at the above given address before the hour of [ ] on the [ ] day of [ ].

"A tender guarantee in an amount of [ ] is required. Evidence of such a guarantee must be submitted with the completed tender documents.

"This project is being financed by [ ]. Accordingly, before a tender can be accepted, the eligibility criteria of the said financing institution(s) must be fulfilled by the tenderer".

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Part Two

Chapter IV. General remarks on drafting

SUMMARY

Each party may find it desirable to establish for himself a procedure setting out the steps which it is necessary to take in negotiating and drawing up a works contract. When tendering procedures are adopted prior to entering into the contract, it is necessary for a first draft to be prepared by the purchaser to be submitted to prospective tenderers with the invitation to tender. If the contract is entered into on the basis of negotiations, a first draft may be prepared by one of the parties after negotiations have taken place on the main technical and commercial issues. Each party may find it useful to designate one person to be primarily responsible for supervising the preparation of the contract documents (paragraphs 1 to 3).

In drawing up the contract the parties should take into account the law applicable to the contract. They should also take into account the different types of relevant mandatory legal rules of an administrative, fiscal or other public nature in the country of each party (paragraphs 4 and 5). The parties may find it useful to examine standard forms of contract, general conditions, standard clauses or previously concluded contracts as aids to drafting, though their provisions should not be adopted without critical examination (paragraph 6).

The contract may be drawn up in only one language version, or in the two languages of the parties where those languages differ. If the contract is drawn up in two language versions, it is advisable to specify which version is to prevail in the event of a conflict between the versions. If the parties provide that both versions are to have equal status, they should attempt to provide guidelines for the settlement of disputes arising out of a conflict between the versions (paragraphs 7 and 8).

The parties may wish to identify and describe themselves in a document which is designed to come first in logical sequence among the contract documents, and to perform a controlling role over the other documents. That document should set forth the names of the parties, their addresses, the subject-matter of the contract, and also record the date on which and the place at which the contract was signed. Parties to works contracts are usually legal entities, and the parties may wish to investigate prior to entering into the contract such issues as the capacity of the entity to enter into the contract and the authority of an official to bind the entity (paragraphs 9 to 10).

The contract should be reduced to writing. It may, in addition, be desirable for the documents forming the contract to be clearly identified, and rules provided for resolving inconsistencies between contract documents (paragraphs 11 and 12). The parties may wish to clarify the extent to which oral exchanges, correspondence and draft documents which came about during the negotiations may be used to interpret the contract documents (paragraph 13).

The parties may wish to provide that headings and marginal notes used in the contract to facilitate its reading are not to be regarded as affecting their rights and obligations. If considered desirable, recitals may be included in the controlling document to describe the object of the contract, or the context in which it was entered into (paragraphs 14 and 15).

Works contracts frequently require a party to notify the other party of certain events or situations. It is desirable to require that all notifications be given in writing. The parties may determine the time when a notification is effective: either upon dispatch by the party giving the notification, or upon delivery to the party to whom the notification is given (paragraphs 18 to 21). The parties may wish to specify in their contract the legal consequences of a failure to notify (paragraph 22).

The parties may find it useful to define certain key words or concepts which are used in their contract. If a definition is to apply throughout a contract, it may be included in the controlling contract document. In formulating definitions relevant to their contract, the parties may find it useful to consider the definitions given in this chapter, and descriptions of concepts contained in other chapters of this *Guide* (paragraphs 23 to 26).

A. General remarks

1. A works contract is usually the end product of extensive exchanges between the parties, including oral communications and correspondence (see chapter III, "Selection of contractor and conclusion of contract"). Each party may find it desirable to establish for himself a procedure setting out the necessary steps to be taken in negotiating and drawing up the contract. Such a procedure, which may include suggestions made in this chapter, could be used as a checklist so as to reduce the possibility of omissions or errors occurring in the steps taken prior to entering into the contract. The purchaser may also wish to consider whether he needs legal or technical advice in drawing up the contract to supplement his own capabilities.

2. When tendering procedures are adopted, it is necessary for a first draft to be prepared by the purchaser to be submitted to prospective tenderers, since they will need to know the terms they are expected to meet when they submit their tenders. The preparation of a first draft may enable the purchaser to clarify his objectives and to determine his negotiating stance. However, if the contract is to be entered into on the basis of negotiations without the use of tendering procedures, it may be preferable for negotiations on the main technical and commercial issues to take place before a first draft is prepared, and for the parties to agree thereafter that one of them is to submit a first draft which reflects the agreement reached during the negotiations. A first draft may be discussed, refined and elaborated, resulting in a preliminary set of contract documents which, after final review, will become the contract between the parties.

3. A contract may need to be administered at a time long after the negotiations have taken place by persons who have not participated in the negotiations which resulted in the contract. Accordingly, the parties may wish to take particular care to ensure that the contract terms as expressed in writing are unambiguous and will not give rise to disputes, and that the relationship between the various documents comprising the contract is clearly established. To this end, each party may find it useful to designate one person, either on his

staff or specially retained for this purpose, to be primarily responsible for supervising the preparation of the contract documents. It is advisable for that person to be a skilled draftsman familiar with international works contracts. To the extent possible, it is advisable for that person to be present during important negotiations. Each party may find it useful to have the final contract documents scrutinized by a team having expertise in the areas of knowledge reflected in the documents in order to ensure accuracy and consistency of style and content.

4. The law applicable to the contract (see chapter XXVIII, "Choice of law", paragraph 1) may affect the contract in different ways. For example, that law may contain rules on the interpretation of contracts and may contain presumptions as to the meaning of certain words or phrases. It may also contain mandatory rules regulating the form or validity of contracts which it is advisable to take into account in drawing up the contract. In certain circumstances, the applicable law may contain non-mandatory rules regulating the contract in regard to certain issues, for instance, in regard to the quality of the goods and services to be supplied. One approach is for the applicable law to be determined at a very early stage of the relationship between the parties. Thus, where tendering procedures are adopted, the applicable law may be stipulated in the invitation to tender, or where those procedures are not adopted, that law may be agreed to at the commencement of negotiations. The contract may then be negotiated and drawn up taking that law into account. Another approach is for the parties to determine the applicable law only after negotiations have taken place on the main technical and commercial issues and have resulted in a measure of agreement between the parties (see paragraph 2, above). They may thereafter review the first draft of the contract, which reflects that agreement, in the light of the applicable law to ensure that the terms of the draft take account of the regulation by that law.

5. In drawing up the contract, the parties should take into account, in addition to the law applicable to the contract, the different types of relevant mandatory legal rules of an administrative, fiscal or other public nature in the country of each party. They should also take into account such mandatory legal rules in other countries when those rules are relevant to the performance of the contract. Certain rules may concern the technical aspects of the works or the manner of its construction (e.g., rules relating to environmental protection, or safety standards to be observed during construction), and the terms of the contract should not conflict with those rules. Other rules may concern export, import and foreign exchange restrictions, and may be taken into account when formulating the rights and obligations of the parties arising out of the export and import of equipment and materials, the supply of services and the payment of the price (e.g., the contract may provide that certain rights and obligations are not to arise until export or import licences have been granted). Legal rules in the country of the supplier of technology, whether he be the contractor or a third person, may regulate the terms upon which the technology can be transferred. Legal rules relating to taxation may be a factor influencing the contracting approach to be chosen (see chapter II, "Choice of contracting approach", paragraph 3, and chapter VII, "Price and payment conditions", paragraph 5) and may determine whether provisions are to be included in the contract dealing with liability for tax. Furthermore, the parties may wish to take into consideration treaties on the avoidance of double taxation which may have been concluded between their countries.

6. The parties may find it useful to examine standard forms of contract, general conditions, standard clauses, or previously concluded contracts as aids to facilitate the preparation of contract documents. Such aids may clarify for the parties the issues which are to be addressed in their negotiations. However, it is inadvisable to adopt their provisions without critical examination. Those provisions may, as a whole, reflect an undesirable balance of interests, or the various terms of the forms, conditions or contracts examined may not accurately reflect the terms agreed to by the parties. The parties may find it advisable to compare the approaches adopted in the forms, conditions or contracts examined by them with the approaches recommended in this *Guide*, and to refer to the illustrative provisions set forth in the various chapters of the *Guide* as aids to drafting (see also "Introduction", paragraphs 16 and 17).

B. Language of contract

7. The contract may be drawn up in only one language version (which need not be the language of either of the parties), or in the two languages of the parties where those languages differ. Drawing up the contract in only one language version will reduce conflicts of interpretation in regard to contractual provisions. On the other hand, each party may understand his rights and obligations more easily if one version of the contract is in his language. If one language only is to be used, the parties may wish to take the following factors into account in choosing that language: that it is advisable for the language chosen to be understood by the senior personnel of each party who will be implementing the contract; that it is advisable for the language to contain the technical terms necessary to reflect the agreement of the parties on technical issues; that it is advisable for the contract to be in a language commonly used in international commerce; that the settlement of disputes might be facilitated if, where the contract contains a jurisdiction clause (see chapter XXIX, "Settlement of disputes", paragraph 51) the language chosen is the language in which proceedings are conducted in the selected court, and where the contract does not contain a jurisdiction clause, the language chosen is one of the languages of the country of the applicable law.

8. If the parties do not draw up the contract in a single language version, it is advisable to specify in the contract which language version is to prevail in the event of a conflict between the two versions. For example, if the negotiations were conducted in one of the languages, they may wish to provide that the version in the language of the negotiations is to prevail. A provision that one of the language versions is to prevail would induce both parties to clarify as far as possible the prevailing language version. The parties may wish one language version to prevail in respect of certain contract documents (e.g., technical documents) and another language version in respect of the remainder of the documents. Alternatively, the parties may provide that both language versions are to have equal status. In that case, however, the parties should attempt to provide guidelines for the settlement of disputes arising out of a conflict between the two language versions. For example, they may provide that the contract is to be interpreted according to the understanding of a reasonable person, due consideration being given to all the relevant circumstances of the case, including any practices which the parties have established between themselves and usages regularly observed in inter-

national trade by parties to international works contracts. The parties may also wish to provide that where a term of the contract in one language version is unclear, the corresponding term in the other language version may be used to clarify that term.

C. Parties to and execution of contract

9. Where the contract consists of several documents, the parties may wish to identify and describe themselves in a principal document which is designed to come first in logical sequence among the documents, and to perform a controlling role over the other contract documents. Where the contract consists of a few documents, and their interrelationship is clear, this controlling role may be reduced. The document should set forth, in a legally accurate form, the names of the parties, indicate their addresses, record the fact that the parties have entered into a contract, briefly describe the subject-matter of the contract, and be signed by the parties. It should also set forth the date on which, and the place where, the contract was signed, and the time at which it is to enter into force. Subsequent reference in the contract to the parties would be facilitated if the phrases "hereinafter referred to as the purchaser" and "hereinafter referred to as the contractor" are added after the names of the purchaser and contractor respectively. The construction of works is sometimes undertaken by two or more enterprises acting in collaboration (sometimes referred to as a consortium: see chapter II, "Choice of contracting approach", paragraphs 9 to 16). In such cases, the names and addresses of each enterprise may be set out. A party may have several addresses (e.g., the address of its head office, the address of a branch through which the contract was negotiated) and it may be preferable to specify in the document the address to which notifications directed to a party may be sent.

10. Parties to works contracts are usually legal entities. In such cases the source of their legal status (e.g., incorporation under the laws of a particular country) may be set out in the contract. There may be limitations on the capacity of legal entities to enter into contracts. Therefore, unless satisfied of the other party's capacity to enter into the contract, each party may wish to require from the other some proof of that capacity. If a party to the contract is a legal entity, the other party may wish to satisfy himself that the official of the entity signing the contract has the authority to bind the entity. If the contract is entered into by an agent on behalf of a principal, the name, address, and status of the agent and of the principal may be identified, and evidence of authority from the principal enabling the agent to enter into the contract on his behalf may be annexed (unless sufficient evidence of authority has already been provided with the tender documents: see chapter III, "Selection of contractor and conclusion of contract", paragraph 22).

D. Contract documents, hierarchy and interpretation

11. It is desirable that the terms of the works contract be certain, and the documents which form the contract be clearly identified. The parties should in the first place reduce to writing the terms agreed upon between them. In addition, the contract should provide that any modification to such terms is also to be effected in writing. The documents forming the contract (e.g.,

documents setting out contract terms, drawings and specifications) may be attached as annexes to the principal document (see paragraph 9, above), with the principal document making clear through a definition of "the contract" (see paragraph 24, below) or otherwise, that the principal document and the annexes constitute the contract. When a draft document produced at an early stage of the negotiations is later intended to be a contract document, it is advisable to make this clear in the principal document. Some provision in the contract is desirable for the inclusion of new documents, such as drawings, specifications, variation orders, training or maintenance documents and schedules, which will only be produced after the contract is signed, but which will become part of the contract documents at some time through a pre-arranged contract mechanism. Where, for reasons of convenience, a single contract document is physically divided into parts, the parts may be identified as together constituting a single document.

12. Despite the best efforts of the parties to achieve consistency, it may be discovered during the performance of a contract that provisions in two documents, or even within the same document, appear to be inconsistent. It may be advisable to provide a method of determining which provision is to prevail in such cases. Parties may wish to provide that, where the principal contract document is inconsistent with other documents, it should always prevail. In particular, the contract should clarify that the obligations of the contractor with regard to the required type and operational capability of the works should, in the event of a conflict, prevail over the scope of the construction as indicated in the specifications and drawings. Where specifications and drawings are inconsistent, which document is to prevail may depend on the aspect of the construction involved. For example, it is often provided that in respect of civil engineering drawings are to prevail over specifications. A possible approach may be to provide that, unless the contract provides otherwise in respect of any special aspect of the construction, specifications should prevail over drawings. This approach may be justified on the basis that written terms may be considered a more reliable reflection of the agreement between the parties than data contained in drawings. As regards other documents, parties may wish, to the extent possible, to determine and indicate in the contract the order of priority among them. Where it is not possible to indicate an order of priority, the contract should provide that any dispute between the parties as to priority should be settled in dispute settlement proceedings (see chapter XXIX, "Settlement of disputes").

13. The parties may wish to clarify the relationship between the contract documents on the one hand, and the oral exchanges, correspondence and draft documents which came about during the negotiations leading to the contract, on the other. The parties may wish to provide that those communications and documents are not part of the contract. They may further provide that those communications and documents cannot be used to interpret the contract, or, alternatively, that they may be used for this purpose to the extent permitted by the applicable law. Under the law applicable to the contract, oral exchanges and correspondence might in some cases be relevant to the interpretation of the contract even if they come about after the contract is entered into. The parties may also wish to clarify in the manner described above the relationship between those communications and documents and the contract documents.

14. Contract documents, or groups of related provisions within a single document, may be introduced by headings. Furthermore, short marginal notes

may also be sometimes placed by the side of contract provisions indicating the substance of those provisions. Since headings and side notes are generally inserted only to facilitate the reading of the contract, the parties may wish to provide that they are not to be regarded as setting out or affecting the contractual rights and obligations of the parties.

15. The parties may wish to consider whether the principal contract document is to contain introductory recitals. The recitals may set forth representations made by one or both parties which induced the parties to enter into the contract. The recitals may also set out the object of the contract or describe the context in which it was entered into. The extent to which recitals are used in the interpretation of a contract varies under different legal systems, and their impact on interpretation may be uncertain. Accordingly, if the contents of recitals are intended to be significant in the interpretation or implementation of the contract, it may be preferable to include those contents in contract provisions.

16. When a contracting approach involving several contracts is adopted, the time-schedules for the performance by two or more contractors of their respective obligations in regard to different aspects of the construction are often interdependent (see chapter IX, "Construction on site", paragraphs 20 and 21). Thus, delay by one contractor may result in a second contractor being unable to commence his part of the construction on the appointed date. The second contractor may be entitled to recover compensation for loss arising out of the delay from the purchaser and the purchaser will wish, in turn, to be indemnified by the delaying contractor. In order to prevent the delaying contractor from later denying that he failed to foresee the possible consequences of his delay, it may be advisable for each contract to mention the relationship of its time-schedule to related time-schedules of other contracts, and to indicate that delay in performance may cause delay in the performance of other contracts (see chapter XX, "Damages", paragraphs 9 and 10). If a time-schedule integrating the performances of the various separate contracts has been prepared, it may be sufficient to annex this integrated time-schedule to the different contracts. Similarly, plans indicating the interdependency of the various aspects of the construction can be annexed to the contracts.

17. The parties should be aware that the successful implementation of the contract will depend on co-operation between them in that implementation. While it may be impossible for the contract to enumerate instances in which co-operation should occur, it may be desirable for the contract generally to obligate each party to both co-operate with the other party to the extent needed for the performance of the other party's obligations and avoid conduct which would interfere with that performance.

E. Notifications

18. Works contracts frequently require a party to notify the other party of certain events or situations. Such notifications may be required for one or more of the following purposes: to enable co-operation in the performance of the contract (e.g., a notification by the contractor that tests will be held on a specified date: see chapter XII, "Inspections and tests during manufacture and construction", paragraph 13); to enable the party to whom notification is given to take action (e.g., a notification by the purchaser of defects discovered by him

in the works, in order to give the contractor an opportunity to remedy the defects: see chapter XVIII, "Delay, defects and other failures to perform", paragraph 44); as the prerequisite to the exercise of a right (e.g., notification by a party to the other of the existence of an exempting impediment, such notification being a prerequisite to the right of the notifying party to rely on an exemption clause: see chapter XXI, "Exemption clauses", paragraph 27); or as the means of exercising a right (e.g., when the contract requires termination to be in writing: see chapter XXV, "Termination of contract", paragraph 2). The parties may wish to address and resolve in their contract certain issues which arise in connection with such notifications.

19. In the interests of certainty, it is desirable to require that all notifications referred to in the contract be given in writing, although in certain cases requiring immediate action the parties may wish to provide that notification can be given orally in person or by telephone, to be followed by confirmation in writing. The parties may wish to define "writing" (see paragraph 24, below) and to specify the means of conveying written notifications (surface mail, airmail, telex, telegraph, facsimile, electronic data transmissions) that are acceptable. They may also wish to specify the language in which notifications are to be given, e.g., the language of the contract or, in technical matters, the language used by the consulting engineer. With regard to the time when a notification is to be effective, two approaches are available to the parties. They may provide that a notification is effective upon its dispatch by the party giving the notification, or after the lapse of a fixed period of time after the dispatch. Alternatively, they may provide that it is effective only upon delivery of the notification to the party to whom it is given (see paragraph 25, below). Under the former approach, the risk of a failure to transmit or an error by the transmitting agency in transmission of the notification rests on the party to whom the notification is sent, while under the latter approach it rests on the party dispatching the notification. The parties may find it advantageous to select a means of transmitting the notification which provides proof of the dispatch or delivery, and of the time of dispatch or delivery. Another approach may be to require the party to whom the notification is given to acknowledge receiving the notification.

20. It may be convenient for the contract to provide that, unless otherwise specified, one or the other approach with respect to when a notification becomes effective (on dispatch or delivery) is to apply to notifications referred to in the contract. Exceptions to the general approach adopted may be appropriate for certain notifications. Thus, when a general rule is adopted that a notification is to be effective upon dispatch, it may nevertheless be provided, for example, that a notification to be given by a party who has failed to perform is to be effective upon delivery. When a general rule is provided that a notification is to be effective upon delivery, it may nevertheless be provided, for example, that where a purchaser who fails to notify the contractor of the existence of defects in the works loses his remedies in respect of those defects, a notification of defects is to be effective upon dispatch. The contract may obligate the purchaser to maintain a representative on site, who is authorized to give and receive notifications on his behalf.

21. Since the contractor will sometimes have a representative in the country where the works is being constructed, the contract may provide that notifications by the purchaser to the contractor may be given to that

representative, and also that the representative is authorized to give notifications on behalf of the contractor. The uncertainties of foreign transmission of notifications may thereby be reduced. All notifications of a routine character required in the course of the performance of the contract may be given to the representative. If the representative is present on site, a written record of the notifications (e.g., a correspondence log) may be jointly maintained on site by the representatives of the purchaser and the contractor. The contract may also provide that notifications which are not of a routine character (e.g., notifications of suspension of obligations, or termination of the contract) are to be given only to the head office of the parties.

22. The parties may wish to specify in their contract the legal consequences of a failure to notify. The possible legal consequences of a failure to notify by a party who is obligated to give a notification are dealt with in chapter XVIII, "Delay, defects and other failures to perform" (paragraph 65). Certain chapters of this *Guide* refer to notifications which may be needed, or be appropriate, in particular contexts, and deal with the legal consequences which may be appropriate in those contexts for a failure to notify. In some cases, a party to whom a notification is given may be required to give a response to that notification. The parties may wish to specify the consequences of a failure to respond. For example, they may provide that a party to whom drawings or specifications are sent for approval who does not respond within a specified period of time is deemed to approve them.

F. Definitions

23. The parties may find it useful to define certain key words or concepts which are frequently used in their contract. A definition ensures that the word or concept defined is understood in the same sense whenever it is used in the contract, and dispenses with the need to clarify the intended meaning of the word or concept on each occasion that it is used. A definition is advisable if a word which needs to be used in the contract is ambiguous. Definitions contained in a contract are sometimes made subject to the qualification that the words defined bear the meanings assigned to them, "unless the context otherwise requires". Such a qualification deals with the possibility that a word which has been defined has inadvertently been used in a context in which it does not bear the meaning assigned to it in the definition. The preferable course is for the parties to scrutinize the contract carefully to ensure that the words defined bear the meanings assigned to them wherever they occur, thereby eliminating the need for such a qualification.

24. Since a definition is usually intended to apply throughout a contract, a list of definitions may be included in the controlling contract document. Where, however, a word which needs definition is used only in a particular provision or a particular section of the contract, it may be more convenient to include a definition in the provision or section in question.

25. Such words as "contract", "site", "contractor's machinery and tools", "dispatch of notification", "delivery of notification" and "subcontractor" may usefully be defined in the contract. The parties may wish to consider the following definitions and to draw guidance from them in formulating definitions relevant to their contract:

"The contract": "The contract" consists of the following documents, and has that meaning in all the said documents:

(*a*) This document

(*b*) . . .

(*b*) . . .

etc.

"Writing": "Writing" includes statements contained in a telex, telegram or other means of telecommunication which provides a record of such statements.

"Dispatch of a notification": "Dispatch of a notification" by a party occurs when it is properly addressed and conveyed to the appropriate authority for transmission by a mode authorized under the contract.

"Delivery of a notification": "Delivery of a notification" to a party occurs when it is handed over to that party, or when it is left at an address of that party at which, under the contract, the notification may be left.

26. The parties may find it useful, when formulating their own definitions, to consider the descriptions contained in the *Guide* of the various concepts commonly used in works contracts. Those descriptions can be located by the use of the index to this *Guide*.

Chapter V. Description of works and quality guarantee

SUMMARY

It is essential that the contract precisely describe the works or portion of the works to be constructed. The contracting approach chosen by the purchaser, and the procedure adopted for concluding the contract, may determine which party is to prepare the documents describing the construction to be effected (paragraphs 1 and 2). The scope of construction and the technical characteristics of the works may be reflected in the principal contract document, and in specifications, drawings and standards. The parties should clearly identify the descriptive documents which form part of the contract (paragraphs 3 and 4). The technical characteristics of the works, or equipment to be incorporated in the works, may be described in terms of operating capability rather than by reference to designs, materials and workmanship. However, in respect of some items (e.g., materials) technical characteristics may need to be described by reference to appropriate requirements as to the quality (paragraphs 8 and 9).

Specifications may describe in technical language the scope of the construction to be effected, and the technical characteristics of the equipment and materials to be incorporated in the works (paragraph 10). Specifications may have general and special provisions (paragraphs 11 and 12). The character of specifications may differ in respect of various elements of the construction (paragraph 13).

The technical characteristics of certain aspects of the construction may be defined by reference to standards. The specified standards should be internationally accepted and widely used. The standards to be applied should be clearly identified in the contract (paragraphs 14 to 16).

Drawings show in diagrammatic form the various component parts of the works. In some cases the purchaser supplies basic drawings, with the contractor being obligated to prepare detailed drawings which elaborate the technical ideas already contained in the basic drawings. The contract may provide that the detailed drawings are to be submitted to the purchaser for his approval (paragraphs 17 to 19).

Specifications and drawings may be inaccurate or insufficient, or inconsistent with one another. It is advisable to determine which party is to bear the costs occasioned by the supply of inaccurate, insufficient or inconsistent specifications and drawings (paragraphs 20 to 22).

The contract may determine the extent to which a party is to treat as confidential technical documents supplied by the other party, and the consequences of a breach of confidentiality. The contract may provide for the transfer to the purchaser of ownership of technical documents supplied by the contractor, but limit the purposes for which they may be used by the purchaser (paragraphs 23 to 25).

It is advisable to provide for a quality guarantee under which the contractor assumes liability for defects discovered and notified before the

expiry of a guarantee period specified in the contract. The parties may wish to provide for certain limitations to the contractor's liability under the guarantee (paragraphs 26 and 27). Various factors may be taken into account in determining a reasonable length for the guarantee period. It is advisable to determine when the guarantee period commences to run, and the circumstances in which the period may be extended (paragraphs 28 to 31).

A. General remarks

1. It is essential that a works contract precisely describe the works or portion of the works to be constructed. Whether a contractor has failed to perform his construction obligations will be decided by reference to that description (see chapter XVIII, "Delay, defects and other failures to perform", paragraph 1). The description may specify the type of the works (e.g., power station), the scope of the construction (i.e., the entire works or aspects of the construction, such as civil engineering, building or the supply and installation of equipment) and the technical characteristics of the works, equipment, materials and construction services.

2. The contracting approach chosen by the purchaser (see chapter II, "Choice of contracting approach") and the procedure adopted for concluding the contract (see chapter III, "Selection of contractor and conclusion of contract", paragraph 1) may determine which party is to prepare the documents describing the construction to be effected. For example, if the purchaser solicits tenders for the construction of the entire works on a turnkey contract basis, he will describe in his invitation to tender the main technical features and operational capabilities which he requires in the works to be constructed. Tenderers may be obligated to prepare and submit specifications and drawings (see paragraph 3, below) describing, in conformity with the invitation to tender, the technical characteristics of the works that they are prepared to construct. If a contracting approach involving several contracts is chosen by the purchaser, and the design for the works is to be supplied by him, he may need to prepare and supply the specifications and drawings in respect of the construction to be effected by each separate contractor. The totality of the specifications and drawings provided to all the contractors should cover without overlap or omission the entire works to be constructed.

B. Determination in contract documents of construction scope and technical characteristics of works

3. The scope of construction and the technical characteristics of the works may be reflected in different types of contract documents. The principal contract document (see chapter IV, "General remarks on drafting", paragraph 11) may identify the type of works to be constructed, and contain a general description of the scope of the construction to be effected and the technical characteristics of the works. In addition, this document may also indicate the major elements of the scope of the construction to be effected (e.g. building, civil engineering, or the major items of equipment to be installed). A detailed description of the scope of construction, the technical characteristics of the works, and the nature of construction processes to be used may be contained in contract documents usually entitled "specifications" (see section E,

below) and "drawings" (see section G, below). Specifications describe the technical characteristics, and drawings depict the intended use, of equipment, materials and construction services. When civil engineering and building are involved, contracts often contain another type of document which sets forth further details of the scope of the construction to be effected. The contract may also specify technical standards to be observed in the construction (see section F, below).

4. Some of the documents mentioned above focus primarily on legal issues, while others focus on technical aspects and engineering details. Nevertheless, all these documents are legally important because together they determine the scope of construction and the technical characteristics of the works. The parties should therefore clearly identify them as contract documents (see chapter IV, "General remarks on drafting", paragraph 11).

5. In preparing contract documents describing the construction to be effected, the parties should take into account any mandatory rules of an administrative or other public nature in force in the country where the works is to be constructed, or in the country in which equipment and materials are to be manufactured, which regulate technical aspects of the works, equipment, materials and construction processes (see chapter XXVIII, "Choice of law", paragraphs 22 and 23). Such rules are often promulgated to secure the safe operation of the works, environmental protection and proper working conditions for personnel operating the works. Apart from relevant local, national and international legal rules and the provisions of the contract, there may exist local, national and international standards or codes of practice concerning health, safety and environmental conservation. It is advisable for the parties to agree that the contractor will comply with these requirements.

C. Scope of construction

6. In the case of a turnkey contract or product-in-hand contract (see chapter II, "Choice of contracting approach", paragraphs 4 to 8), the general description of the scope of construction (see paragraph 3, above) may be complemented by an additional contractual provision obligating the contractor to effect all construction which, although not specifically described, is nevertheless necessary or usual, having regard to the agreed operational capabilities of the works. Such a provision may avoid disputes as to who is to supply small items of material or perform minor items of construction either forgotten during the negotiations or not considered worthy of special mention. The mere use of the term "turnkey" or "product-in-hand" may not be sufficient to impose such an obligation on the contractor (see chapter II, "Choice of contracting approach", paragraphs 4 to 8).

7. Where more than one contractor is engaged to effect the construction, the purchaser may sometimes wish to add to the description of the construction to be effected by each contractor an enumeration of the construction to be effected by other contractors. Although it is not essential to enumerate construction not to be performed by a contractor, such a negative identification sometimes makes for certainty. Where one contractor is to design the entire works, that contractor may be obligated to describe the construction to be effected by other contractors to enable the purchaser to include that description in the contracts concluded with those contractors (see chapter II, "Choice of contracting approach", paragraph 18).

D. Technical characteristics of works, equipment, materials and construction services

8. The technical characteristics of the works or equipment to be incorporated in it may be described in terms of operation capability rather than by reference to designs, materials and workmanship. By employing this approach, the contractor would be liable for a failure of the works or equipment to reach the agreed capability without a need for the purchaser to prove that the failure resulted from defective design, materials or workmanship. This approach is particularly advisable when the purchaser enters into a turnkey or product-in-hand contract. However, this approach may also be used where several contractors are engaged for the construction, and the portion of the works to be constructed or the equipment to be supplied and installed by each contractor can be described in terms of operation capability. Depending upon the type of works to be constructed, operation capability may be expressed by reference to the quantity and quality of products to be produced by the works, consumption of raw-materials by the works, consumption of power, and other factors.

9. In respect of some items, in particular, materials to be incorporated in the works, a description in terms of operation capability may not be possible, and the characteristics of the materials or construction services may need to be described in technical language, by reference to some appropriate requirements as to the quality (e.g. the strength of steel). The use of terms such as "first class", "the best quality" or "most suitable" to indicate a level of excellence may result in uncertainty. However, the use of certain terms (such as "new and at least of regular commercial quality") may be justified if they have acquired a degree of settled meaning in commercial practice, or under the law applicable to the contract.

E. Specifications

10. Some specifications may describe in technical language the scope of the construction to be effected, and the technical characteristics of the equipment and materials to be incorporated in the works. Other specifications may, in addition, describe the construction processes to be used and how the equipment and materials are to be utilized in the construction processes. In many cases, the specifications are a combination of both approaches.

11. Specifications may have general provisions and special technical provisions. The general provisions in specifications, while corresponding in content to the general description of the construction in the principal contract document (see paragraph 3, above), may be more elaborate. No guidelines applicable in all cases can be laid down for the drafting of these provisions in specifications. However, the generally technical nature of specifications will result in these provisions containing more technical data and being more technically precise and elaborate than the descriptive provisions of the principal contract document. It is advisable for the parties to compare the description of the construction contained in the principal contract document with that contained in the specifications in order to prevent any inconsistency.

12. The special provisions of specifications may contain a detailed technical description of each element of the construction. These provisions may describe the types and kinds of equipment and materials to be used, their physical

properties and performance characteristics, their sizes and dimensions. In some cases these provisions specify the techniques to be used in manufacture, and indicate other technical data which reflect agreed technical characteristics. In some instances, it may be useful for the provisions to specify the construction processes to be used by the contractor, or a special sequence to be followed during the construction process.

13. The character of specifications may differ in respect of various elements of the construction. The specifications for building may need to be more detailed than those for civil engineering due to the multitude of smaller items contained in the building component of the construction. In specifications for equipment, where the emphasis is likely to be on the operation capability of the equipment, the specifications will necessarily have to leave considerable latitude to contractors in selecting the proper design, manufacturing techniques and materials to achieve the required capability. In regard to materials, their technical characteristics may in some cases have to be defined in terms of outward appearance, while in others they may have to be defined in terms of physical or chemical properties. The contract may require specified inspections and tests to be conducted in respect of certain materials in order to ensure that they are of the required quality (see chapter XII, "Inspections and tests during manufacture and construction").

F. Standards

14. Professional engineering institutions and trade associations often specify criteria with which equipment, materials and construction processes may be required to comply. These criteria are referred to in this chapter as "standards". The parties may find it convenient to define the technical characteristics of various elements of the construction (e.g. civil engineering, equipment, materials) by reference to specified standards.

15. Some standards have become internationally accepted and are widely used in international tendering and contracting. Such standards may relate to matters such as the quality, contents, dimensions, form, weight, composition, packing, and testing of certain equipment or materials. As a rule, the use of such standards is advisable, because the standards give tested and verified criteria in respect of the matters which they regulate, and provide an assurance of quality through uniform testing and inspection procedures.

16. Standards to be applied should be clearly identified in the contract, e.g. by reference to the body which issued the standard and the date on which the standard was issued. The parties should make sure that the standards chosen by them are appropriate for the type of works to be constructed, since the use of inappropriate standards may lead to defects in the works. Standards specified in an invitation to tender (see chapter III, "Selection of contractor and conclusion of contract", paragraphs 15 to 18) should be both internationally accepted and familiar in the purchaser's country. Specifying standards which are not internationally accepted may preclude contractors from certain regions from tendering; specifying standards which are not familiar in the purchaser's country may reduce the possibility of engaging subcontractors or using materials from that country.

G. Drawings

17. Drawings show in diagrammatic form the various component parts of the works and, in some cases, the appearance of the whole works. In cases where the purchaser is responsible for supplying the drawings, it may often occur that drawings supplied by the purchaser before the contract is entered into (e.g. together with the invitation to tender) will not be sufficient for the execution of the construction, and that further drawings become necessary. In such cases the purchaser may be obligated to supply further and more detailed drawings after the contract is entered into. Such further drawings should be consistent with earlier drawings, as otherwise the new drawings may be considered a variation order (see chapter XXIII, "Variation clauses", paragraph 3).

18. In some cases, although the purchaser is to supply basic drawings, the contractor may be obligated under the contract to prepare detailed or "shop" drawings (drawings which contain detailed elaboration of the technical ideas already contained in the basic drawings). The contract may provide that the detailed drawings which the contractor is to prepare are not to contain any deviations from the basic drawings. In order to maintain proper control over the work of the contractor, it may in some cases be desirable to obligate the contractor to submit all detailed drawings to the purchaser. The contract may entitle the purchaser to require corrections to be made to the detailed drawings so as to make them accord with the basic drawings, and to require that any work already executed on the basis of inconsistent detailed drawings be re-executed so as to conform to the basic drawings. It is advisable that the contract determine whether detailed drawings submitted by the contractor require the approval of the purchaser before they can be acted upon by the contractor.

19. If the contract requires the purchaser's approval of the detailed drawings, the purchaser may, if he approves the drawings, be obligated to notify his approval within a specified period of time after the drawings have been delivered to him. If he fails to do so, he may be liable for delay in performing this obligation (see chapter XVIII, "Delay, defects and failures to perform", paragraphs 65 and 66). The contract may provide that once he has approved the drawings, the purchaser is entitled to require a change in them only in accordance with the provisions in the contract regulating variations (see chapter XXIII, "Variation clauses"). Where the purchaser is not required to approve drawings, the contract may provide that the absence of objection by the purchaser to detailed drawings is not to be deemed to be consent by the purchaser to deviations in those drawings from the basic drawings.

H. Liability for inaccurate, insufficient or inconsistent specifications and drawings

20. When specifications and drawings are to be supplied by the purchaser, the contractor may be obligated to analyze them with a view to discovering inaccuracies or insufficiencies in the information contained therein, or inconsistencies between them. The contract may provide that the contractor is to be liable for damages if, within a specified or reasonable period of time after he has discovered or could reasonably have been expected to have discovered any inaccuracies, insufficiencies or inconsistencies in the specifications and

drawings, he fails to notify the purchaser of them. The purchaser may be obligated under the contract to pay costs reasonably incurred by the contractor in making corrections and changes required by inaccuracies, insufficiencies or inconsistencies which the contractor did not discover and could not reasonably have been expected to discover. When the contractor could not reasonably have been expected to discover the defects, and the construction must be interrupted due to the defects, the contract should entitle the contractor to be compensated for reasonable costs incurred by him as a result of the defects, including the interruption of his performance, and to an extension of time for completion.

21. When specifications and drawings are to be supplied by the contractor, he may be required under the contract to bear the costs occasioned by all corrections and changes necessitated by inaccuracies, insufficiencies or inconsistencies. Moreover, if there is a resulting delay in the contractor's performance, he may, in addition, be liable to the purchaser for that delay (see chapter XVIII, "Delay, defects and other failures to perform", paragraphs 17 to 25).

22. In some cases drawings might be prepared jointly by the parties, and they may wish to consider how errors in the drawings are to be corrected and how the liability for those errors is to be allocated between them. Where each party prepares a distinct part of the drawings, the contract may provide that each party is liable for errors in that part of a drawing which he has prepared. Where the entire drawing has been prepared jointly, the contract may obligate the parties to correct the errors jointly, and to share equally the costs incurred.

I. Protection of specifications, drawings and other technical documents

23. Each party may sometimes wish to keep the contents of certain specifications, drawings or other technical documents confidential. Mandatory rules of an administrative or other public nature in force in the countries of the parties may regulate the extent to which obligations as to confidentiality may be imposed on a party. Those rules may also obligate the parties to disclose the contents of the documents to public authorities in the country of the purchaser or of the contractor. Where certain documents are to be kept confidential, it is advisable in the contract to identify clearly these documents, and to specify the extent and duration of the confidentiality and the extent of permissible disclosure. The parties may wish to agree that the obligation to maintain confidentiality is to remain in force for a certain duration even if the contract is terminated. The contract may provide that the purchaser is entitled to disclose the contents of confidential documents to persons engaged to complete the construction, to cure defects in the works (see chapter XVIII, "Delay, defects and other failures to perform"), or to maintain or repair the works (see chapter XXVI, "Supplies of spare parts and services after construction") to the extent necessary for those persons to perform their duties, provided those persons give undertakings to the purchaser that they will not disclose the contents to third persons.

24. The contract may provide for the transfer to the purchaser of ownership of the documents containing specifications, drawings and other technical data handed over by the contractor to the purchaser for the purposes of indicating the scope of construction and the technical characteristics of the works. The purchaser may need these documents for later maintenance and repair of the works. Since the contractor may have rights based on industrial or other

intellectual property in respect of the contents of the documents, the parties may wish to provide that the purchaser is entitled to use the documents only for maintenance and repair of the works covered by the contract, but not for the construction of other works.

25. The parties may also wish to provide for the consequences of a breach of an obligation relating to confidentiality (see paragraph 23, above) or the use by the purchaser of a technical document for a purpose for which he is not entitled to use it (see previous paragraph). The aggrieved party may be entitled to damages. If the breach occurs before completion of the construction, the aggrieved party may, in addition, also be entitled in some situations to terminate the contract (see chapter XVIII, "Delay, defects and other failures to perform", paragraph 65).

J. Quality guarantee[1]

26. It is advisable to provide in the contract for a quality guarantee under which the contractor assumes liability for defects in the works, and for inaccuracies or insufficiencies in technical documents supplied with the works, discovered and notified to him before the expiry of a guarantee period specified in the contract. The guarantee may cover the entire works or only a portion of the works, depending on whether the contractor has constructed the entire works or only a portion. What constitutes a defect in the works and the remedies which the purchaser may have when the contractor is liable under the guarantee, and the question whether there exists any liability after the expiry of the guarantee period are discussed in chapter XVIII, "Delay, defects and other failures to perform".

1. *Limitation in scope of guarantee*

27. The parties may wish to agree that the contractor is not to be liable under the guarantee if the works fail to operate in accordance with the contract during the guarantee period as a result of:

(*a*) Normal wear and tear;

(*b*) Faulty operation or maintenance of the works by the purchaser or persons engaged by him, unless the faulty operation or maintenance is the result of incorrect instructions on operation or maintenance given by the contractor;

(*c*) Defective design, equipment or materials supplied or incorrect instructions given by the purchaser;

(*d*) Improper repair or alteration of the works effected without the contractor's consent by the purchaser or a person engaged by him. However, where the contract entitles the purchaser to repair the defects in the works by engaging a new contractor at the expense and risk of the contractor (see chapter XVIII, "Delay, defects and other failures to perform", paragraphs 36, 40 and 47), the contract may provide that the contractor is liable under the guarantee in respect of defects in the works caused by improper repair by the new contractor;

(*e*) Events which cause loss or damage to the works where the risk of such loss or damage is borne by the purchaser (see chapter XIV, "Passing of risk").

2. *Guarantee period*

(a) *Length of guarantee period*

28. Various factors may be taken into account in determining a reasonable length for the guarantee period, such as the nature of the works (in particular the level of sophistication of the equipment installed in the works) and the difficulty of discovering defects. The parties may also wish to take into account the length of the guarantee period which is usually specified under international trade practice in respect of works of the same type or works with similar characteristics. The purchaser may have to pay a higher price if he wants a guarantee period that is longer than normal. In respect of certain types of works, it may be reasonable to specify guarantee periods of different lengths in respect of different portions of the works.

(b) *Commencement of guarantee period*

29. If a single contractor is to construct the entire works, the guarantee period may commence to run from the date of acceptance of the works by the purchaser, or, alternatively, from the date of take-over of the works by him. If several contractors are engaged for the construction, and the portion of the works constructed by a contractor (e.g. a power station) can be operated and performance tests conducted in respect of that portion before completion of construction of the rest of the works, the guarantee period may commence to run when that portion of the works is accepted or taken over by the purchaser (see chapter XIII, "Completion, take-over and acceptance"). If it is not possible to operate that portion and conduct performance tests in respect of that portion until the completion of construction of the entire works, it may be provided that the guarantee period in respect of that portion commences to run from the date of acceptance of the entire works. However, the contractor may be reluctant to postpone the commencement of the guarantee period until the date of acceptance of the entire works, since this might lead to an extension of the period for which the contractor is responsible for defects as a result of the delay of another contractor. An approach which may resolve this difficulty is to add to the normal guarantee period for that portion of the works an estimated period for completing the rest of the construction, and to provide that the guarantee period in respect of the portion is to consist of the combined length of these two periods, commencing to run from the date of completion of the construction of the portion by the contractor. If this approach is adopted, a delay in the completion of the entire construction due to a failure of performance by another contractor will not result in any extension of the guarantee period. Another approach which may resolve the difficulty is to provide in the contract that the normal guarantee period for the portion of the works commences to run from the date of acceptance or take-over of the entire works, but that the guarantee does not extend beyond a longer period of time to be specified in the contract, which would be longer than the normal guarantee period, commencing to run from the date of completion of the portion constructed by the contractor.

(c) *Extension of guarantee period*

30. The contract may provide that the guarantee period is to be extended by any period of time during which the works cannot be operated as a result of a defect covered by the guarantee. This extension may cover the entire works if

no part thereof could be operated, or a portion thereof if only a portion could not be operated. If defective equipment or materials are repaired or replaced, a new guarantee period may commence to run in respect of the repaired or replaced equipment or materials. If as a result of the defects in the equipment and materials the works could not be operated, this new guarantee period may commence to run from the date when the works can be operated after the repair or replacement. If the works could be operated despite the defects in the equipment and materials, the new guarantee period may commence to run from the date of the repair or replacement. The contract may determine the length of the new guarantee period. The parties may wish to consider whether it is advisable to agree that any new guarantee period is not to exceed a maximum period commencing to run from the date that the initial guarantee period in respect of the equipment or materials commenced to run.

3. *Manufacturer's guarantee*

31. If equipment to be installed in the works is not manufactured by the contractor but by third persons, those manufacturers may provide to the contractor a guarantee in respect of that equipment with a guarantee period longer than the guarantee period provided by the contractor to the purchaser in respect of the construction to be effected by the contractor. The contractor may be obligated to inform the purchaser of the content and length of such guarantees provided by manufacturers, and to transfer to the purchaser all the contractor's rights arising from such guarantees. If a transfer is not permitted under the applicable law, the parties may wish to agree that the guarantee provided by the contractor to the purchaser is not to expire in respect of the equipment covered by the manufacturer's guarantee before the expiration of that guarantee.

Footnote to chapter V

[1]*Illustrative provisions*

"(1) The contractor guarantees that, during the guarantee period, the works will be capable of operation in accordance with the contract, that all equipment, materials and other supplies annexed to or forming part of the works will conform with the drawings, specifications and other contractual terms relating to the equipment, materials or other supplies, and that all technical documents supplied by him are correct and complete.

"(2) The contractor is liable only in respect of defects in the works, equipment, materials or other supplies, or inaccuracies and insufficiencies in technical documents, which are notified to him by the purchaser before the expiry of the guarantee period.

"(3) The contractor is not liable under paragraphs (1) and (2) of this article if the works fail to operate in accordance with the contract during the guarantee period as a result of:

- normal wear and tear;
- faulty operation or maintenance carried out by the purchaser or persons engaged by him, unless the faulty operation or maintenance is a result of incorrect instructions on operation or maintenance given by the contractor;
- defective design, equipment or materials supplied or incorrect instructions given by the purchaser;
- improper repair or alteration of the works effected by the purchaser or persons engaged by him, unless the repair or alteration was effected with the written consent of the contractor;
- any event which causes loss or damage to the works where the risk of such loss or damage is borne by the purchaser.

"(4) The guarantee period commences to run from the date of [acceptance] [take-over] of the works, and continues for . . . (indicate a period of time).

"(5) The guarantee period ceases to run during any period of time during which the works is not capable of being operated due to a defect covered by this guarantee. If only a portion of the works is not capable of being operated, the guarantee period ceases to run in respect of that portion.

"(6) When the works cannot be operated as a result of defective equipment or materials, and the defective equipment or materials are repaired or replaced, a new guarantee period commences to run in respect of the repaired or replaced equipment or materials from the date the works can be operated after the repair or replacement. Where the works can be operated despite defective equipment or materials, a new guarantee period commences to run in respect of the repaired or replaced equipment or materials from the date of the repair or replacement."

Chapter VI. Transfer of technology

SUMMARY

The purchaser will require a knowledge of the technological processes necessary for production by the works, and require the technical information and skills necessary for its operation and maintenance. The communication to the purchaser of this knowledge, information and skills is often referred to as the transfer of technology (paragraph 1).

Differing contractual arrangements can be adopted for the transfer of technology and the performance of the other obligations necessary to construct the works (paragraph 2). The transfer of technology itself may occur in different ways, for example, through the licensing of industrial property (paragraph 3), through the creation of a joint venture between the parties (paragraph 4) or the supply of confidential know-how (paragraph 5). The information and skills necessary for the operation and maintenance of the works may be communicated through the training of the purchaser's personnel or through documentation (paragraph 6).

The manner in which the technology is to be described may depend on the contractual arrangements which are adopted (paragraph 11). When deciding whether various restrictions are to be imposed on the purchaser's use of the technology, the parties should take into account mandatory legislation which may regulate such restrictions and should attempt to negotiate provisions which are balanced and which impose only those restrictions necessary to protect the legitimate interests of each party (paragraphs 12 to 16).

The guarantees to be given by the contractor may depend on the contractual arrangements adopted. Under certain arrangements a separate guarantee in respect of the technology may be unnecessary, while under other arrangements a qualified guarantee may be given that the use of the technology will result in the operation of the works in accordance with specified parameters provided certain conditions are satisfied (paragraph 17). The price for technology which is transferred is usually determined as a lump sum or in the form of royalties (paragraphs 18 to 20).

The parties may wish to include in the contract an undertaking by the contractor that the use of the technology transferred will not result in claims by a third person whose industrial property rights may be infringed by the use (paragraph 21). They may wish to specify the procedure to be followed by them and their rights and obligations in the event of a claim by a third person (paragraph 22).

The contractor will wish to obligate the purchaser to maintain confidentiality in respect of know-how supplied. The contract should clearly define the extent to which confidentiality is imposed, and provide for situations in which the purchaser may reasonably need to disclose the know-how to third persons (paragraphs 23 and 24).

In drafting contract provisions on the training of the purchaser's personnel, issues to be dealt with may include the categories and numbers of trainees, their qualifications, the procedure for selecting the trainees, the places at which they are to receive training, and the duration of the training (paragraphs 27 to 29).

The training obligations of the contractor should be clearly defined. The contractor may be obligated to engage trainers with qualifications and experience appropriate for the training (paragraph 30). The contract should also fix the payment conditions relating to the training (paragraph 31).

When technical information and skills are conveyed through documentation, the contract may address such issues as the description of the documents to be supplied, demonstrations needed to explain the documents, and the times at which the documents are to be supplied (paragraphs 33 and 34).

A. General remarks

1. The works to be constructed will embody various technological processes necessary for the manufacture of products by the works in a form suitable for use or marketing. The purchaser will often wish to acquire a knowledge of these various processes and their application. The purchaser will also wish to acquire the technical information and skills necessary for the operation and maintenance of the works. Even where the purchaser has the basic capability to undertake certain elements of the construction (e.g., building, civil engineering), he may need to acquire a knowledge of special technical processes necessary to effect the construction in a manner appropriate to the works in question. The communication to the purchaser of this knowledge, information and skills is often referred to as the transfer of technology.

2. It may be noted that differing contractual arrangements can be adopted for the supply of technology and the performance of the other obligations necessary to construct the works (see chapter II, "Choice of contracting approach"). For example, the purchaser may select a contractor who is able to supply the technology to be embodied in the works, as well as to construct the works or that portion of the works which embodies the technology. Alternatively, the purchaser may enter into one contract for the supply of the technology, and into one or more separate works contracts for the construction of the works embodying that technology.

3. The transfer of technology may occur in different ways. It may occur through the grant of licences to use industrial products or processes which are the subject of different forms of industrial property. Most legal systems provide for the registration, subject to certain conditions, of industrial products or processes which are thereby recognized and protected under the law relating to industrial property in force within the territory of the country in which the registration takes place. The owner of the industrial property obtains the exclusive right to exploit the products or processes which are the subject of the industrial property. A common form of industrial property consists of patents. Under the legal systems of many countries, a person who invents a product or

process can apply to a governmental institution designated by the law of the country for the grant to him of a patent protecting the invention in the country. Once a patent is granted, for a limited period determined by the legal system, the invention which is the subject-matter of the patent can be exploited in that country only with the consent of the patent holder. A person can apply in more than one country for the grant to him of a patent. Most legal systems also recognize other forms of industrial property. For example, a distinctive sign used to identify goods and indicate their origin (e.g., as coming from a particular manufacturer) may be protected through registration as a trade mark. A protected trade mark cannot be used without the consent of the registered owner of the trade mark. In these cases, the transfer of technology would occur in conjunction with the licence of a trade mark. A patent holder or the owner of a trade mark may licence the patent or trade mark to the purchaser (i.e., permit the purchaser, subject to the conditions of the licence, to use the subject-matter of the patent, or the trade mark, in return for remuneration). Some legal systems recognize additional forms of industrial property, such as utility models and industrial designs.

4. One of the ways of assuring a complete and permanent transfer of technology by the contractor to the purchaser concerning the product or the industrial process is the creation of a joint venture between them in order to exploit the industrial works. Some of the advantages of joint ventures between contractors and purchasers are mentioned in chapter II, "Choice of contracting approach", paragraphs 26 to 31. If transfer of technology is important to the purchaser, he should at an early stage investigate the feasibility of one of the various kinds of joint ventures.

5. Certain industrial processes may be known only to one or a few enterprises. These enterprises might not wish, or may have been unable, to protect the industrial processes through registration in accordance with the law relating to industrial property. They may, instead, keep this knowledge confidential. In such cases, the transfer of technology may occur through the supply of this knowledge (generally called know-how) to the purchaser.[1] Such supply is usually subject to conditions as to the maintenance of confidentiality by the purchaser (see paragraphs 24 and 25, below).

6. The information and skills necessary for the operation and maintenance of the works may be communicated by the contractor through the training of the personnel of the purchaser (see section D, below) or through documentation (see section E, below). It may be noted that the different ways in which technology is transferred referred to in this and the previous paragraphs may be combined.

7. The *Guide* does not attempt to deal comprehensively with contract negotiation and drafting relating to the licensing of industrial property, or the supply of know-how, as this subject has already been dealt with in detail in publications issued by certain United Nations bodies.[2] The present chapter merely notes certain major issues which the parties may wish to address when a works contract contains provisions relating to the licensing of industrial property or the supply of know-how.

8. In drafting their contract provisions relating to the transfer of technology, the parties should take account of mandatory legal rules regulating such transfers which may be in force in the purchaser's and the contractor's countries.[3] Regulation may take place directly through laws specifically directed

at the transfer of technology. Among those laws are legal regulations prohibiting or restricting the transfer of certain kinds of advanced technology. Contracts violating the prohibitions or restrictions may be void or unenforceable. Under some legal regulations, contracts involving the transfer of technology require the approval of a governmental institution prior to their entry into force. Such an institution may implement the national policy on technology by requiring the contract to contain terms transferring certain forms of technology possessed by the contractor (e.g., technology which might increase productivity in the purchaser's country), or by requiring the deletion or modification of terms which transfer other forms of technology (e.g., where indigenous technology exists equivalent to that sought to be transferred). Contracts or contractual provisions which are not approved may be void or unenforceable. Furthermore, legal regulations often exist which make void or unenforceable contractual provisions in transfer of technology transactions which restrain competition between entities, or which hinder the technological development of a country (see paragraph 12, below). Legal regulations may also govern the pricing of technology. They may, for example, require each element of the technology transfer to be separately priced, or regulate the extent of the price payable, or the manner of payment (e.g., the manner in which royalties are to be calculated).

9. Indirect regulation of transfer of technology may occur when export or import licences are not granted in respect of equipment which embodies certain kinds of technology, or when authority to make payment for technology is refused under exchange control regulations. Even where the law of the purchaser's country mandatorily regulates the transfer of technology in the interests of the purchaser, contract provisions may be needed to supplement that transfer, and to ensure that the purchaser will obtain the knowledge and skills needed to operate the works so that it achieves the performance parameters specified in the contract. Contract provisions on technology transfer will assume even greater importance when the law of the purchaser's country does not regulate the transfer of technology.

10. Where tenderers or enterprises with which the purchaser is negotiating (see chapter III, "Selection of contractor and conclusion of contract") have made offers to construct the works which reflect different technological processes, the purchaser should determine which is the most appropriate process for his needs and for local conditions. A less sophisticated or older technology may be more appropriate, in particular if it can be acquired at a lower price.

B. Issues common both to licensing and to know-how provisions

1. *Description of technology*[A]

11. In some cases the contract may need to contain a precise and comprehensive description of the technology. Such a description may be needed, for example, where the purchaser adopts a contracting approach involving several contracts, i.e., with one enterprise for the supply of the technology and for the supply and installation of some of the equipment necessary for the utilization of the technology, and with other enterprises for the performance of other obligations necessary to construct the works (e.g.,

supply of design of the works, civil engineering or building). Even where a single contractor is to perform all the obligations necessary to construct the works (e.g., under a turnkey contract), such a description may be needed if the purchaser requires a particular technology to be used. In some cases, however, the purchaser may prefer the obligations of a turnkey contractor to be defined primarily in terms of constructing works which, when operational, will achieve certain performance parameters (e.g., produce goods of a quantity and quality stipulated in the contract). In these cases a general description of the technology may be sufficient, and the contractor may be required to provide the description since he has special knowledge of the technology which he proposes to embody in the works.

2. *Conditions restricting use of technology*

12. The contractor may sometimes be prepared to transfer technology only if the purchaser accepts certain restrictions on the purchaser's use of the technology, or on the purchaser's disposal of the products obtained by using the technology. Some of these restrictions are regulated by mandatory legal rules in many countries (e.g., declared void or unenforceable) not only because they create possible hardship to the purchaser, but also because they may conflict with public policy (for example, the restrictions may restrain competition, or hinder the development of national technological capabilities). Some legal rules also exist at a regional level regulating these restrictions on the basis of the public policy existing within the region. Attempts are also being made at the global level to formulate norms which may be applicable to these restrictions where they are included in international transfer of technology transactions.[5] This chapter does not attempt to make normative recommendations as to the formulation of these restrictions, but merely describes a few restrictions of special importance in the context of works contracts, and the interests of the parties in regard to them. It is very desirable that the parties attempt to negotiate provisions which are balanced and which impose only those restrictions necessary to protect the legitimate interests of each party.

13. The contractor might seek to include a provision that the purchaser is obligated to purchase from him, or from sources designated by him, some or all of the raw materials or semi-finished articles needed for the production of goods by the works. The contractor might seek to include such a provision when, for example, the goods produced by the works can be associated with him by third parties (e.g., if they bear his trade mark), and the quality of the goods depends on the quality of the materials or articles used in their production. He may also wish to prevent any lowering of the quality of the goods if the goods are to be bought by him, or to be supplied to his customers. Such a provision may, however, be disadvantageous to the purchaser (e.g., he may be able to obtain from other sources on more advantageous terms materials or articles of the same quality as those which the contractor wishes to supply). A provision reconciling these competing interests may, for example, provide that the purchaser is obligated to purchase the materials or articles from the contractor, but that the contractor in turn is obligated to supply the materials or articles on terms not less favourable than the terms offered by the contractor to any other of his customers, or on terms not less favourable than those on which the purchaser can secure materials or articles of the same quality from another source.

14. The contractor might seek to include a provision that the purchaser is prevented from adapting the technology, or from introducing innovations to it. He might seek to include such a provision because he fears that adaptations or innovations by the purchaser may lower the quality of the products obtained by using the technology, and that such a lowering of quality may adversely affect him (see previous paragraph). The purchaser, however, might wish to adapt the technology to suit local conditions, or to introduce innovations which lower the cost of production, even if the adaptations or innovations lead to a slight loss of quality in the products. This loss of quality may not be significant in relation to the purchaser's requirements. A provision reconciling these interests of the parties may, for example, provide that the purchaser may not adapt the technology or introduce innovations to it without the consent of the contractor if the goods to be produced by the works are to bear a trade mark of the contractor.

15. The contractor might seek to include a provision that the purchaser is obligated to communicate to the contractor any improvements to the technology made by the purchaser in the course of using it. Such a provision could have certain disadvantages to the purchaser. It could prevent the purchaser from competing with the contractor in the field of technology in question, since the level of technological knowledge of the contractor will be maintained at a level not less than that of the purchaser. If, in addition to being obligated to communicate the improvements to the contractor, the purchaser is also obligated not to disclose them to third parties, the purchaser may be prevented from realizing their full commercial value. If the improvements are to be communicated without remuneration therefor being paid by the contractor, the contractor could benefit at the purchaser's expense. Since each party to a transfer of technology usually has an interest in obtaining improvements to that technology made by the other party, the contract may, for example, provide that each party is obligated to communicate to the other improvements he has made to the technology, and the party acquiring the improvements may in return be obligated to pay a reasonable remuneration. Another possibility is for the parties to make arrangements for joint research with a view to improving the technology.

16. The contractor might seek to include a provision restricting the purchaser from exporting the products manufactured by the use of the technology to countries specified in the contract. He may previously have supplied confidential know-how to enterprises in the specified countries, and given undertakings to them that in the further supply of the know-how to others he would ensure that those others would not compete in the specified countries. Or, again, an enterprise other than the contractor might have industrial property rights covering the same technology in the specified countries, and export of the products to the specified countries by the purchaser might result in legal proceedings being brought against the contractor. The purchaser may himself be interested in principle in export restrictions, since he might wish the contractor to restrict others from exporting to the purchaser's country competing products manufactured by using the same technology. On the other hand, the purchaser might seek to have export possibilities after the market capacity in his own country is exhausted. Mandatory legal rules relating to restrictive business practices[6] and to the transfer of technology are of special relevance in the field of export restrictions, and the parties may find it advisable to agree upon an equitable provision, taking those rules into account. For example, while export restrictions might be imposed on the purchaser in respect of certain markets, other export markets might be reserved exclusively for him.

3. *Guarantees*[7]

17. When the turnkey contract approach is adopted and the obligations of the contractor are defined primarily in terms of the construction of works which, when operational, will achieve specified performance parameters (see paragraph 11, above), no separate guarantee concerning the technology may be necessary, as the guarantees concerning the operation of the works would require the supply of appropriate technology by the contractor. Where, however, a contracting approach involving several contracts is adopted (see paragraph 11, above), the supplier of the technology may be unwilling to give a guarantee concerning the operation of the works, since whether the works will operate in accordance with the specified parameters will depend on proper performance of their construction obligations by other enterprises. The supplier of technology may in such cases be required to guarantee that the use of the technology will result in the operation of the works in accordance with certain specified parameters, provided the technology is utilized and the works is constructed in accordance with conditions specified by him (e.g., use of certain construction methods, standards, components and raw materials; use of a certain design for the works; provision of certain operating conditions). Guarantees in respect of the operation of the works, together with issues such as the length, commencement and extension of the guarantee period, and defects excluded from the guarantee, are dealt with in chapter V, "Description of works and quality guarantee", paragraphs 26 to 31.

4. *Payment for technology*[8]

18. The price for technology which is transferred is usually determined as a lump sum, or in the form of royalties. The unit-price method (see chapter VII, "Price and payment conditions", paragraphs 25 to 27) is unsuitable, as no units are supplied. When the contractor obtains the technology from a third person, the parties may in some cases wish to adopt the cost-reimbursable method and to provide that the costs incurred in obtaining the technology are to be reimbursed by the purchaser, provided that they do not exceed a specified limit (cf. chapter VII, "Price and payment conditions", paragraph 15).

19. If the lump-sum method is used, the total price is determined at the time the contract is entered into, and this price is payable in one or more instalments. The price for the supply of know-how is often determined as a lump sum. If the royalty method is used, the price payable (i.e., the royalty) is fixed by reference to some economic result of the use of the transferred technology. For example, the royalty is often fixed by reference to the production, sales, or profits arising from the use of the technology. Where the volume of production is used as the reference factor, the royalty may be determined, for instance, as a fixed amount per unit or quantity (e.g., per ton or per litre) produced. Where the volume of sales is used as the reference factor, the royalty may be determined as a percentage of the sales price. Under each method, what is meant by production, sales price, or profits will need careful definition.

20. Each method of price calculation may have certain advantages and disadvantages,[9] depending on the economic circumstances attending the contract. If, for example, royalties are payable over a long period, economic circumstances may change during this period affecting the volume of sales, and consequently the royalties payable. The two methods may also be combined (e.g., an initial lump-sum payment followed by the payment of royalties).

5. *Claims by third person*[10]

21. The purchaser may wish to include in the contract an undertaking by the contractor that the use of the technology transferred will not result in claims against the purchaser by a third person whose industrial property rights may be infringed by the use. Infringement may occur, for example, through the use of a process which is transferred, or through the distribution of products manufactured by using the process, or through the construction of the works itself. The contractor may wish to include an undertaking by the purchaser that, where the contractor has to manufacture equipment in accordance with designs supplied by the purchaser, the manufacture will not infringe the industrial property rights of a third person. Because of the difficulty of conducting a world-wide investigation as to whether any third persons may have industrial property rights in the technology transferred, a supplier will normally undertake only that the use of the technology transferred will not infringe the rights of third persons in specified countries.

22. The parties might wish to specify the procedure to be followed by them in the event of a claim by a third person that his industrial property rights have been infringed, or that the industrial property rights held by the parties are invalid. Each party may be obligated to notify the other of any claim immediately after he learns of the claim. If legal proceedings are brought against the transferee of the technology as a result of the transfer, the supplier may be obligated to assist the transferee in his defence by, for example, bearing the costs incurred in the defence, giving legal advice, or producing evidence as to the validity of the industrial property rights of the supplier. The parties might seek to specify their rights and obligations during the pendency of the legal proceedings (e.g., they may provide for the suspension of royalty payments by the purchaser during the proceedings). They may further provide, for example, that, if the claim by the third person succeeds and the supplier is found to be in breach of his undertaking, the use of the technology transferred will not infringe the rights of third persons (see previous paragraph), royalty payments are to cease, that royalties already paid are to be reimbursed, or that modified technology which does not infringe the rights of the third person and which does not adversely affect the capability of the works to operate in accordance with the contract is to be supplied.[11]

C. Issue special to know-how provisions: confidentiality[12]

23. The contractor will usually require the know-how supplied by him to be kept confidential (see paragraph 5, above). He may require such confidentiality at two stages. Firstly, he may supply some know-how to the purchaser during negotiations in order to enable the purchaser to decide whether he wishes to enter into a contract, and to make proposals as to contract terms. He will wish the purchaser to keep this know-how confidential. Secondly, if a contract is entered into, the contractor will require the additional know-how supplied thereafter to be kept confidential. To achieve these results, it may be necessary under some legal systems for the parties, prior to the commencement of negotiations, to conclude an agreement under which the purchaser undertakes to maintain confidentiality with regard to know-how supplied during negotiations, and thereafter to include provisions on confidentiality in the works contract if the negotiations lead to the conclusion of a contract. Other legal

systems, however, impose on parties involved in negotiations obligations as to the observance of good faith during negotiations. These obligations would entail the maintenance of confidentiality by the purchaser. Where the applicable law imposes obligations as to the maintenance of good faith, the contractor may wish to consider whether it is necessary for him to supplement those obligations by contractual obligations as to the maintenance of confidentiality.

24. The extent to which contractual provisions may impose obligations as to confidentiality on the purchaser may be regulated by mandatory legal rules in the purchaser's country. Issues to be addressed by such contractual provisions may include clear identification of the know-how to be kept confidential, the duration of the confidentiality (e.g., a fixed period) and the extent of permissible disclosure (e.g., disclosure being permissible in specified circumstances, or to specified persons). The parties might seek to provide that once the know-how to be kept confidential becomes available to the public, the obligation of confidentiality terminates, as does the obligation to pay royalties. The parties may also wish to provide, for example, that an engineer employed by the purchaser to supervise the construction is to be allowed access to such of the know-how as is necessary for him to exercise effective supervision. They may further wish to provide that if the contract is terminated by the purchaser because of a failure of performance by the contractor, or because the contractor is prevented by an exempting impediment from completing the construction (e.g., regulations in the contractor's country prevent him from exporting certain equipment), and the purchaser wishes to complete the construction by engaging another contractor, the purchaser may disclose to the other contractor such part of the know-how as is necessary for completion of construction by the other contractor. The purchaser may, however, be obligated to obtain from the engineer or the other contractor prior to the disclosure of the know-how to him an undertaking that he will not disclose the know-how to others.

25. In some cases an obligation of confidentiality may need to be imposed on the contractor (e.g., when improvements to the technology made by the purchaser are communicated to the contractor). A contractual provision for this purpose may be included in the contract. The issues to be taken into account when formulating a contractual provision imposing confidentiality on the purchaser (see paragraph 24, above) may also be relevant in formulating such a provision.

D. Training of personnel

26. The most important method of conveying to the purchaser the technical information and skills necessary for the proper operation and maintenance of the works is the training of the purchaser's personnel. In order to enable the purchaser to decide on his training requirements, in the invitation to tender or during the contract negotiations the purchaser might request the contractor to supply him with an organizational chart showing the personnel requirements for the operation and maintenance of the works, including the basic technical and other qualifications which the personnel must possess (see also chapter XXVI, "Supplies of spare parts and services after construction"). This statement of requirements should be sufficiently detailed to enable the

purchaser to determine the extent of training required in the light of the personnel available to him. The contractor will often have the capability to provide the training. In some cases, however, the training may be given more effectively by a consulting engineer, or through an institution specializing in training.

27. It may be advisable for the contract to fix the categories of employees in respect of which training is to be given, the numbers to be trained, and the duration of the training. It may also be advisable to fix the qualifications which trainees for a particular post must possess (e.g., educational background, linguistic abilities, technical skills, work experience). If these qualifications are not agreed in the contract, the contractor may have grounds for attributing the failure of the training to lack of relevant qualifications. The parties may also wish to provide that the selection of trainees is to be done jointly by the parties. Despite these procedures, the contractor may find during training that it is not feasible to train a particular trainee. The contractor may in those cases be obligated to inform the purchaser of, and provide supporting evidence for, his finding immediately after he makes it. The parties may thereafter be obligated to consult with a view to reaching an appropriate solution.

28. It is advisable to define clearly the training obligations of the contractor in relation to each category of trainee. In this connection, the contract may obligate the contractor to supply to the purchaser a training programme which will enable the trainees to obtain the information and skills necessary for the proper discharge of their duties in the operation and maintenance of the works. The programme may include a time-schedule for training which is harmonized with the time-schedule for construction. The parties may provide that the training is to be completed by the time agreed for the completion of construction. The programme should also describe the nature of the training to be given. The contract may provide that this programme is to be approved by the purchaser. The purchaser may be obligated not to remove trainees during the implementation of the training programme without good reason.

29. Training will often be required both on site and at places abroad. The places abroad at which training is to be given may be specified. While these would normally be the contractor's places of manufacture, in some cases the appropriate training might be available only at works or factories of third persons (e.g., equipment suppliers). In such cases, the contractor may be obligated to obtain placement of the trainees at those places. It may be advisable to provide that the training must take into account the operational conditions which the trainees will later encounter in the country of the purchaser. The parties may also wish to specify the working and living conditions to be provided for trainees who are to be trained abroad, and for trainers who are to provide training in the purchaser's country. The contractor may be obligated to assist in obtaining necessary visas, entry permits or work permits when training is to be given abroad.

30. The contract may obligate the contractor to engage trainers with qualifications and experience appropriate for the training and to notify the purchaser before the commencement of training of the qualifications and experience of the trainers to be used. In formulating training obligations, the parties may wish to take into account legal rules governing the employment of the personnel to be trained, which may regulate the qualifications and experience which the personnel must possess. Where the parties enter into a

product-in-hand contract (see chapter II, "Choice of contracting approach", paragraph 7), the contractor is obligated to prove during a test period that the works can be successfully operated by the purchaser's personnel. The result of such an obligation is that the contractor must give the purchaser's personnel the training required by them for operating the works. Under this contracting approach, it may be unnecessary to specify particular training obligations of the contractor.

31. In some cases only minimal training of the personnel of the purchaser may be necessary, e.g., making them acquainted on site with the procedures for operating and maintaining the works. The parties might wish to agree that no price is to be paid for such training, as it would be ancillary to the obligations of the contractor to supply and construct the works. Where more extensive training is required, the price for the training might be included in the overall price charged for the construction, but identified separately, or it might be charged separately. The price may be payable in instalments (e.g., a percentage as an advance payment, a further percentage during the performance of the training programme, and the balance after proof of completion of the programme). The training programme may involve other costs (e.g., the living expenses of the trainees in the contractor's country, or the living expenses of the contractor's trainers in the purchaser's country), and it is advisable to settle the allocation of those costs. The contract may provide that the portion of the price for the training which covers costs incurred in the purchaser's country is to be paid in the currency of that country (see chapter VII, "Price and payment conditions", paragraph 35).

32. For practical reasons, it may not be possible to settle at the time the contract is entered into some issues which may arise in regard to training (e.g., the date for commencement of training, or the duration of training). The parties may wish to agree that such issues are to be settled by the parties within a specified period of time after the contract is entered into.

E. Supply of documentation

33. Technical information and skills necessary for the proper operation and maintenance of the works may also be conveyed through the supply of technical documentation. The documentation to be supplied may consist of plans, drawings, formulae, manuals of operation and maintenance, and safety instructions. It may be advisable to list in the contract the documents to be supplied. The contractor may be obligated to supply documents which are comprehensive and clearly drafted, and which are in a specified language. It may be advisable to obligate the contractor, at the request of the purchaser, to give demonstrations of procedures described in the documentation if the procedures cannot be understood without demonstrations.

34. The points of time at which the documentation is to be supplied may be specified. The contract may provide that the supply of all documentation is to be completed by the time fixed in the contract for completion of construction. The parties might also wish to provide that construction is not to be considered as completed unless all documentation relating to the operation of the works and required under the contract to be delivered prior to the completion has been supplied. It may be advisable to provide that some documentation (e.g.,

operating manuals) is to be supplied during the course of construction, as such documentation may enable the purchaser's personnel or engineer to obtain an understanding of the working of machinery or equipment while it is being erected. It may also be advisable to provide that the contractor is liable to pay damages for loss caused to the purchaser through any errors or omissions in the documentation (see chapter XX, "Damages" and chapter XXI, "Exemption clauses").

Footnotes to chapter VI

[1]In some countries the term "licensing" is used to describe both the permission to exploit industrial property rights and the supply of know-how. In this chapter the term is used only with the first of these meanings.

[2]The negotiation and drafting of contracts for the licensing of industrial property and the supply of know-how is dealt with in detail in World Intellectual Property Organization, *Licensing Guide for Developing Countries* (WIPO publication No. 620(E), 1977), hereinafter referred to as the *WIPO Guide.* The main issues to be considered in negotiating and drafting such contracts are set forth in *Guidelines for Evaluation of Transfer of Technology Agreements*, Development and Transfer of Technology Series, No. 12 (ID/233, 1979), hereinafter referred to as the *UNIDO Guidelines* and in *Guide for Use in Drawing Up Contracts Relating to the International Transfer of Know-How in the Engineering Industry* (United Nations publication, Sales No. E.70.II.E.15). Another relevant publication is the *Handbook on the Acquisition of Technology by Developing Countries* (UNCTAD/TT/AS/5, 1978).

[3]See *WIPO Guide*, section U, "Approval of government authorities". The legal regulations of several countries relating to the transfer of technology are contained in *Compilation of Legal Material Dealing with Transfer and Development of Technology* (TD/B/C.6/81, 1982).

[4]See *WIPO Guide*, section D, 1, "Identification and description of the basic technology".

[5]These norms are being negotiated at the United Nations Conference on an International Code of Conduct on the Transfer of Technology, convened under the auspices of UNCTAD.

[6]A draft model law on restrictive business practices is being prepared under the auspices of UNCTAD.

[7]*See WIPO Guide*, section G, 4, "Guarantee of know-how", and *UNIDO Guidelines*, chapter III, "Performance of know-how—licensor's guarantee obligations".

[8]The different methods of determining the price payable for technology are considered in detail in *WIPO Guide*, section N, "Compensation; consideration; price; remuneration; royalties; fees", and *UNIDO Guidelines*, chapter VII, "Remuneration".

[9]The advantages and disadvantages of the different methods of price calculation are discussed in *WIPO Guide*, section N.3, "Direct monetary compensation: lump-sum payment; royalties; fees".

[10]See *WIPO Guide*, section E, "Special aspects concerning patents", and section S, 2, d, "Warranty against claims by third persons for infringement".

[11]The possible rights and obligations of the parties are discussed in *WIPO Guide*, section E, "Special aspects concerning patents", paras. 202-205.

[12]See *WIPO Guide*, section G, 2, "Legal means for preventing communication, disclosure or use of valuable information and expertise". In addition to confidentiality in respect of know-how, the contractor may require confidentiality in respect of documents describing the works. This is dealt with in chapter V, "Description of works and quality guarantee", paragraph 23.

Chapter VII. Price and payment conditions

SUMMARY

Three main methods of pricing are in common use in works contracts. These are the lump-sum, cost-reimbursable and unit-price methods. Under the lump-sum method, the purchaser is obligated to pay a certain amount which remains constant unless it is adjusted or revised, even though the costs of construction turn out to be different from those anticipated at the time of the conclusion of the contract (paragraphs 2, 6 to 9).

Under the cost-reimbursable method, the purchaser is obligated to pay all reasonable costs incurred by the contractor in constructing the works, together with an agreed fee (paragraphs 2, 10 to 24). Under this method, the purchaser bears the risk of an increase in the costs of construction over those anticipated at the time of the conclusion of the contract. The risk of an increase in construction costs borne by the purchaser may be limited by agreeing upon a ceiling on the total amount of reimbursable costs or a target cost (paragraphs 13 to 15). An incentive to economy and speed of completion of construction may be created by a target fee (paragraph 23).

Under the unit-price method, the parties agree on a rate for a unit of construction, and the price is determined by the total units actually used. The risk of cost increases which occur because the actual quantity of units exceeds the quantity estimated at the time of the conclusion of the contract is borne by the purchaser, while the risk of increases in the cost of each unit is borne by the contractor (paragraphs 2, 25 to 27).

If the purchaser is interested in completion of construction earlier than envisaged in the contract, bonus payments may be agreed in the contract (paragraphs 28 to 30).

Fluctuations in the exchange rate of the currency in which the price is determined may create certain risks for the parties which might be dealt with in the contract (paragraphs 31 to 37).

Even if a lump-sum price or unit-price rate is employed, the parties may wish to provide for the price to be adjusted or revised in specific situations (paragraphs 38 to 62). The contract might provide for an adjustment of the price when the construction under the contract is varied, when incorrect data are supplied by the purchaser, when the contractor encounters unforeseeable natural obstacles, and in the case of changes in local regulations and conditions (paragraphs 41 to 46).

The revision of the price due to a change in construction costs may be effected on the basis of an index clause (paragraphs 49 to 55). Another approach may be to use the documentary proof method. That approach may, however, be appropriate for use only in cases where an index clause cannot be used, and may be limited to portions of the price based on unstable factors (paragraphs 56 and 57).

Changes in the exchange rate of the price currency in relation to other currencies may be dealt with through a currency clause (paragraphs 58 and 59) or a unit-of-account clause (paragraphs 60 to 62).

The payment conditions in the contract may provide for specified percentages of the price to be payable at different stages of construction. They may also stipulate modalities of payment and indicate the place of payment (paragraphs 63 to 66).

An advance payment by the purchaser may be limited to the portion of the price reasonably needed to cover the contractor's expenses in the initial stages of the construction and protect him against loss in the event of termination of the contract in the initial stages (paragraph 67). Payment of portions of the price during construction may depend upon the progress of construction (paragraphs 68 to 74).

A certain percentage of the price may be payable after acceptence or, in some cases, take-over, of the works upon proof that construction has been successfully completed (paragraph 75), with the remainder of the price payable only after expiration of the guarantee period (paragraph 76). If a credit is granted by the contractor to the purchaser, the portion of the price covered by the credit may be payable in instalments within a certain period of time after take-over or acceptance of the works (paragraphs 77 to 79).

A. General remarks

1. The formulation of contractual provisions relating to the price to be paid by the purchaser must take into account a number of factors. The price will often cover varying aspects of construction by the contractor, e.g., the supply of equipment, materials and services, and the transfer of technology. A considerable period of time may elapse from the conclusion of the contract until the completion of construction, and during that period the costs of construction may change. In addition, the extent of construction to be effected may not be precisely determinable at the time of the conclusion of the contract. The parties should decide who is to bear the consequences of changes in costs and reflect their decision in the contract. When construction of the works is financed by an international lending institution, that institution may require certain issues discussed in this chapter to be settled in particular ways.

2. Three main methods of pricing are in common use in works contracts. These are the lump-sum, cost-reimbursable and unit-price methods. However, in appropriate circumstances, two, or all three, methods may be used in combination for pricing different aspects of the construction of the works.

(a) *Lump-sum method.* Under this method, the parties agree on the total amount to be paid for the construction (see paragraphs 6 to 9, below). This amount remains constant even if the actual cost of construction turns out to be different from that anticipated at the time of the conclusion of the contract, unless the contract or the law applicable to the contract provides for an adjustment of the price (see paragraphs 41 to 46, below) or its revision (see paragraphs 47 to 62, below).

(b) *Cost-reimbursable method.* Under this method, the purchaser is obligated to pay all reasonable costs incurred by the contractor in constructing the works, together with an agreed fee to cover the contractor's profit and overhead (see paragraphs 10-24, below).

(c) *Unit-price method.* Under this method, which may be used as a complement to the other methods, the parties agree on a rate for a unit of construction, and the total contract price is determined by the total number of units actually used. This pricing method may be practical only in respect of certain portions of the construction (see paragraphs 25 to 27, below).

3. It is advisable for the contract to specify the price, or a method for determining it. Under some legal systems, the contract is not valid if it does not do so. Under other legal systems, however, the contract is valid, and if the parties fail to agree upon the price at a later stage the price is determined in accordance with the rules of the legal system. However, under some of those legal systems, the rules for determining the price may not be appropriate for works contracts. Therefore, if a firm price cannot be specified in the contract, it would be preferable in certain situations for the parties to use the cost-reimbursable or unit-price method, or to specify a lump-sum price subject, in some cases, to an adjustment or revision, rather than to provide for a provisional price with the final price to be agreed upon by the parties at a later stage (see paragraphs 11, 26 and 38 to 62, below, and chapter XXIX, "Settlement of disputes", paragraph 3).

4. In choosing a pricing method and drafting the payment conditions (see section F, below), the parties should consider applicable foreign exchange regulations and other legal rules of an administrative or other public nature. The violation of those rules may result in the invalidity of the contract, or of some of its provisions, or in the termination of the contract by operation of law. Special problems which may arise in connection with the price to be paid for the transfer of technology are discussed in chapter VI, "Transfer of technology", paragraphs 18 to 20. The price and the payment conditions relating to the supply of spare parts and the maintenance, repair and operation of the works by the contractor after the completion of construction are dealt with in chapter XXVI, "Supplies of spare parts and services after construction".

5. In drafting contractual provisions on price, the parties should take into consideration legislation in the country where the works is to be constructed which imposes taxes in connection with certain aspects of the construction. Under some tax legislation, the purchaser may be obligated to pay on behalf of the contractor the taxes for which the contractor is liable in the purchaser's country and may be able to deduct the amount of the taxes paid from the price payable to the contractor. Practice under other legal systems permits the purchaser to undertake to pay the taxes on behalf of the contractor without right of reimbursement from him. International treaties on avoidance of double taxation concluded between the countries of the parties may be relevant to the settlement of some taxation issues in the contract.

B. Methods of pricing

1. *Lump-sum method*

6. Under the lump-sum method, the contractor is entitled only to the price set forth in the contract, regardless of the actual costs incurred by him during the construction. The mere use of the term "lump-sum price" may be insufficient to achieve this result. Accordingly, it is advisable for the parties to include in the contract clear provisions to this effect. However, the parties may wish to provide for an adjustment or revision of the price in certain defined

circumstances (see paragraphs 38 to 62, below). The parties may find the lump-sum method of pricing suitable for use in the single contract approach (cf. paragraphs 14 and 26, below, and chapter II, "Choice of contracting approach"). It may also be used when an approach involving several contracts is chosen, in particular in cases where, at the time of entering into the contract, the extent of construction is known and significant changes in the scope and quality of the works at a later stage are not anticipated.

7. For practical reasons, it may be advisable to break down the lump-sum price into specific amounts payable for different portions of the works, or amounts payable for equipment, for materials, for different kinds of services and for the transfer of technology. Such a breakdown may facilitate adjustment or revision of the price in certain cases envisaged in the contract (for example, in the case of a variation of a portion of the construction: see chapter XXIII, "Variation clauses", paragraphs 26 to 29). In addition, a breakdown will be needed if different payment conditions are agreed upon for different portions of the works, or for the performance of different kinds of obligations by the contractor (see paragraph 64, below). Tax legislation or other regulations of a public nature may also require certain elements of the price to be specified separately, e.g., the portion of the price to be paid for a transfer of technology (see chapter VI, "Transfer of technology", paragraph 8).

8. The main advantage for the purchaser of the lump-sum method of pricing is that he knows the total price he will be obligated to pay and the contractor bears the risk of increases in the cost of construction. However, this advantage will be reduced to the extent that the lump-sum price may be adjusted or revised. Moreover, the purchaser is obligated to pay the lump-sum price even if the costs incurred by the contractor turn out to be lower than those anticipated at the time of the conclusion of the contract. Another advantage of a lump-sum contract for the purchaser is that the administration of such a contract is normally less burdensome than under the unit-price method, where the extent of construction completed must be measured in order to determine the price to be paid, or under the cost-reimbursable method, where the costs incurred by the contractor must be verified.

9. Since the contract price in a lump-sum contract may include an amount to compensate the contractor for bearing the risk of increases in the cost of construction, the price may be higher in some cases than if the cost-reimbursable pricing method were used for the same construction (cf. paragraph 11, below). In addition, the lump-sum pricing method requires a precise specification in the contract of the scope of the works. It might also be advisable for the purchaser to monitor the performance by the contractor to ensure that the contractor is not tempted to reduce his construction costs by using substandard materials or construction methods.

2. *Cost-reimbursable method*

10. If the cost-reimbursable method is used by the parties, the exact amount of the price is not known at the time of entering into the contract, since the price will consist of the actual costs of construction incurred by the contractor, plus a fee to be paid to him to cover his overhead and profit. For it to function effectively, this method of pricing requires more detailed contractual provisions than does the lump-sum method.

11. The cost-reimbursable method may be appropriate in a limited class of cases. For example, it may be appropriate when the extent of construction services or materials and the kinds of equipment needed for the construction cannot be accurately anticipated at the time of the conclusion of the contract (e.g., where the works has not been completely designed because of the speed at which construction has to be commenced, or where a substantial part of the construction is to be effected under ground and underground conditions cannot be accurately predicted), or where a substantial part of the construction is to be done by subcontractors and the prices to be charged by them are not known at the time of the conclusion of the contract. This method may also be used in cases where the construction of the works presents unusual difficulties (e.g., special design or complex engineering) involving many unknown factors which affect pricing. In cases such as those, a lump-sum price might have to include an amount sufficient to protect the contractor against his risks. This amount may often turn out to be too high in the circumstances.

12. The main disadvantage of the cost-reimbursable pricing method for the purchaser is that he bears the risk of an increase in the costs of construction over those anticipated at the time of the conclusion of the contract. Financing institutions are therefore often opposed to this method of pricing. It is advisable for the purchaser to have a reasonable estimate of the costs of construction at the time of entering into the contract.

(a) Methods for reducing purchaser's risk

13. In order to reduce the risk for the purchaser it is advisable for the contract to obligate the contractor to construct the works efficiently and economically, and to entitle him to the costs of construction only to the extent that they are reasonable. In practice, however, it may be difficult to enforce or apply such general obligations. In some cases, the parties may agree upon a ceiling on the total amount of reimbursable costs or a system of target costs (see paragraph 15, below). Furthermore, the fee of the contractor may be structured so as to give him an incentive to minimize the costs of construction (see paragraph 23, below).

14. As a means to control costs to be reimbursed, the contract may require the participation of the purchaser in the selections of subcontractors if they are not specified in the contract (see chapter XI, "Subcontracting", paragraphs 15 to 26). The desirability of such participation makes this pricing method inappropriate for most turnkey contracts. Since an essential aspect of a turnkey contract is that the contractor assumes responsibility for constructing works which will operate in accordance with the contract, he will usually assume that responsibility only if he is allowed to choose his subcontractors freely.

15. The risk to the purchaser of an increase in construction costs under a cost-reimbursable contract may be limited by providing a ceiling on the total amount of reimbursable costs. Another approach may be for the parties to agree at the time of entering into the contract upon an estimate of the costs of construction (i.e., a "target cost"), which is not, however, to constitute a ceiling on the total amount of reimbursable costs. The contract might provide that, if the actual costs exceed the target cost, the contractor is to be paid only a percentage of that excess. The contract might also provide that this percentage is to decrease as the excess increases. Alternatively, the parties may agree that, if the actual costs exceed the target cost by a specified amount or percentage,

the purchaser may terminate the contract without being liable to the contractor for costs incurred by the contractor incidental to the termination (cf. chapter XXV, "Termination of contract", paragraphs 17, 18, 34 and 35). The right of the purchaser to terminate may give the contractor an incentive to keep his costs within the estimate. Under this alternative, however, the purchaser may face the difficult choice of having either to refrain from terminating the contract and to proceed with construction by the contractor, with an obligation to pay him reimbursable costs exceeding the target cost, or to terminate the contract and complete the construction by engaging another contractor, bearing in mind the effect this would have upon total costs.

(b) *Determination of reimbursable costs*

16. It may be desirable for the contract to provide a method of determining which costs are reimbursable and which are to be borne by the contractor out of his fees. In order to prevent disputes as to which kinds of costs are reimbursable, it is advisable either to enumerate the costs to be reimbursed and to provide that all other costs are to be borne by the contractor, or to enumerate the costs which are not reimbursable and to provide that all other reasonable costs are to be reimbursed.

17. The contract may specify which overhead expenses of the contractor are to be excluded from the costs which are to be reimbursed by the purchaser. These excluded costs may include the costs connected with the operation of the contractor's head office, for example, the wages of the personnel at that head office. In addition, telephone, postal and cable expenses may be excluded even if they are incurred on the site. However, wages and other reasonable costs connected with the stay of the contractor's personnel on the site might be regarded as reimbursable by the purchaser to the contractor. In some cases, the cost-reimbursable method may not be appropriate for pricing equipment manufactured by the contractor to be used in the construction. In those cases, it is advisable for the contract to provide an amount to be paid for that equipment by the purchaser. The cost-reimbursable method may, however, be used for supplies obtained by the contractor from subcontractors and suppliers (see chapter XI, "Subcontracting", paragraph 1).

18. Routine items of equipment or materials taken from the contractor's stocks may have been bought by the contractor at various prices before commencement of or during the construction, and disputes may arise on how to value them. Such disputes may be prevented by stipulating their prices in schedules which form a part of the contract.

19. The contract might provide that costs incurred in employing subcontractors and suppliers are to include only costs actually paid by the contractor, taking into account discounts granted to the contractor by subcontractors and suppliers. However, the parties may wish to consider whether discounts granted to the contractor against payments in cash by the contractor are also to be taken into account. They might consider, for example, that the contractor should receive the benefit of cash payments made from his own funds, rather than funds advanced to him by the purchaser.

20. The smooth progress of construction requires that all the necessary materials be available on the site in accordance with the time-schedule. In some cases, however, it may be very difficult to envisage the precise quantities needed

for construction. The contractor may over-order and may incur losses in the resale of unused excess materials. The parties may wish to consider whether and to what extent such losses are to be reimbursed by the purchaser. The contract might, for example, set a limit to which the losses are to be reimbursed.

(c) *Fee to be paid to contractor*

21. The fee to be paid to the contractor might be fixed at a specified amount. The contract may provide for an adjustment of the fee in case of variations of the extent of construction (see chapter XXIII, "Variation clauses", paragraph 32).

22. Fixing the fee at a specified amount gives no particular incentive to the contractor to minimize his costs of construction, although he may be generally interested in completing the construction as soon as possible in order to receive the fee. It is not advisable for the fee to be calculated as a percentage of the actual costs of construction since this mechanism may provide an incentive to the contractor to increase those costs. Such a method of determining the fee is forbidden under some legal systems.

23. A method of providing for the contractor's fee is to specify a "target fee" to be applied in combination with the target cost (see paragraph 15, above). If the reimbursable costs are less than the target cost, the target fee would be increased by a specified percentage of the saved cost. The contract might also provide that, as the saved costs increase, the percentage payable is also to increase. If, however, the reimbursable costs are more than the target cost, the target fee would be decreased by a specified percentage of that excess. The contract might also provide that as the excess increases, the percentage to be deducted is also to increase. In addition to the costs of construction, other factors might be regarded as relevant in increasing or decreasing the target fee, such as the time taken to complete construction, and the performance of the completed works (e.g., its consumption of raw materials or energy). It may be noted that providing an incentive to the contractor to lower the costs of construction by varying the fee payable may be combined with an incentive based on an obligation to share the costs of construction when they exceed a target cost (see paragraph 15, above).

(d) *Maintenance of records*

24. To ensure a smooth operation of the cost-reimbursable method, the contract might require a system of record keeping which would accurately give evidence of the costs incurred by the contractor. For example, the contractor might be required to maintain records in accordance with forms and procedures reasonably required by the purchaser reflecting charges incurred and payments effected by the contractor, and the parties may provide that the purchaser shall have access to those records.

3. *Unit-price method*

25. Under the unit-price method, the parties agree on a rate for a construction unit, and the total price to be paid is dependent upon the number of construction units used for the construction. The rate fixed for a construction

unit should include an increment representing the contractor's profit. The construction unit may be a quantity unit of materials needed for the construction (e.g., a ton of cement for concrete), a time-unit of construction (e.g., an hour of labour in excavation), or a quantity unit of construction result (e.g., a cubic meter of reinforced concrete). Different construction units may be appropriate for different portions of the construction (e.g., material-units for construction of buildings, time-units for installation of equipment).

26. The unit-price method may be desirable where the quantity of materials or the quantity of construction services needed for a portion of the construction cannot be envisaged accurately at the time of entering into the contract, and for this reason it is difficult for the parties to determine a lump-sum price. In most cases, this method can be used only in combination with other pricing methods, since it is not suitable for pricing elements of the construction which, by their nature, cannot be divided into several identical units (e.g., equipment). It may be used, for example, for civil engineering, building and installation of equipment. In a contract in which it is difficult to control the quantities of units to be used for the construction (e.g., in a turnkey contract, where the techniques of construction are left to the discretion of the contractor) it would be advisable for the purchaser to take necessary measures to assess a fair price for the construction effected.

27. If the parties choose the unit-price method, and the contract does not provide for a revision of the unit price in the event of changes in unit costs, the risk of increases and the potential benefits arising out of decreases in construction costs are divided between the contractor and the purchaser. Since the price per construction unit is firm, the contractor bears the risk of an increase of the costs of materials and labour for each unit or receives the benefit of a decrease in those costs. The risk of an increase in the estimated total contract price due to the need to use more units for the construction than anticipated at the time of entering into the contract is borne by the purchaser, while he receives the benefit if fewer units are needed. The purchaser's risk may be reduced by providing in the contract that the purchaser is to pay for quantities up to a specified quantity, but that the contractor would have to bear the costs, or a specified percentage of the costs, of quantities beyond that quantity. In some cases, the contract might also provide for an increase in the unit price where the actual quantity of units does not achieve a certain percentage of an estimated quantity, specified in the contract, or a decrease in the unit price if the actual quantity of units exceeds a specified percentage of the estimated quantity. Since the price payable by the purchaser depends on the number of units needed for the construction, it is advisable to agree in the contract on adequate and clear methods of measuring the quantities used in order to avoid disputes.

C. Bonus payment

28. In cases where the purchaser is interested in the completion of construction and the commencement of the operation of the works as early as possible, he may be willing to pay a higher price, in the form of a bonus payment, if the construction is successfully completed by the contractor prior to the date fixed for completion in the contract. The amount of the bonus may represent a share of the estimated additional profit of the purchaser resulting

from an earlier commencement of the operation of the works. It is not usually advisable to provide for a bonus payment for early completion of construction if the cost-reimbursable pricing method is used in the contract, since this might induce the contractor to incur higher costs in order to complete the works quickly and obtain the bonus.

29. For the calculation of the bonus, the parties may determine the estimated profit to be gained by the purchaser for each day of earlier completion of the works. This amount of money per day may then be expressed in the contract as a fixed amount, as a percentage of the contract price if the lump-sum method of pricing is used, or as a percentage of the fee if the cost-reimbursable method of pricing is used. Representing the bonus payment as a percentage of the price or fee will enable the amount of the bonus to change if the price or fee changes (e.g., due to adjustment or revision of the price, or cost savings in comparison with the target cost). This would to some extent enable the bonus to take account of changes in price levels. If the unit-price method is used, the amount may remain as a fixed amount per day of earlier completion. Whether the bonus payment is specified as a fixed amount per day or as a percentage, it may be limited to a maximum amount.

30. It is advisable to provide for payment of the bonus to be due only after the works has operated continuously for a specified period of time. This approach may deter the contractor from adopting methods of construction which are less time consuming, but which result in defective construction. The period of time for continuous operation of the works might commence to run at the time of take-over or acceptance of the works by the purchaser (see chapter XIII, "Completion, take-over and acceptance", paragraphs 22, 31 and 32).

D. Currency of price

31. The currency in which the price is to be paid may involve certain risks for a party arising from the fluctuation in the purchasing power of the price currency and from the fluctuation in exchange rates between the price currency and other currencies (see paragraphs 47 to 62, below). If the price is to be paid in the currency of the contractor's country, the purchaser bears the consequences of a change in the exchange rate between that currency and the currency of his country. The contractor, however, will bear the consequences of a change in the exchange rate between the currency of his country and the currency of another country in which he has to pay for equipment, materials or services for the construction. If the price is to be paid in the currency of the purchaser's country, the contractor bears the consequences of a change in the exchange rate between this currency and the currency of his country. If the price is to be paid in the currency of a third country which the parties consider to be stable, each party bears the consequences of a change in the exchange rate between this currency and the currency of his country. Where a financing institution has granted the purchaser a loan for the construction of the works, the purchaser may prefer the price to be paid in the currency in which the loan is granted.

32. In stipulating the currency in which the price is to be paid, the parties should take into consideration foreign exchange regulations and international treaties in force in the countries of the contractor and the purchaser, which may

mandatorily govern this question. The parties should also take into account that under some legal systems the price in an international contract must be paid in the currency in which it is denominated, while other legal systems may permit, or even require, payments in the currency of the place of payment, even if the price is denominated in a foreign currency.

33. In cases where the parties use the lump-sum or unit-price method of pricing, the risk borne by the contractor arising from fluctuations in exchange rates will be reduced if the price is to be paid in the same currencies in which he must pay for equipment, materials and services connected with the construction. If this approach is adopted, the price for various portions of the works may be payable in different currencies. The contractor may also reduce to some extent the risk of fluctuations in exchange rates by specifying in his subcontracts that the price is to be paid in the same currency as that in which the price under the works contract is to be paid. Even in these cases, however, except when the currency is that of his own country, the contractor will bear the consequences of a change in the exchange rate of that currency occurring between the date when he bought the currency to pay the subcontractor and the date when the price under the works contract in respect of the subcontractor is paid to him by the purchaser.

34. If the parties use the cost-reimbursable pricing method, the contract might stipulate that the contractor's costs are to be reimbursed to him in the same currency in which they are to be paid by him. Alternatively, it might provide that the costs are to be reimbursed in the same currency as the currency in which the fee is to be paid. If this approach is adopted, and the costs are payable in a currency other than the currency of the fee, the costs will have to be converted into the currency of the fee at a particular rate of exchange. It is advisable to provide in the contract that this conversion is to be made at the exchange rate prevailing at a specified place on a specified date. This date may be either the date on which the costs were incurred by the contractor (in this case, the purchaser will bear the risk of a change in the exchange rate from that date until the date when the costs are reimbursed by the purchaser to the contractor), or the date when the costs are reimbursed by the purchaser to the contractor (in this case, the risk will be borne by the contractor).

35. If the country of the purchaser has scarce foreign exchange resources, that country may be interested in ensuring that at least a portion of the price is to be paid in the currency of the country. The contract might provide for the currency of the purchaser's country to be used for payment in respect of those costs of construction which are incurred by the contractor in the purchaser's currency (e.g., payment of local labour or subcontractors, or costs of accommodation of the contractor's personnel in the purchaser's country). This approach might be used even in cases where the lump-sum pricing method is used in the works contract. Such a contract might specify the part of the lump-sum price to be paid in the local currency, on the basis of an estimate of the costs to be incurred by the contractor in that currency. Another method might be for the contract to denominate the entire lump sum in a foreign currency, but provide that costs incurred in the local currency, after they are ascertained, are to be paid in the local currency and be deducted from the lump sum at a specified exchange rate. The contract might also provide for a change in the currencies in which the price is denominated where supplies foreseen to be procured from local sources become unavailable, and imports of those supplies from foreign sources are authorized.

36. The contract might denominate the price in a currency which the parties consider to be stable, but provide that it is to be paid in another currency. The effects of such an approach may be similar in substance to those achieved by a currency clause (see paragraphs 58 and 59, below), and restrictions imposed by the applicable law in respect of currency clauses may also apply to such provisions. If this approach is used in the contract, it is advisable to agree on the exchange rate which is to apply between the currency in which the price is denominated and the currency in which the price is to be paid. That exchange rate may be defined by reference to the rate prevailing at a specified place on a specified date. If the price is formulated on a lump-sum or unit-price basis, the contractor may prefer for the contract to specify that the relevant date is to be the date when the price is actually paid. If the price is determined on a cost-reimbursable basis, one of the dates referred to in paragraph 34, above, might be specified.

37. It is not advisable for the contract to denominate the entire price for the works in two or more currencies, and allow either the debtor or the creditor to decide in which currency the price is to be paid. Under such a clause, only the party having the choice is protected, and the choice may bring him unjustified gains.

E. Adjustment and revision of price

38. In view of the long-term and complex nature of a works contract, the parties may wish to provide for a lump-sum price or rates in a unit price to be adjusted or revised in specified situations. Since, under the cost-reimbursable method of pricing, the purchaser reimburses the contractor for the construction costs actually incurred by him, a provision for adjustment or revision of the price is not needed, except in respect of the fee, the ceiling, if any, on the total amount of reimbursable costs, or target costs (see paragraphs 15 and 23, above).

39. A distinction is made in the *Guide* between "adjustment" and "revision" of the price. Adjustment refers to cases where construction costs become higher or lower after entering into the contract due to a change in the construction required under the contract. This change may be due to a variation in the works to be constructed (see chapter XXIII, "Variation clauses", paragraphs 25 to 32) or a change in the method of construction from that anticipated at the time of entering into the contract due, for example, to incorrect data supplied by the purchaser (see paragraph 43, below), unforeseeable natural obstacles (see paragraphs 44 and 45, below) or changes in local regulations and conditions (see paragraph 46, below). Revision of price refers to situations where the construction required under the contract remains the same, but certain economic factors have changed in such a way that the cost of the construction and the price to be paid for it have become substantially unbalanced. This may occur, for example, due to substantial change in prices of equipment, material or construction services or in tax regulations or tariffs after the contract has been entered into or due to a substantial change in exchange rates of the price currency in relation to other currencies. An adjustment or revision may increase or decrease the price, although experience shows that an increase is more usual. It is advisable to limit adjustment and revision of the price to situations clearly determined in the contract or provided for by the law applicable to the contract.

40. The contract may provide for the price adjustment or revision to be determined in accordance with certain criteria specified in the contract (see sub-sections 1 and 2, below). This approach is in general permissible under most legal systems. In regard to adjustment, the contract might, for example, provide that the price is to be adjusted by reference to costs reasonably incurred by the contractor in specified circumstances. In regard to revision, the contract might provide that the price is to be revised in accordance with a specified mathematical formula, or that allowance is to be made for costs reasonably incurred. It may be inadvisable for the contract merely to obligate the parties to agree upon an adjustment or revision when stipulated circumstances arise since, if the parties fail to agree, difficulties may arise in settling the question in arbitral or judicial proceedings (see chapter XXIX, "Settlement of disputes", paragraph 3). The parties may further provide that, if disputes between them are being settled in arbitral or judicial proccedings, the construction is not to be interrupted during the proceedings. When the purchaser is a State enterprise, the parties should be aware that difficulties may be encountered in obtaining additional funds in cases of price adjustment or revision, or otherwise.

1. *Adjustment of price*

41. The parties may wish to define carefully the circumstances in which the price determined in the contract is to be adjusted, so as to avoid uncertainty as to the price. In addition, a contract intended to be a lump-sum contract may tend to take on the nature of a cost-reimbursable contract if adjustment is possible in too wide a range of circumstances.

42. The contract might provide for an adjustment of the price when the construction under the contract is varied (see chapter XXIII, "Variation clauses", paragraphs 25 to 32) as well as in the situations discussed below.

(a) *Incorrect data supplied*

43. The parties may wish to provide that the price is to be adjusted in cases where, as a result of incorrect data supplied by the purchaser, additional construction is required or a more expensive method of construction must be used in comparison with the method reasonably envisaged at the time of entering into the contract. However, the parties may wish to provide that the price is not to be adjusted if the contractor could reasonably have discovered the incorrectness of the data at the time of entering into the contract. The price adjustment might cover the reasonable costs of the additional construction or more expensive method of construction. The parties may also wish to provide that, even in cases where the incorrectness of the data could not reasonably have been discovered at the time of entering into the contract, the price is not to be adjusted unless the contractor subsequently discovered the incorrectness of the data at the time it could reasonably have been discovered, and gave notification of the errors at that time to the purchaser. In cases of incorrect data supplied by the contractor, he should not be entitled to an increase of the price.

(b) *Unforeseeable natural obstacles*

44. The contractor might be expected to have inspected the site and its surroundings, to the extent practicable, before submitting a tender or negotiating a contract, and to have based his negotiations on the findings made at the inspection. During such an inspection, however, it may not be possible, even with reasonable efforts, to discover certain natural obstacles on the site, in particular hydrological and sub-surface conditions.

45. Different approaches may be adopted in the contract for cases where, during construction, natural obstacles, in particular hydrological and sub-surface conditions, are encountered which could not reasonably have been discovered by the contractor during his inspection. The risk of such obstacles might be placed on the contractor, and he might be obligated to bear the extra costs incurred as a result of the unforeseeable obstacles. An alternative approach might be to provide that the price is to be increased so as to reflect the higher costs reasonably incurred by the contractor due to the natural obstacles encountered if they are notified to the purchaser within a reasonable period of time after they could reasonably have been discovered. The parties may also consider the possibility of dividing the costs between them.

(c) *Changes in local regulations and conditions*

46. Certain legal rules of an administrative or other public nature in the purchaser's or the contractor's country may mandatorily regulate certain aspects of the methods of construction (e.g., in the interests of safety, or for environmental protection, see chapter XXVIII, "Choice of law", paragraphs 22 and 23). If the construction to be effected does not accord with legal rules coming into force after the contract has been entered into, changes in the method of construction may be needed. The contract might specify who is to bear the risk of these changes. If the risk is to be borne by the purchaser, the contract might provide for the price to be adjusted. Changes in the works which may be required by such legal rules are discussed in chapter XXIII, "Variation clauses", paragraph 23. The contract may also provide for an adaptation of the price where supplies foreseen to be procured from local sources become unavailable and imports of those supplies from foreign sources are authorized.

2. *Revision of price*

47. Under most legal systems, the principle of "nominalism" governs the payment of a contract price. That is, the amount to be paid in the currency specified in the contract remains the same even if the value of that currency changes between the time of entering into the contract and the time the payment is made. The value of the currency may change in terms of its exchange rate in relation to other currencies. It may also change in terms of its purchasing power, with the result that the construction costs of the contractor may increase or, in exceptional cases, decrease. Many long-term contracts contain clauses directed at reducing these risks borne by the contractor. Such clauses may provide for revision of the price on the basis of indices (see paragraphs 49 to 55, below) or on the basis of costs actually incurred (see paragraphs 56 and 57, below). However, contractual provisions concerning

price revision due to a change in the value of the price currency are mandatorily regulated under some legal systems. The parties should, therefore, examine whether a clause which they intend to include in the contract is permitted under the law of the country of each party.

48. The contract might provide for the price revision clause to apply only in cases where its application would result in a revision exceeding a certain percentage of the price. The parties may wish to take into consideration that the price revision clauses are usually not used in practice where the duration of the construction as determined in the contract is less than 12 to 18 months from the coming into force of the contract.

(a) *Change in costs of construction*

(i) *Index clauses*

49. The purpose of index clauses is to revise the contract price in accordance with changes in the costs of construction by linking the contract sum price to the levels of the prices of certain goods or services prevailing on a certain date. In works contracts, the contract price may be linked to the levels of prices of materials or services needed for the construction of the works. A change in the agreed indices automatically effects a change in the price, without the necessity of examining the actual prices paid by the contractor during construction. Under the laws of some countries, the use of index clauses is not allowed or is restricted. For example, in some countries index clauses are permitted only for the purpose of dealing with changes in construction costs occurring between the time the contract is entered into and its coming into force. An index clause may need to be adapted to a new situation in the event of a substantial revision in the scope of the construction.

50. In drafting an index clause, it is advisable to use an algebraic formula to determine how changes in the specified indices are to be reflected in the price. Several indices, with different weightings given to each index, may be used in combination in the formula in order to reflect the proportion of different cost elements (e.g., materials or services) to the total cost of construction. Different indices reflecting the costs of different materials and services may be contained in a single formula. Different indices may be needed when the sources of the same cost element are in different countries.

51. Separate formulae, each with its own weightings, may be used for different aspects of the construction. If, for instance, the construction involves a number of dissimilar types of operations, such as excavation, concreting, brickwork, installation, and dredging, a single price revision formula may be difficult to draft, and may produce inaccurate results. Therefore, it may be preferable to have a separate formula for each main aspect of the construction.

52. An index clause may include a certain percentage of the price (commonly 5-20 per cent) which is not subject to any revision under the clause. This percentage is intended to make allowance for the fact that some items may be paid for by the contractor at a lower price level than that reflected in the price index for those items. It may also afford some protection against other inaccuracies resulting from the formula used in the clause. In addition, if the aim of the index clause is to protect the contractor only against higher costs of construction and not against inflation in general, this percentage may reflect the contractor's profit.

53. The contract may provide that the index clause is to be applied to determine whether a price revision is needed at the time of each interim payment. In order to use the agreed indices, it is advisable to specify in the contract the date to be used as a basis for comparing the levels of the indices. The contract might provide that the base date is the date when the contract was entered into. Alternatively, when the contract is entered into on the basis of tendering, the contract may provide that the base date is a specified number of days (e.g., 45 days) prior to the date of submission of the contract bid, or a specified number of days prior to the closing date for the submission of tenders since the tender price may be based upon price levels existing at those times. The contract might provide that the index levels on the base date are to be compared with the index levels existing a specified number of days prior to the last date of the period of construction in respect of which payment is to be made since the costs will be incurred by the contractor before the end of this period. Alternatively, it might provide that the index levels on the base date are to be compared with the levels existing a specified number of days prior to the date on which payment is due. However, the contract might also provide that if the contractor is in delay in completing the construction, the index levels existing a specified number of days prior to the agreed date for performance are to be used if those levels are more favourable for the purchaser. The ability of the purchaser to exercise this option might be limited to cases where the contractor is not prevented from performing in time due to exempting impediments (see chapter XXI, "Exemption clauses", paragraphs 9 to 26).

54. Several factors may be relevant in deciding on the indices to be used. The indices should be readily available (e.g., they should be published at regular intervals). They should be reliable. Indices published by recognized bodies (such as well-established chambers of commerce), or governmental or inter-governmental agencies, may be selected. Where certain construction costs are to be incurred by the contractor in a particular country, it may be advisable to use the indices of that country in respect of those costs. The parties should exercise caution in using indices based on different currencies in a formula, as changes in the relationships between the currencies may affect the operation of the formula in unintended ways.

55. In some countries, particularly in developing countries, the range of indices available for use in an index clause may be limited. If an index is not available for a particular element of costs, the parties may wish to use an available index in respect of another element. It is advisable for an element to be chosen such that its price is likely to fluctuate in approximately the same proportions and at the same times as the actual material to be used (e.g., because it is composed of the same raw material, or can be used as an alternative to the actual material to be used). For example, in cases where it is desired to provide an index for labour costs, a consumer price index or cost-of-living index is sometimes used if there is no wage index available.[1]

(ii) Documentary proof method

56. The contract might provide a method, often referred to as the documentary proof method, to deal with changes which may occur after the conclusion of the contract in the costs of certain specified elements connected with the construction. The documentary proof method is based on the principle that the contractor is to be paid the amount by which his actual costs connected with

the construction, if they are reasonable, exceed the costs upon which the calculation of the contract price was based, due to changes other than changes in the quantity of materials, equipment and construction services needed for the construction. The documentary proof method, therefore, requires that the contract indicate the quantity and the price for each unit of the materials, equipment and work upon which the calculation of the price was based. Revision of the price under this method would include the difference between the price reflected in the calculation and the price actually paid by the contractor for quantity units in respect of the quantity determined in the contract. In contrast to the cost-reimbursable pricing method, under the documentary proof method the contract price should not be revised when the contractor incurs higher costs due to under-estimation of the scope of his construction obligations at the time of the conclusion of the contract. This method has certain disadvantages for the purchaser, since it imposes on him the risk of increases in construction costs due to the increases in the prices of equipment, materials and labour. In addition, the ability to recover increases in his costs may give the contractor little incentive to keep down the costs of construction. The administrative procedures needed by the contractor to obtain documentary proof of the costs of construction, and by the purchaser to verify such costs, may be almost as extensive as the administrative procedures under a cost-reimbursable contract. For these reasons, the parties may wish to use the documentary proof method only in respect of portions of the price calculated on the basis of unstable cost factors where the index clause method cannot be used (e.g., where relevant indices are not available).

57. If the parties wish to use the documentary proof method, they should specify in the contract the portion of the price that is subject to revision under that method. It is advisable to identify in the contract the equipment, materials or services in respect of which revision of the price is to take place, and separately state the quantity and the amount of the costs relating to a unit of such equipment, materials or services upon which the contract price is based. It is also advisable to stipulate that a revision of the price is to occur not only in the case of an increase, but also in the case of a decrease in costs. The contract might set forth procedures, similar to those which are to be used under a cost-reimbursable contract (see paragraph 24, above), by which the contractor is to prove the costs actually incurred by him. The contract might require the contractor to purchase equipment or materials in respect of which price revision is permitted from approved sources, or after obtaining competitive bids.

(b) Change in exchange rate of price currency in relation to other currencies

(i) Currency clause

58. Under a currency clause, the price to be paid is linked to an exchange rate between the price currency and a certain other currency (referred to as "the reference currency") determined at the time of entering into the contract. If this rate of exchange has changed at the time of payment, the price to be paid is increased or reduced in such a way that the amount of the price in terms of the reference currency remains unchanged. For purposes of comparing exchange rates, it may be desirable to adopt the time of actual payment, rather than the time when the payment falls due. If the latter time is adopted, the contractor may suffer a loss if the purchaser delays in payment. Alternatively, the currency

clause may give the contractor a choice between the exchange rate prevailing at the time when payment falls due or that prevailing at the time of actual payment. It is advisable to specify an exchange rate prevailing at a particular place.

59. If a currency clause is to serve its purpose, the reference currency must be stable. The insecurity arising from the potential instability of a single reference currency may be reduced by reference to several currencies. The contract may determine an arithmetic average of the exchange rates between the price currency and several other specified currencies, and provide for revision of the price in accordance with changes in this average.

(ii) *Unit-of-account clause*

60. If a unit-of-account clause is used, the price is denominated in a unit of account composed of cumulative proportions of a number of selected currencies. The unit of account may be one defined in an international treaty or by an international organization, and which will specify the selected currencies making up the unit and the relative weighting given to each currency. In contrast to a currency clause, in which several currencies are used, the weighting given to each selected currency of which the unit of account is composed is usually not the same, and greater weight is given to currencies generally used in international trade.[2]

61. The main advantage of using a unit of account as the currency unit with which the price currency is to be compared is that a unit of account is relatively stable, since the weakness of one currency of which the unit of account is composed is usually balanced by the strength of another currency. A unit-of-account clause will therefore give substantial protection against changes in exchange rates of the price currency in relation to other currencies.

62. In choosing a unit of account to be used in a clause, the parties should consider whether the relation between the price currency and the unit of account can be easily determined at the relevant times, i.e., at the time of entering into the contract and at the time of actual payment. The unit of account defined by the International Monetary Fund as the Special Drawing Right (SDR) might be used. The parties might also refer to the European Currency Unit (ECU) as a unit of account. The values of these units of account in terms of a number of currencies are published daily.

F. Payment conditions

63. Payment conditions in the contract may determine when and where various portions of the price are to be paid, and the modalities of payment. The time of payment may influence the price since the contractor may take into consideration interest in calculating the price. Payment conditions might provide an incentive for the contractor to perform in accordance with an agreed time-schedule by providing for a substantial portion of the price to be paid to the contractor as various steps in the construction are completed. The place of payment may have important consequences. For example, while funds are being transferred to a different country the value of currency may change. In addition, a transfer may be subject to foreign exchange restrictions. The

modalities of payment (e.g., a letter of credit or the documents against payment) may be structured so as to reduce the risk of the contractor in not being paid on time and of the purchaser in paying for construction not effected in accordance with the contract.

64. In drafting payment conditions, the parties should take into consideration the pricing method or methods (see paragraph 2, above) used in the contract. If the lump-sum pricing method is used, the lump-sum price might be broken down and allocated against major aspects of the construction to be effected by the contractor (e.g., civil engineering, supply of equipment, or transfer of technology). The portions of the price in respect of such major items may be payable at different stages, in specified percentages. For example, a portion might be allocated to the supply of equipment. A certain percentage of that allocation might be payable in advance (see paragraph 67, below), a certain percentage during construction (see paragraphs 68 to 74, below), a certain percentage after take-over or acceptance of the works (see paragraph 75, below), and the rest after expiry of the guarantee period (see paragraph 76, below).

65. If the cost-reimbursable pricing method is used for the works or a portion of the works, the contract might contain an estimate of the costs of construction covered by that method. A specified percentage of the total estimated reimbursable costs might be payable in advance, a specified percentage of the costs incurred during construction might be payable within a specified short period of time after receipt by the purchaser of the documents required under the contract (see paragraph 71, below), a specified percentage of those costs might be payable after take-over or acceptance of the works (see chapter XIII, "Completion, take-over and acceptance", paragraphs 22, 31 and 32), and the rest might be payable after expiry of the guarantee period (see chapter V, "Description of works and quality guarantee", paragraphs 28 to 30). In agreeing upon the time when the fee is to be paid to the contractor, the parties should take into consideration the nature of the fee to be paid (see paragraphs 21 to 23, above). A certain portion of the fee may be payable as portions of the construction are completed, a certain portion after acceptance and the rest after the expiry of the guarantee period.

66. If the unit-price method is used, the contract might provide that a specified percentage of the estimated price, calculated on the basis of estimated quantity of construction covered by this pricing method, is to be paid in advance, a specified percentage of the price in respect of the construction as actually effected is to be paid at the times specified in the contract, a specified percentage of the price in respect of that construction is to be paid after take-over or acceptance and the rest after the expiry of the guarantee period.

1. *Advance payment*

67. An advance payment might be required under the contract to cover the contractor's working capital and expenses in the initial stages of the construction (e.g., for initial purchases of equipment and materials, transport and accommodation of personnel). An advance payment may also provide to the contractor some protection against loss in the event of a termination of the contract by the purchaser prior to the commencement or at an early stage of

the construction. The purchaser might be protected by a guarantee against failure by the contractor to repay the advance. The amount of the advance payment might be calculated so as to cover the initial expenses of the contractor which are anticipated. The contract might require the advance payment to be directly remitted by the purchaser to a bank designated by the contractor within a specified period of time after the provision by the contractor of the performance and repayment guarantees. Performance and repayment guarantees are dealt with in chapter XVII, "Security for performance", paragraphs 10 to 13.

2. *Payment during construction*

68. It is advisable to provide in the contract for the payment of portions of the price as the construction progresses. The amount to be paid during construction should be determined taking into consideration the nature of the construction to be effected and the pricing method adopted.

69. One approach to determining the time and extent of payment may be to identify specific portions of the construction (e.g., excavation, or construction of the foundations), and to provide that specified portions of the price are to be payable upon completion of those portions. An alternative approach may be to provide that the contractor is entitled to receive progress payments for the construction completed within specified periods of time (e.g., every month), the amount of the payment depending upon the extent of construction effected within that period.

70. Equipment and materials supplied by the contractor may be paid for after they are incorporated in the works, under either of the approaches described in the preceding paragraph. The parties may, however, agree on another approach, particularly in cases where the equipment and materials are taken over by the purchaser after their delivery, and are in his physical possession until their use for construction. In these cases, the portion of the price in respect of such equipment and materials may be payable against the submission to the purchaser or the purchaser's bank of documents proving that they have been handed over to the first carrier for transmission to the purchaser and insurance has been taken out, or that they have been handed over to the purchasers on the site (see chapter VIII, "Supply of equipment and materials", paragraph 10).

71. It is advisable to specify in the contract the documents which the contractor is obligated to submit in order to obtain payment, such as invoices, bills of lading, certificates of origin, packing lists, and inspection certificates. The documents to be required may depend upon the time and manner of performance. Differing documents may be required in respect of supplies of equipment, materials, or services. The documents required may also differ depending on the method of pricing used by the parties.

72. Since payments during the construction process are to be effected in respect of construction already completed, the parties should clearly agree upon the procedures for determining such completion. The purchaser may wish to authorize the consulting engineer to measure the extent of the completed construction. To obtain a progress payment, the contract might require the contractor to submit to the consulting engineer at the end of each payment

period certain documents supported by a detailed report concerning the construction completed in the relevant payment period. The contract might provide for payments to be effected on the basis of interim certificates issued by the consulting engineer or the purchaser.

73. If the cost-reimbursable pricing method is used, special contractual provisions may be needed for the verification of costs incurred by the contractor. The contract might entitle the purchaser to audit the contractor's records. Since the payment conditions in subcontracts concluded by the contractor may be expected to correspond to the payment conditions in the works contract, the contract might entitle the contractor to payment of a portion of the price in respect of subcontracted construction only if he has already paid his subcontractor, or if the payment to the subcontractor has at least become due. The purchaser may be able to influence payment conditions in subcontracts by participating in the selection of the subcontractors (see chapter XI, "Subcontracting", paragraphs 15 to 26), or by including in the works contract requirements for payment conditions in subcontracts.

74. The contract might specify a period of time within which an interim certificate for payment must be issued by the consulting engineer or the purchaser, and a period of time after issuance of this certificate within which payment must be effected by the purchaser. The portion of the price under the certificate might be made due within a specified period of time after submission of the certificate to a bank to be specified in the contract. In case of a failure to issue the certificate even though the event entitling the contractor to payment has occurred, or to pay the amount due under the certificate, the contractor might be entitled to claim payment in dispute settlement proceedings (see chapter XXIX, "Settlement of disputes").

3. *Payment within specified time after take-over or acceptance of works*

75. Certain percentages of some portions of the price (e.g., those in respect of equipment and materials supplied, civil engineering, installation, or transfer of technology) might be payable only upon proof that construction has been successfully completed, i.e. after acceptance of the works. The contract might require the purchaser to pay those portions of the price within a specified period of time after such proof (e.g., within two weeks after successful performance tests have been conducted, or an acceptance protocol has been signed). In some cases, where take-over precedes acceptance of the works, a portion of the price might be made payable within a specified period of time after take-over (see chapter XIII, "Completion, take-over and acceptance").

4. *Payment within specified time after expiration of guarantee period*

76. To protect the purchaser against the consequences of defective construction by the contractor, the contract might provide that a certain percentage of the price is payable only within a specified period of time after expiration of the guarantee period (see chapter V, "Description of works and quality guarantee," paragraphs 28 to 30). In fixing that percentage, the parties may wish to take into account the other securities which are available to the purchaser in case of

the discovery of defects during the guarantee period. If the purchaser is sufficiently protected by a performance guarantee (see chapter XVII, "Security for performance", paragraphs 10 to 12), the contract might provide that the entire price is to be paid within a specified period of time after the date of the acceptance of the works. The contract might further provide that if any defects are discovered and notified within the guarantee period, the purchaser is entitled to retain from the portion of the price then outstanding an amount which is needed to compensate him for the defects. The retention might last until the contractor cures the defects and pays any damages to which the purchaser may be entitled.

5. *Credit granted by contractor or contractor's country*

77. In most cases, the construction of a works is financed by a loan granted to the purchaser by a financing institution. However, in some cases, where the contractor has at his disposal ample financial resources and the works to be constructed is not large, the contractor may prefer to grant a credit to the purchaser in respect of a portion of the price. In such cases, the portion of the price covered by the credit might be repayable in instalments within a specified period of time after take-over or acceptance of the works by the purchaser.

78. Where the contractor grants such a credit to the purchaser, some of the same issues which are dealt with in a loan agreement with a financing institution (e.g., security for repayment of the loan by the purchaser, interest payable on the loan) must also be settled between the purchaser and the contractor in the works contract.

79. The construction of a works is sometimes financed by a credit granted by the contractor's country to the purchaser's country. In these cases, the parties should, when drafting the payment conditions in the works contract, take into consideration the provisions of the agreement between the Governments of these two countries and the rules which may be issued in the purchaser's country in connection with the implementation of the agreement (e.g., conditions under which the credit may be used for construction).

APPENDIX

"The price revision envisaged in article . . . of this contract is to be made by the application of the following formula:

$$P1 = \frac{P0}{100}\left(a + b\frac{M1}{M0} + c\frac{N1}{N0} + d\frac{W1}{W0}\right)$$

Where:

P1 = price payable under index clause

P0 = initial price as stipulated in the contract

a, b, c, d, represent the contractually agreed percentages of individual elements of construction price covered by the index clause, which add up to 100 (a + b + c + d = 100).

a = proportion of price excluded from adjustment = . . . percent
b = proportion of . . . (to specify materials covered by this weighting) = . . . percent
c = proportion of . . . (to specify other materials covered by this weighting) = . . . percent
d = proportion of . . . (to specify wages covered by this weighting) = . . . percent
M0 = base level of price indices for materials specified under b;
M1 = comparable level of price indices for materials specified under b;
N0 = base level of price indices for materials specified under c;
N1 = comparable level of price indices for materials specifed under c;
W0 = base level of price indices for wages specified under d;
W1 = comparable level of price indices specified under d."

Notes:

— "b", "c" and "d" should be equal to percentage indicated in paragraph 3 of the illustrative provision contained in footnote 1 to this chapter; "a" should include the remaining percentage;

— The dates provided for in paragraph 2 and the price indices indicated in paragraph 5 of the illustrative provision contained in footnote 1 to this chapter should be used for base levels under M0, N0 and W0 and comparable levels under M1, N1, and W1.

Footnotes to chapter VII

[1]*Illustrative provision (index clause)*

"(1) The agreed price is to be revised if there is an increase or decrease in the costs of . . . [list materials or services to be covered by this clause]. The revision is to be made by the application of the formula contained in the annex to this contract." [see appendix to the present chapter].

"(2) The base levels of the indices are to be those existing [at the time of the entering into the contract] [. . . days prior to the actual submission of the bid] [. . . days prior to the closing date for the submission of bids]. These levels are to be compared with the levels of the indices for the same materials or wages existing [. . . days prior to the last day of the period of construction in respect of which payment is to be made] [. . . days prior to the date on which the payment claimed is due]. However, if the contractor is in delay in construction, the base levels are, at the purchaser's option, to be compared with the levels existing . . . days prior to the agreed date for performance [unless the delay was due to an exempting impediment].

"(3) The price subject to revision is to be . . . per cent of the price for the construction of . . . (indicate items to be covered by this clause) effected during the construction period in respect of which the interim payment is to be made.

"(4) If a dispute arises between the parties with regard to the weightings in the formula, the weightings are to be adjusted by [the arbitrators] [the court] if they have been rendered unreasonable or inapplicable as a result of changes in the nature or extent of construction or major changes in the cost relationship of the factors weighted."

(This paragraph may be included in the index clause if the laws applicable to the contract and the law applicable to arbitral or judicial proceedings permit an arbitral tribunal or a court to exercise the authority specified in this paragraph).

"(5) For the purposes of this provision the indices published by . . . in . . . [indicate the country] are to be used. If these indices cease to be available, other indices are to be used if they can reasonably be expected to reflect price changes in respect of the construction costs covered by this clause.

"(6) This clause applies only in cases where its application results in a revision of the price exceeding . . . per cent of the price agreed in the contract."

[2]*Illustrative provision*

"The price is agreed upon subject to the condition that . . . [indicate a unit of price currency] is equal to . . . [indicate unit or units of a unit of account]. Should this relationship have changed at the time of the actual payment of the price by more than . . . per cent, the price to be paid is to be increased or decreased so as to reflect the new relationship between the unit of account and the unit of the price currency."

Chapter VIII. Supply of equipment and materials

SUMMARY

In structuring provisions in their contract concerning the supply of equipment and materials, the parties might bear in mind that supply of equipment and materials by the contractor under a works contract has features which may differ from those in respect of delivery of goods under a sales contract (paragraph 2).

The parties may wish to consider whether certain issues connected with the supply of equipment and materials should be settled in their works contract in accordance with a particular trade term as interpreted in the International Rules for the Interpretation of Trade Terms (INCOTERMS). Since trade terms are interpreted in INCOTERMS primarily in the context of sales contracts, some issues in a works contract may need to be resolved in a manner different from that in INCOTERMS (paragraph 3).

The necessity for and nature of the description in the contract of equipment and materials to be supplied by the contractor may depend upon the contracting approach chosen by the purchaser as well as the extent of the contractor's obligations (paragraphs 6 and 7).

It is advisable to specify in the contract the time when and the place where equipment and materials are to be supplied. In some cases, the contract might obligate the contractor to supply equipment and materials on a specified date; in other cases, it might obligate him to supply them within a specified period of time. The place of supply may depend upon whether or not the purchaser is to take over the equipment and materials (paragraphs 8 to 10).

The contract may specify which party is obligated to arrange for the transport of equipment and materials and to bear the costs connected with that transport. It may also deal with such ancillary issues as the packing of the equipment and materials, permits required for the transport, marking of the equipment and materials, and delivery to the purchaser of the documents connected with the transport (paragraphs 11 to 14).

The contract might specify which party is to arrange customs clearance of the equipment and materials and to pay the customs duties (paragraphs 15 and 16).

The parties should take into account any legal rules in the country where the works is to be constructed which prohibit the import of certain equipment and materials, and any legal rules which prohibit the export of certain equipment and materials from the contractor's country or another country from which they are to be exported. The contract might allocate responsibility for obtaining necessary import or export licences. The contract might also provide that its entry into force depends upon the granting of all import and export licences which are required at the time the contract is entered into, except in respect of such licences as are not obtainable before the start of construction (paragraphs 17 and 18).

Equipment and materials supplied by the contractor may need to be taken over by the purchaser in order to store them, or prior to their being incorporated in the works by the purchaser, or by a contractor other than the one who supplied them. The contract might contain provisions concerning the checking by the purchaser of equipment and materials taken over by him, and the giving of notice of a lack of conformity (paragraphs 19 and 20).

The contract may establish the responsibilities of the parties in connection with the storage of equipment and materials on site. If the equipment and materials are to be stored by the purchaser, the contract might establish the extent of the purchaser's responsibility for loss of or damage to the equipment or materials during storage (paragraphs 21 to 26).

If the purchaser assumes the obligation to supply certain equipment and materials needed for the construction of the works by the contractor, it is advisable for the contract to specify the quantity and quality of the equipment and materials to be supplied, as well as the time when they are to be supplied. In addition, the contract might obligate the contractor to inspect the equipment and materials promptly after they have been supplied by the purchaser, and require notice to be given to the purchaser of any lack of conformity of the equipment and materials (paragraphs 27 to 29).

A. General remarks

1. This chapter deals with the supply of equipment and materials which are to be incorporated in the works. Certain related issues are discussed in other chapters. Inspection and tests of equipment and materials during manufacture and construction, as well as the consequences of defects discovered through the inspection and tests, are discussed in chapter XII, "Inspections and tests during manufacture and construction". The passing of the risk of loss of or damage to equipment and materials, and the consequences of the passing of risk, are discussed in chapter XIV, "Passing of risk", paragraphs 7 to 19. The transfer of ownership of equipment and materials is discussed in chapter XV, "Transfer of ownership of property", paragraphs 6 and 7. Insurance of equipment and materials is discussed in chapter XVI, "Insurance", paragraphs 24 to 26. Spare parts for equipment incorporated in the works to be supplied by the contractor after completion of construction are discussed in chapter XXVI, "Supplies of spare parts and services after construction", paragraphs 10 to 21. The remedies which the purchaser may have for the supply of defective equipment and materials by the contractor are dealt with in chapter XVIII, "Delay, defects and other failures to perform", paragraphs 26 to 32.

2. In structuring provisions in their contract concerning the supply of equipment and materials, the parties might bear in mind that supply of those items under a works contract has features which may differ from those in respect of the delivery of goods under a sales contract. For example, since equipment and materials supplied by the contractor under a works contract are to be incorporated in the works by him or by another contractor under his supervision, the mere supply of the equipment and materials is only a partial performance of the supplying contractor's obligations. The passing of risk or the transfer of ownership in respect of equipment or materials may occur at a time different from the time when they are supplied. In some cases (in

particular, if only a single contractor is engaged to construct the whole works), the equipment and materials may remain in the hands of the contractor after their arrival at the site until their incorporation in the works. In other cases, they may be taken over by the purchaser for storage purposes, and later handed back to the contractor for incorporation in the works (see section B,6 and 7, below).

3. Some of the issues involved in the supply of equipment and materials (e.g., transport, passing of risk, obtaining of export and import licences, and packing) are addressed by trade terms (e.g., f.o.b., c. & f.) as interpreted in the International Rules for the Interpretation of Trade Terms (INCOTERMS). If the parties wish certain issues under their works contract to be settled in accordance with a particular trade term, they might include in the contract a provision to that effect.[1] The parties should be aware, however, that trade terms are interpreted in INCOTERMS primarily in the context of sales contracts, and that certain issues arising in the context of a works contract may not be resolved in INCOTERMS, or may need to be resolved in a manner different from that in INCOTERMS.

4. Some of the equipment and materials needed for the construction of the works may be available in the country where the works is to be constructed. Even when the use of local equipment and materials is not required by the local law or by the local authorities in order to strengthen the industrial development of the country, it is advisable for the purchaser to use such equipment or materials if, for example, they are less costly than those obtainable from abroad, or if their use enables the purchaser to conserve foreign exchange. Therefore, the purchaser may wish to assume the obligation to supply specific locally available equipment and materials, if he is in a better position to procure them than the contractor (see paragraphs 27 to 30, below). If the purchaser does not wish to assume this obligation, the contract might obligate the contractor to obtain and use specified locally available equipment and materials.

5. In some cases, the contractor may perform his obligation to supply equipment or materials by providing them from his own stocks. In many other cases, however, he will engage third persons (e.g., subcontractors or suppliers) to supply them directly to the place specified in the contract. In the latter case, the supply by a third person might be regarded under the works contract as performance of the supply obligations of the contractor (see, e.g., chapter XI, "Subcontracting", paragraph 1). The discussion in the present chapter is intended to apply whether the contractor performs his obligation to supply equipment or materials by providing them from his own stocks or by engaging a third person to supply them.

B. Supply of equipment and materials by contractor

1. *Description of equipment and materials to be supplied*

6. The necessity for and nature of the description in the contract of equipment and materials to be supplied by the contractor may depend upon the contracting approach chosen by the purchaser as well as the extent of the contractor's obligations. In some cases, for example, the contractor may be one of several engaged to construct the works, and each contractor may be obligated to supply certain types of equipment and materials. In those cases,

the purchaser will have to co-ordinate the obligations and performance of the several contractors in order to achieve his construction targets (see chapter II, "Choice of contracting approach", paragraph 18). To achieve that co-ordination, he should see to it that the equipment and materials to be supplied by each contractor are clearly specified in the contract with that contractor, and that all of the equipment and materials needed for the construction of the entire works are allocated among the various contractors.

7. When a single contractor is engaged to construct the entire works, or a particular portion of the works which can be operated separately (e.g., a power station), and the contractor must supply all the equipment and materials needed for the construction, the contract need not describe in detail all the items which are to be supplied. However, it is advisable for the contract to contain a description of the operation capability to be attained by the important items of equipment and technical characteristics of main materials to be supplied, since the quality of the construction will depend in large measure on the quality of those items and materials (see chapter V, "Description of works and quality guarantee", paragraphs 8 and 9, and cf. chapter XII, "Inspections and tests during manufacture and construction", paragraphs 4 and 5).

2. *Time and place of supply*

8. It is advisable to specify in the contract the time when and the place where equipment and materials are to be supplied. When equipment and materials are to be supplied by one contractor but incorporated in the works by other contractors under the supervision of the supplying contractor, it is important for the contract to specify the time when the equipment and materials must be supplied in order to enable the performances of the various contractors to be co-ordinated. In such cases, it is usually desirable to provide in the time-schedule for construction that the time when the equipment and materials are to be supplied is obligatory. Even in cases where the equipment and materials are to be incorporated in the works by the contractor who supplied them, the parties may agree on a time-schedule for the supply of certain items at given times in order to enable the purchaser to monitor the progress of construction and to subject the contractor to sanctions for delay if those times are not met (see chapter IX, "Construction on site", paragraphs 18 to 23, and chapter XVIII, "Delay, defects and other failures to perform", paragraphs 17 and 18). The contract might link the obligation of the purchaser to pay a portion of the price to the time when certain equipment and materials are supplied (see chapter VII, "Price and payment conditions", paragraph 70).

9. The contract might obligate the contractor to supply equipment and materials on a specified date or within a specified period of time. A specified date may be appropriate when a rigid time-schedule has been established for the construction process, with the contractor being obligated to supply on the specified date and not earlier (e.g., because storage facilities would not be available earlier). In certain circumstances, however, it may not be possible to specify a date in the contract, for example, when the equipment and materials are required subsequent to the completion of certain elements of construction by another contractor, and the time of that completion is uncertain at the time when the contract for the supply of equipment and materials is entered into. In such cases, the contract might entitle the purchaser, after the contract has been entered into, to specify a date falling within a period of time set forth in the contract when the contractor

must supply the equipment and materials. In determining what period of time to set forth in the contract, the purchaser may take into consideration the time frame within which he expects the equipment and materials to be needed for the construction. Such an approach would take into account the uncertainty at the time of entering into the works contract as to precisely when the equipment or materials would be needed, but would give the contractor an indication as to the period of time within which he must supply them (cf. chapter IX, "Construction on site", paragraph 20). In circumstances where it is not needed to specify a particular date for the supply of equipment and materials (e.g., where only one contractor is to construct the entire works), the contract might permit the contractor to supply them at any time within a period of time specified in the contract.

10. With regard to the place of supply, if equipment and materials are to remain in the hands of the contractor until he incorporates them in the works, the contract may specify that supply to the site is relevant for determining compliance with the time-schedule, as well as for the allocation of the costs of supply. If they are to be taken over by the purchaser (see paragraph 19, below), the contract might obligate the contractor to hand them over to the purchaser at the site, or at some other specified place. In cases where the purchaser is to arrange for the transport of the equipment and materials to the site (see section B,3, below), the contract might obligate the contractor to supply the equipment and materials at a specified place for handing over to the first carrier engaged by the purchaser. Except where the cost-reimbursable method of pricing is used (see chapter VII, "Price and payment conditions", paragraphs 10 to 24), the contract might obligate the contractor to bear the costs of supplying the equipment and materials at the place specified.

3. *Transport of equipment and materials*

11. Normally, it would be appropriate for the party obligated to supply the equipment and materials to be obligated to arrange and pay the costs of transport to the stipulated place of supply. Where equipment and materials are to be supplied at a place other than the site, it is desirable for the contract to specify which party is obligated to arrange for their transport from that place to the site and to pay the costs of transport.

12. Even when the equipment and materials are to be supplied at a place other than the site, it is desirable in most cases for the contractor to be responsible for the packing and protecting of the equipment and materials in a manner adequate for their transport to the site by the means of transport envisaged. The packing of equipment and materials may be governed by legal rules applicable to international transport or to transport in the countries through which the equipment is to be transported (e.g., rules imposing limitations on the dimensions of packages or requiring that dangerous goods be packed in particular ways). If the contract provides for a lump-sum price, the costs of packing the equipment and materials may be included in the price.

13. The transport of equipment and materials may require road, rail or other transport permits, and it is advisable for the contract to specify which party is to be responsible for obtaining the permits. The contract might obligate the party not responsible for obtaining the permits to render to the other party any

assistance necessary to obtain them (e.g., by providing information about the dimensions of the equipment, the kind of packaging used, or the formalities to be satisfied for obtaining the permits under applicable regulations).

14. If equipment and materials are to be taken over by the purchaser at the place of supply, it may be desirable for the contract to obligate the contractor to mark the packages containing the equipment and materials in such a manner that they can be identified by the purchaser. In addition, the contractor might be obligated to mark the equipment and materials as required by the legal rules applicable to the mode of transport envisaged (e.g., to use the appropriate marking to indicate that the materials are dangerous). The contract might also obligate the contractor to deliver to the purchaser the documents connected with the transport (e.g., invoices or transport documents). Some of these documents, such as bills of lading, may be needed by the purchaser to be able to take over the equipment and materials; the contract might require such documents to be delivered to the purchaser, or, in the case of a documentary credit transaction, to the purchaser's bank, so that they are received in sufficient time to enable the purchaser to take over the equipment and materials when they arrive at the place of destination. The receipt of such documents by the purchaser may also be made a precondition to payment of the price for the equipment and materials (see chapter VII, "Price and payment conditions", paragraph 71).

4. *Customs clearance and customs duties*

15. The contract might specify which party is to arrange customs clearance of the equipment and materials and to pay the customs duties. Customs duties are normally imposed on equipment and materials being imported. However, in exceptional cases, they may be imposed on equipment and materials being exported. In addition, transit charges and fees may be imposed on equipment and materials during transit. It may be appropriate to provide in the contract that customs clearance of equipment and materials for export, and the payment of export customs duties, are the responsibility of the contractor. This may be the case even where the place of supply is the place where the equipment and materials are to be handed over to the carrier engaged by the purchaser (see paragraph 10, above). The contract might provide that customs clearance and the payment of customs duties during transit are the responsibility of the party arranging the transport. The parties may take into account in the contract any exemption from customs duties provided under local law.

16. The customs clearance of imported equipment and materials might be undertaken by the purchaser if they are to be taken over by him after import (see paragraph 19, below). If equipment and materials are to remain in the hands of the contractor after import, import customs clearance may be the responsibility either of the contractor or the purchaser, depending on which party would find it easier to engage in the clearance procedures or which party is obligated under local law to engage in those procedures. The contract might obligate the party not responsible for the clearance to assist in the clearance procedures, in particular, by providing documents which may be needed (e.g., the contractor might be required to assist by providing invoices and certificates of origin, and the purchaser by providing import licences or other required permits issued in his country). As regards the payment of import customs

duties, it may be preferable in some cases to provide that the payment is to be the responsibility of the purchaser. If the contractor is to be responsible for the payment, a change in the rates of import customs duties from those existing at the time the contract is entered into may necessitate a revision of the price to account for the change (see chapter VII, "Price and payment conditions", paragraphs 38 and 39).

5. *Prohibitions and licence requirements*

17. Legal rules in the country where the works is to be constructed may prohibit the import of certain equipment and materials. In addition, legal rules in the contractor's country, or another country from which equipment and materials are to be exported, may prohibit the export of certain equipment and materials. The parties should take those rules into account when drawing up the works contract, since violating them may render the contract invalid. If import and export are permitted only upon the obtaining of licences, it is advisable for the contract to obligate the purchaser to obtain any import licences and the contractor to obtain any export licences which are required by law at the time the contract is entered into, or which may become required by law after the contract has been entered into. In addition, the contract may obligate each party to co-operate with the other in obtaining such licences. The party who is to obtain the licences may be obligated by the contract to notify the other party in time of the steps taken towards obtaining them and the results achieved.

18. The contract might provide that its entry into force depends upon the granting of all import and export licences which are required at the time the contract is entered into (see chapter III, "Selection of contractor and conclusion of contract", paragraph 50). In some cases, however, licences required for the import or export of certain equipment or materials may not be obtainable before the start of construction. For example, applicable regulations might enable an application for a licence to be acted upon only a short time before the proposed date of export or import, which may be some time after the start of construction. In such cases, it would not be possible to condition the entry into force of the contract upon the granting of those licences, but the contract might provide for the consequences of a failure to obtain a licence by the party obligated to obtain it. It might also provide that, if the party who is obligated to obtain a licence does not do so within a specified period of time after the contract is entered into, the other party may suspend his performance or terminate the contract (see chapter XXIV, "Suspension of construction" and chapter XXV, "Termination of contract"). Such consequences might also be provided for a failure to obtain a licence which becomes legally required after the contract has been entered into.

6. *Take-over of equipment and materials by purchaser*

19. In certain circumstances, equipment and materials supplied by the contractor may need to be taken over by the purchaser. For example, the purchaser may need to take them over in order to store them (see section B,7, below). He may also need to take them over prior to their being incorporated in the works when the incorporation is to be done either by himself or by a

contractor other than the one who supplied them (e.g., in cases where the supplying contractor only supervises the installation of the equipment). The contract might provide that take-over occurs when the purchaser takes physical possession of the equipment and materials. It might also provide that take-over by the purchaser does not connote any approval by him of the equipment or materials supplied by the contractor (see chapter XII, "Inspections and tests during manufacture and construction", paragraph 1, and chapter XVIII, "Delay, defects and other failures to perform", paragraphs 8 and 44). Furthermore, the contract might provide that where the purchaser is obligated to take over equipment and materials and he fails to do so, they are deemed to be taken over at the time that they are placed at the disposal of the purchaser.

20. In some cases, the contract might provide that the take-over of the equipment and materials by the purchaser is to result in the passing to the purchaser of the risk of loss of or damage to the equipment and materials (see chapter XIV, "Passing of risk", paragraphs 9 to 17). Where the risk so passes, disputes may arise as to whether loss or damage occurred before or after take-over. Disputes may also arise as to whether defects in the equipment and materials were caused prior to take-over, e.g., by faulty manufacture or inadequate packing by the contractor, or after take-over, e.g., by improper storage by the purchaser. Such disputes may be reduced if the purchaser is obligated to check the apparent condition of the equipment and materials at the time of take-over, and to notify the contractor promptly of any lack of conformity which the purchaser discovers. However, the purchaser might not be capable of determining whether the equipment and materials are in good condition (e.g., because he is not aware of the specifications of the equipment and materials, or does not have the technical knowledge to determine whether the specifications are met). In addition, some defects may be discoverable only after the incorporation of the equipment and materials in the works and the completion of construction. The parties might therefore wish to consider whether the contract should provide that in such cases the purchaser would not lose his remedies in respect of a lack of conformity which he did not notify to the contractor, if that lack of conformity arose from causes for which the contractor was liable to the purchaser.

7. *Storage on site*

21. Equipment and materials must be available at the site at the time when they are needed for incorporation in the works. They are, therefore, usually supplied to the site and stored there prior to the time when they will be used. The contract may establish the obligations of the parties in connection with that storage.

22. Provisions concerning storage may be unnecessary if the equipment and materials are to remain in the hands of the contractor after being supplied to the site and the contractor bears the risk of loss of or damage to them. In such cases, the contractor's liability for defects in the works, or the portion of the works in which the stored equipment and materials are to be incorporated, will be a sufficient incentive by him to exercise proper care in storage. In cases where the storage is to be effected by the contractor, but the risk is to be borne by the purchaser during the storage, it is advisable to determine in the contract the degree of care expected of the contractor in performing the storage.

23. The choice of which party is to be responsible for storage may depend upon the contracting approach chosen by the purchaser. If only one contractor is engaged to construct the works, that contractor might assume responsibility for storage (see, also, paragraph 22, above). If more than one contractor is to supply equipment and materials, each contractor might assume responsibility for storing the equipment and materials supplied by him if his personnel are to be present on site at the time of supply, and if he has suitable storage facilities. Otherwise, the purchaser might assume responsibility for the storage. Such an arrangement may, however, give rise to disputes. In that case, the contract might obligate the contractor supplying the equipment or materials to advise the purchaser on the manner in which they are to be stored, if the purchaser requests such advice. It might also obligate the contractor to inform the purchaser of any special measures which have to be taken in storing the equipment and materials, even if the purchaser makes no such request.

24. In cases where the contractor is reponsible for storage, that responsibility might include the provision of adequate storage facilities (e.g., storage sheds or rooms). However, the contract might require the purchaser to provide the land on which the facilities are to be located. If the purchaser is better able to provide the storage facilities, the contract might obligate him to provide them at a time set forth in the time-schedule for construction (see chapter IX, "Construction on site", paragraphs 18 to 23).

25. If the equipment and materials are to be taken over and stored by the purchaser, and the risk of loss of or damage to the equipment and materials during storage is to be borne by him (see chapter XIV, "Passing of risk", paragraphs 9 to 17), the contract might obligate the purchaser to hand over the equipment and materials to the contractor in the same condition in which the purchaser took them over for storage. However, the contract might exclude from such liability loss or damage caused by the contractor or by a person engaged by him, or loss or damage occurring by reason of the inherent character of the equipment or materials. In cases where storage is to be effected by the purchaser but the risk is to be borne by the contractor, it is advisable to determine in the contract the degree of care expected of the purchaser in performing the storage. In cases where the purchaser stores the goods, the contractor might obligate him to notify the contractor promptly of any loss or damage occurring to the stored equipment and materials.

26. The contract might establish the time and manner in which equipment and materials stored by the purchaser are to be handed back to the contractor for incorporation in the works. It might obligate the contractor to inspect the equipment and materials at the time they are handed back to him by the purchaser, and to notify the purchaser of any loss or damage. Whether the purchaser is liable for the loss or damage may depend on the nature of the purchaser's responsibility for storage (see paragraph 25, above). The contract might provide that the contractor loses his right to hold the purchaser liable for loss of or damage to the stored equipment or materials if the contractor does not give notice to the purchaser specifying the nature of the loss or damage within a reasonable period of time after the contractor can reasonably be expected to have discovered it, and, at the latest, within a period of time, specified in the contract, after the stored equipment or materials have been handed over to the contractor by the purchaser.

C. Supply of equipment and materials by purchaser

27. Under some works contracts, the purchaser may assume the obligation to supply certain equipment and materials needed for the construction of the works by the contractor (see paragraph 4, above). This should be distinguished from the situation where the purchaser has undertaken to construct a portion of the works himself and he is to be solely responsible for that construction (see chapter II, "Choice of contracting approach", paragraph 1).

28. It is advisable for the contract to specify the equipment and materials to be supplied by the purchaser. The time when the equipment and materials are to be supplied by the purchaser may be set forth in the time-schedule by reference to dates or periods of time in a manner similar to that discussed in paragraph 9, above, concerning the time of supply by the contractor.

29. The contract might obligate the contractor to inspect the equipment and materials promptly after they have been supplied by the purchaser. It might also provide that the contractor loses his right to hold the purchaser liable for a lack of conformity of equipment and materials if the contractor does not give notice to the purchaser specifying the lack of conformity within a reasonable period of time after the contractor can reasonably be expected to have discovered it, and at the latest, within a period of time, specified in the contract, after the equipment and materials have been supplied by the purchaser. The remedies available to the contractor for a failure by the purchaser to supply equipment and materials in time and free of defects are dealt with in chapter XVIII, "Delay, defects and other failures to perform", paragraph 63.

30. The parties may wish to agree that the contractor is not to pay for equipment and materials supplied by the purchaser, but that the value of that equipment and materials is to be accounted for in determining the price to be paid by the purchaser for the construction of the works.

Footnote to chapter VIII

[1] *Illustrative provision*

"(1) The supply of equipment and materials by the contractor for incorporation in the works is to be effected on the basis of [FOR . . . (named departure point)] [f.o.b. . . . (named port of shipment)] [c. & f. . . . (named port of destination)] [Freight/Carriage Paid to . . . (named port of destination)] [Ex Ship . . . (named port of destination)] [Ex Quay (duty paid . . . named port)] [Delivered at Frontier . . . (named place of supply at frontier)] [Delivered Duty Paid at . . . (named place of destination in the country of importation)].

"(2) The trade term referred to in paragraph (1) is to be interpreted in accordance with the International Rules for the Interpretation of Trade Terms (INCOTERMS) of the International Chamber of Commerce in force on the date of entering into the contract, unless the contract provides otherwise in respect of any of the issues regulated by that trade term". (INCOTERMS, as revised in 1980, are contained in ICC Document No. 350).

Chapter IX. Construction on site

SUMMARY

Construction on site as discussed in this chapter covers civil engineering, building and the installation of equipment. It also covers the supply by the contractor of certain construction services relating to installation to be effected by the purchaser or an enterprise engaged by the purchaser. The scope of the construction to be effected will depend on the terms of the particular works contract. Mandatory legal rules in force in the country where the works is to be constructed may require certain standards or procedures to be observed during the construction (paragraphs 1 to 3).

Some preparatory work is usually needed on the site before construction can commence. The contract may specify the items of preparatory work to be undertaken by each party. The purchaser may be obligated to obtain any authorizations required for the use of the site for construction. The contract may also specify the facilities which will be needed by the contractor's personnel during the construction, and determine how those facilities are to be provided (paragraphs 6 to 9).

The contract may obligate the contractor to equip himself with the construction machinery and tools that he needs for the construction. If the purchaser is to supply some of the construction machinery and tools, the contract may determine the rights and obligations of the parties in regard to the supply. The purchaser may be obligated to assist the contractor in obtaining authorizations for the import of the construction machinery and tools into the country where the works is to be constructed (paragraphs 11 and 12).

The contract should set forth the dates when the construction is to be commenced and completed by the contractor, and also determine whether completion prior to the date set for completion is permissible (paragraphs 14 to 17).

It is advisable for the contract to contain a time-schedule which establishes the sequential order in which construction is to take place. In designing the time-schedule, the parties may wish to consider using the "critical path method". The time-schedule may establish obligatory and non-obligatory milestone dates for the completion of portions of the construction (paragraphs 18 to 23).

The date for completion of construction may need to be changed in certain circumstances. The contract may establish a mechanism for making the change if those circumstances occur (paragraphs 24 and 25).

If the purchaser undertakes the installation of equipment, the contractor may be obligated to supervise the installation. The contract may specify the rights and obligations of the parties in relation to the supervision. Where supervision by the contractor is not needed, the contractor may be obligated to give advice on installation, if so requested by the purchaser (paragraphs 27 to 30).

Each party will need access to the site for certain purposes. The contract may define the access to be granted, and include provisions regulating access (paragraphs 31 and 32).

In cases where the purchaser is to construct a portion of the works, he may sometimes find it advantageous to require the contractor to purchase on his behalf some of the equipment and materials needed for the construction (paragraphs 33 and 34).

The contract may obligate the contractor to clear the site periodically, and to leave it in a clean and workmanlike condition after the completion of construction (paragraph 36).

A. General remarks

1. Construction under a works contract may include the supply of equipment and materials to be incorporated in the works, as well as civil engineering, building, installation of equipment and the supply of other construction services (e.g., supervision of installation). In addition to undertaking the construction, the contractor may undertake to transfer technology (see chapter VI, "Transfer of technology", paragraph 2) and to supply the design for the works (see chapter II, "Choice of contracting approach", paragraph 2).

2. Construction on site as discussed in this chapter covers civil engineering, building and the installation of equipment. It also covers the supply by the contractor of certain construction services relating to installation to be effected by the purchaser, or by an enterprise engaged by the purchaser. The supply of equipment and materials is dealt with in chapter VIII, "Supply of equipment and materials". The scope of the construction on site to be effected will depend on the terms of the particular works contract (e.g., the construction may be limited to the installation of equipment, or may include, in addition, civil engineering and building: see chapter V, "Description of works and quality guarantee", paragraph 3). In some cases, equipment supplied by the contractor may be installed by the purchaser or an enterprise engaged by him, and the obligation of the contractor may be limited to the supervision of the installation (see paragraphs 27 to 30, below). In other cases, some equipment may be supplied by enterprises engaged by the purchaser, and the contractor may be obligated to install that equipment in addition to equipment supplied by him.

3. Mandatory legal rules in force in the country where the works is to be constructed may require certain standards or procedures to be observed during the construction on site (e.g., in the interests of the health and safety of the personnel effecting the construction and in the interests of environmental conservation). The contract may, however, obligate the purchaser to assist the contractor in obtaining information concerning such rules, and the purchaser may find it convenient to perform some of the obligations imposed by the rules. In addition, certain mandatory legal rules of the contractor's country relating to working conditions may apply even to construction effected on the site in the purchaser's country by the contractor's personnel. Apart from relevant local, national and international legal rules and regulations and the provisions of the contract, there may exist local, national and international standards or codes of practice concerning health, safety and environmental conservation. It is advisable for the parties to agree that the contractor will comply with those requirements.

4. When several contractors are engaged to construct the works, and construction by them is to proceed simultaneously, the contract may require each of them to avoid conduct which would interfere with the performance of his obligations by other contractors.

5. The contract may provide that representatives of the parties are to meet periodically at specified intervals on the site to promote co-operation between them and to resolve outstanding issues concerning the construction on site. Such meetings may help to resolve routine problems or misunderstandings, and thus dispel the need to invoke contract provisions on dispute settlement (see chapter XXIX, "Settlement of disputes", paragraph 9).

B. Preparatory work

6. Most works contracts obligate the purchaser to provide the site on which the works is to be constructed. The site may be identified in the contract, e.g., by reference to maps or plans. The contractor will normally have inspected the site prior to entering into the contract, and may have assumed some obligations as to the suitability of the site for the proposed construction (cf. chapter VII, "Price and payment conditions", paragraphs 44 and 45).

7. Some preparatory work on the site (e.g., clearing and levelling the site, providing access roads or railways, and making water and energy available to the site) is usually needed to enable construction on site to commence and to progress smoothly. The contract may specify the items of preparatory work to be undertaken by each party, fix a time-schedule for the completion of the work (see section C,3, below), and determine which party is to bear the cost of the work.

8. It is desirable for the contract to obligate the purchaser to obtain official approvals or authorizations required under the law of the country where the works is to be constructed for the use of the site for construction (cf. chapter XXVIII, "Choice of law", paragraph 24). The parties may also wish to provide that the purchaser is to assist the contractor in obtaining visas, work permits, and similar documents which are necessary for the contractor's personnel to enter the country of the site, and to commence work there.

9. It is desirable that the contract specify the facilities which will be needed by the contractor's personnel during the construction on site, which party is to provide those facilities, and which party is to bear the costs of providing them. If the purchaser is to pay for facilities to be provided by the contractor, the amount of the payment may be included in a lump-sum price or, alternatively, the amount may be payable on a cost-reimbursable basis (see chapter VII, "Price and payment conditions", paragraph 2). In some cases, the contractor may be obligated under the contract to provide certain facilities needed by the purchaser's personnel during the construction on site. The purchaser may wish to consider undertaking some or all of the following obligations: to provide offices and living quarters suitable for the contractor's personnel; to equip such accommodations with furniture, telephones and other utilities; to provide food or catering facilities for the contractor's personnel; to provide sanitary facilities on the site; and to provide daily transportation for the contractor's personnel between their living quarters and the site. The contract may specify the standard of the facilities to be provided, taking into account requirements

imposed by the applicable law in respect of the working conditions of construction personnel. It may be desirable for the contract to require, prior to the commencement of construction on site, a joint inspection by the parties of the facilities to be provided by the purchaser. The condition of the facilities as ascertained by the inspection may be set forth in a protocol signed by both parties.

10. It is usually necessary to establish a workshop for the purposes of the construction on site, and the contract may obligate the contractor to provide it. The purchaser may wish to retain this workshop after construction has been completed since it may be useful for the purposes of repairing and maintaining the works. The cost of providing the workshop may be included in the contract price.

C. Construction on site to be effected by contractor

1. *Machinery and tools for effecting construction*

11. The contractor will need construction machinery (e.g., excavators, cranes, earth movers) and tools (e.g., drills, saws) for effecting the construction on site, and he may be obligated to equip himself with the machinery and tools that he needs. In certain cases, however, it may be advantageous for the purchaser to supply the contractor with some of the construction machinery and tools (e.g., when he has the possibility of inexpensively leasing such machinery and tools for local currency). In such cases, the contract may enumerate the items to be supplied by the purchaser, and provide that the contractor is responsible for obtaining all the other items needed by him. Furthermore, it is advisable for the contract to specify the rights and obligations of the parties in respect of items supplied by the purchaser (e.g., whether the items are to be sold or leased to the contractor, and whether the amount payable by the contractor in respect of the sale or hire has been accounted for in the contract price or has to be paid separately). The contract may also address other issues which will arise under such arrangements, for example, the dates on which various items are to be supplied, the quantity and quality of the items, which party is to be responsible for maintenance and repairs, the purposes for which the items may be used, and which party bears the risk of loss of or damage to the items. The same issues will have to be addressed if the purchaser is to construct a portion of the works, and he finds it advantageous to obtain from the contractor some of the machinery and tools he needs for the construction.

12. Special licences and authorizations (e.g., customs clearances) may be required in respect of construction machinery and tools imported by the contractor into the country where the works is to be constructed, even if they are to be exported after completion of the construction. The purchaser may be obligated under the contract to assist the contractor in obtaining such licences and authorizations, or to obtain them on behalf of the contractor.

13. The parties may wish to agree upon how the transport on the site needed for effecting the construction is to be provided. For example, the contract may require one of the parties to provide the vehicles needed, and may allocate responsibility in respect of the maintenance, repair and replacement of the vehicles. Issues connected with the transport of equipment and materials to the site are discussed in chapter VIII, "Supply of equipment and materials", paragraphs 11 to 14.

2. *Time for completion of construction*

14. The contract should clearly set forth the times when the construction is to be commenced and is to be completed by the contractor. The time for completion may be determined either by reference to a calendar date or by reference to a period of time. If construction is to be completed by a calendar date, it is advisable for the contract to specify the situations in which this date may be postponed, and the criterion for determining the length of postponement. The contract may provide that construction is to be completed within a specified period of time in cases where the date on which construction can commence is uncertain (e.g., because approval of the contract by a governmental institution is required before the contract can enter into force, or because licences for the import of equipment and material required for the construction have to be obtained by the purchaser). The contract should specify when the period is to commence (see succeeding paragraph), under what circumstances it will cease to run or will be extended or shortened, and the criterion for determining the change in the period (see paragraphs 24 to 26, below, chapter XXIII, "Variation clauses", paragraph 8, and chapter XXIV, "Suspension of construction", paragraphs 13 and 14).

15. The parties may wish to provide that a period of time for completion of construction is to commence from one of the following dates:

(*a*) The date on which the contract enters into force;

(*b*) The date on which the purchaser makes an advance payment of a part of the price required to be made under the contract, or the date on which the purchaser delivers to the contractor a guarantee as security that such an advance payment will be made;

(*c*) The date on which the purchaser delivers a notification to the contractor that the purchaser has obtained all licences for import of equipment and materials, and all official approvals for construction of the works required in the country where the works is to be constructed;

(*d*) The date on which the purchaser has delivered to the contractor all the contract documents defining the scope of construction and the technical characteristics of the works (e.g., designs, drawings) which are needed for the commencement of construction;

(*e*) The date on which the site is handed over to the contractor.

16. Alternatively, the parties might refer to more than one of the dates mentioned in the preceding paragraph, and provide that the period of time is to commence to run from the date which occurs last. The consequences of a failure by the contractor to complete construction in time are discussed in chapter XVIII, "Delay, defects and other failures to perform" and in chapter XIX, "Liquidated damages and penalty clauses".

17. Where only one contractor is engaged to construct the works and co-ordination by the purchaser of construction on site by several contractors is not needed, it may be in the interest of the purchaser that the construction is completed as early as possible. In such a case, the date fixed for completion, or the end of the period of time for completion, may be considered as the final time for completion, with earlier completion being permissible or even encouraged (see chapter VII, "Price and payment conditions", paragraphs 28 to 30). Sometimes, however, the purchaser may not desire earlier completion for various practical reasons, including his financial arrangements. The contract should determine whether early completion is permitted.

3. *Time-schedule for construction*

18. It is advisable for the contract to contain a time-schedule which establishes the sequential order in which construction is to take place. A time-schedule facilitates an evaluation of the progress of the construction. It may also facilitate the determination of a change in time for completion of construction when this time has to be changed (see sub-section 4, below). The parties may wish to negotiate a time-schedule acceptable to them prior to entering into the contract, since it may be more difficult to reach agreement at a later stage. However, where it is impracticable to formulate a complete and detailed time-schedule prior to entering into the contract, the contract may set forth a basic time-schedule dealing with the construction of major portions of the works, and provide for a detailed time-schedule to be prepared by the contractor within a specified period of time after the contract has entered into force.

19. The time-schedule should be prepared in such a form (e.g., graphically or by using computer facilities) as would permit the actual progress of the construction to be recorded and compared with the time-schedule. One method for designing the time-schedule which the parties may wish to consider is the so-called "critical path method". In this method, the entire construction is divided into individual tasks, and each task is assigned a period of time within which it is to be performed. These periods are incorporated in a schematic diagram depicting the sequence and interrelationship of construction activities. Critical activities, i.e., activities on which other activities depend, form a continuous chain, known as the critical path, through the schematic diagram. This method may facilitate the evaluation of the consequences of delay in certain construction activities upon other such activities.

20. Where several contractors are engaged for the construction (see chapter II, "Choice of contracting approach", paragraphs 17 to 25), each contract may include a time-schedule of the sequence of construction under that contract to enable the purchaser to harmonize it with the purchaser's overall time-schedule for the construction of the entire works. However, while in some cases it may be possible to stipulate the period of time within which the construction to be effected by each contractor is to be completed, it may not be possible to specify the dates for commencement of construction by each contractor (e.g., because the exact dates of completion by other contractors are uncertain). The contract with each of the contractors may provide that the date on which that contractor is to commence construction must fall within a period of time specified in the contract, and may further provide that the date of commencement is to be specified in a notification to the contractor to be delivered within a specified period of time prior to that date. The contract may further provide that, if the purchaser does not require the commencement of construction by the end of the specified period, the contractor is entitled to terminate the contract (see chapter XXV, "Termination of contract").

21. The time-schedule may establish milestone dates (that is, dates by which specified portions of the construction are expected to be completed) for the purposes of assessing the progress of construction. The completion of a portion of construction by a milestone date may be obligatory. When several contractors are engaged for the construction, strict compliance by each contractor with his own time-schedule will be necessary in order for the

construction to be successfully co-ordinated by the purchaser. In such cases, therefore, the contract may provide that the milestone dates are obligatory, and that a contractor who fails to meet a milestone date is liable for delay (see chapter XVIII, "Delay, defects and other failures to perform", paragraphs 17 and 18).

22. When only a single contractor is engaged to construct the entire works, milestone dates are not needed for the purposes of co-ordinating construction activities; the single contractor will be obligated to co-ordinate the activities and to complete construction of the entire works by the date specified in the contract for completion. Nevertheless, even in such cases, obligatory milestone dates may be useful to the purchaser. In the absence of milestone dates requiring certain portions of the construction to be completed by those dates, under some legal systems the purchaser may have no remedy until the date fixed for completion of construction is reached, even where the contractor has fallen far behind the time-schedule for construction. The purchaser may therefore wish to provide in the time-schedule one or several obligatory milestone dates by which certain major portions of the construction are to be completed. The contract may provide that the purchaser is entitled to terminate the contract if the contractor fails to complete one of those portions within a reasonable or specified period of time after the passing of the relevant milestone date (see chapter XVIII, "Delay, defects and other failures to perform", paragraphs 17 and 18, and chapter XXV, "Termination of contract", paragraph 9).

23. Non-obligatory milestone dates may be useful for certain purposes. For example, the use of such dates to delimit the periods of time within which portions of the construction are expected to be completed may facilitate the determination of the length of an extension of time to be granted to a contractor in the event of a variation or suspension of the construction. However, a contractor who failed to meet a non-obligatory milestone date would not be in delay in the performance of his construction obligations.

4. *Change in time for completion of construction*

24. The time for completion of construction may need to be extended or shortened in certain circumstances. If the law applicable to the contract does not adequately provide for such an extension or shortening, it is advisable for the parties to do so in the contract. The circumstances requiring a change in the time for completion is discussed in various other chapters of this *Guide* (see, for example, chapter XXIII, "Variation clauses", paragraph 8, and chapter XXIV, "Suspension of construction", paragraphs 13 and 14). If the time for completion is changed, the time-schedule for construction will have to be adapted accordingly.

25. The contract may obligate the contractor to notify the purchaser promptly of the occurrence of any event on which the contractor intends to rely for the exercise of his right to an extension of time for completion and of the causes of the event. Furthermore, the contractor may be obligated to notify the purchaser of the length of the extension which is needed as soon as the contractor is in a position to specify that length. If, within a specified period of time after the delivery of the notification, the parties fail to agree on the length

of the extension which the contractor is to be given, the time for completion of construction may be deemed under the contract to be extended by a period of time reasonably needed for the completion. The parties may provide that, if disputes between them are settled in arbitral or judicial proceedings (see chapter XXIX, "Settlement of disputes"), the construction is not to be interrupted during the proceedings.

26. A change in the time for completion of construction may require a consequential extension of insurance cover in respect of the construction (see chapter XVI, "Insurance") or of the period of validity of performance guarantees (see chapter XVII, "Security for performance", paragraphs 10 to 12). The party who is obligated to obtain insurance or provide security may be obligated to take the necessary measures.

D. Installation of equipment to be effected under contractor's guidance

27. Where the several contracts approach is adopted (see chapter II, "Choice of contracting approach", paragraphs 17 to 25), the purchaser may wish to undertake the installation of equipment supplied by a contractor, or to engage a local enterprise to install the equipment. The contract may obligate the contractor to supervise the installation. Such an arrangement would reduce the purchaser's outflow of foreign exchange, and might lead to the acquisition of technical skills in his country.

28. It is advisable for the contract to specify the duties to be performed by the contractor in the course of supervision. The contract may obligate him to give specific instructions to the personnel installing the equipment on technical, health and safety aspects of the installation. The contract may specify the qualifications required of the persons to carry out the supervision on behalf of the contractor, and may obligate the contractor to notify the purchaser of the names of persons authorized to carry out the supervision. The contract may indicate the estimated duration of the installation to be supervised, and the approximate date when the installation is to commence. The contract may obligate the contractor to commence his supervision within a specified period of time after delivery to him by the purchaser of a notice to commence. The contract may obligate the purchaser, within a specified period of time before the supervision by the contractor is due to commence, to notify the contractor of the personnel to be supervised.

29. The contract may obligate the contractor to inspect equipment installed under his supervision in order to verify that the installation has been properly carried out, and to notify the purchaser promptly of any defects which he discovers or may reasonably be expected to discover at the inspection. The contract may provide that the contractor is not liable for defects caused by a failure of the purchaser or enterprise engaged by the purchaser to follow instructions given by the contractor.

30. The purchaser, or a local enterprise engaged by the purchaser, may have the technical capability to install the equipment without supervision by the contractor. In such cases, the contract may obligate the contractor to give advice on installation, if so requested by the purchaser. The contract may also obligate the contractor to inspect the equipment installed after the installation is completed, and to notify the purchaser promptly of any defects which he discovers or may reasonably be expected to discover at the inspection.

E. Access to site

31. Each party will need access to the site for certain purposes. The contract may define access to the site to include access to the area where the construction is to be carried out, and also to workshops, laboratories, stores and other facilities established for the purposes of construction on site. Where several contractors are engaged for the construction, in determining the access to be given by the purchaser to a contractor to portions of the works constructed by another contractor, account should be taken of undertakings as to confidentiality (e.g., with regard to drawings, specifications or technology) given by the purchaser to the other contractor.

32. It is advisable for the contract to regulate access to the site. The nature of the access to be granted may depend upon which party is to be in physical possession of the site and the works during construction. When the site and the works during construction are to be in the physical possession of the contractor, the contract may obligate him to give the purchaser, and persons nominated by the purchaser, access to the site for the purpose of enabling them to ascertain the progress of construction, and to exclude persons having no right of access. When the site and the works during construction are to be in the physical possession of the purchaser, the contract may obligate him to give the contractor, and persons engaged by him (including subcontractors), access for the purpose of constructing the works and ensuring curing defects during the guarantee period (see chapter XIII, "Completion, take-over and acceptance", paragraph 23). The contract may obligate each party to take such security measures as are necessary to prevent loss of or damage to equipment, materials and the works when the risk of loss or damage is borne by the other party (see chapter XIV, "Passing of risk").

F. Assistance by contractor in purchasing equipment and materials

33. In cases where the purchaser is to construct a portion of the works, he may sometimes find it advantageous to require the contractor to purchase on his behalf some of the equipment and materials needed for the construction (e.g., the contractor may be in a position to obtain such items more efficiently or more inexpensively). The services relating to purchasing to be supplied by the contractor may include suggesting appropriate specifications for the equipment and materials; suggesting the contractual undertakings, including quality guarantees, to be required from potential suppliers; selecting suitable suppliers; preparing tender and other documents needed for entering into contracts with suppliers; entering into purchase contracts on behalf of the purchaser; and taking over and inspecting supplies. It is advisable for the contract to contain special provisions concerning payment by the purchaser for items purchased on his behalf by the contractor, since the payment conditions applicable to the construction to be effected by the contractor may not be appropriate in respect of those items.

34. The contract may specify the liability of the contractor for a failure to perform his obligations. In contrast to the cases where the contractor engages subcontractors or other persons for the performance of his own construction obligations (see chapter XI, "Subcontracting", paragraphs 27 and 28), it may be provided that the contractor is not liable if suppliers fail to perform their

obligations under contracts which they have entered into with the purchaser. The contractor may be liable only where he has failed to exercise the care which can reasonably be expected from him in the performance of his obligations related to purchasing.

35. In some cases, the purchaser may be capable of purchasing the necessary equipment and materials himself, but may need assistance on a few issues (e.g., appropriate specifications for the equipment and materials, or the guarantees which may be required from suppliers). In such cases, the contractor may be obligated to give suitable advice.

G. Clearance of site

36. The contract may obligate the contractor to clear the site periodically of excess materials and waste. Furthermore, it may obligate him to remove his construction machinery and tools from the site after take-over or acceptance of the works by the purchaser, with the exception of machinery and tools which he may need to repair defects notified to him during the guarantee period. The contract may also obligate the contractor to depart from the site after completion of the construction, leaving it in a clean and workmanlike condition. For the contractor's obligations with respect to his construction machinery and tools when the contract is terminated, see chapter XXV, "Termination of contract", paragraphs 23 to 25.

Chapter X. Consulting engineer

SUMMARY

A consulting engineer as dealt with in this chapter is an engineer engaged by the purchaser to render advice and technical expertise to the purchaser, to take certain actions under the works contract on behalf of the purchaser, or to exercise certain independent functions under the contract (paragraphs 1 to 3). It is advisable for the works contract to set forth clearly the authority and functions of the consulting engineer to the extent that they affect the rights and obligations of the contractor (paragraph 4). The contract need not authorize or regulate the rendering by the consulting engineer of advice and technical expertise to the purchaser (paragraphs 5 and 6). It is advisable, however, for the contract to set forth any authority of the consulting engineer to act on behalf of the purchaser, including any limitations on such authority (paragraphs 7 and 8).

In some works contracts, the parties may wish to provide for a consulting engineer to exercise certain functions independently, rather than for or on behalf of the purchaser (paragraphs 9 to 12 and 16). Such independent functions may be limited to matters of a technical nature, and may include, for example, resolving on site technical questions arising during the course of construction, resolving discrepancies, errors or omissions in the drawings or specifications, interpreting the technical provisions of the contract, and certifying the existence of certain facts giving rise to rights and obligations under the contract (paragraphs 13 and 14). The parties may wish to consider whether the consulting engineer should be authorized to decide disputes between the parties (paragraph 15).

It is desirable for the contract to establish the extent to which an act of the consulting engineer pursuant to an independent function is to be considered binding on the parties. This may depend upon whether the act relates to the resolution of routine problems and questions, or is in connection with the settlement of a dispute between the parties (paragraphs 17 to 19).

If the consulting engineer is only to render advice and technical expertise to the purchaser, or to act on behalf of the purchaser, he might be selected by the purchaser alone. However, if he is to exercise independent functions, the contractor may wish to have the right to participate in the selection. It is desirable for the contract to establish procedures relating to the selection and replacement of the consulting engineer (paragraphs 20 to 26). It may be desirable for the parties to deal with the question of delegation by the consulting engineer of his authority, if they are able to do so under the applicable law (paragraphs 27 and 28).

The contract might obligate the contractor to provide to the consulting engineer such information or grant access to the site, places of manufacture and the completed works to the same extent that he must provide the information or grant access to the purchaser under the works contract (paragraph 29).

A. General remarks

1. The purchaser is likely to require the services of an engineer from the early stages of an industrial works project. Prior to the conclusion of the works contract, an engineer may be required in connection with the performance of feasibility and other pre-contract studies (see chapter I, "Pre-contract studies"), preparation of the design, drawings and specifications for portions or all of the works, preparation of tender and contract documents (see chapter III, "Selection of contractor and conclusion of contract"), and for advice on various other technical matters. After the contract has been entered into, an engineer may provide advice and technical expertise to the purchaser in connection with the construction of the works. In some cases, the purchaser may authorize an engineer to act on his behalf with respect to certain actions to be taken by the purchaser under the works contract (see paragraphs 7 and 8, below). In addition, an engineer may be authorized to exercise independent functions under the works contract which directly affect the rights and obligations of the parties (see paragraphs 9 to 19, below).

2. The scope of the functions to be exercised by an engineer may vary depending upon the contracting approach chosen by the purchaser (see chapter II, "Choice of contracting approach"). The scope would be greater, for example, if the purchaser were to choose an approach involving several contractors and the engineer was required to assist the purchaser in co-ordinating the performances of the various contractors, than if he were to choose a turnkey contract in which such co-ordination was not normally required. Even in a turnkey contract, however, the purchaser may find the services of an engineer to be valuable in connection, for example, with monitoring the progress and checking the quality of the construction performed by the contractor.

3. In some cases, the purchaser may have on his own staff engineers who are capable of supplying the various services which the purchaser will require in connection with the construction of the works. In other cases, however, the purchaser's staff may not be able to supply all the engineering services required, and the purchaser may wish to engage an engineer in order to obtain those services. Such a third-party engineer is referred to in this chapter as the "consulting engineer". Even in cases where the purchaser's in-house engineering capabilities are sufficient, the purchaser may wish to engage a consulting engineer in order to supplement those capabilities, for example, where a consulting engineer has particular expertise or experience in the type of works or construction involved. In addition, if the works contract provides for certain independent functions to be exercised by an engineer, the contract may require that those functions be exercised by a third party, rather than by engineers on the staff of the purchaser. In choosing a consulting engineer, the purchaser may wish to consider whether the engineer who performed the pre-contract studies should be chosen (see chapter I, "Pre-contract studies", paragraph 16).

4. The present chapter deals with provisions in the works contract with respect to the authority and functions of a consulting engineer who is engaged by the purchaser. As far as the consulting engineer is concerned, such authority and functions will be established by the contract between him and the purchaser, rather than by the works contract, to which the consulting engineer

is not normally a party. To the extent that the consulting engineer takes actions either on behalf of the purchaser or independently in his own right which are to have consequences upon the rights and obligations of the contractor under the works contract, it is advisable for the works contract, too, to set forth the authority and functions of the consulting engineer. This will give the contractor the legal authorization as well as the obligation to give effect to such actions of the consulting engineer. It is important for the provisions of the works contract with respect to the authority and functions of the consulting engineer to be consistent with those of the contract between the purchaser and the consulting engineer. If there is more than one works contract for the construction of the works, it is advisable for the provisions in those contracts with respect to the authority and functions of the consulting engineer to be consistent.

B. Authority and functions of consulting engineer

1. *Rendering services to purchaser*

(a) *Rendering advice and technical expertise to purchaser*

5. With any type of works contract, it is important for the purchaser to possess or to have access to the technical expertise necessary to satisfy himself that the design and specifications for the works meet his requirements and that the construction is progressing satisfactorily, and to take the various decisions and exercise the other functions which are within his province under the contract. For example, he must be able to approve the construction time-schedule submitted by the contractor, monitor the progress of the construction, assess the performance of the contractor in order to determine whether to make payments claimed to be due, evaluate delays or defects in construction and determine what measures to take in that regard, order variations or decide upon variations proposed by the contractor, decide upon subcontractors proposed by the contractor, deal with exempting impediments or hardship situations and evaluate the results of inspections and tests. In certain contracts, it may be necessary for the purchaser to contract for equipment and materials, check and evaluate drawings submitted by the contractor, evaluate guarantees proffered by contractors and suppliers and schedule and co-ordinate work performed by various contractors. In a cost-reimbursable contract, it will be necessary for the purchaser to ascertain whether the costs of items for which the contractor seeks reimbursement are reasonable and correct. In a unit-price contract, the purchaser will have to verify the amount of construction units to be paid. The purchaser will often find it desirable to engage a consulting engineer to advise him and render technical expertise as to matters such as these.

6. If the consulting engineer merely renders such advice and expertise to the purchaser, and does not, either on behalf of the purchaser or in his own right, take actions which directly affect the contractor's contractual rights and obligations, there is no need for the works contract to authorize or regulate the exercise of such functions by the consulting engineer. On the other hand, it may be desirable for the works contract to contain provisions designed to enable the consulting engineer to perform such functions, or to facilitate that performance, such as provisions granting him access to the site or place of manufacture or information necessary to monitor the progress of the work and to exercise his other functions (see paragraph 29, below).

(b) *Acting on behalf of purchaser*

7. In addition to rendering advice and technical expertise to the purchaser, a consulting engineer may be authorized to take, on behalf of the purchaser, some or all of the acts of the nature referred to in paragraph 5, above. Since, in some cases, such acts by the consulting engineer may directly affect the contractor's contractual rights and obligations, it is advisable for the works contract to set forth the authority of the consulting engineer in this regard, including any limitations upon that authority (e.g., any restrictions on the authority of the engineer to order or agree to variations on behalf of the purchaser). In addition, it is advisable for the works contract to obligate the purchaser to notify the contractor in writing of any addition to or change in the authority of the consulting engineer effected after the contract has been entered into.

8. It is desirable for the works contract to specify any authority of the consulting engineer to communicate with the contractor on behalf of the purchaser. For example, the contract might provide for communications between the purchaser and the contractor dealing with matters within the authority of the consulting engineer to be transmitted through the engineer.

2. *Independent functions*

9. The parties may wish to consider whether a consulting engineer should exercise certain functions independently, rather than for or on behalf of the purchaser. Such a practice is sometimes a feature of works contracts in certain areas of the world, but may be unfamiliar in other areas. It may have certain advantages. For example, it could enable technical questions arising during the course of construction to be resolved expeditiously and in an independent manner by one who is conversant with the construction and knowledgeable about the project, and who has immediate access to the relevant personnel, factual information and correspondence. An act taken independently by a consulting engineer in whom both parties have confidence may be more readily accepted by the parties than one taken by or on behalf of one of them, and might avoid time-consuming and costly arbitral or judicial proceedings.

10. On the other hand, there may be certain disadvantages to the exercise of independent functions by a consulting engineer. For example, if the consulting engineer is chosen, engaged and paid by the purchaser, the contractor may question whether the consulting engineer will be able to perform his independent functions impartially. Such concern may arise, in particular, if, in addition to his independent functions, the consulting engineer is to perform various other functions for or on behalf of the purchaser. The contractor may question the ability of the consulting engineer to shift from protecting the interests of the purchaser in some cases to acting impartially and independently in other cases.

11. In theory, it would be possible for each party to appoint a consulting engineer and to have independent functions performed by agreement between them. It would also be possible for the purchaser to engage one consulting engineer to render advice and technical expertise to him or to act on his behalf, and another one to exercise independent functions. In practice, however, such arrangements could prove cumbersome.

12. The ability of the consulting engineer to exercise independent functions, the scope of such functions and the degree to which independent acts by the consulting engineer are to be binding upon the parties, may depend upon the extent to which both parties participate in the selection of the consulting engineer (see section C, below). For example, if the consulting engineer is selected exclusively by the purchaser, a contractor might be reluctant to agree to the exercise of any independent functions by the consulting engineer; or, he might agree to the exercise by the consulting engineer of independent functions of only a restricted scope. Also, he may not agree to accord any binding effect to independent acts of the consulting engineer, or may agree only to a limited binding effect (see paragraph 17, below). Permitting both parties to participate in the selection of the consulting engineer could enable the independent role of the consulting engineer to be broadened. However, even in the case where the consulting engineer is selected by the purchaser alone, the selection of an engineer who has a high international reputation for competence and fairness could increase the acceptability to potential contractors of a broader independent role of the consulting engineer.

13. With respect to the types of independent functions which the consulting engineer may exercise, the parties may wish to limit those functions to such matters of a technical nature as the methods of construction, specifications of equipment and materials to be incorporated in the works, and the quality of the works. For example, the parties may wish to authorize the consulting engineer to be on site to be able expeditiously to answer technical questions which arise during the course of construction, to resolve discrepancies, errors or omissions in the drawings or specifications or to interpret technical provisions of the contract. In addition, the parties might wish to authorize the consulting engineer to certify the existence of certain facts which would give rise to rights or obligations under the contract. For example, the consulting engineer might be authorized to certify the entitlement of the contractor to payments claimed by him, the existence of a delay in construction, or the occurrence and duration of events asserted by a party to be exempting impediments, to give rise to rights under a hardship clause, or to justify suspension of construction. He might also be authorized to certify whether mechanical completion tests or performance tests are successful, or the existence of circumstances asserted by the contractor as a ground for objecting to a variation ordered by the purchaser.

14. Some of the functions referred to in the previous paragraph might be exercised by the consulting engineer either on behalf of the purchaser or independently, such as certifying the entitlement of the contractor to payment, or that mechanical completion tests were successful. It is advisable for the contract to indicate clearly whether a particular function is to be exercised on behalf of the purchaser or independently, and to exclude from independent functions those functions which are to be exercised on behalf of the purchaser.

15. The parties may wish to consider whether the consulting engineer should be authorized to decide disputes between the parties concerning matters of a technical nature. If the parties designate a referee to deal with such disputes (see chapter XXIX, "Settlement of disputes", paragraphs 16 to 21) who is different from the consulting engineer, they may wish to restrict the authority of the consulting engineer to resolving routine problems and questions and certifying the existence of facts (see paragraph 13, above). The consulting engineer might himself exercise the role of a referee to settle disputes. In such a

case, considerations such as those discussed in paragraphs 10 to 12, above, are likely to be relevant. For example, such a role is more likely to be acceptable to the contractor if he can participate in the selection of the consulting engineer. If the consulting engineer is to exercise that role, the settlement of such issues as the appointment of the consulting engineer and the scope of his authority to decide disputes may be in accordance with the discussion concerning the referee in chapter XXIX, "Settlement of disputes", paragraphs 17 to 19.

16. If the consulting engineer is to be authorized to exercise independent functions, the contract should provide that those functions are to be exercised impartially with respect to the purchaser and the contractor. Moreover, the contract should provide that the consulting engineer is to apply and give effect to the provisions of the contract, and not simply to act in accordance with his own conception of fairness and without regard to the contract.

17. It is desirable for the contract to establish the extent to which an act of the consulting engineer pursuant to an independent function is to be considered binding on the parties. With respect to the resolution of routine problems and questions and certification of the existence of facts, the contract might provide that any such act may be referred by either party for review in dispute settlement proceedings provided for in the contract. Another possibility may be to provide that acts involving a value less than a stipulated amount are to be binding on the parties and non-reviewable. The contract might also provide that any matter upon which the consulting engineer has failed to act within a specified period of time after having been requested by a party to do so may be referred to dispute settlement proceedings, unless the contract provides another means of dealing with the matter.

18. As to the status of the act in question during the pendency of dispute settlement proceedings, the contract might provide that the act must be conformed to or complied with until it is modified or reversed in such proceedings, or unless the tribunal conducting the proceedings otherwise decides as an interim measure (cf. chapter XXIX, "Settlement of disputes", paragraph 21). Such an approach would avoid lengthy and costly interruptions in the construction. If that approach is adopted, however, the contract might entitle either party to be compensated by the other party for any costs incurred, not otherwise compensated under the contract, as a result of conforming to or complying with an act of the consulting engineer which is subsequently modified or reversed in dispute settlement proceedings.

19. With respect to the settlement of disputes by the consulting engineer, the discussion in chapter XXIX, "Settlement of disputes", paragraphs 16 to 21, concerning the settlement of disputes by a referee, is also relevant to questions concerning the binding nature of a decision by the consulting engineer and the status of such a decision during the pendency of dispute settlement proceedings.

C. Selection and replacement of consulting engineer

20. If the consulting engineer is only to render technical advice and technical expertise to the purchaser, or to act on behalf of the purchaser, he might be selected by the purchaser alone. However, if he is to exercise independent functions, the contractor may wish to have the right to participate in the selection (see, e.g., paragraphs 10 to 12, above).

21. In some cases, the purchaser may designate the consulting engineer in the tender documents. In deciding on whether or not to submit a tender, a potential contractor may take into consideration his knowledge of the designated consulting engineer or his reputation and the role to be played by the consulting engineer under the works contract, particularly if the consulting engineer is to exercise independent functions. It is, therefore, in the purchaser's own interest to designate a firm which is likely to be acceptable to potential contractors.

22. If the consulting engineer is to be selected by the purchaser alone after the works contract has been entered into and the consulting engineer is to act on behalf of the purchaser, it is desirable for the contract to obligate the purchaser to deliver to the contractor written notice of the name and address of the consulting engineer. If the consulting engineer is only to render advice and assistance to the purchaser, such a provision may not be necessary.

23. If the contractor is to participate in the selection of a consulting engineer after the contract has been entered into and the consulting engineer is to exercise independent functions, it would be desirable for the contract to provide a mechanism for the selection. The contract might require the purchaser to notify the contractor in writing of the name and address of the proposed consulting engineer and seek the contractor's consent to his appointment. It might permit the purchaser to engage the proposed consulting engineer immediately, but provide that the consulting engineer is not to exercise any independent functions until the contractor consents in writing to the appointment of the consulting engineer. This would enable the consulting engineer to render technical advice and expertise to the purchaser and to take actions on his behalf, and thus permit the construction to proceed to the extent that it can in the absence of the performance of independent functions by a consulting engineer. The contract might further provide that the consulting engineer may exercise the independent functions provided for in the contract if the purchaser does not receive, within a specified period of time after the despatch of his notice to the contractor, his written objection to the appointment specifying his grounds for the objection.

24. The parties may wish to consider various possible approaches to deal with the case where the contractor objects to the consulting engineer proposed by the purchaser. Under one approach, the contract might obligate the purchaser to propose another consulting engineer to exercise independent functions who meets the contractor's objections. Under another approach, the contractor might provide for the parties to agree upon a third person to select the consulting engineer. Under a third approach, the contract might permit either party to submit the question of the appointment of the consulting engineer to dispute settlement proceedings. If, in those proceedings, the contractor's objection is found not to be reasonable, the contract may authorize the consulting engineer to perform independent functions. If the objection is found to be reasonable, the purchaser may be obligated to propose another consulting engineer to perform the independent functions who meets the contractor's objections. Alternatively, the contract might permit the purchaser to request the person, tribunal or court before which the proceedings are brought to substitute its consent to the appointment of the consulting engineer for that of the contractor, if it is competent under the applicable law to do so.

25. The contract might also contain provisions to deal with the case where the consulting engineer must be replaced after the contract has been entered into. If the original consulting engineer was selected by the purchaser alone after the conclusion of the contract, then the replacement might also be chosen by the purchaser alone, subject to his giving written notice to the contractor of the name and address of the replacement if such notice was required for the appointment of the original consulting engineer. If the original consulting engineer was stipulated in the works contract, or if the contractor participated in the selection of the consulting engineer after the works contract was entered into, the contract might entitle the contractor to participate in the selection of the replacement. Procedures in that regard may be similar to those described in the previous paragraphs with respect to the participation by the contractor in the selection of the original consulting engineer.

26. It is desirable for the contract to provide that acts taken by the original consulting engineer which are in effect at the time of the appointment of the replacement are to remain in effect to the same extent as if the original consulting engineer had not been replaced.

D. Delegation of authority by consulting engineer

27. The delegation of authority by the consulting engineer will often be regulated by rules of the applicable law. However, it may be desirable for the parties to deal with that question in the contract, if they are able to so (i.e. if not restricted by mandatory rules of law). For example, in cases where the consulting engineer is to exercise independent functions, the parties may consider it desirable to provide that he may not delegate his authority to exercise those functions to another consulting engineer without the written consent of both parties. If such a restriction is desired, it is advisable to include it both in the purchaser's contract with the consulting engineer and in the works contract. Similarly, in cases where the consulting engineer is to act on behalf of the purchaser, it is advisable for any limitations which the purchaser may wish to impose upon the ability of the consulting engineer to delegate his authority to exercise such functions to be contained both in the purchaser's contract with the consulting engineer and in the works contract, so that the contractor is made aware of and subject to those limitations.

28. The contract might also provide that any acts taken by a person to whom authority has properly been delegated by the consulting engineer shall have the same effect as if the acts had been taken by the consulting engineer himself. It might also provide that the consulting engineer may take any act which the person to whom authority has been delegated is authorized to take but has not taken.

E. Information and access to be provided to consulting engineer

29. In order to enable the consulting engineer to exercise his functions effectively, he may need to have various types of information, as well as access

to the site, access to the places of manufacture of equipment, materials and supplies to be incorporated in the works, and access to the works during construction and to the completed works. The contract might obligate the contractor to provide such information or grant such access to the consulting engineer to the same extent that he must provide the information or grant the access to the purchaser under the works contract.

Chapter XI. Subcontracting

SUMMARY

The term "subcontracting" as used in this *Guide* refers to the engagement by the contractor of a third person to perform certain of the contractor's obligations under the works contract. It is desirable for the contract to contain provisions dealing with the permissible scope of subcontracting, the selection of subcontractors and other aspects of subcontracting. It is also desirable for the contract to specify the obligations of the contractor which are to be subject to those provisions (paragraphs 1 to 4). Under many legal systems, no legal relationship exists between the purchaser and the subcontractor. It may be desirable for the works contract to deal with certain consequences which arise from this fact (paragraphs 5 and 6).

In particular cases, the contract might prohibit the contractor from subcontracting the performance of some, or all, of his obligations (paragraphs 8 and 9).

With regard to the selection of subcontractors, the parties might consider two basic approaches: the selection of subcontractors by the contractor alone (paragraph 10), and participation of the purchaser in the selection of subcontractors (paragraphs 11 to 26).

If possible, it is desirable for the parties to agree upon the subcontractors prior to entering into the works contract. The names of the subcontractors may be specified in the contract, in order to avoid disputes as to the choice of subcontractors. Alternatively, the parties might agree upon a list of acceptable potential subcontractors, from which the subcontractor would be selected by the contractor (paragraphs 13 and 14).

If the contract provides for the subcontractors to be selected with the participation of the purchaser after the contract had been entered into (paragraph 15), the contract might entitle the purchaser to raise reasonable objections to a subcontractor proposed by the contractor (paragraphs 16 to 19), or obligate the contractor to engage as a subcontractor a firm nominated by the purchaser, subject to the right of the contractor to object to the firm on specified grounds (paragraphs 20 to 26). The nomination system should be used with caution, and with a full understanding of the procedures involved, as well as of the contractual provisions and their consequences (paragraph 23). In either case, it is advisable for the parties to agree upon an expeditious procedure for dealing with disputes between themselves concerning the engagement of a subcontractor (paragraphs 17 and 18, and 26, respectively).

The parties may wish to provide that the engagement by the contractor of a subcontractor to perform any obligation of the contractor under the works contract does not diminish or eliminate the liability of the contractor for a failure to perform that obligation (paragraph 27). The contract might also require the contractor to indemnify the purchaser against losses resulting from damage caused by the subcontractor to property of the purchaser, or resulting from liabilities incurred by the

purchaser towards third persons as a result of acts or omissions of the subcontractor, to the same extent that the contractor would be liable to the purchaser had those losses resulted from an act or omission of the contractor himself. Alternatively, the contract might leave those issues to be resolved by the applicable law (paragraph 28).

In some situations, the purchaser might wish the subcontractor to undertake certain obligations towards him, and might wish to be able to claim directly against the subcontractor for a failure to perform those obligations. The parties may wish to consider providing in the works contract a mechanism to make this possible (paragraphs 29 to 31).

The parties may consider it desirable for the works contract to authorize the purchaser to pay a subcontractor directly and to recover from the contractor the sums paid or otherwise be credited for those payments (paragraphs 32 to 34), and to provide for co-operation and communication between the purchaser and a subcontractor (paragraphs 35 and 36).

It is desirable for the provisions of the works contract and of the subcontract to be compatible (paragraph 37).

A. General remarks

1. The term "subcontracting" as used in this *Guide* refers to the engagement by the contractor of a third person to perform on behalf of the contractor certain of the contractor's obligations under the works contract. The term includes, for example, third persons who are engaged by the contractor to install equipment or to supply other construction services, or to manufacture major equipment which the contractor is obligated to supply for incorporation in the works. The term does not include third persons from whom the contractor obtains standard equipment, materials or services used by the contractor himself in connection with the performance of his contractual obligations. The latter type of third persons, sometimes referred to as "suppliers", is not dealt with in the *Guide*. Contractual relations with those third persons do not present the special problems presented by contractual relations with subcontractors; accordingly, only the latter need be dealt with in the works contract.

2. It is difficult to draw a precise borderline between subcontractors and suppliers. While certain third persons engaged by the contractor may clearly fall within one category or the other, others will not. Therefore, it is advisable for the parties not to attempt to differentiate in the contract between them. Rather, it is preferable for the contract to specify the obligations of the contractor which are to be subject to the contractual provisions restricting or regulating the engagement by the contractor of a third person to perform his contractual obligations.[1]

3. It is common for a contractor to engage subcontractors to perform certain of his obligations under a works contract. A contractor might not possess the expertise, personnel, equipment or financial resources to perform by himself all of the specialized work for which he is responsible under the contract. Even if a contractor is able to perform all of his contractual obligations himself, he might be required by regulations in force in the country where the works is to be constructed to engage local subcontractors to perform certain types of obligations. In some situations, an organization, such as a State foreign trade

organization which does not itself possess the capability of performing any aspect of the construction, may enter into a contract for the construction of an industrial works, and subcontract for the performance of all of the construction obligations under the works contract.

4. It is desirable for a works contract to contain provisions dealing with the permissible scope of subcontracting, the selection of subcontractors and other aspects of subcontracting. Without such provisions, under some legal systems a contractor might be able to subcontract more liberally than would be desirable from the point of view of the purchaser; under other legal systems his ability to subcontract without the express consent of the purchaser might be restricted. The parties should give due attention to provisions on subcontracting when negotiating and drafting the works contract, since unsatisfactory treatment of issues associated with subcontracting could result in problems with the progress of the construction and the quality of the works. In formulating provisions on subcontracting, the parties should consider any mandatory rules on the subject in the law applicable to the contract, and mandatory legal rules of an administrative or other public nature in force in the country where the works is to be constructed (see chapter XXVIII, "Choice of law", paragraph 22).

5. Since a subcontract is a contract solely between the contractor and the subcontractor, under many legal systems no legal relationship exists between the purchaser and the subcontractor. Thus, if the subcontractor fails to perform, he is liable only to the contractor. The purchaser can recover only from the contractor for loss suffered by the purchaser as a result of the failure of the subcontractor to perform, and only if the contractor is liable to the purchaser under the works contract for that loss (see paragraph 27, below). Similarly, in those legal systems where there is no legal relationship between the purchaser and the subcontractor, the purchaser is not obligated to pay the subcontractor for his services; the subcontractor must seek payment from the contractor, who will in turn recover that payment in some form from the purchaser under the works contract (see, however, paragraphs 32 to 34, below). For example, the cost of the services of the subcontractor may be included in a lump-sum price charged by the contractor, or it may be reimbursed to the contractor in the case of a cost-reimbursable contract. In some legal systems, however, certain legal rights and obligations flow directly between the purchaser and the subcontractor by operation of law.

6. The absence of a contractual relationship between the purchaser and the subcontractor could be beneficial to the purchaser by, for example, insulating him from disputes between the contractor and the subcontractor with respect to a failure by the subcontractor to perform or a failure by the contractor to pay the subcontractor. However, this insulation is usually not complete, and it may be desirable for the works contract to contain provisions dealing with matters of concern to the purchaser in relation to the subcontractor. These are discussed in subsequent sections of this chapter.

B. Right of contractor to subcontract

7. In some countries, there are legal rules obligating the contractor to subcontract certain works to national enterprises. Where such legal rules do not exist, the parties should provide in the contract whether, and to what extent, the contractor is entitled to subcontract.

8. The purchaser might rely upon the contractor's expertise and reputation for the creation of the design, the supply of certain equipment or materials for the works, or the performance of certain services in connection with the construction; he may therefore wish the contractor to perform those obligations himself. On the other hand, the purchaser might expect the contractor to subcontract for the supply of certain other equipment, materials or services. In addition, a purchaser who supplies the technology or design might wish to restrict or prohibit the contractor from subcontracting in order to protect the confidentiality of the technology or design.

9. Different approaches are possible for restricting or prohibiting the contractor from subcontracting. In some cases, the parties might wish to provide that the contractor cannot subcontract a major portion of his obligations with respect to the construction of the works. In other cases, the contract might specify those obligations which the contractor cannot subcontract and those which may be subcontracted, subject to the other provisions of the contract (e.g., those discussed in the following section). In still other cases, the parties might agree that the contractor cannot subcontract any of his obligations. In cases in which the contractor is an organization which does not itself possess the capability of performing any aspect of the construction (see paragraph 3, above), the contract might permit the contractor to subcontract for the performance of all of his construction obligations.

C. Selection of subcontractors

1. *Selection by contractor alone*

10. In some cases, the purchaser may have little or no interest in the selection of a subcontractor. In those cases, the selection of the subcontractor might be left exclusively to the contractor.

2. *Participation by purchaser in selection of subcontractor*

11. In other cases, however, the purchaser may have a concrete interest in the selection of a subcontractor. He may be interested in being assured that the subcontracted obligations will be performed by a firm that possesses the expertise and resources needed to perform those obligations satisfactorily. The purchaser may wish to be assured that particular equipment to be installed will be of a certain standard which can be met only by certain subcontractors. In contracts in which the price charged by a subcontractor will directly affect the price payable by the purchaser to the contractor, such as in cost-reimbursable contracts, the purchaser will be interested in having the subcontracted obligations performed at the most reasonable price. The purchaser may wish to restrict the contractor to the employment of local subcontractors, or he may be obligated to do so by the law of the country where the works is to be constructed. Due to arrangements with a foreign financing organization, the purchaser may be obligated to ensure that subcontracts amounting to a certain value are entered into with firms from the country of that organization.

12. The circumstances mentioned in the preceding paragraph may be accommodated by having the contract provide for the purchaser to participate in the selection of a subcontractor. The degree and nature of the purchaser's participation may vary, depending on the contracting approach chosen by the parties (see chapter II, "Choice of contracting approach") and the importance to the purchaser of being able to exercise control over the cost and quality of the performance of the obligations to be subcontracted. Purchasers should be aware, however, that the inclusion in the contract of a right to compel a contractor to subcontract with a particular subcontractor could have adverse financial consequences for a purchaser, since the contractor might include in his price the cost of exercising increased supervision over a subcontractor with whose work he may not be familiar, as well as an increment to account for the increased risk resulting from being liable to the purchaser for losses due to failures to perform by the subcontractor. In addition, the purchaser should be aware that his participation in the selection of subcontractors could diminish the liability of the contractor arising from failure by the subcontractor to perform (see paragraph 27, below).

(a) *Specification of subcontractors in works contract*

13. If possible, and in particular when the equipment, materials or construction services to be supplied by a subcontractor are critical for the construction, it is desirable for the parties to agree upon the subcontractors prior to entering into the works contract, and for the names of the subcontractors to be specified in the contract. This will avoid disputes as to the choice of subcontractors in particular instances, and the interruptions of the work and the financial consequences which may arise from those disputes. Moreover, such an approach might help to avoid "bid-shopping" by the contractor after the contract has been awarded. Under that practice, a contractor uses a bid which he has obtained for a subcontract from one firm, and upon which his own contract price was based, to try to obtain lower bids for the subcontract from other firms, and possibly to force a lower bid from the first firm. If the contractor is successful in procuring a lower bid from the first firm (which, in most lump-sum contracts, will not lead to a reduction of the price payable by the purchaser), that firm may be induced to reduce his expenses and to perform the subcontract less satisfactorily in order to prevent his profit margin from being reduced.

14. The works contract might specify that a particular subcontractor is to perform a certain aspect of the construction. Alternatively, it might include a list of acceptable potential subcontractors who have been agreed to by the purchaser and the contractor. The agreement of the purchaser to a subcontractor or to a list of potential subcontractors might be facilitated if the contractor were to obtain bids from proposed subcontractors and present them to the purchaser together with details of their past work records. However, the solicitation of bids by the contractor could result in extra expenses to him which would ultimately have to be borne by the purchaser. Moreover, in contracts other than cost-reimbursable contracts, the contractor may be reluctant to reveal to the purchaser bids submitted by subcontractors.

(b) *Participation by purchaser in selection of subcontractor after works contract entered into*

15. There is an increased possibility of disputes arising between the parties as to the subcontractors to be engaged when the subcontractors are to be selected

after the contract has been entered into. This could result in an interruption of the work, with possible financial consequences for both parties. The use of this approach, therefore, requires a high degree of co-operation and prompt communication between the parties. For example, if the contract provides for a subcontractor to be proposed by the contractor or nominated by the purchaser (discussed below), it would be desirable for the other party to inform the proposing or nominating party as early as possible of potential subcontractors who do not meet with his approval. The following paragraphs discuss various possible procedures for participation by the purchaser in the selection of a subcontractor after the works contract has been entered into.

(i) Right of purchaser to object to subcontractor proposed by contractor

16. The contract might provide that the contractor cannot engage as a subcontractor a firm against which the purchaser has a reasonable objection. The contract could obligate the contractor to deliver to the purchaser a written notice of his intention to subcontract with a particular firm, including the name and address of the firm and the work to be performed by it. In contracts in which the price charged by the subcontractor will directly affect the price to be paid by the purchaser, e.g., cost-reimbursable contracts, and lump-sum contracts incorporating the documentary-proof method for price revision (see chapter VII, "Price and payment conditions", paragraphs 56 and 57), it is desirable for the notice also to include the price to be charged by the firm. The parties may also wish to consider requiring the contractor to provide to the purchaser a copy of the proposed subcontract, as well as additional information relative to the firm which the purchaser might reasonably require. Unless the purchaser delivers to the contractor a written objection to the engagement of the firm within a specified period of time after receiving the notice, specifying reasonable grounds for the objection, the contractor would be permitted to engage the firm.[2]

17. It is advisable for the parties to agree upon an expeditious procedure for dealing with disputes concerning objections by the purchaser to the subcontractor proposed by the contractor, so that the interruption of construction is prevented or minimized. Under one approach, either party might be permitted to submit the dispute immediately for settlement in dispute settlement proceedings (see chapter XXIX, "Settlement of disputes"), and the works contract might provide for a decision to be rendered within a short period of time (e.g., one month). No subcontractor would be engaged until the dispute was resolved, but the construction would be interrupted only to the extent that it could not be performed without a subcontractor having been engaged. If the purchaser's objections were found to be reasonable, the contractor could be obligated to propose another subcontractor and to bear the financial consequences of the interruption of construction. If the purchaser's objections were found not to be reasonable, the contractor could be permitted to subcontract in accordance with his notice to the purchaser, and the purchaser could be required to bear the financial consequences of the interruption of construction.

18. Under another approach, the contractor might be obligated to deliver to the purchaser a new notice of intention to subcontract within a short period of time (e.g., one week) after receipt of the purchaser's objection to the subcontractor originally proposed. If the firm proposed as a subcontractor in

the new notice was acceptable to the purchaser, that firm would be engaged by the contractor. The dispute concerning the reasonableness of the purchaser's objection to the firm proposed in the first notice of intention to subcontract could be submitted to dispute settlement proceedings immediately or at some later time. The pendency of those proceedings would not postpone the engagement of the firm proposed in the new notice of intention to subcontract. If, in the dispute settlement proceedings, the purchaser's objections were found not to be reasonable, the purchaser could be required to bear the financial consequences of any interruption in construction, and the additional financial consequences to the contractor of engaging the new firm rather than the one proposed originally. If the purchaser's objections were found to be reasonable, the contractor could be required to bear those consequences and losses. For the case where the firm proposed in the new notice was not acceptable to the purchaser, the contract might provide a procedure such as that described in paragraph 17, above.

19. In certain types of contracts, e.g., cost-reimbursable contracts, the parties may wish to consider requiring the contractor to solicit bids from a certain number of firms for the performance of the obligations to be subcontracted, and to submit them to the purchaser with an indication of those bids which he would be prepared to accept. The subcontractor would be selected from those bidders by the purchaser. This mechanism might not be appropriate for the supply of highly specialized items or services, since there might not exist a range of firms from which bids could be solicited.

(ii) *Nomination system*

20. Even more extensive involvement by the purchaser in the selection of subcontractors may be provided by having the purchaser himself select the subcontractor and require the contractor to execute a subcontract with him. This, in essence, is the system of "nomination", which is common in certain parts of the world.

21. Under the nomination system, the purchaser identifies and negotiates with prospective subcontractors to perform obligations which are specified in the contract as being subject to that system. Those negotiations may take place before the works contract is entered into. If so, it may be possible to include in the contract the essential terms of a subcontract to be concluded by the contractor, including the price. In a lump-sum contract, if a price for the subcontracted work is not established at the time of entering into the contract, an estimated price for that work may be set forth in the contract, and the contract price may be increased or decreased by the difference between the estimated price and the actual price for the subcontracted work. In essence, the subcontracted work would be cost-reimbursable (see chapter VII, "Price and payment conditions", paragraphs 10 to 24). In any event, the contract would obligate the contractor to enter into a subcontract with the firm nominated by the purchaser.

22. There are various advantages to the purchaser of a mechanism such as the nomination system. It enables the purchaser to choose a subcontractor, and gives the purchaser a large measure of control over the price and other terms under which the subcontracted obligations will be performed. It also enables him to make use of a particular design, equipment or services supplied by a

particular subcontractor. In addition, it is a way for the purchaser to ensure that subcontracts are awarded to local firms. These benefits may be achieved by the purchaser without himself having to enter into a contractual relationship with the subcontractor.

23. However, the nomination system should be used with caution and with a full understanding of the procedures involved, as well as of the contractual provisions and their consequences. There are various pitfalls which could be encountered in the use of the system and these should be dealt with by appropriate contractual provisions. For example, unless clearly negatived by the contract, the high degree of the purchaser's involvement in the selection of a subcontractor might lead to an undesired implication that contractual rights and obligations flow directly between the subcontractor and the purchaser, or that the contractor's liability for a failure to perform by the subcontractor is restricted or excluded. In the latter case, in addition to being unable to recover from the contractor, the purchaser may be unable to recover from the subcontractor, with whom he has no contractual relationship, and he would have to bear the loss himself. These consequences could be avoided by providing in the contract that the engagement by the contractor of a subcontractor to perform any obligation of the contractor under the contract does not diminish or eliminate his liability for a failure to perform that obligation (see paragraph 27, below; however, see, also, paragraph 24, below). In addition, in negotiating with a firm which may be nominated as a subcontractor, the purchaser must take care that the results of those negotiations cannot be construed as an agreement that that firm will be engaged as a subcontractor. Otherwise, the purchaser might be held liable to that firm if it were not to be ultimately engaged as a subcontractor by the contractor. Due to the disadvantages and pitfalls of the nomination system, the purchaser may wish to consider whether it would be preferable for him to engage a firm directly as a separate contractor instead of nominating it as a subcontractor.

24. If the nomination system is adopted, it may be advisable to allow the contractor to object to the firm nominated as subcontractor on certain grounds, in order to protect the contractor against being obligated to enter into a contractual relationship with a subcontractor which is unduly prejudicial to the contractor's interests. These grounds might include, for example, one or more of the following:

(*a*) The refusal of the firm nominated as subcontractor to undertake towards the contractor obligations and liabilities of the same scope as are imposed on the contractor towards the purchaser, including obligations and liabilities with respect to quality, timing, guarantees, and financial amounts of liability;

(*b*) The refusal of the firm nominated as subcontractor to agree to indemnify the contractor against any liability which the contractor incurs towards the purchaser or a third person as a result of acts or omissions of the subcontractor;

(*c*) The lack of qualifications to perform the obligations to be subcontracted on the part of the firm nominated as subcontractor;

(*d*) Any other reasonable objection of the contractor to subcontracting with the firm nominated as subcontractor. This could include, for example, that the

contractor has previously had unsatisfactory experience with that firm, or that its financial situation prejudices its ability to perform satisfactorily.

25. The parties may wish to consider certain approaches to deal with cases in which the contractor objects to a firm nominated by the purchaser as a subcontractor because that firm refuses to undertake towards the contractor obligations and liabilities of the same scope as are imposed on the contractor towards the purchaser. For example, the works contract might obligate the contractor to enter into the subcontract if the purchaser agrees to a reduction in the scope of the obligations of the contractor towards the purchaser, so that they match the obligations of the subcontractor towards the contractor. Alternatively, the contract might limit the damages payable by the contractor to the purchaser in the event of a failure by a subcontractor to perform to no more than the damages that are recoverable by the contractor from the subcontractor.

26. The parties should consider what should occur if a dispute arises from a refusal by the contractor to enter into a contract with a firm nominated by the purchaser as a subcontractor. In this regard, the parties may wish to consider approaches comparable to those described in paragraphs 17 and 18, above, with the financial consequences to be allocated on the basis of whether or not the contractor's refusal to engage that firm was justified.

D. Extent of liability of contractor for losses of purchaser due to failure to perform by subcontractor or other acts or omissions of subcontractor

27. The parties may wish to consider the extent to which the contractor should be liable to the purchaser for a failure by the former to perform an obligation under the works contract if the failure resulted from failure of the subcontractor to perform the subcontract. In this regard, they may wish to provide that the engagement by the contractor of a subcontractor to perform any obligation of the contractor under the works contract does not diminish or eliminate the liability of the contractor for a failure to perform that obligation.[3] This approach would preserve the purchaser's right to redress for losses arising from a failure of a subcontractor to perform. If, under the works contract, the contractor may be compelled to engage a subcontractor against whose engagement he has reasonable objections (see, however, paragraphs 12 and 24, above), the parties might wish to consider restricting the liability of the contractor for losses due to a failure of the subcontractor to perform (see, e.g., paragraph 25, above). In legal systems in which the subcontractor is considered to have a legal relationship only with the contractor and not with the purchaser, a consequence of the latter approach is that the purchaser would have to bear the losses arising from failures to perform by a subcontractor to the extent that the contractor was not liable to the purchaser for those losses.

28. Related issues the parties may wish to consider are whether and the extent to which the contractor should be liable to the purchaser for losses resulting from damage caused by the subcontractor to property of the purchaser, or resulting from liabilities incurred by the purchaser towards third persons as a result of acts or omissions of a subcontractor. The latter liabilities could arise, for example, from injury caused by the subcontractor to third persons or their

property. One possible approach would be to require the contractor to indemnify the purchaser against such losses to the same extent that the contractor would be liable to the purchaser had those losses resulted from an act or omission of the contractor himself. [4] Another possible approach would be to leave these issues to be resolved by the applicable law.

E. Right of purchaser to claim directly against subcontractor

29. In some situations, the purchaser might wish the subcontractor to undertake certain obligations towards him, and might wish to be able to claim directly against the subcontractor for a violation of those obligations. For example, the purchaser might wish the subcontractor to be obligated to preserve the confidentiality of the design. Similarly, the contractor might not wish to be liable to the purchaser for defects in the design of a specialized element of the works which is to be designed and supplied by a subcontractor, e.g., air conditioning, and the parties might agree that the purchaser should be able to claim directly against the subcontractor that supplies the design. Where there is no contractual relationship between the purchaser and subcontractor, obligations such as those would not flow from the subcontractor directly to the purchaser, and the purchaser could not claim against the subcontractor for violating them.

30. One approach which the parties might wish to consider in such cases is for the purchaser to enter into a separate agreement with the subcontractor limited to the obligations sought to be imposed on him. For example, the subcontractor could undertake towards the purchaser an obligation of confidentiality, or could guarantee the suitability of the design. The purchaser could then claim directly against the subcontractor for a violation of the obligation.

31. An alternative approach would impose the relevant obligations on the contractor and require the contractor to obtain the same obligations from the subcontractor. This might be accomplished either by a provision in the contract requiring the contractor to do so, or by the purchaser's conditioning his consent to a subcontractor proposed by the contractor on the contractor's obtaining such obligations from the subcontractor. In order for the purchaser to be entitled to claim directly against the subcontractor, an additional provision would be included in the contract by which the contractor assigned to the purchaser the contractor's rights against the subcontractor for a violation of the obligations, if such an assignment was permitted by the applicable law.

F. Payment for performance by subcontractors

32. As noted above (see paragraph 5), the purchaser will in most cases not be obligated to pay a subcontractor; rather, the subcontractor will have to seek payment from his contracting party, the contractor. There may, however, be instances in which the purchaser wishes to pay a subcontractor, such as when the contractor fails to pay a sum previously due to the subcontractor and the smooth progress of the construction is threatened by a reluctance of the subcontractor to continue to work. Furthermore, in some legal systems a subcontractor may have a right to enforce payment of the sums due him by establishing a lien or priority in the works itself. The parties may consider it

desirable, therefore, for the works contract to authorize the purchaser to demand proof from the contractor that payment due to a subcontractor has been made and, if within a specified period of time after delivery of such a demand to the contractor, the contractor does not deliver the proof to the purchaser, or deliver to the purchaser a written statement of reasonable grounds for not making the payment, to pay a subcontractor and to recover from the contractor the sums paid or otherwise to be credited for those payments. Unless the purchaser is expressly authorized by the works contract to pay a subcontractor, a purchaser who does so will place himself in peril, since his obligation to pay the contractor will not be reduced by the amount of the payment to the subcontractor. In order to avoid the implication that a contractual relationship exists between the purchaser and the subcontractor, the works contract could also make it clear that such direct payments by the purchaser are made on behalf of the contractor.

33. The method by which the purchaser recovers from the contractor or is credited the amount of his direct payment to the subcontractor may depend upon the payment conditions in the works contract between the purchaser and the contractor. In a lump-sum contract, the purchaser might be entitled to deduct the amount of his payment from the contract price to be paid to the contractor. In a cost-reimbursable contract, if the purchaser pays the subcontractor on behalf of the contractor in respect of the subcontracted work, no adjustment need be made as between the contractor and the purchaser, since the contractor will not have incurred a cost for the subcontracted work which is to be reimbursed by the purchaser.

34. It may be noted that payment by the purchaser to the subcontractor could have the disadvantage of involving the purchaser in disputes between the contractor and the subcontractor, and could in some cases impair relations between the purchaser and the contractor. Moreover, the purchaser should exercise caution in making such payments, lest disputes arise between him and the contractor as to whether the payment should have been made or whether the amount paid was that actually due.

G. Co-operation and communication between purchaser and subcontractor

35. As discussed in chapter IX, "Construction on site", paragraph 3, the contract may obligate the purchaser to provide certain types of information to the contractor relevant to the performance by the contractor (e.g., information concerning safety or environmental laws in force in the country of the purchaser), and to co-operate in other ways with the contractor (e.g., by storing equipment or materials of the contractor). The parties may also wish to consider obligating the purchaser to provide information to, or to co-operate with, the subcontractor in the same way and to the same extent when the subcontractor is performing the obligations of the contractor.

36. Direct communication between the purchaser and a subcontractor is often desirable in order to enable matters relevant to the performance by the subcontractor to be discussed and understood by both of them. The parties may wish, therefore, for the works contract to authorize the purchaser to communicate with the subcontractor as to technical matters or matters relating

to the design or quality of the works, insofar as they relate to the performance by the subcontractor. The contract might also entitle the contractor to be present at discussions between the purchaser and the subcontractor, and might obligate the purchaser to inform the contractor of any other communications between the purchaser and the subcontractor. The parties may wish to provide that agreements between the purchaser and the subcontractor in respect of matters about which the purchaser is authorized to communicate with the subcontractor are binding upon the contractor, provided that the contractor participated or was entitled to participate in the discussions between the purchaser and the subcontractor, or was informed of communications between them, and provided that the agreements do not alter the terms of the works contract between the contractor and the purchaser.

H. Compatibility of subcontract with works contract

37. It is desirable for the provisions of the works contract and of the subcontract to be in harmony, so that the scope and quality of the work to be performed by the subcontractor fulfil the obligations incumbent upon the contractor under the works contract.

Footnotes to chapter XI

[1]*Illustrative provision*

"The engagement by the contractor of one or more third persons to perform the obligations hereinafter listed shall be subject to the provisions of this contract regarding subcontracting, and such a third person shall be regarded as a subcontractor. The obligations referred to in the previous sentence are the following: . . ."

[2]*Illustrative provision*

"The contractor shall deliver to the purchaser written notice of his intention to subcontract, which shall include the name and address of the proposed subcontractor, and a description of the work to be performed by him [and the price to be charged by him] [and any other information relative to the proposed subcontractor which the purchaser might reasonably require]. [The contractor shall also deliver to the purchaser a copy of the proposed subcontract.] The contractor shall be permitted to subcontract in accordance with such notice after the expiration of . . . days following the delivery thereof to the purchaser, unless within the said . . . days the purchaser delivers to the contractor an objection to the proposed subcontractor, the obligations to be subcontracted, [the price to be charged by the subcontractor] [or the terms of the subcontract], specifying reasonable grounds for the objection."

[3]*Illustrative provisions*

"(1) All subcontractors engaged by the contractor are those of the contractor alone, and no provision of this contract is to be interpreted or applied so as to give rise to or imply the existence of a contractual relationship between the purchaser and any subcontractor, except to the extent that this contract expressly provides otherwise.

"(2) The engagement by the contractor of a subcontractor to perform any obligation of the contractor under this contract does not diminish or eliminate the liability of the contractor for a failure to perform that obligation."

[4]*Illustrative provision*

"The contractor agrees to indemnify the purchaser against any loss resulting from damage caused by the subcontractor to property of the purchaser, or resulting from any liability which the purchaser may have to bear towards a third person as a result of an act or omission of a subcontractor, to the same extent that the contractor would be liable to the purchaser had such loss resulted from an act or omission of the contractor himself."

Chapter XII. Inspections and tests during manufacture and construction

SUMMARY

The parties may wish to specify in the contract the requirements and procedures for inspections and tests during manufacture and construction. The purpose of inspecting and testing during manufacture and construction may be to satisfy the purchaser that manufacture and construction are proceeding in accordance with the agreed time-schedule and in accordance with the contract (paragraph 1).

In drafting contractual provisions on inspecting and testing during manufacture and construction, it is advisable to take into account municipal legal regulations prescribing inspections and tests in the countries where the works is to be constructed and where equipment or materials are to be manufactured (paragraph 3). Inspections and tests may be conducted by an independent institution (paragraphs 2, 6 and 19).

It is advisable to describe the character of the inspections and tests to be conducted during manufacture (paragraph 8). The contract may provide for the purchaser to have access to places where inspections and tests are to be conducted, and specify the facilities to be given to the purchaser for the purposes of inspecting and testing (paragraphs 10 and 11). While the time for conducting the tests may be fixed by the contractor, the purchaser should be notified in advance of that time (paragraphs 12 to 14).

Additional or modified tests not specified in the contract may be required by legal rules issued in the purchaser's country, or may be desired by the purchaser even if not so required. The contract should determine the allocation of the costs of conducting those tests (paragraph 15).

The contract should determine the consequences if tests conducted during manufacture and construction are unsuccessful (paragraph 16) and provide for the issue of test reports and certificates (paragraphs 17 to 19).

If certain payments are to made upon shipment of equipment and materials (chapter VII, "Price and payment conditions", paragraph 70), the contract might provide for inspection by the purchaser upon shipment. Inspection upon shipment may be also advisable if the risk of loss of or damage to equipment and materials (chapter XIV, "Passing of risk") is to pass to the purchaser upon shipment (paragraphs 21 and 22). The contract may require inspection of equipment and materials on their arrival on the site if they are to be taken over by the purchaser at that time (paragraph 23).

The contract might entitle the purchaser to inspect how the construction on the site proceeds, or might require specified tests to be conducted during the construction by the contractor. Issues arising in connection with inspections and tests during construction might be settled in a manner analogous to the manner in which issues arising in connection with inspections and tests during manufacture are settled (paragraphs 24 and 25). Inspection by the purchaser may be facilitated if records are maintained by the contractor of the construction as it proceeds (paragraph 26).

A. General remarks

1. This chapter deals with inspections and tests to be conducted during manufacture and construction. Tests to be conducted after completion of construction are dealt with in chapter XIII, "Completion, take-over and acceptance". It is important for a works contract to specify clearly the requirements and procedures for inspecting and testing to be conducted during manufacture and construction, and the legal effects of those inspections and tests. Procedures for inspecting and testing might be established to ascertain whether the manufacture and construction process conforms to contractual requirements, since such conformity will reduce the occurrence of defects in the completed works. The procedures might relate not only to inspection by the purchaser through visual checking, but might also relate to a variety of tests to be performed by the contractor during manufacture and construction. The purchaser may be entitled, though not obligated, to inspect equipment and materials and participate in specified tests to be effected during manufacture or construction (see paragraphs 8 and 24, below). The precise nature, scope and timing of the inspections and tests provided for in the contract may depend upon the contracting approach chosen by the purchaser and the nature of the works to be constructed (see chapter II, "Choice of contracting approach"). Inspections and tests to be conducted during manufacture and construction are not, in principle, intended to demonstrate that the contractor has met his construction obligations. The inspections and tests are, rather, intended to satisfy the purchaser that manufacture and construction are proceeding in accordance with the agreed time-schedule (see chapter IX, "Construction on site", paragraphs 18 to 23) and in accordance with the contract (see chapter XVIII, "Delay, defects and other failures to perform", paragraph 26). Consequently, it is advisable to provide that a failure of the purchaser to detect and notify a defect during manufacture and construction does not deprive him from later claiming a remedy for that defect (see paragraph 8, below, and chapter VIII, "Supply of equipment and materials", paragraph 20).

2. A number of countries, especially those in which industry is highly developed, have issued legal regulations which require that equipment and materials to be incorporated into industrial works must be inspected by public authorities or authorized private institutions. In regard to certain matters, the inspections and tests may also be prescribed at an international level.

3. Inspections and tests prescribed by municipal legal regulations which relate primarily to safety, health and environmental standards are in principle applicable irrespective of whether or not they are provided for in the contract. Legal regulations of this character may exist in the country where the works is to be constructed. Such regulations should be taken into account when drafting the contract. In addition, where certain quality control requirements have to be met during manufacture under legal regulations in the country of manufacture, additional contractual provisions on testing the equipment and materials might not be necessary. It might be sufficient for the contractor to show that the inspections and tests required in the country of manufacture have been properly carried out, if those requirements are in conformity with the quality requirements specified in the contract.

4. The contractor may conduct tests during manufacture or construction as a part of his quality control system. The purchaser should satisfy himself that this

quality control system is adequate. Excessive testing requirements during manufacture and construction, like other interferences with the contractor's performance, are likely to lead to an increase in the cost of the construction.

5. A number of technical standards prepared by national or international standardization institutions specify testing requirements. Therefore, the contract may provide that the standards of a specified international standardization institution, or the standards of a specified national standardization institution, preferably one in the country where the works is to be constructed, are to be applied, if such standards settle all relevant issues in a satisfactory manner.

6. Where a new industry is being developed it may be preferable, at the initial stages, to have some of the inspections and tests carried out by an experienced foreign institution which is ready to carry out inspections and tests abroad. The necessary arrangements can be made between the purchaser and the institution. Alternatively, the contract might provide that the necessary arrangements are to be made by the contractor with an institution specified in the contract and might require the production of certificates from the institution that the inspections and tests have been successful.

7. In some cases, inspections and tests might be required in the contract with respect to equipment and materials supplied by the purchaser that are to be incorporated into the works by the contractor. The contractor might be obligated to make the inspections and tests as soon as possible after the equipment and materials have been supplied to him. The contract might deal with the consequences of the contractor's failure to discover defects and notify them to the purchaser (see chapter VIII, "Supply of equipment and materials", paragraph 29, and chapter XVIII, "Delay, defects and other failures to perform", paragraph 65).

B. Inspections and tests during manufacture

1. *Description and effects of inspections and tests during manufacture*

8. The parties may agree that the purchaser is entitled to inspect the processes involved in the manufacture of certain equipment and materials to be incorporated into the works, and to participate in specified tests to be conducted during manufacture by the contractor. The purpose of the inspections and tests during manufacture might be to check whether an appropriate manufacturing process has been followed, and whether the equipment and materials have the required technical parameters. It is advisable to describe the character of the inspections and tests to be conducted during manufacture as precisely as possible, taking into consideration the nature of the equipment and materials. The contract might provide that the purchaser's failure to discover defects during those inspections and tests does not release the contractor from the responsibility to demonstrate by appropriate tests after completion that the works is free of defects (cf. chapter XIII, "Completion, take-over and acceptance", paragraphs 1 and 24, and chapter XVIII, "Delay, defects and other failures to perform", paragraph 8).

9. Inspection of equipment during manufacture may also give to the purchaser's personnel an opportunity to acquaint themselves with certain

aspects of the equipment. If the purchaser wishes to have this opportunity, the contract might specify that the right to attend inspections during manufacture is not limited to the purchaser's engineer or other personnel supervising the construction of the works, but also extends to other employees of the purchaser whom he may nominate. However, the purchaser's right should be limited to having his employees participate in normal inspection procedures, since any improper operation could affect the contractor's obligation to deliver equipment free of defects.

2. *Purchaser's access to places of manufacture and facilities to be provided by contractor*

10. If the purchaser wishes to inspect equipment and materials during manufacture, or participate in tests during manufacture, the contract may provide that for the purposes of such inspections and tests the purchaser is to have access during working hours to all places where the equipment and materials are manufactured. Difficulties in conferring this right on the purchaser may arise primarily for two reasons. Firstly, the contractor may wish to protect the confidential know-how of certain manufacturing processes, or he may be under an obligation to preserve such confidentiality either under contractual arrangements with other persons, such as licensors, or under arrangements with certain clients, for example when he also performs certain contracts for Government authorities in sensitive subjects. In addition, legal rules in the country of manufacture may restrict the purchaser's access to the place of manufacture. In those cases, the only possibility for according the purchaser an opportunity for some form of inspection might consist in retaining a specialized inspection institution which could provide the guarantees of confidentiality acceptable to the contractor or to the third parties concerned, or which might be permitted to have access under the legal rules. Secondly, the contractor's subcontractors and suppliers (in particular where they are specialists in high technology products) may refuse to allow the purchaser access to their premises. Where the subcontractor and suppliers have no contractual relationship with the purchaser (see chapter XI, "Subcontracting", paragraph 5) the works contract between the purchaser and the contractor may require the contractor to include in the contracts with his subcontractors and suppliers a right of access for the purpose of inspecting and testing during manufacture.

11. Where the purchaser has a right to inspect or participate in tests, the contract may specify what facilities are to be given to the purchaser's representatives for this purpose. The facilities may consist in particular of office space, or in the supply of samples for independent testing by the purchaser or by institutions retained by him.

3. *Time for conducting tests during manufacture*

12. Since tests during manufacture may form part of the contractor's quality control system, he is usually entitled to fix the times of those tests. However, it is rare for those times to be fixed in the time-schedule for contract performance, except possibly in respect of some critical major items.

13. The contract may provide that the purchaser has the right to observe the tests. In order to enable the purchaser to exercise this right, the contractor might be obligated to notify him in advance of the time when the tests will be conducted. The contract may require a specified period of notice to be given to the purchaser. The length of the period may depend on the time which is usually needed for the purchaser to make the necessary travel and other arrangements for his representatives to attend the tests.

14. In the case of specified important items of equipment, the contract may allow the contractor to proceed with further manufacture and construction only after those items have been successfully tested in the presence of the purchaser. If the purchaser fails to attend the tests due to causes for which the contractor is not responsible, the contract might entitle the contractor to conduct the tests in the absence of the purchaser.

4. *Additional or modified tests*

15. It may not be possible to specify in the contract all the tests required. Additional or modified tests not specified in the contract may be required by legal rules issued in the purchaser's country subsequent to entering into the contract. The contractor may be entitled to be compensated for reasonable costs incurred by conducting such tests, and to a reasonable extension of the period of time for supply of the equipment and materials and for completion of the construction if an extension is needed due to the additional or modified tests. If additional or modified tests are not required by such legal rules, but the purchaser wishes to have them conducted, the tests may be conducted with the consent of the contractor. As in cases where the tests are necessary, the contractor may be entitled to be compensated for reasonable costs incurred and to a reasonable extension of time for supply of equipment and materials and for completion of construction. Alternatively, the costs of additional or modified tests may be allocated in the contract in accordance with international standard practice in the industry.

5. *Unsuccessful tests*

16. If the tests are unsuccessful the contract might require them to be repeated. The contractor might not be granted additional time for performance if unsuccessful tests have to be repeated for reasons for which the contractor is responsible, and he might be required to bear all the costs of the unsuccessful tests. The purchaser's remedies in cases of defects discovered during manufacture are dealt with in chapter XVIII, "Delay, defects and other failures to perform", paragraph 28.

6. *Test reports and certificates*

17. The contract may require reports to be made on all tests conducted. The test reports might include the procedures which were followed and the test results. When a test has been attended by representatives of the purchaser, the test report should also be signed by those representatives. However, the

signature might be deemed to constitute only an acknowledgement that the test procedures and readings have been correctly recorded.

18. When a test is not attended by representatives of the purchaser, the contractor might be obligated to transmit the test reports immediately to the purchaser. If the purchaser has been given proper notice of the tests (see paragraph 13, above), the procedures and results recorded in the reports might be deemed to be correct.

19. When inspections and tests are carried out by an independent inspection or testing institution, the institution normally issues a certificate or a similar document. The contract may obligate the contractor to transmit the document to the purchaser either promptly after it has been issued or as part of the documentation submitted to the purchaser prior to acceptance of the works.

7. *Costs*

20. In most cases, the parties may wish to agree that the costs of inspections and tests are to be borne by the contractor. However, the costs of attendance by the purchaser's representatives (see paragraph 13, above) might be borne by the purchaser. The costs to be borne by the contractor might include the cost of labour, materials, electricity, fuel and other items necessary for the proper conduct of the inspections and tests.

C. Inspection upon shipment or arrival on site

21. When certain payments are to be made upon shipment of equipment or materials (see chapter VII, "Price and payment conditions", paragraph 70) or when the risk of loss of or damage to the equipment or materials is to pass from the contractor to the purchaser upon shipment (see chapter XIV, "Passing of risk", paragraph 12), the contract might provide for inspection of the equipment and materials by the purchaser upon shipment. In addition to covering the equipment and materials, the inspection might cover their packing, in particular if the risk of loss or damage during the transport is to be borne by the purchaser. The contractor might be obligated to give reasonable advance notice to the purchaser when and where the equipment and materials will be available for inspection.

22. Where equipment and materials are to be inspected, the contractor may be obligated under the contract to dispatch them only after the inspection has been conducted or after the purchaser, despite timely notification, has failed to conduct the inspection within a period of time to be specified in the contract. The parties may agree that the inspection is to be conducted by a specified independent organization at the cost either of the purchaser or the contractor. The contract may require a certificate of the organization confirming that no defects were discovered during the inspection, and the contractor may be obligated to dispatch the equipment and materials only after the issue of the certificate. If defects are discovered, the purchaser may be entitled to stop the shipment and require their cure (see chapter XVIII, "Delay, defects and other failures to perform", paragraph 28).

23. As an alternative to inspection prior to shipment, the contract may require that the inspection take place upon the arrival of the equipment and

materials on the site. This procedure might be adopted in cases when payments are to be made or the passing of the risk is to occur at that time. In addition, inspection upon arrival might be agreed upon by the parties if the equipment and materials are to be taken over by the purchaser at the time of arrival on the site. The inspection may facilitate the identification of defects for which the contractor is liable and the preservation of potential rights against the carrier for loss of or damage to the equipment and materials during transport. The consequences of a failure by the purchaser to inspect, or to notify in time, defects discovered during the inspection, are discussed in chapter VIII, "Supply of equipment and materials", paragraph 20, and the remedies which the purchaser may have in respect of discovered defects are discussed in chapter XVIII, "Delay, defects and other failures to perform", paragraphs 8 and 30 to 32.

D. Inspections and tests during construction on site

24. The purchaser might be entitled under the contract to inspect how the construction on the site proceeds. In addition, the contract might require specified tests to be conducted during the construction by the contractor, and the purchaser might be entitled to be notified in time of those tests and to participate therein.

25. Issues arising in connection with inspections and tests during construction might be settled in a manner analogous to the manner in which issues arising in connection with inspections and tests during manufacture are settled. However, the period of notice to be given to the purchaser of the time when tests will be conducted can be considerably shorter, since the purchaser will usually have a representative on the site to observe or supervise the construction process. In addition, the problems of confidentiality, to which reference has been made in paragraph 10, above, do not normally occur on the site. The purchaser's remedies for defective construction, and the consequences of his failure to discover defects in construction or to notify in time defects which he discovers, are discussed in chapter XVIII, "Delay, defects and other failures to perform", paragraphs 8 and 30 to 32.

26. Inspection by the purchaser may be facilitated if records are maintained of the construction as it proceeds. Accordingly, the contractor might be obligated to keep complete records of the construction and to produce them to the purchaser upon request. Alternatively, the records might be checked periodically by the purchaser's representative and the correctness of the records authenticated by his signature.

27. When equipment is to be installed by the purchaser or another person under the supervision of the contractor (see chapter IX, "Construction on site", paragraphs 27 to 29), the contractor might be made responsible for specifying and conducting the inspections and tests to be made during the installation. The contractor might be obligated to keep records of those inspections and tests.

Chapter XIII. Completion, take-over and acceptance

SUMMARY

It is advisable that the contract clearly specify when completion, take-over and acceptance are to occur, and their legal consequences. Completion of construction will normally occur prior to take-over and acceptance (paragraphs 1 and 2).

The contractor may be obligated to prove completion of construction through the conduct of successful completion tests. The contract may describe the tests that are required. The contract may require the conduct of the tests within a specified period after notification of completion to the purchaser. If the tests are unsuccessful, the contractor may be obligated to repeat them. The contract may require the tests to be conducted in the presence of both parties (paragraphs 4 to 8).

The contract may allocate the costs of tests between the parties. The contract may require the results of completion tests to be reflected in a report to be signed by both parties. The contract may determine the date when construction is considered to be complete if completion tests are successful (paragraphs 9 to 13).

The sequence in which take-over, performance tests and acceptance are to occur may depend on the contracting approach chosen by the parties, and on whether the parties have provided for a trial operation period. It is advisable for the contract to determine which party is to provide the items needed to operate the works during the trial operation period (paragraphs 14 to 20).

The contract should specify when the purchaser is obligated to take over the works. The parties may be obligated to prepare a take-over statement which describes the construction of the works at the date of take-over. It is advisable for the contract to determine the legal consequences of take-over (paragraphs 21 to 23).

Performance tests serve to demonstrate that the works meets the technical characteristics specified in the contract. The contract may provide that acceptance can occur after performance tests have been conducted. The contract may obligate the contractor to conduct performance tests within a specified period of time after the expiry of the trial operation period, or, if the contract does not provide for a trial operation period, after completion of construction. It is desirable that the contract describe the tests to be conducted. The results of the tests may be reflected in a report to be signed by both parties (paragraphs 24 to 28).

The contract may obligate the purchaser to accept the works within a specified period after the conduct of successful performance tests, and obligate the parties to prepare an acceptance statement, to be signed by both parties. The statement may list the defects in the works discovered during the performance tests, and set forth a time-schedule for their cure (paragraphs 29 and 30).

The contract may provide that, if the contractor is prevented from conducting performance tests due to a failure by the purchaser to perform an obligation, acceptance is deemed to occur. Where performance tests can be conducted independently in respect of portions of the works, those portions may be accepted separately (paragraphs 32 and 33).

It is advisable for the contract to determine the legal consequences of acceptance, in particular if the contract provides for provisional acceptance (paragraphs 34 to 36).

A. General remarks

1. It is advisable that the contract clearly specify when completion of construction, and take-over and acceptance of the works, are to occur, and their legal consequences. The contract may provide that the completion of construction is to occur when equipment, materials and construction services (e.g., installation of equipment) required under the contract have been supplied by the contractor, and the supply proved through successful completion tests; that take-over is to occur when the purchaser takes physical possession of the works from the contractor; and that acceptance is to occur when the purchaser states that he is satisfied that the works is free of serious defects, or, despite the existence of serious defects in the works, expresses his intention not to exercise remedies which are available to him solely in respect of serious defects in the works (see chapter XVIII, "Delay, defects and other failures to perform", paragraph 35). However, even if acceptance occurs, the contract may entitle the purchaser to exercise other remedies for defects in the accepted works (see chapter XVIII, "Delay, defects and other failures to perform", paragraphs 38 to 48). The contract may also provide that acceptance is deemed to occur in certain situations (see paragraph 32, below).

2. Under normal construction procedures, completion of construction will occur prior to take-over and acceptance. The sequence in which take-over and acceptance are to occur may depend upon a number of factors (see section C, below).

3. The take-over of uncompleted or defective works after the termination of the contract is discussed in chapter XXV, "Termination of contract", paragraph 26. The take-over of works where construction is to be completed or defects in the works are to be cured by a new contractor at the expense of the original contractor is discussed in chapter XVIII, "Delay, defects and other failures to perform". The take-over of equipment and materials to be incorporated in the works is discussed in chapter VIII, "Supply of equipment and materials", paragraphs 19 and 20.

B. Completion of construction

1. *Proof of completion through completion tests*

4. The contract may obligate the contractor, after he considers the entire construction to have been completed, to notify the purchaser of the completion, and to prove the completion through the conduct of successful completion tests. The contract may provide that the construction is to be considered as

completed even if the completion tests disclose that certain minor items (i.e., items the absence of which does not prevent the conduct of performance tests, or, in cases where performance tests are not required, the use of the works) have not been supplied. The contract may provide that the absence of such a minor item is to constitute a defect in the works, and not delay in construction (see chapter XVIII, "Delay, defects and other failures to perform", paragraph 5). When several contractors are engaged for the construction, completion tests may be required from each contractor in respect of the portion of the construction effected by him after the completion of that portion. Even if only one contractor is engaged for the construction, the parties may wish to provide that completion tests in respect of certain portions of the construction are to be conducted before the construction of the entire works is completed (e.g., when the purchaser wishes to use a portion of the works before the construction of the entire works is completed: see also paragraph 33, below).

5. It is desirable that the contract describe the tests which are required to determine whether construction has been completed. These tests may include some or all of the following procedures as are appropriate to the construction effected: visual inspection of the works and its components; checking and calibration of instruments; safety tests; dry runs; mechanical operation of the works and its various components; examination of the technical documentation which the contractor has to supply to assist the purchaser in operating and maintaining the works (e.g., as-built plans, manuals of instruction, and lists of spare parts); and verification of the stock of spare parts which the contractor may be obligated to deliver before completion of the construction (cf. XXVI, "Supplies of spare parts and services after construction", paragraphs 10 to 21). Mandatory legal rules in the country where the works is to be constructed may provide that, upon completion of construction, certain tests must be successfully conducted before the works can be operated. The contract may provide that, in addition to the tests required under the contract, any tests required by such rules must also be conducted.

6. The contract may obligate the contractor to commence the completion tests within a specified period of time after he notifies the purchaser of completion (see paragraph 4, above). The contract may require the parties to agree on a date within this period for the commencement of the tests. The contract may provide that, if the parties fail to agree upon such a date, the contractor is obligated to commence the tests on the last day of the specified period.

7. The construction may be considered as incomplete until the tests are successfully conducted. If completion tests conducted by the contractor are unsuccessful, the contract may obligate him to repeat the tests. In addition, if the tests are not successfully conducted by the date specified in the contract for the completion of construction (see chapter IX, "Construction on site", paragraphs 14 to 17), the contractor may be liable for delay in completion (see chapter XVIII, "Delay, defects and other failures to perform", paragraphs 19 to 25). If, however, the contractor was prevented from conducting completion tests within the period specified in the contract for the conduct of tests due to a failure by the purchaser to perform an obligation (e.g., to provide the necessary power: see paragraph 9, below) the construction may be deemed to be completed on the expiry of that period. If, however, the failure to perform by the purchaser was due to an exempting impediment, the contractor may be obligated to repeat the tests.

8. The contract may require the tests to be conducted in the presence of both parties. If the purchaser is prevented from attending the tests by an unavoidable impediment, he may be entitled under the contract to ask that the tests be postponed. If the purchaser fails to attend the tests, and either does not request a postponement, or requests a postponement when he is not entitled to do so, the contractor may be entitled under the contract to conduct the tests in the absence of the purchaser. The contract may provide that tests which are postponed at the request of the purchaser must be held within a specified period after the notification of the completion of construction (see paragraph 4, above).

9. The contractor may be obligated to conduct the tests at his expense. However, the purchaser may be obligated to provide specified forms of assistance for the conduct of the tests (e.g., to provide power needed for running equipment), and to bear the costs of providing such assistance. The contract may determine which party is to bear the costs of tests not required under the contract but which are required by mandatory legal rules in the country where the works is to be constructed which are enacted after the contract is entered into (see paragraph 5, above).

10. Which party is to be required to bear the costs of tests which are repeated or postponed may depend on the cause for the repetition or postponement. If tests have to be repeated because the initial tests are not successful, the contract may provide that the contractor is to bear all costs reasonably incurred by the purchaser as a result of the repetition. If the conduct of tests is prevented because the purchaser has failed to perform an obligation, and the tests have to be postponed, it may be provided that the purchaser is to bear all costs reasonably incurred by the contractor as a result of the postponement. If tests have to be postponed because the purchaser is prevented from attending them by an unavoidable impediment, it may be provided that the parties are to bear the costs of the postponed tests in the same manner in which the costs of the tests which were postponed would have been borne by them.

11. If the contract requires certain formalities (e.g., the participation of an inspecting authority) to be complied with during the conduct of the completion tests, and such formalities cannot be complied with due to an unavoidable impediment, the contract may entitle the contractor to conduct the tests without complying with the formalities. In some cases, the applicable law may require an inspecting authority to participate in the tests. If such an inspecting authority requires alterations to the works, the contractor may be obligated to make the alterations on the basis of procedures provided in the contract for variation of the construction (see chapter XXIII, "Variation clauses", paragraphs 12 to 19).

12. The contract may require the results of the completion tests to be reflected in a report to be signed by both parties. The report may specify the dates when the tests were commenced and completed, and indicate whether the tests were successful or unsuccessful. Where the tests are unsuccessful, the report may indicate in what respects the construction is incomplete. Where the tests are successful, the report may indicate defects in the works discovered during the tests, and specify a period of time within which the contractor is obligated to cure them. The purchaser's remedies for such defects are discussed in chapter XVIII, "Delay, defects and other failures to perform", paragraphs 38 to 42. If

the contractor was entitled to conduct the tests in the absence of the purchaser (see paragraph 8, above), the report may be signed by the contractor alone. The contract may require the contractor to send the report promptly to the purchaser.

2. *Date of completion of construction*

13. The contract may provide that, where the completion tests are successful, the construction is considered to be completed as of the date agreed by the parties for the commencement of the tests (see paragraph 6, above), or, alternatively, on the date of the completion of the tests. In cases where completion tests were postponed at the request of the purchaser (see paragraph 8, above) and have been successfully conducted, the construction may be considered under the contract to be completed on the date on which the tests were to be conducted before the postponement.

C. Sequence of take-over, performance tests and acceptance: trial operation period

14. The sequence in which the contract provides for take-over, performance tests and acceptance to occur may depend on the contracting approach chosen by the purchaser (see chapter II, "Choice of contracting approach") and, in particular, on whether the parties have provided in the contract for a trial operation period.

15. The contract may provide that after the completion of construction the works is to be operated for a trial period. Such a period enables the works to be run in, to reach normal operating conditions, and to be made ready for the conduct of performance tests. The contract may provide that during this period the contractor is to train the purchaser's personnel, provide technical supervision of the operation and maintenance of the works, and cure with all possible speed any defects discovered in the works.

16. Where the works during construction is to be in the physical possession of the contractor (see chapter XIV, "Passing of risk", paragraphs 20 and 21), and the works is to be operated during the trial operation period by the purchaser under the supervision of the contractor, take-over of the works by the purchaser for the purposes of the trial operation may occur after completion of construction. The contract may provide for the conduct of performance tests at the expiry of the trial operation period, and for acceptance of the works by the purchaser if the performance tests are successful (see section E,1, below).

17. In cases where the works is to be operated during the trial operation period by the contractor (e.g., under a product-in-hand contract: see chapter II, "Choice of contracting approach", paragraph 7), the works may remain in his physical possession during this period. In these cases, performance tests may be conducted at the end of the trial operation period and, if they are successful, the works may be accepted and taken over by the purchaser in that order. Alternatively, the contract may provide that acceptance and take-over are to occur concurrently.

18. When the parties do not provide for a trial operation period, the contract may provide for the conduct of performance tests after completion of construction, and, if the performance tests are successful, for acceptance and take-over of the works to take place in that order. Alternatively, the contract may provide that acceptance and take-over are to occur concurrently.

19. The works will not be taken over by the purchaser if it has already been in his physical possession during construction (e.g., where several contractors are engaged to construct the works simultaneously). In such cases, completion of construction may be followed by the conduct of performance tests, and, if the performance tests are successful, by acceptance.

20. It is advisable for the contract to determine which party is to provide the personnel, energy, raw materials and other items needed to operate the works during the trial operation period, and to allocate between the parties the costs of providing those items. If a product-in-hand contract has been concluded, the costs of training the purchaser's personnel during this period may be allocated to the contractor. It may be provided that the output of the works is to be owned by the purchaser. The contract may specify the length of the trial operation period and the circumstances in which this period may be extended.

D. Take-over of works

1. *Obligation to take-over*

21. If the take-over of the works by the purchaser is to precede acceptance (see paragraph 16, above), the contract may obligate the purchaser to take over the works within a specified period of time after the date of completion of the construction (see paragraph 13, above). If acceptance of the works is to precede take-over (see paragraph 18, above), the contract may obligate the purchaser to take over the works within a specified period of time after the date of acceptance (see section E.2, below).

2. *Take-over statement and date of take-over*

22. It is advisable that the contract obligate the parties to prepare a take-over statement, to be signed by both parties, describing the condition of the works at the date of take-over. The contract may provide that, if the statement does not indicate the date of take-over, the date is to be that on which the statement is signed by the parties. A take-over statement may not be needed if take-over is to occur immediately after the conduct of completion tests, or concurrently with or immediately after acceptance of the works. In such cases, the take-over may be reflected in the completion tests report (see paragraph 12, above) or in the acceptance statement (see section E.2, below).

3. *Legal consequences of take-over*

23. It is advisable for the contract to determine the legal consequences of take-over. The contract may provide that, as from the date of take-over, the risk of loss of or damage to the works passes from the contractor to the

purchaser (see chapter XIV, "Passing of risk", paragraph 20); that the purchaser is obligated to pay a portion of the price (see chapter VII, "Price and payment conditions", paragraph 75); and that the quality guarantee period commences to run (see chapter V, "Description of works and quality guarantee", paragraph 29). Alternatively, the contract may provide that these consequences, or some of them, are to occur upon acceptance, and not upon take-over (see paragraph 34, below). The contract may obligate the purchaser to give the contractor access to the site after take-over, and to protect the works (see chapter IX, "Construction on site", paragraph 32).

E. Acceptance of works

1. *Performance tests*[1]

24. Performance tests serve to demonstrate that the works meets the technical characteristics specified in the contract. These technical characteristics may relate not only to the quantity and quality of the output, but also to a number of other parameters, such as the consumption of energy and raw materials by the works (see chapter V, "Description of works and quality guarantee", paragraph 8). The tests may also serve to demonstrate the performance of the works under a variety of operating conditions. The contract may provide that performance tests are to be considered successful if they do not reveal the existence of serious defects in the works (see chapter XVIII, "Delay, defects and other failures to perform", paragraph 27).

25. The contract may provide that acceptance can occur only after performance tests have been conducted. However, in respect of certain elements of the construction (e.g., building, civil engineering), performance tests may not be the appropriate method for determining whether the required technical characteristics have been satisfied, and the contract may require the conduct only of completion tests in respect of those elements.

26. The contract may obligate the contractor to conduct performance tests within a specified period of time after the expiry of the trial operation period, or, if the contract does not provide for a trial operation period, after completion of construction (see paragraph 18, above). The contract may require the parties to agree on a date within this period on which the tests are to commence. The contract may provide that, if the parties fail to agree upon such a date, the contractor is obligated to commence the tests on the last day of the specified period. The contract may provide that, if tests are unsuccessful, the contractor is obligated to repeat them. The contract may also limit the number of times the contractor is permitted to repeat them, and may specify the period of time within which unsuccessful tests must be repeated. The remedies to which a purchaser may be entitled when the last tests the contract permits the contractor to conduct are unsuccessful are dealt with in chapter XVIII, "Delay, defects and other failures to perform", paragraphs 35 to 37. The contract may provide that when the last tests the contract permits the contractor to conduct are unsuccessful, the purchaser is entitled to require the conduct of further tests.

27. It is desirable that the contract describe the tests to be conducted. The description may include the duration of the tests, the performance criteria to be

met, the methods of measurement and analysis to be adopted in the conduct of the tests, and the tolerances permitted. In case of a variation in construction (see chapter XXIII, "Variation clauses", paragraph 1), the performance tests may also be varied so as to be appropriate to the varied construction. Issues such as the responsibility of the contractor for conducting performance tests, the assistance to be provided by the purchaser in the conduct of the tests, the allocation between the parties of the costs of tests, the postponement of tests, the conduct of additional tests required by mandatory legal rules, and compliance with prescribed formalities during the conduct of tests, may be settled in a manner analogous to that in which they are settled in relation to completion tests (see paragraphs 8 to 11, above).

28. The contract may require the results of the performance tests to be reflected in a report to be signed by both parties within a specified period of time. The report may record the dates when the performance tests were commenced and completed, the test procedures followed, and the readings achieved. In addition, the reading and results may be evaluated in the report, and the tests judged to be successful or unsuccessful. If the tests are unsuccessful, the report may indicate a date on which the tests are to be repeated. The contract may provide that any differences of view between the parties concerning the readings and results achieved or their evaluation are to be reflected in the report. If the contractor was entitled to conduct the tests in the absence of the purchaser, the report should be signed by the contractor alone. The contract may require the report to be also signed by an independent expert, if this is permitted by the applicable law. The contract may obligate the contractor to send the report promptly to the purchaser. Where performance tests are successful and the results of the tests may be recorded without difficulty, the parties may not wish to prepare a performance tests report, but instead include those results in the acceptance statement.

2. *Acceptance statement and date of acceptance*

29. The contract may obligate the purchaser to accept the works within a specified period of time after the conduct of successful performance tests, and also obligate the parties to prepare an acceptance statement, to be signed by both parties, which confirms the acceptance of the works by the purchaser on a stated date.[2] Such a statement would minimize disputes as to the date on which the works was accepted, and whether the works was accepted despite the discovery of serious defects in it (see chapter XVIII, "Delay, defects and other failures to perform", paragraph 38).

30. The acceptance statement may list the defects in the works discovered during the performance tests. In addition, it may set forth a time-schedule for the cure of the defects, unless the purchaser has chosen to exercise remedies other than cure in respect of the defects (e.g., price reduction: see chapter XVIII, "Delay, defects and other failures to perform", paragraphs 39, 41 and 42). If the parties differ on certain issues, such as the time-schedule for the cure of defects, the statement may reflect the views of both parties. The statement may also indicate measures which need to be taken by the parties in connection with acceptance, e.g., transfer of rights under an insurance policy.

31. The contract may provide that, if the statement does not indicate the date of acceptance, the date is to be that on which the statement was signed by both

parties. If the acceptance statement has not been signed by both parties (e.g., due to the purchaser's failure to attend the performance tests, or due to a dispute between the parties as to whether the performance tests were successful), the date on which the performance tests were successfully completed may be considered as the date of acceptance. In cases where performance tests are not required by the contract (see paragraph 25, above) and the acceptance statement is not signed by both parties, the contract may provide that the date of acceptance is considered to be the date on which completion tests were successfully conducted.

32. The contractor may be prevented from conducting performance tests during the period of time specified in the contract for conducting them due to a failure by the purchaser to perform an obligation (e.g., a failure to provide assistance needed for the conduct of the tests: see paragraph 27, above). The contract may provide that, in such cases, acceptance is deemed to occur on the date when a notice stating that acceptance has occurred is delivered by the contractor to the purchaser. The contract may further provide that, if performance tests cannot be conducted for a specified period of time due to causes for which neither party is responsible (e.g., due to the failure of an inspecting organization to attend the tests, when the attendance of the organization is required under the contract), the works is to be put into operation. If the works is operated successfully and no serious defects in the works are discovered during a period of time equivalent to that which would have been expended in the conduct of performance tests, acceptance may be deemed to occur after expiry of that period.

33. When several contractors are engaged to construct the works (see chapter II, "Choice of contracting approach", paragraphs 17 to 25), and the different contractors complete the portions of the works which they are engaged to construct at different times and performance tests can be conducted independently in respect of each portion, the contract may provide for the portions of the works to be accepted separately. Even when a single contractor is engaged to construct the works, it may be possible in some cases to conduct performance tests independently in respect of portions of the works, and the contract may provide for those portions to be accepted separately. In such cases, issues arising in relation to acceptance of a portion may be settled in the same manner in which they would be settled in relation to acceptance of the entire works. If independent performance tests cannot be conducted in respect of a portion, since the portion cannot be operated separately, the contract may provide that acceptance of that portion is to occur only after completion of construction of the entire works.

3. *Legal consequences of acceptance*

34. It is advisable for the contract to determine the legal consequences of acceptance. In addition to having the consequences noted in paragraph 23, above, the acceptance of the works may affect certain remedies which might otherwise be available to the purchaser for defects in the works, e.g., acceptance might exclude the right to terminate the contract (see chapter XVIII, "Delay, defects and other failures to perform", paragraphs 47 and 48).

4. *Provisional acceptance*

35. In practice, the parties sometimes provide in their contract that the purchaser may accept the works provisionally, in particular in cases where the contract does not recognize the concept of take-over and distinguish it from acceptance. The purpose of permitting provisional acceptance is to enable the purchaser to take physical possession of the works without the occurrence of certain consequences of acceptance (e.g., the loss of some remedies for defects in the works). When he accepts provisionally, the purchaser takes physical possession of the works, but makes acceptance subject to the fulfillment of certain conditions by the contractor, such as the cure of defects in the works discovered during performance tests. However, similar results may be achieved without the use of provisional acceptance by providing in the contract that the purchaser is entitled to take over the works even if performance tests are unsuccessful, and that he is obligated to accept only after successful performance tests have been conducted by the contractor.

36. If the parties prefer to provide for provisional acceptance, it is desirable to clarify the consequences of such an acceptance. In particular, it is desirable to describe clearly the situations in which the purchaser may accept provisionally, and to determine whether the legal consequences of acceptance (see paragraph 34, above) are to arise upon the satisfaction of the conditions attaching to the acceptance, or whether at least some of these consequences are to arise as from the date of the provisional acceptance.

Footnotes to chapter XIII

[1]*Illustrative provisions*

"(1) The contractor must conduct performance tests within ... (indicate a period of time) after [expiry of the trial operation period] [completion of the construction]. If the parties fail to agree upon a date falling within this period for the commencement of the tests, the contractor must commence the tests on the last day of this period.

"(2) The performance tests must be conducted in the presence of both parties. If the purchaser is prevented from attending the tests by an unavoidable impediment, he is entitled to request that the tests be postponed to the earliest date falling within . . . (indicate a period of time longer than that indicated in paragraph (1)) on which he can attend the tests. The purchaser is not entitled to require postponed tests to be held after the expiry of this period. If the purchaser fails to attend the tests, and either did not request or was not entitled to request a postponement, the contractor is entitled to conduct the tests in the absence of the purchaser.

"(3) The performance tests to be conducted are described in annex . . . to this contract.

"(4) If the performance tests are unsuccessful, the contractor is obligated to repeat them within . . . (indicate a period of time) after the date of the unsuccessful tests. The contractor is not permitted to repeat unsuccessful tests more than . . . times, or after the expiry of . . . (indicate a period of time) from the [expiry of the trial operation period] [completion of the construction]. However, the purchaser may require the contractor to repeat unsuccessful tests even after unsuccessful tests have been repeated . . . times (indicate same number as that indicated above), or after the expiry of . . . (indicate same period as that last-mentioned) from the [expiry of the trial operation period] [completion of the construction].

"(5) The contractor must bear the costs of conducting the performance tests. However, the purchaser must supply at his own expense the following items needed for the conduct of the tests: . . . (indicate items).

"(6) If performance tests are repeated because the initial tests are unsuccessful, the contractor must bear all costs reasonably incurred by the purchaser as a result of the repetition. If the conduct of tests is prevented because the purchaser has failed to perform an obligation, and the tests are postponed, he must bear all costs reasonably incurred by the contractor as a result of the postponement.

"(7) Within . . . (indicate period of time) after the conduct of performance tests, the parties must prepare a report, to be signed by both parties, reflecting the results of the tests. The report must indicate whether the tests were successful or unsuccessful. It must also set forth the following information: . . . (indicate information required)."

[2]*Illustrative provisions*

"(1) The purchaser must accept the works within . . . (indicate period of time) after the conduct of successful performance tests.

"(2) Within . . . (indicate period of time) after the conduct of successful performance tests, the parties must prepare an acceptance statement. The acceptance statement must contain the following information: . . . (indicate required information).

"(3) Acceptance occurs on the date of acceptance mentioned in the acceptance statement prepared under paragraph (2) of this article. If the acceptance statement does not mention a date, acceptance occurs on the date on which the statement is signed by both parties. If the acceptance statement is not signed by both parties, acceptance occurs on the date on which successful performance tests were completed.

"(4) If the conduct of performance tests is prevented during the period specified in article . . . of this contract because the purchaser has failed to perform an obligation, the contractor may deliver to the purchaser a notice stating that acceptance has occurred, and acceptance occurs on the date on which the notice is delivered.

"(5) If performance tests cannot be conducted during the period specified in article . . . of this contract due to causes for which neither party is responsible, the parties must commence the operation of the works. The works must be operated for . . . (indicate a period of time). If no serious defects are discovered in the works during this period, acceptance occurs on the expiry of this period."

Chapter XIV. Passing of risk

SUMMARY

Loss or damage may be caused to equipment and materials to be incorporated in the works and to the works before or after completion, as well as to tools and construction machinery to be used by the contractor for effecting the construction. This chapter deals with loss or damage which may be caused by accidental events or by the acts of third persons for whom neither party is responsible, and the issue of allocating the risk of such loss or damage between the parties (paragraphs 1 to 4).

In determining how the risk of loss or damage is to be allocated between the parties, several factors need to be considered and balanced (paragraph 5). The parties may sometimes wish to exclude certain specified events from the risks to be borne by the contractor, and to allocate the risk of loss or damage from that event to the purchaser (paragraph 6).

Mandatory rules in many legal systems provide that, after equipment and materials are incorporated in the works, they lose their separate identity, and the party bearing the risk in respect of the works will also bear the risk in respect of the incorporated equipment and materials. The time at which equipment and materials are considered to be incorporated in the works will be determined by criteria specified in the applicable law (paragraphs 7 and 8).

The parties may wish to determine the allocation of risk in respect of equipment and materials supplied by the contractor, and the time at which the risk is to pass from one party to the other. This may depend, in particular, on which party is to be in physical possession of the equipment and materials and the need to avoid a multiple passing of risk (paragraphs 9 to 15).

Equipment which is supplied by the contractor is sometimes not intended to be incorporated in the works. If they are able to do so under the applicable legal rules, the parties may wish to allocate the risk in respect of such equipment on the basis of which party is to be in physical possession of the equipment prior to the take-over of the works (paragraphs 16 and 17).

In respect of equipment and materials supplied by the purchaser for incorporation in the works, the parties may wish to determine the allocation of risk on the basis of factors similar to those which would be relevant to an allocation of risk in respect of equipment and materials supplied by the contractor (paragraphs 18 and 19).

In respect of the works during construction and the completed works, where only one contractor is engaged to construct the entire works it is advisable to provide that the contractor is to bear the risk until take-over or acceptance by the purchaser (paragraphs 20 and 21). Where several contractors participate in the construction in succession, the contract may provide that the risk is to pass to each contractor at the time the uncompleted works is taken over by him, and pass to the purchaser at the time the works is taken over by the purchaser (paragraph 22).

Where the contractor bears the risk of loss or damage, the contract may require him to cure with all possible speed and at his own expense any loss or damage which occurs. Where the purchaser bears the risk in respect of equipment and materials supplied by the contractor, the contract may obligate him to pay the entire price for equipment and materials which are lost or damaged (paragraph 23).

It is advisable for the contractor to bear the risk in respect of the contractor's tools and construction machinery brought to the site for effecting the construction (paragraph 30).

A. General remarks

1. Loss or damage may be caused to equipment or materials to be incorporated in the works, to the works during construction, or to the completed works, as well as to tools and construction machinery to be used by the contractor for effecting the construction. Liability for damages in cases where such loss or damage is caused by a party to the works contract, or by a third person for whom a party is responsible, is discussed in chapter XX, "Damages". The present chapter deals with loss or damage which may be caused by accidental events, or by the acts of third persons for whom neither party is responsible. Such loss or damage is not uncommon during the construction of an industrial works. It is therefore advisable for the contract to allocate the risk of this loss or damage between the parties.

2. The party bearing a risk of loss or damage will have to bear the financial consequences of the loss or damage without being able to obtain compensation from the other party. For example, if loss or damage is caused to equipment, materials or the works, and the contractor bears the risk of that loss or damage, he will be obligated to cure the loss or damage by replacing the lost items or repairing the damage at his own expense. If the purchaser bears the risk of that loss or damage, he will be obligated to pay the price in respect of the lost or damaged items despite the loss or damage. The party bearing those risks may wish to take out insurance covering the risk, or may even be obligated to do so under the works contract (see chapter XVI, "Insurance", paragraphs 17 to 26). However, a party will be compelled to bear the consequences of those risks against which insurance is not obtained.

3. It may sometimes be difficult to discover whether loss or damage was caused by an accidental event, or by a third person for whom neither party is responsible (e.g., where goods are found to be damaged after transportation, and the damage is of a kind which might have been caused either by an accidental event or by a third person). It is therefore advisable to provide that the risk of loss or damage to be borne by a party includes both loss or damage caused by accidental events and loss or damage caused by a third person for whom neither party is responsible.

4. An accidental event or act of a third person causing loss or damage to the works may also prevent a party from performing his contractual obligations. For example, if the works is damaged by a storm during a period when the contractor bears the risk of accidental damage, the contractor may be prevented from completing the construction in time. The issue of whether the party who has failed to perform his contractual obligations is liable to pay

damages to the other party for financial loss suffered due to the failure should be distinguished from the issue of who should bear the risk of loss or damage caused by the accidental event or act of the third person. Even if the person bearing the risk is liable to cure the loss or damage covered by the risk, he may not be liable to pay damages for his failure to perform due to the loss or damage if the accidental event or the act of the third person constituted an exempting impediment (see chapter XX, "Damages", paragraph 3, and chapter XXI, "Exemption clauses", paragraphs 9 to 26). In the example given above, the contractor may be obligated to repair the damage to the works caused by the storm, but he would not be liable to pay damages to the purchaser for the financial loss arising from his failure to perform if the storm constituted an exempting impediment under the exemption clause contained in the contract.

5. In determining how the risk of loss or damage is to be allocated between the parties, factors such as the following need to be considered and balanced:

(*a*) First, and most importantly, which party is able to insure the goods at the least cost, or, under the works contract, is to provide the insurance cover for the loss or damage in question, or is in a better position to claim against an insurer;

(*b*) Which party can better control the circumstances which may result in loss or damage; this party will usually be the party who is in physical possession of the equipment, materials or the works. An allocation of risk to that party may create an incentive to care for the goods with diligence. In addition, allocation of the risk to the party in physical possession of the property may avoid disputes over whether the loss or damage was caused by a failure to take due care of the property, or by an accidental event or act of a third person which could not have been prevented. The parties may wish to attach considerable weight to this factor in allocating risk;

(*c*) The undesirablility of a multiple passing of risk between the parties (e.g., from contractor to purchaser, and then from purchaser to contractor). The parties may also wish to attach considerable weight to this factor;

(*d*) Which party can best salvage and dispose of the damaged property.

6. The parties may sometimes wish to exclude from the risks to be borne by the contractor the risk of loss or damage caused by certain specified events, for example, war, other military action, riots (unless solely caused by employees of the contractor or his subcontractors), earthquake, or floods (so-called "excepted risks").[1] Since the exclusion will result in those risks being borne by the purchaser, it is advisable for the contract to specify the cases when the purchaser is to bear them. The parties may wish to provide that the purchaser bears those risks only where the loss or damage is caused by the specified events in the country where the works is to be constructed. If, however, the parties wish to provide that the purchaser is to bear the risks even in respect of loss or damage caused outside the country where the works is to be constructed, it is desirable for the contract to specify the time when the purchaser is to commence to bear those risks (e.g., at the time when the equipment and materials are handed over to the first carrier for transportation to the site).

B. Equipment and materials supplied by contractor

1. *Equipment and materials to be incorporated in works*

(a) *Consequences of incorporation under applicable law*

7. Mandatory rules in many legal systems provide that equipment and materials lose their separate identity after they are incorporated in the works. Thereafter, the party bearing the risk in respect of the works will also bear the risk in respect of the incorporated equipment and materials. The time at which equipment and materials are considered to be incorporated in the works will be determined by criteria specified in the applicable law. The parties may find it advisable to ascertain when incorporation takes place under those criteria.

8. Under most legal systems, materials are considered to be incorporated in the works after their use in the construction, since such use often results in a change in the physical characteristics of the materials. In respect of equipment, different approaches are adopted by various legal systems. Under some legal systems, equipment is considered to be incorporated only after it is installed in the works in such a manner that it cannot be separated from the works without damage to the equipment. Under other legal systems, installation of a less permanent character suffices for the equipment to be considered incorporated in the works. If the rules of the applicable law regulating when incorporation takes place are not mandatory, and do not settle the issue in an appropriate manner, the parties may wish to determine in the contract when equipment and materials are to be considered as incorporated in the works (e.g., at the time when equipment is installed in the works, whether or not the equipment could be subsequently removed without damage to the equipment).

(b) *Rules on passing of risk adopted in contract*

9. The parties may wish to determine in the contract which party bears the risk of loss of or damage to equipment and materials supplied by the contractor for incorporation in the works during the period prior to their incorporation. If the equipment and materials are to remain in the physical possession of the contractor until their incorporation in the works by the contractor, it is advisable to provide that the risk of loss or damage is to be borne by the contractor until their incorporation (see footnote 1 to this chapter).

10. In certain circumstances, it may be necessary for the purchaser to take over for the purpose of storage equipment and materials supplied by the contractor (see chapter VIII, "Supply of equipment and materials", paragraphs 21 to 26). In those circumstances, whichever approach is adopted for the allocation of risk will have one of two disadvantages: a multiple passing of risk; or physical possession of the equipment and materials by one party and the bearing of risk in respect of the equipment and materials at the same time by the other. Thus, the contract might provide that the purchaser is to bear the risk in respect of the works during construction, and also in respect of the equipment and materials until their incorporation in the works, thereby avoiding a multiple passing of risk. However, this approach has the disadvantage that, when the contractor takes the equipment and materials out of storage for incorporation in the works, they will be in his physical possession until their incorporation, while the risk of loss or damage during that period is

borne by the purchaser. If, alternatively, it is provided in the contract that the risk is to be borne by whichever party is for the time being in possession of the equipment and materials, that disadvantage is avoided.

11. When the risk of loss or damage to the uncompleted works is to be borne by the purchaser and the equipment or materials are to be taken over by the purchaser for storage and are to be handed back to the contractor only immediately prior to their incorporation in the works, the parties may wish to provide that the risk in respect of the equipment and materials is to pass to the purchaser and is to remain with him until their incorporation in the works. When the risk of loss of or damage to the uncompleted works is to be borne by the contractor, or, whether the purchaser or the contractor is to bear the risk in respect of the uncompleted works, when after the storage the equipment or materials are to be taken over by the contractor and are to remain in his physical possession for a considerable period of time prior to their incorporation in the works, the parties may wish to agree that the risk is to pass back to the contractor and is to remain with him.

12. In all cases where equipment and materials are to be taken over by the purchaser for the purpose of storage or installation by the purchaser or another enterprise engaged by the purchaser (see chapter IX, "Construction on site", paragraphs 27 to 30), the contract should determine when the risk of loss or damage passes to him. The parties may wish to select one of the following times for the passing of risk to the purchaser:

(*a*) The time when the equipment and materials are handed over to the first carrier for transport to the purchaser, or when they effectively pass the ship's rail at the agreed port of shipment;

(*b*) The time when the equipment and materials are taken over by the purchaser, or, if he is in delay in taking them over, the time when they are placed at his disposal.[2]

13. In determining which of these times is appropriate, the parties may wish to select a time at which the purchaser has the possibility of checking the condition of the equipment and materials. If the equipment and materials are not checked at the time when the risk passes, and they are later found to be lost or damaged, it may be difficult to determine when the loss or damage occurred, and who is to bear the consequences of the loss or damage.

14. The approach described in the preceding paragraphs may be used whether the contractor supplies the equipment or materials from his own stocks, or whether he contracts with a subcontractor or a supplier to supply them direct to the place of supply specified in the contract (see chapter VIII, "Supply of equipment and materials", paragraph 5). In the latter case, the supply of the equipment or materials by a subcontractor or supplier may be regarded as the performance by the contractor of his supply obligations under the works contract (see chapter XI, "Subcontracting", paragraphs 27 and 28). The works contract will, therefore, be able to allocate between the contractor and the purchaser the risk of loss of or damage to the supplied items, although it will not be able to allocate that risk between the subcontractor or supplier and the contractor. The latter allocation will be effected by the contract between those parties. To the extent possible, the contractor may wish to protect himself by seeing to it that the risk does not pass to him under his contract with the subcontractor or supplier at a time earlier than when the risk passes from him to the purchaser under the works contract.

15. Where the equipment and materials are being supplied by the contractor to the purchaser under a relevant trade term of the International Rules for the Interpretation of Trade Terms (INCOTERMS) (e.g., f.o.b., c & f), that trade term may determine the time of the passing of risk to the purchaser. This approach may be advisable in cases where the trade term as interpreted in INCOTERMS determines the passing of risk in a manner appropriate to a works contract (see chapter VIII, "Supply of equipment and materials", paragraph 3).

2. *Equipment not to be incorporated in works*

16. Equipment which is supplied by the contractor is sometimes not intended to be incorporated in the works (e.g., movable equipment for unloading the products of the works). Such equipment is, under some legal systems, considered to be appurtenant to the works, and the risk in respect of the equipment is deemed to pass from the contractor to the purchaser at the same time as the risk in respect of the works. However, the parties are often given the autonomy to determine by agreement that the risk is to pass at some other time. Such an agreement may be desirable when the applicable legal rules do not allocate the risk in respect of such equipment in a manner which is appropriate for a works contract. It may also be advisable for the works contract to determine the time of passing of the risk in respect of such equipment in cases where the applicable law does not consider the equipment to be appurtenant to the works.

17. The parties may wish to allocate the risk on the basis of which party is to be in the physical possession of the equipment prior to the take-over of the works. If the contractor is to be in possession, the risk may be borne by the contractor, and pass to the purchaser when the risk passes in respect of the works. If the purchaser is to take over the equipment prior to the take-over of the works (e.g., for purposes of storage), the risk may pass to the purchaser at a time determined by the parties (see paragraphs 12 to 15, above).

C. Equipment and materials supplied by purchaser

18. Under some works contracts, the purchaser may be obligated to supply equipment and materials to be used by the contractor for incorporation in the works. The parties may wish to provide that, if the contractor bears the risk in respect of the works during construction, the risk in respect of the equipment and materials supplied by the purchaser is to pass from the purchaser to the contractor at the time when they are taken over by the contractor or, if he is in delay in taking them over, at the time when they are placed at his disposal. The contract may provide that the contractor is obligated to inspect the equipment and materials at the time of take-over (see chapter VIII, "Supply of equipment and materials", paragraph 29). This approach has the advantage of reducing disputes between the parties as to which of them should bear the consequences of loss of or damage to the equipment and materials.

19. The advantage of the approach described above is less when the purchaser bears the risk in respect of the works during construction. In such a case, this approach results in a double passing of risk (from the purchaser to the

contractor and from the contractor to the purchaser when the equipment and materials are incorporated in the works). Furthermore, disputes as to the cause of a failure of the works to operate may not be substantially reduced, as the purchaser would bear the risk in respect of the equipment and materials after their incorporation in the works. The parties may wish to provide that, in cases where the equipment and materials are to be stored on the site by the purchaser and are to be taken over by the contractor only immediately before their incorporation in the works, the risk is to borne by the purchaser until the incorporation.

D. Works during construction and completed works

20. When only one contractor is engaged to construct the entire works (in particular, in the case of a turnkey contract), it is advisable for the contract to provide that the contractor is to bear the risk of loss of or damage to the works during construction, and to the completed works until acceptance of the works, or, alternatively, take-over of the works, by the purchaser (see chapter XIII, "Completion, take-over and acceptance", paragraph 23).

21. The advantage of having the contract provide that the risk in respect of the works is to pass from the contractor to the purchaser at the time of the take-over of the works by the purchaser is that, from that time, the works will be in the physical possession of the purchaser and the purchaser can therefore control the circumstances which may result in loss or damage to the works. However, where the works is to be operated under the supervision of the contractor for a trial period commencing to run from the time of the take-over of the works by the purchaser (see chapter XIII, "Completion, take-over and acceptance", paragraph 16), the parties may prefer not to have the risk pass until the time when the works is accepted by the purchaser. The time when take-over and acceptance may occur is discussed in chapter XIII, "Completion, take-over and acceptance", paragraph 22, 25, 29, 31 and 32. The contract may provide that, if the purchaser fails to take over or accept the works when obligated to do so, the contractor is entitled to require him to do so, and that if the purchaser fails to do so within a specified period of time, the risk is to pass on the date when a notice that the risk has passed is delivered to him by the contractor (cf. chapter XVIII, "Delay, defects and other failures to perform", paragraphs 60 and 61). In the exceptional case where the works is to be in the ownership of the contractor during the construction (see chapter XV, "Transfer of ownership of property", paragraph 8), the parties may prefer to provide that the risk is to pass from the contractor to the purchaser at the time of the transfer of ownership of the works to the purchaser.

22. Where several contractors participate in the construction in succession, and each of them is to be in physical possession of the works during the period of construction by him, the contract may provide that the risk is to pass to each contractor at the time the uncompleted works is taken over by him, and pass to the purchaser at the time the works is taken over by the purchaser. Each of the contractors may be obligated to conduct completion tests after completion of the portion of the construction to be effected by him. These tests will involve inspection by the parties of the completed portions (see chapter XIII, "Completion, take-over and acceptance", paragraph 4). Any loss or damage

the risk of which is borne by a contractor may be discovered during the inspection. The contractor who is required to construct next may participate in the inspection, and any loss or damage which is discovered may be reflected in a take-over statement (see chapter XIII, "Completion, take-over and acceptance", paragraph 22).

E. Some consequences of bearing of risk

23. Where the contractor bears the risk of loss of or damage to equipment or materials supplied by him, to the works during construction, or to the completed works until take-over or acceptance, he will be required to cure any loss or damage covered by the risk at his own expense with all possible speed. The contract may provide that, in curing the loss or damage, the contractor has the option of either replacing or repairing property which has been damaged. Under many legal systems, the purchaser is obligated to pay the entire price of property supplied by the contractor in cases where the loss of or damage to the property is covered by the risk to be borne by the purchaser. If the applicable law does not provide that the bearing of risk by the purchaser has these consequences, it is advisable for the contract to do so. Where loss or damage covered by the risk to be borne by the purchaser occurs to equipment and materials supplied by the contractor, and the purchaser has therefore to cure the loss or damage at his own expense, he will in many cases not be able to do so himself. It may be advisable for the contract to determine how this issue is to be resolved (cf. chapter XVIII, "Delay, defects and failures to perform", paragraph 49).

F. Contractor's tools and construction machinery to be used for effecting construction

24. The contractor will bring tools and construction machinery to the site to be used for the construction. The risk of loss of or damage to such property which may be caused by accidental events, or by the acts of third persons for whom neither party is responsible, would be borne under many legal systems by the contractor, and would not pass to the purchaser. The contract may provide that the tools and machinery may, in some situations, be used by the purchaser, or by a third person engaged by him, for the construction. Even in those situations, however, it may be advisable to provide that the risk is to be borne by the contractor if the tools and machinery are used for the construction to be effected under the contract.

Footnotes to chapter XIV

[1]*Illustrative provisions*

"(1) Except as provided in paragraph (2) of this article, the contractor bears the risk of any loss or damage from any cause whatsoever to any equipment and materials supplied by him until their incorporation in the works.

"(2) However, the risk borne by the contractor does not cover any loss or damage caused by the purchaser or any person engaged by him [or caused by . . . (here indicate "excepted risks"; see paragraph 8, above) in the country where the works is being constructed]."

[2]*Illustrative provisions*

"(1) Except as provided in paragraph (2) of this article, the risk of loss or damage from any cause whatsoever to equipment and materials to be supplied by the contractor for incorporation in the works passes from the contractor to the purchaser at the time when [the equipment and materials are handed over in accordance with this contract to the first carrier for transmission to the purchaser] [the equipment and materials effectively pass the ship's rail at the agreed port of shipment] [the equipment and materials are taken over by the purchaser or, if he is in delay in taking them over, they are placed at the disposal of the purchaser].

"(2) [As in paragraph (2) of the illustrative provisions in note 1]".

Chapter XV. Transfer of ownership of property

SUMMARY

The issue of whether various types of property involved in the construction of an industrial works are owned by the contractor or the purchaser may be important in connection with questions of insurance, taxation, and liability to third persons arising from the property or its use. The issue is also important because the property may be seized by creditors of its owner and is subject to bankruptcy proceedings against him (paragraph 1). This *Guide* deals with the transfer of the ownership of property as an issue distinct from the passing of risk of loss of or damage to that property (paragraph 2).

The transfer of ownership of equipment and materials which are to be incorporated in the works is often governed by mandatory rules of the legal system where the property is situated (paragraph 3). Many legal systems contain a mandatory rule that all things affixed to land become subject to the ownership of the landowner (paragraph 4). Even if the applicable law permits the parties to regulate through contract provisions the transfer of ownership of property from one party to the other, they may need to include such provisions only where the applicable law does not regulate the transfer in a satisfactory manner (paragraph 5).

Contractual provisions allocating the ownership of equipment and materials to the party who does not own the works may cease to have effect upon the incorporation of the equipment materials in the works (paragraph 6).

In regard to the transfer of ownership of equipment and materials supplied by the contractor, it may be desirable that ownership does not remain with him after the purchaser has paid a substantial portion of the price for them. In regard to the transfer of equipment and materials supplied by the purchaser, it may be desirable that the ownership of the equipment and materials is not to pass to the contractor unless he pays for them before their incorporation (paragraph 7).

It may be desirable for ownership of the works during construction to be allocated in certain circumstances to the purchaser, for example when he pays a substantial portion of the price in the form of progress payments during construction. In other circumstances, an allocation to the contractor may be desirable, for example if credit has been given by the contractor to the purchaser in respect of the payment of the price (paragraph 8).

A. General remarks

1. The issue of whether various types of property involved in the construction of an industrial works are owned by the contractor or the purchaser may be important in connection with questions of insurance, taxation and liability to third persons arising from the property or its use. The issue is also important because the property may be seized by creditors of its owner, and is subject to bankruptcy proceedings against him.

2. The *Guide* deals with the transfer of the ownership of property involved in the performance of a works contract as an issue distinct from the passing of risk of loss of or damage to that property (see chapter XIV, "Passing of risk"). Although under some legal systems the risk of loss of or damage to property passes with the transfer of ownership of the property, under other legal systems this is not the case. For example, under some legal systems the issue of who bears the risk of loss of or damage to property may depend on who has possession of the property. Furthermore, even legal systems under which the risk passes with the transfer of ownership may permit the parties to agree otherwise.

3. The transfer of ownership of equipment and materials which are to be incorporated in the works is often governed by mandatory rules of the legal system where the property is situated, leaving the parties only limited autonomy to specify in the contract the time when ownership is transferred from one party to the other. Under most legal systems, ownership of equipment and materials may not pass till the property is identified as that which is to be supplied in performance of the contract. Some legal systems require, in addition, that the equipment and materials be delivered to the party who is to acquire them.

4. Many legal systems contain a mandatory rule that all things affixed to land become subject to the ownership of the landowner. If that rule exists in the law of the country where the site is located, the works during construction and after its completion will be owned by the owner of the site, who is normally the purchaser. Other legal systems have non-mandatory rules determining the ownership of things affixed to the land, although under many of these legal systems as well the things will become subject to the ownership of the landowner unless the parties provide otherwise. However, under contract provisions or the applicable law, the ownership of the equipment and materials which are to form part of the works may have passed to the purchaser even prior to their incorporation in the works (see section B, below).

5. Even if the applicable law permits the parties to regulate through contract provisions the transfer of ownership of property from one party to the other, they may need to include such provisions only where the applicable law does not regulate the transfer in a satisfactory manner. Sections B and C of this chapter contain suggestions for regulating in an appropriate manner the allocation of ownership in certain circumstances if the allocation by non-mandatory rules of the applicable law in those circumstances is unsatisfactory. When formulating provisions regulating the transfer of ownership, it is in general advisable for the parties to avoid, as far as possible, multiple transfers and retransfers of ownership of property.

B. Transfer of ownership of equipment and materials to be incorporated in works

6. The parties may wish to note that contractual provisions allocating the ownership of equipment and materials to the party who does not own the works may cease to have effect upon the incorporation of the equipment and materials in the works. Under mandatory legal rules existing in many legal systems, equipment and materials which are incorporated in the works become

merged in it upon incorporation, and cease to be objects of independent ownership. The incorporated equipment and materials will thereafter be owned by the party owning the works.

7. In regard to the transfer of ownership of equipment and materials supplied by the contractor, it may be desirable that the equipment and materials do not remain in the ownership of the contractor after the purchaser has paid a substantial portion of the price for them. The purchaser may otherwise suffer serious loss if the property of the contractor is seized by his creditors, or if the contractor is declared bankrupt. In regard to the transfer of ownership of equipment and materials supplied by the purchaser, it may be desirable that the ownership of the equipment and materials is not to pass to the contractor prior to their incorporation in the works, whether the works is to be owned by the purchaser during construction, or, exceptionally, by the contractor. However, if the works during construction is to be owned by the contractor and he pays for the equipment and materials before their incorporation, it may be provided that ownership is to pass to him at the time of payment.

C. Ownership of works during construction and after completion

8. In certain circumstances an allocation by the parties of ownership of the works during construction to the purchaser may be desirable (cf. paragraph 4, above). For example, it may be desirable for ownership to be allocated to the purchaser when he pays a substantial portion of the price in the form of progress payments during construction. It may also be desirable for ownership to be allocated to the purchaser in cases where the allocation to the contractor may lead to difficulties, for example, where several contractors participate in the construction and it is not practicable for each contractor to own the portion of the works constructed by him. In other circumstances, however, an allocation of the ownership to the contractor may be desirable. For example, if credit has been given by the contractor to the purchaser in respect of the price, a substantial portion of which is to be paid on a date after the expiration of the guarantee period, the contractor may be protected by an allocation of ownership until a specified percentage of the price is paid. Such an arrangement may, however, approximate to an agreement for the retention of ownership, and the law of the site may require compliance with certain formalities if the allocation is to be validly effected. Furthermore, the law of the site may require compliance with additional formalities to effect a valid transfer of ownership of the works to the purchaser after the specified percentage of the price has been paid by him.

Chapter XVI. Insurance

SUMMARY

It is desirable for the parties, and particularly for the purchaser, to obtain advice regarding insurance from specialists in the field of insurance of industrial works projects. The works contract need normally deal only with those types of insurance which it is desirable for a party expressly to be obligated to provide (paragraphs 1 to 4).

It is advisable for the contract to require property insurance and liability insurance, and to specify the risks which are to be insured against, the party who is obligated to obtain the insurance, the parties and other entities who are to be named as insured parties, the minimum amount of insurance, the applicable deductible or excess, and the period of time to be covered by the insurance (paragraphs 5 to 15).

It is advisable for the contract to require property insurance against loss of or damage to the works during construction, the completed works, temporary structures and structures ancillary to the works (paragraphs 16 to 23), and equipment and materials to be incorporated in the works (paragraphs 24 to 26).

Where the contractor is to bear the risk of loss of or damage to the entire works during construction and after completion, it may be desirable for the contract to obligate the contractor to obtain property insurance covering the entire works and to keep it in force. Where several contractors are engaged to construct the works, and no single contractor bears the risk of loss of or damage to the entire works, the parties may wish to consider whether it is desirable for each contractor to obtain insurance covering the portion of the works and structures covered by his construction (paragraph 18). It is normally desirable for both the contractor and the purchaser to be named as insured parties (paragraph 19).

Different approaches may be adopted with respect to the risks required by the contract to be covered by property insurance (paragraphs 20 and 21). The parties should consider the nature of the losses to be compensated by the insurance and the amount of insurance to be required (paragraphs 22 and 23).

With respect to insurance covering equipment and materials to be incorporated in the works, the contract might provide for those items to be insured under a cargo policy from the point of shipment to delivery at the site, and after delivery by property insurance as previously discussed. Alternatively, it may be desirable in some cases for a single insurance policy to insure them for the entire period from the time of shipment to the time of incorporation in the works (paragraphs 24 to 26).

In some cases, it may be desirable for the contractor to be obligated to obtain insurance covering machinery and tools used by him for the construction, including hired machinery and tools (paragraph 27).

It is desirable for the contract to obligate the contractor to insure against his extra-contractual liability for loss, damage, or injury caused in connection with his performance of the contract, including acts or omissions of his employees, subcontractors and suppliers, as well as his liability under indemnities which he assumes under the contract (paragraphs 28 to 37).

It may be desirable for the contract to require the contractor also to provide specific types of liability insurance, such as products liability insurance (paragraph 29), professional indemnity insurance (paragraph 30), insurance against liabilities arising from the operation of vehicles (paragraph 31), and insurance to compensate employees for work-related injuries (paragraphs 32 to 35). The contract might require liability insurance to be in effect prior to the time when he or any subcontractor commences construction on the site and might cover loss, damage or injury occurring throughout the construction phase and the guarantee period (paragraph 36).

It is advisable for the contract to obligate the contractor to produce to the purchaser specified types of proof that insurance which the contractor is obligated to obtain is in effect, or instruct his insurer to provide such proof directly to the purchaser. Similar obligations might be imposed upon the purchaser in respect of insurance required to be obtained by him (paragraph 38). The parties may wish to consider provisions to deal with the situation where the obligated party fails to obtain or keep in force any insurance which he is required to provide (paragraphs 39 to 41).

A. General remarks

1. The construction of a large industrial works carries with it the risks of loss, damage and injury resulting from a wide variety of possible accidents and events. One of the functions of the works contract is to allocate these risks between the contractor and the purchaser. This is accomplished by clauses under which a party assumes a particular risk or under which the risk is shared by both parties, for example, clauses relating to passing of risk (see chapter XIV, "Passing of risk"), exemptions (see chapter XXI, "Exemption clauses"), and hardship (see chapter XXII, "Hardship clauses"). Risks which are not allocated by the contract will be imposed upon one party or the other by rules of law. A party may wish to transfer to third parties, such as insurers, certain risks to which he is subject, or portions of those risks.

2. It is usually advisable for the works contract to contain provisions relating to insurance covering certain risks. There may be cases in which the purchaser wishes the contractor to be obligated to provide insurance covering certain risks borne by the contractor. This may be the case with respect to risks which, if they materialized, would produce financial consequences beyond the ability of the contractor to bear and which could impair or prevent performance of the contract by the contractor, or which could otherwise prejudice the purchaser if the contractor failed to bear them. For similar reasons, lending institutions financing the construction of a works often require insurance coverage for certain risks borne by the contractor. In some cases, the parties may agree that the contractor is to arrange and pay for insurance covering certain risks borne by the purchaser (see, e.g., paragraph 21, below). In exceptional cases, the purchaser might undertake in the contract to arrange and pay for insurance covering some of the contractor's risks (see paragraphs 6 and 14, below).

3. It should be noted that the contract need normally deal only with those types of insurance which it is desirable for a party expressly to be obligated to provide; it need not normally deal with other types of insurance which it would be prudent or legally necessary for a party to have. This chapter concerns only those types of insurance which the parties may wish expressly to require in the works contract.

4. The insurance of industrial works projects is a highly specialized field. There exists a wide variety of types of insurance to cover various risks; most of these are subject to a complex array of exclusions and restrictions. Where the overall insurance scheme for a project consists of several policies covering different risks—some policies taken out by the contractor and others by the purchaser—the individual policies must be co-ordinated so as to achieve the intended overall coverage and to avoid undesired gaps in, as well as duplication of, coverage. It is therefore desirable for the parties to obtain advice regarding insurance from specialists in the field of insurance of international industrial works projects. The purchaser, in particular, may wish to obtain a thorough analysis of the risks to which he is subject in connection with the project and advice as to the insurance of those risks. It would be desirable for him to do so even at the pre-contract stage, since professional risk-management and insurance advice will be important for the structuring of risk-allocating and insurance provisions of the draft contract to be presented to prospective contractors. International lending institutions sometimes require purchasers to obtain advice from risk management professionals in connection with projects financed by those institutions.

5. The contract may contain provisions relating to:

(a) *Property insurance,* to insure against loss of or damage to the works during construction, the completed works, temporary structures and structures ancillary to the works, equipment and materials to be incorporated in the works and the machinery and tools used by the contractor for the construction (including hired machinery and tools). This insurance insures property owned by the insured party or in which he otherwise has an insurable interest (e.g., property in respect of which he bears the risk of loss or damage);

(b) *Liability insurance,* to insure the contractor against his extra-contractual liability for loss, damage or injury caused in connection with his performance of the contract, as well as his liability under indemnities which he assumes under the contract.

6. Whether it is desirable for a particular type of insurance to be obtained by the contractor or the purchaser will depend upon a number of factors, many of which are discussed elsewhere in this chapter. In many cases, it may be desirable for the insurance to be obtained by the party who bears the risk covered by the insurance. In some cases, however, it may be preferable for one party to arrange and pay for insurance covering risks borne by the other party. This might be the case, for example, if the party who does not bear the risk can obtain the insurance more cheaply than the other, or if the insurance in question must be co-ordinated with other insurance (see paragraph 13, below). The purchaser may therefore wish to consider whether, taking into consideration the foregoing circumstances, it would be more desirable for him to obtain certain types of insurance covering his own or the contractor's risks, rather than requiring the contractor to do so. The parties may wish to provide that the

insurance required under the contract must be obtained from an insurer acceptable to both parties to the works contract (see, however, paragraph 15, below).

7. It is advisable for the contract to provide that the fact that a party has obtained insurance covering certain risks should not constitute a limitation or discharge of the liabilities of that party under the contract in respect of those risks, even if the contract requires him to insure against them.

8. It is advisable for the insurance provisions in the contract to specify the risks which are to be insured against, the party who is obligated to obtain the insurance, the parties and other entities who are to be named as insured parties, the minimum amount of insurance, the "deductible" (or "excess"), if any, applicable to each risk (i.e., the amount of a financial loss which the insured must bear himself, the insurer compensating under the insurance policy only to the extent the loss exceeds such amount), and the period of time to be covered by the insurance. Due to the complex and often unique nature of industrial works projects, insurance coverage will usually have to be tailored to meet the particular circumstances of the project.

9. The parties should be aware that the type or amount of insurance which can be obtained will be limited by what is available in the insurance market. Some insurance coverage which a party might consider desirable may not be available. Other coverage may be obtainable only at a cost which may not be economically justified in a particular project. Therefore, in drafting insurance provisions, the parties should bear in mind whether it is possible to obtain the contemplated coverage at reasonable rates. It should be noted that due to changing market conditions, the availability of certain types of insurance discussed in this chapter may change after the time of this writing.

10. The amount of insurance required by the contract and the scope of the risks insured against should not exceed those which are necessary or prudent under the circumstances of the project. Purchasers should be aware that even if the contractor obtains insurance, the costs of insurance will usually ultimately be borne by the purchaser. Excessive insurance required by the purchaser will unnecessarily increase the price which he must pay. Moreover, in a lump-sum contract, imposing excessive insurance costs on the contractor might tempt him to reduce other costs in order to maintain the attractiveness of his bid or his profit margin. Such a practice could adversely affect the quality of the works to be supplied to the purchaser.

11. The parties may wish to consider providing in the contract for a means to adjust the amounts of the insurance required by the contract, in order to take account of inflation. The adjustment could be made automatically, in accordance with a change in a relevant index, or the contract could provide for a review of the amounts upon the request of either party. The contract might also specify which party is to bear the increases in the cost of insurance resulting from increases in the amounts of insurance; this might be the party who is obligated to obtain the insurance. To the extent legally possible (see paragraph 15, below), the parties may wish to require that the insurance proceeds in the event of a claim be payable in a freely convertible currency.

12. The purchaser may also wish to consider the amounts of the deductibles (see paragraph 8, above) to which the various types of insurance required by the contract should be subject. The insurer will in most cases require a

minimum deductible, although a higher deductible could be required in the works contract. A higher deductible could reduce the cost of the insurance; however, if the risk insured against materializes, the loss up to the amount of the deductible will have to be borne by the party who bears that risk. If such a risk is borne by the contractor, he might include an increment in his price to account for that contingency.

13. It is advisable that the insurance programme for the works during construction and after completion be co-ordinated to the greatest extent practicable. The existence of numerous separate policies covering different risks and different parties and issued by different insurers, perhaps in different countries, often results in duplication of insurance against some risks and gaps with respect to insurance against other risks. It is often desirable to have a single policy cover as many of the risks and parties as possible. If separate policies are necessary, it may be desirable for them to be issued by the same insurer (see paragraphs 25 and 37, below).

14. A relatively new form of insurance is becoming available, which, in a single policy obtained by the purchaser, provides comprehensive coverage for a wide range of risks. This insurance, sometimes referred to as "wrap-up insurance", might present certain advantages over the traditional approach of having separate insurance policies covering different risks and taken out by several contractors, subcontractors, suppliers, engineers and other participants in the project. For example, it might in some cases be less costly than separate policies, and could provide co-ordinated coverage, avoiding the duplication and gaps which may exist under separate policies. However, at the time of this writing, this form of insurance is not without controversy, and the purchaser should consult with a professional risk manager or insurance specialist as to whether it may be appropriate in connection with the project. If the purchaser does obtain wrap-up insurance, he should be sure that he does not, either directly or indirectly, bear the cost of insurance taken out by contractors, subcontractors or other participants in the construction covering risks which are also covered by the wrap-up insurance.

15. The parties should be aware of any mandatory rules of law relating to insurance in connection with the construction of industrial works. For example, in many legal systems, an insured party must have a legal interest in the property which is the subject of the insurance or bear the risk insured against. In addition, the laws of some countries require that insurance covering loss, damage or injury occurring in connection with the construction of works in those countries be taken out with insurers in those countries. This could affect the scope of coverage available, and might make it necessary for insurance beyond that which is available locally to be obtained elsewhere. In addition, foreign exchange controls might require local insurers to pay their claims in the local currency. The parties may wish to take this into account in particular in connection with insurance covering equipment or materials to be incorporated in the works which can only be replaced from a source outside the country.

B. Property insurance

16. Except to a limited extent, property insurance (see paragraph 5, above) will not compensate for the costs of repairing or replacing defective equipment or materials supplied by the contractor or of portions of the works defectively constructed by him. In addition, property insurance usually will not insure against

loss of or damage to the works resulting from defective design or construction. However, property insurance is generally available where defectively designed or constructed portions of the works cause loss of or damage to other portions of the works. Loss or damage caused by defective design may be covered by professional indemnity insurance (see paragraph 30, below). It should be noted, however, that professional indemnity insurance normally covers only loss or damage resulting from negligent design. Thus, loss or damage resulting from non-negligent defects in the design will often not be covered either by property insurance or professional indemnity insurance. With respect to manufactured equipment to be incorporated in the works, however, it may be possible to obtain insurance covering defective materials, workmanship and design, whether or not due to the manufacturer's negligence.

1. *Insurance of works during construction, completed works, temporary structures and structures ancillary to works*

17. It is advisable for the contract to require insurance against loss of or damage to the works during construction, to the completed works and to temporary structures and structures ancillary to the works until the works has been accepted by the purchaser. After acceptance, the works should normally be covered by insurance obtained by the purchaser; however, the contract need not contain a provision to that effect. The parties may wish to consider whether the contract should also require insurance during the guarantee period to cover any additional construction which was not included in the works accepted by the purchaser, as well as any temporary structures and structures ancillary to the works which exist or remain during that period.

18. In a turnkey contract, and in other types of contracts in which the contractor bears the risk of loss of or damage to the entire works during construction and to the completed works prior to take-over or acceptance, it may be desirable for the contract to obligate the contractor to obtain insurance covering the entire works and to keep it in force (see, however, paragraph 6, above). Where an approach involving several contractors is adopted for the construction of the works (see chapter II, "Choice of contracting approach", paragraphs 17 to 25), and no single contractor bears the risk of loss of or damage to the entire works, the parties may wish to consider whether it is desirable for each contractor to obtain insurance covering the portion of the works and structures covered by his construction. This might result in the overlapping of insurance and duplication of insurance costs, and might present problems in administering claims for loss or damage involving two or more contractors. In such cases, it may be preferable for the purchaser to obtain insurance against loss or damage covering the works as a whole, and temporary structures and structures ancillary to the works. On the other hand, a contractor who has a continuing relationship with a particular insurer and an established and favourable claims history might be able to get more advantageous rates than would the purchaser. When one contractor, in addition to supplying equipment or performing construction services, is to co-ordinate construction by the other contractors, the parties may wish to consider whether that contractor should be obligated to provide and keep in force the insurance in respect of the entire works and of all structures.

19. The contract should stipulate who are to be named as insured parties in the insurance policy. It is normally desirable for both the contractor and the purchaser to be named, regardless of who bears the risk of loss to the insured items. A failure to name both parties could in some cases give an insurer who pays a claim to the named party, in respect of loss or damage caused by the party not named, a right of subrogation against the party not named. This could cause the non-named party to obtain his own insurance covering that liability, resulting in duplication of insurance and higher overall insurance costs. Moreover, naming both parties would entitle each of them to rights under the insurance policy, e.g., participation in legal proceedings under the policy and notification of any changes in insurance conditions.

20. Different approaches may be adopted with respect to the question of which risks should be required by the contract to be covered by the insurance. One approach may be to specify in the contract that the insurance must cover all loss or damage arising from any peril. The parties should be aware, however, that insurance satisfying such an all-encompassing requirement is unlikely to be available. Some insurers make available an insurance policy, sometimes designated as "all-risks" insurance, which insures against loss or damage from all perils, with the exception of certain specifically excluded perils (such as normal wear and tear, and pressure waves caused by aircraft). Loss or damage from some of the excluded perils may be insured against by special endorsements to the policy or under a separate policy, at additional cost. If the contract is to require that an insurance policy of this nature be provided, the parties should carefully consider whether the policy excludes any perils which present risks against which insurance should be provided, given the nature of the construction to be performed under the contract. It may in some cases be preferable for the contract to require an insurance policy of this nature and additional insurance against risks arising from perils excluded from the policy, than to attempt to itemize in the contract the specific perils which are to be covered by insurance.

21. The contractor may be exempted by the contract from bearing risks arising from certain perils (so-called "excepted risks"; see chapter XIV, "Passing of risk", paragraph 6). If that approach is adopted in the contract, it would be desirable, if possible, for the insurance which the contractor is obligated to obtain to cover even risks arising from those excepted risks. (However, certain of those risks, e.g., war and nuclear risks, may not be insurable.) Otherwise, the purchaser would have to obtain separate insurance for them. Such a division of insurance could lead to gaps in or unnecessary duplication of insurance, and higher insurance costs. Moreover, in the event of loss or damage, a time-consuming and costly dispute could arise as to whether the loss or damage was insured against under the insurance taken out by the contractor, or under that taken out by the purchaser.

22. The insurance of the works during construction, the completed works and temporary and ancillary structures will normally compensate for loss or damage to the property. It will usually not compensate for other types of losses, for example, lost profits, and increased loan-servicing costs resulting from the fact that, due to the loss or damage, the works could not be completed on time. However, those losses might be insurable by a special endorsement or policy. If the parties decide that those losses should be covered, that coverage should be specifically required in the contract.

23. It may be desirable for the contract to require the property insurance to compensate for the cost of repairing or replacing the lost or damaged portions of the works. The contract might also require the insurance to compensate for costs connected with the repair or replacement, such as architects', surveyors', lawyers' and engineers' fees, and costs connected with dismantling and removing the damaged portions. The amount of insurance required should be sufficient to cover all of the various types of losses to be compensated by the insurance (see paragraphs 9 to 12, above). The contract might therefore take into account the effects of inflation in determining the amount of insurance.

2. *Insurance of equipment and materials to be incorporated in works*

24. It is advisable for the contract to require insurance against loss of or damage to equipment and materials to be incorporated in the works. The contract might provide for the equipment and materials to be insured under a cargo policy from the point of shipment to delivery at the site. After delivery, they may be covered by the property insurance discussed in the previous sub-section of this chapter. In order to avoid problems arising from the difficulty of proving whether loss or damage occurred to an item while it was covered by the cargo insurance or by subsequent property insurance, the contract might require both policies to contain a clause whereby, in cases where it is impossible to prove whether the loss or damage occurred during a period covered by one policy or the other, each insurer will pay 50 per cent of the loss or damage. It may be noted that with cargo insurance, coverage is often available also against war risks, while those risks are often excluded from the property insurance discussed in the previous sub-section of this chapter.

25. Alternatively, it may be desirable in some cases for a single insurance policy to insure the equipment and materials for the entire period from the time of shipment to the time of incorporation in the works. If the equipment and materials were to be insured under separate policies for individual stages within this period (e.g., transit, storage off-site and storage on-site), incomplete or overlapping coverage could result. Moreover, insuring under a single policy would avoid questions as to the stage at which loss or damage occurred. Insurance covering equipment and materials during the entire period is available in some of the insurance policies described in paragraph 20, above. In the event that it is not possible to obtain insurance for the entire period in a single policy, the contract might require the separate policies providing insurance during the various individual stages to be taken out, if possible, with the same insurer.

26. The discussion in paragraphs 19 to 23, above, concerning the insured parties, risks to be insured against and the amount of insurance is equally applicable to insurance of equipment and materials to be incorporated in the works.

3. *Insurance of machinery and tools used by contractor for construction*

27. In some cases, the purchaser may have an interest in seeing that the machinery and tools used by the contractor for the construction (including hired machinery and tools) are insured against loss or damage, so that funds are available to have them replaced or repaired expeditiously and with minimal

interruption of the construction. This insurance will often be taken out and paid for by the contractor in the ordinary course of his business. The purchaser may wish to consult with a prospective contractor to make sure that the insurance is adequate. In particular projects, it may be desirable for the contract itself to obligate the contractor to obtain and maintain insurance, in an appropriate amount to be specified in the contract, against loss of or damage to the machinery and tools during shipment to the site, while they are stored off-site and while they are on the site, and to provide that the cost of the insurance is to be borne by the contractor. It may be possible for such coverage to be included in a comprehensive insurance policy insuring the works (see paragraph 14, above). The parties should be aware of the difficulties which could arise if the contractor were compelled to take out the insurance with an insurer in the country where the works is to be constructed (see paragraph 15, above).

C. Liability insurance

28. It is desirable for the contract to obligate the contractor to insure against his extra-contractual liability for loss of or damage to the property of the purchaser or of a third person, and for injury to any person, caused in connection with the contractor's performance of the contract, including acts or omissions of his employees, subcontractors and suppliers. In addition, the contractor might be obligated to insure against his liability under any indemnities which he assumes under the contract (e.g., undertakings by him to indemnify the purchaser against the purchaser's liability to third persons). A contractor will often maintain blanket insurance for some of these liabilities in the ordinary course of his business. This insurance should not be duplicated; rather, the purchaser may wish to consult with a prospective contractor concerning his existing coverage, and perhaps require him in the contract to obtain and maintain such additional insurance as is needed to cover fully the risks and term, and to meet the amount, as the purchaser may consider desirable.

29. Liability insurance will often not be available to insure the contractor against his liability to the purchaser for defective performance by the contractor of his obligations under the contract. However, some liability insurance policies may insure against the contractor's liability for loss of or damage to portions of the works not being worked on, resulting from acts or omissions of the contractor in the course of construction. It may be desirable for the contract to require such insurance. In addition, the contract might obligate the contractor to insure against his liability for loss of or damage to other property of the purchaser or to the property of a third person, and for injury to any person, due to a defect in the works constructed by him. While such coverage is often included in a liability insurance policy, it may be necessary for the contractor to obtain it under a separate products liability insurance policy.

30. If the contractor is to provide design or similar professional specialist services, it may be desirable for the contract to obligate him to obtain professional indemnity insurance. This insurance insures against the liability of the supplier of such specialist services for loss or damage caused to the purchaser or to third persons or their property as a result of the

negligent performance of the services. However, a contractor who both designs and constructs the works may have difficulty in obtaining this insurance.

31. Liability for loss of or damage to property and for personal injury arising out of the operation of motor vehicles owned or used by the contractor and subcontractors may have to be insured against separately. It may be desirable for such insurance, which is mandatory in many countries, to be specifically required by the contract. Coverage for liability arising out of the operation of aircraft and watercraft might also be required if they are to be used in the construction of the works.

32. Many legal systems have statutory schemes with respect to compensation for injury to workmen on the site and other employees of the parties and of subcontractors. Some of these schemes require employers to obtain insurance to compensate employees for work-related injuries. In other legal systems, workmen may be left to their remedies under general legal principles governing injury and damages. It may be desirable for the contract to obligate the contractor to obtain such insurance as is required under the law of the place where the works is to be constructed and other relevant laws. If insurance is not required by law, the purchaser may wish the contract to obligate the contractor to insure against his liability for injury to his employees and those of his subcontractors, particularly in respect of employees from the country where the works is to be constructed. Moreover, if under relevant laws insurance to compensate for injury suffered by employees is required in a certain amount, but an employee is able to recover an amount in excess of the required amount of insurance, insurance against this excess exposure might be required in addition to the insurance required by law.

33. Some countries have national social security schemes, rather than the statutory schemes mentioned above, under which injured employees may receive compensation from the State. Nevertheless, the contractor or subcontractor who caused the injury may remain liable for all or a portion of the loss suffered as a result of the injury, and the parties may wish to consider ensuring that that liability is covered by insurance.

34. In some legal systems, an injured employee of a contractor or a subcontractor may be able to recover compensation from the purchaser. Therefore, the contract might obligate the contractor to name the purchaser, as well as the contractor, as insured parties in the insurance described in the foregoing paragraphs (see also paragraph 37, below).

35. Employees of a contractor or subcontractor from a country other than the one where the works is to be constructed may have rights under employee compensation or social security schemes in their home countries. The parties may wish to see to it that the liabilities of the contractor, subcontractor and the purchaser in respect of those employees are also covered by insurance.

36. The contract might require the contractor to have the insurance discussed in this sub-section in effect prior to the time when he or any subcontractor commences construction on the site. The required insurance might cover loss, damage or injury occurring throughout the construction phase and the guarantee period. Insurance against liabilities which could arise after those periods (e.g., liability for loss of or damage to property or persons arising from defective equipment, materials or construction) might be required to be

maintained until the expiration of the applicable legal prescription or limitation period. Laws in some countries hold contractors liable for structural defects in the works for the first ten years of the life of the works, and make insurance against such liability mandatory.

37. Because of the possibility that a single incident resulting in loss, damage or injury to a third person could give rise to claims against several or all of the participants in the construction (e.g. purchaser, contractor and subcontractors), it is usually prudent for each of those participants to be insured against their liabilities for such loss, damage or injury. The most desirable way to accomplish this would be for all participants to be named as insured parties in one policy, if possible. If they were to be insured under separate policies, and if the loss, damage or injury suffered by a third person could have been caused by more than one participant, the various participants and their insurance companies may become involved in time-consuming and costly litigation to establish which participant should ultimately bear the loss or the extent to which the participants should contribute to the compensation payable to the claimant. If it is not possible for all participants to be insured under one policy, it would be desirable for all of the policies covering the various participants to be taken out with the same insurer. However, this, too, could be difficult to achieve in practice, particularly with several contractors and subcontractors from different countries, each having his own insurer.

D. Proof of insurance

38. In order for the purchaser to be able to satisfy himself that the contractor has performed his obligations to obtain insurance and to keep it in force, it is advisable for the contract to obligate the contractor to produce to the purchaser, within a specified period of time after being requested by the purchaser to do so, duplicates of the insurance policies, or certificates of insurance showing all of the relevant terms of the policies, and receipts for the payment of premiums. In addition, the contract might require the contractor to instruct his insurer to provide the purchaser directly with proof of insurance, and to notify the purchaser if a premium is not paid when due. The contract might similarly require the purchaser to provide to the contractor proof of insurance required to be obtained by the purchaser. If both parties are named as insured parties in the insurance policy, each party will usually have these rights automatically.

E. Failure of parties to provide insurance

39. The parties may wish to consider how to deal with the situation where the contractor fails to obtain or keep in force any insurance which he is required to provide. One approach may be to provide in the contract that the purchaser may notify the contractor requiring him to obtain or keep in force the insurance, and that if the contractor does not do so within a specified period of time, the purchaser may obtain the insurance himself. If the purchaser obtains the insurance himself, it would be desirable for him to be obligated to notify the contractor of that fact, so that the contractor does not duplicate the insurance. In a lump-sum contract, the purchaser might be permitted to deduct reasonable amounts paid by him for such insurance from sums due to the

contractor, or, alternatively, to recover those amounts from the contractor. In a cost-reimbursable contract, the purchaser might be permitted to deduct from sums due to the contractor, or recover from the contractor a reasonable amount equal to the difference between what the purchaser had to pay for the insurance and the cost of the insurance which would have been reimbursable by the purchaser to the contractor had the contractor fulfilled his obligation to obtain it or keep it in force.

40. In the exceptional cases where the purchaser is unable to obtain the insurance himself, another approach may be to enable the purchaser to terminate the contract if the contractor does not, within a specified period of time after notice by the purchaser, obtain the insurance or keep it in force. In addition the contract might provide for the contractor to be liable to the purchaser for any loss suffered by the purchaser as a result of the contractor's failure. In regard to liability insurance, the parties may wish to provide in the contract that, if the contractor fails to obtain or keep in force such insurance, the purchaser may suspend all payments due to the contractor under the contract until he duly obtains such insurance or keeps it in force.

41. In cases where the contract obligates the purchaser to obtain insurance and keep it in force and the purchaser fails to do so, the contract may entitle the contractor to notify the purchaser requiring him to obtain or keep the insurance in force, and, if the purchaser does not do so within a specified period of time, entitle the contractor to obtain the insurance himself. If the contractor obtains the insurance himself, it would be desirable for him to be obligated to notify the purchaser of that fact so that the purchaser does not duplicate the insurance. The contract may entitle the contractor to claim from the purchaser reasonable costs incurred in obtaining the insurance.

Chapter XVII. Security for performance

SUMMARY

Each party to a works contract may seek security against failure of performance by the other. A security in favour of the purchaser may be in the form of a guarantee, while that in favour of the contractor may be in the form of a guarantee or an irrevocable letter of credit in his favour (paragraph 1). Security interests in property are not a significant form of security for performance under works contracts (paragraph 2).

It is advisable for the works contract to set forth the forms of security to be furnished by each party, and the consequences of a failure to do so (paragraph 4). The law applicable to the security may contain mandatory provisions regulating certain aspects of the security (e.g., form and period of validity) (paragraph 6).

A guarantee for performance by the contractor may provide that, if specified failures to perform by the contractor occur, a third person is to be responsible for those failures in the manner described in the guarantee (paragraph 7). Guarantees of this type are used for the following purposes: that a contractor who has submitted a tender will not withdraw his tender before the date specified in the tender for awarding the contract (tender guarantees: paragraph 9); as security for proper performance under the contract (performance guarantees: paragraphs 9 to 12) and as security that an advance payment made by the purchaser to the contractor will be repaid to the purchaser (repayment guarantees: paragraphs 9 and 13). Performance guarantees may take the form of a monetary performance guarantee or a performance bond (paragraph 11).

The purchaser may wish to consider identifying in the invitation to tender the guarantors whom he is willing to accept. He may also wish to consider whether to specify that the guarantors must be institutions from his own country. There are advantages and disadvantages to these courses of action (paragraphs 14 to 16).

The terms of a guarantee may make a claim under the guarantee independent or accessory (paragraphs 17 to 19). Independent guarantees and accessory guarantees have their respective advantages and disadvantages (paragraphs 20 to 23). The parties may wish to provide that where a monetary performance guarantee is to be furnished, it is to be neither completely accessory nor a pure first demand guarantee (paragraph 24).

The guarantee may be furnished at the time the contract is entered into, or within a specifed period of time after it is entered into (paragraph 25). The extent of liability under a guarantee is normally limited to a stated amount (paragraphs 26 to 28).

The parties may wish to consider the effect of a variation of the scope of obligations under the works contract, or a termination of the contract, on the obligations of the guarantor, and to deal with this issue in a suitable

manner (paragraphs 30 to 34). They may also wish to consider the possible duration of the guarantee, and difficulties which may arise if the guarantee has a fixed expiry date (paragraphs 35 to 39).

As security for the payment of the price, the purchaser may be required to arrange for a guarantee (paragraph 40). Alternatively, the purchaser may be required to arrange for a letter of credit to be opened by a bank in favour of the contractor, the bank undertaking to effect payment up to a stated amount within a prescribed time limit against the presentation by the contractor of stipulated documents (paragraph 41). The contractor may wish to determine in the contract the bank which is to open the letter of credit (paragraph 42). It is important that the payment terms under the letter of credit and the payment conditions under the works contract be harmonized (paragraph 43). It is advisable for the parties to agree on the documents against the presentation of which the bank is to make payment (paragraph 44). It is also advisable for the parties to consider the period for which the letter of credit is to remain open (paragraph 45).

A. General remarks

1. A failure by a party to a works contract to perform his contractual obligations can cause considerable loss to the other party. While, under the works contract, the aggrieved party will have contractual remedies against the other for the failure, he may also wish to arrange for some form of security upon which he can rely in place of, or in addition to, his contractual remedies. The security may take different forms. A security in favour of the purchaser may be in the form of a guarantee (see paragraphs 7 and 9, below). A security in favour of the contractor may be in the form of a guarantee or an irrevocable letter of credit in his favour for the payment of the price (see paragraphs 39 and 40, below).

2. Security interests over the property of one party in favour of the other may also constitute a form of security for performance. Those security interests may be created independently of the agreement of the parties by the operation of mandatory provisions of law (e.g., a contractor who supplies labour and materials for construction may under some legal systems be given a security interest in the works constructed as security for payments due to him). They may also be created by agreement of the parties (e.g., a security interest in the construction machinery of the contractor may be created in favour of the purchaser as security for performance by the contractor). Security interests in property are not, however, a significant form of security for performance under works contracts.

3. It may be noted that a party may obtain protection against a failure to perform by the other party through means other than a security. The purchaser, for example, may obtain protection against a failure to perform by the contractor through the formulation of the payment conditions (see chapter VII, "Price and payment conditions", paragraphs 75 and 76), while the contractor, for example, may obtain protection against a failure by the purchaser to pay the price through a suspension clause which entitles him to suspend construction in the event of a failure (see chapter XXIV, "Suspension of construction", paragraphs 5 to 7).

4. It is advisable for the invitation to tender (where tender procedures are adopted) and for the works contract to set forth the forms of security to be furnished by each party, and the consequences of a failure by a party to do so.

Since the furnishing of security entails costs for the party who furnishes it, the parties may wish to determine the degree of protection that they reasonably require, and avoid over-protection. In addition, they may wish to compare the costs of different forms of security in order to secure the necessary protection with the minimum outlay.

5. The works contract may obligate a party to arrange for a security to be furnished through third persons, and determine the kind of security to be furnished (see sections B and C, below). However, the arrangements made by the obligated party with the third person with a view to furnishing the security required under the works contract will create a contractual relationship between them which is independent of the works contract. After the security is furnished, a third legal relationship will arise between the third person and the other party to the works contract in whose favour the security is furnished.

6. A law applicable to the security, which may not be the same as that applicable to the contract, may contain mandatory provisions regulating certain aspects of the security, such as its form and its period of validity. Where the security consists of a guarantee, the applicable law may contain mandatory provisions on, for example, who can give the guarantee (e.g., either by stipulating that it must be given by a financial institution in the purchaser's country, or by stipulating that it must be given by a financial institution which is authorized to issue guarantees involving payment in a foreign currency) or the rights arising from retention by the purchaser of the guarantee document after the expiry date of the guarantee. That law may also regulate the relationship between the security and the works contract. The parties should, therefore, take account of that law in determining the type of security to be furnished, and the contractual terms regulating the security. In addition, it may be necessary to take account of the law of the country of the person furnishing the security, which may contain mandatory provisions regulating the issuance of the security, or imposing ceilings on the amounts which may be guaranteed.

B. Security for performance by contractor: guarantees

7. Guarantees of the kind dealt with in this chapter provide that, if specified failures to perform by the contractor occur, a third person (the guarantor) will be responsible for that failure in the manner described in the guarantee. The term "guarantee" is not the only term used to describe such agreements, and the terms "bond", "suretyship agreement" and "indemnity" are sometimes used. In some countries, banks are prohibited from issuing guarantees. However, "standby letters of credit", having the same function as guarantees, may be issued by banks. In the context of a works contract, a standby letter of credit may be issued by a bank on the instructions of the contractor in favour of the purchaser (the beneficiary) to provide security for the purchaser in the event of a failure to perform by the contractor. The purchaser is entitled to claim funds up to a stated limit from the bank in the circumstances specified in the standby letter of credit (e.g., upon the presentation of stipulated documents). Accordingly, the discussion in section B on guarantees for security of performance by the contractor applies to standby letters of credit.[1]

8. The guarantees dealt with in this chapter are to be distinguished from guarantees of quality. The latter type of guarantee consists of contractual

undertakings by a party warranting the quality of his performance, e.g., that equipment or materials to be supplied by him will be of a stated quality. That type of guarantee is dealt with in chapter V, "Description of works and quality guarantee", paragraphs 26 to 31.

9. Guarantees as security in favour of the purchaser are frequently used in the following contexts:

(*a*) As security that a contractor who has submitted a tender will not withdraw his tender before the date specified in the invitation to tender, that he will enter into a contract if the contract is to be concluded with him, and that he will submit any performance guarantees (see below) specified in the invitation to tender. These guarantees, commonly known as tender guarantees, are dealt with in chapter III, "Selection of contractor and conclusion of contract", paragraphs 28 to 30;

(*b*) As security against loss that a purchaser might suffer if a contractor who has entered into a contract fails to perform in accordance with the contract. These guarantees are commonly known as performance guarantees;

(*c*) As security that an advance payment made by the purchaser to the contractor will be repaid, if so required by the contract. These guarantees are commonly known as repayment guarantees.

1. *Performance guarantee: function*

10. A purchaser who is entering into a works contract will seek a contractor who possesses the financial as well as the technical and operational resources needed to complete the work. Often, however, a purchaser may not have full information concerning a prospective foreign contractor's finances, the extent of his other work commitments (which could interfere with his performance), his prior performance record, or other factors bearing on the contractor's ability to see the project through to completion. Furthermore, unforeseen factors occurring after the contract is entered into may affect the contractor's ability to perform the contract. Invitations to tender and works contracts may therefore provide that performance guarantees must be furnished by the contractor, so that means are available to satisfy the liabilities of the contractor in the event of a failure to perform. Requiring performance guarantees may have the additional advantage of preventing contractors who are unreliable or have no financial resources from tendering. Guarantor institutions generally make careful inquiries about the contractors whom they are asked to guarantee, and will normally provide guarantees only when they have reasonable grounds for believing that the contractor can successfully perform the contract.

11. Performance guarantees are generally of two types. Under one type, hereinafter referred to as a "monetary performance guarantee", the guarantor undertakes only to pay the purchaser funds up to a stated limit to satisfy the liabilities of the contractor in the event of the contractor's failure to perform. Monetary performance guarantees, which may take the form of a standby letter of credit, are often furnished by banks. Under the other type, hereinafter referred to as a "performance bond", the guarantor at his option undertakes either himself to cure or complete defective or incomplete construction effected by the contractor, or to obtain another contractor to cure or complete the

construction, and also to compensate for other losses caused by the failure to perform. The value of such undertakings is limited to a stated amount. The guarantor under a performance bond also frequently reserves the option to discharge his obligation solely by the payment of money to the purchaser up to the stated amount. This type of guarantee is generally furnished by specialist guarantee institutions, like bonding and insurance companies. The purchaser may wish to specify in the invitation to tender which of the two types of guarantee is to be furnished by a tendering contractor. Alternatively, he may permit a tendering contractor to furnish either type of guarantee, as the contractor may have business relations with a guarantor institution willing to make available one or other of those types to the contractor at an inexpensive rate. From the point of view of the purchaser, each type of guarantee has its own advantages and disadvantages (see paragraphs 20 to 23, below). For the possible relevance of liability insurance in this connection, see chapter XVI, "Insurance", paragraph 29.

12. In most works contracts, the contractor undertakes not merely to complete the construction, but also to cure defects notified to him by the purchaser before the expiry of the period of the quality guarantee (see paragraph 8, above). The contractor's performance during this guarantee period may be secured either by the same performance guarantee which covers performance up to the acceptance of the works, or by a separate performance guarantee, sometimes called a maintenance guarantee. The considerations set forth below as relevant to a performance guarantee are also relevant to a separate maintenance guarantee.

2. *Repayment guarantee: function*

13. In order to assist the contractor in the mobilization of capital necessary to commence construction (e.g., the purchase of construction machinery and materials), a purchaser often makes an advance payment to the contractor of part of the price (see chapter VII, "Price and payment conditions", paragraph 67). To protect the purchaser against failure of repayment by the contractor, the contract may provide that the contractor must furnish a monetary performance guarantee which secures the repayment to the purchaser of the advance payment in case the contractor does not do so.

3. *Choice of guarantor*

14. The purchaser may wish to consider naming in the invitation to tender specified guarantors whom he is willing to accept. The purchaser may also wish to consider whether to specify that the guarantors must be institutions from his own country. The advantage of specifying guarantors is that guarantors may be identified who have the financial reserves to satisfy the obligations in the guarantee, and have a satisfactory record of settling claims. The advantage of specifying that guarantors must be institutions from the purchaser's country is that guarantees furnished by those institutions can be more easily enforced by the purchaser. In some countries, mandatory regulations provide that only guarantees furnished by local institutions may be accepted by purchasers.

15. Possible disadvantages to the purchaser in naming specific guarantors are that some potential contractors with no access to the specified guarantors may be prevented from tendering, while others may be prevented from using guarantors with whom they have a close relationship and who are willing to provide them with guarantees inexpensively. Possible disadvantages of the purchaser specifying that the guarantors must be institutions from his own country are that those institutions may charge more for guarantees (e.g., when they have to obtain counter-guarantees from foreign institutions in order to ensure that convertible currency is available to satisfy possible payment obligations). They may also not be prepared to give certain forms of guarantees, such as performance bonds. Furthermore, a first-class financial institution from a country which is neither that of the purchaser nor of the contractor might be as dependable as an institution in the purchaser's country, although it may be more difficult for the purchaser to enforce a guarantee as given by such an institution as compared to a guarantee given by an institution in his own country.

16. A possible approach is to provide in the invitation to tender and in the contract that contractors who tender may in the first instance submit guarantors of their choice. Where the guarantors submitted are not acceptable to the purchaser, the contractors may be required within a specified period of time to submit different guarantors acceptable to the purchaser, or to have the guarantees furnished by the guarantors confirmed by a financial institution in the purchaser's country. A guarantee involving confirmation may, however, entail more expense than one involving a single financial institution.

4. *Nature of guarantor's obligation*

17. The terms of the guarantee, and the law applicable to the guarantee, will establish the legal relationship between the purchaser and the guarantor and determine in what circumstances a claim may successfully be made under the guarantee. Those terms may make the guarantee independent of the works contract or accessory to it. Under an independent guarantee (often called a first demand guarantee), the guarantor is obligated to make payment on demand by the purchaser, and the latter is entitled to recover under the guarantee upon his bare statement that the contractor has failed to perform. The guarantor is not entitled to refuse payment on the ground that there has in fact been no failure to perform under the works contract; however, under the law applicable to the guarantee the right of the purchaser to claim under the guarantee may in very exceptional circumstances be excluded (e.g., when the claim by the purchaser is fraudulent). Under a standby letter of credit, the issuing bank is obligated to make payment upon the presentation by the purchaser to the bank of a document containing his bare statement that the contractor has failed to perform. As with an independent guarantee, the bank is not entitled to refuse payment on the ground that there has in fact been no failure to perform under the works contract, although under some legal systems in exceptional circumstances the bank may be restrained from making payment.

18. It is advisable for the works contract to provide that, even when the guarantee is independent, the purchaser is entitled to claim under the guarantee only if there is in fact a failure to perform by the contractor. If the purchaser makes a claim when there has been no failure to perform, the purchaser will be liable in damages to the contractor for loss suffered as a result of the improper claim.

19. A guarantee is accessory when the obligation of the guarantor is linked to evidence of liability of the contractor for failure to perform under the works contract. The nature of the link may vary under different guarantees, e.g., the purchaser may have to establish the contractor's liability by producing an arbitration award which holds that the contractor is liable. Performance bonds usually have an accessory character.

20. The advantage to the purchaser of a first demand guarantee is that he is assured of prompt recovery of funds under the guarantee, without evidence of failure to perform by the contractor or of the extent of the purchaser's loss. A purchaser may frequently lack the technical knowledge required to prove the contractor's failure to perform. Furthermore, guarantors furnishing monetary performance guarantees, in particular banks, prefer first demand guarantees, as the conditions are clear as to when their liability to pay accrues, and they are not involved in disputes between the purchaser and the contractor as to whether or not there has been a failure to perform under the works contract.

21. A disadvantage to the purchaser of a first demand guarantee is that a contractor who furnishes such a guarantee may wish to take out insurance against the risk of recovery by the purchaser under the guarantee when there has been in fact no failure to perform by the contractor, and to include in the price the cost of that insurance. The contractor also may include in the price the potential costs of any action which he may need to institute against the purchaser to obtain the repayment of the sum improperly claimed under the guarantee. In addition, since the purchaser can obtain the sum payable under the guarantee upon his bare statement that the contractor has failed to perform (see paragraph 17, above), the contractor may wish to fix the sum payable under the guarantee at a small percentage of the contract price, and thereby limit the loss he may suffer through having to indemnify the guarantor in the event of a claim by the purchaser when there has been no failure to perform.

22. A disadvantage to the contractor of a first demand guarantee is that, if there is recovery by the purchaser under the guarantee when there has been no failure to perform by the contractor, the latter may suffer immediate loss through the guarantor reimbursing himself from the assets of the contractor after payment to the purchaser, and also experience difficulties and delays in compensating himself for that loss through the subsequent recovery from the purchaser of the sum improperly claimed.

23. The terms of a performance bond (see paragraph 11, above) usually require the purchaser to prove the failure of the contractor to perform, and the extent of the loss suffered by the purchaser. Furthermore, the defences available to the contractor if he were sued for a failure to perform are available to the guarantor. Accordingly there is a possibility that the purchaser will face a protracted dispute when he makes a claim under the bond. However, as a reflection of the lesser risk borne by the guarantor, the monetary limit of liability of the guarantor may be considerably higher than under a first demand guarantee. A performance bond may also be advantageous if the purchaser cannot conveniently arrange for the cure or completion of construction himself, but would need the assistance of a third person to arrange for cure or completion. Where, however, the construction involves the use of a technology known only to the contractor, cure or completion by a third person may not be feasible, and a performance bond may not have the last-mentioned advantage over a monetary performance guarantee.

24. The manner in which guarantees are to be formulated may be agreed between the purchaser and the contractor, though the formulation agreed to must also be acceptable to the guarantor. The parties may wish to provide that where a monetary performance guarantee is to be furnished, it is to be neither completely accessory nor a pure first demand guarantee. In deciding on the terms of such a guarantee, they may wish to consider one of the following possible arrangements:

(*a*) That the guarantor is obligated to make payment only if the demand is made in writing, and is accompanied by a written statement identifying the failure to perform which has resulted in the demand. The guarantor would, however, be under no duty to investigate the correctness of the statements made regarding the failure to perform;

(*b*) That before making a claim under the guarantee, the contractor must be given notice of the failure to perform in respect of which a claim is to be made, and that the claim can be made only after the lapse of a specified time period from the delivery of that notice. The existence of an interval between the notice and the claim may enable negotiations to take place between the purchaser and the contractor with a view to settling the dispute between them;

(*c*) That on demand by the purchaser, in cases where a dispute exists between the purchaser and the contractor as to whether the contractor has failed to perform, the guarantor is obligated to make payment not to the purchaser but to a third person. The third person would hold the money until the dispute between the purchaser and the contractor was decided in dispute settlement proceedings, and he would thereafter hand over the money in accordance with the decision;

(*d*) That the guarantor is obligated to make payment only if the demand of the purchaser is accompanied by a certificate of the consulting engineer, or an independent third person, deciding that there has been failure to perform by the contractor.

5. *Time of furnishing guarantee*

25. Disputes between the parties as to the terms and nature of guarantees to be furnished may be minimized if the guarantee becomes effective concurrently with the parties' entering into the contract. Alternatively, the parties may wish to provide that the guarantee is to be furnished within a specified period of time after the contract is entered into, since this may be less expensive. In order to assure the purchaser that a contractor with whom a contract was or is to be concluded will furnish the required performance guarantee, the tender guarantee to be furnished may provide that it is not to expire until the performance guarantee is furnished (see chapter III, "Selection of contractor and conclusion of contract", paragraphs 28 to 30). The parties may also wish to agree on the purchaser's rights under the works contract in case the guarantee is not furnished within the specified period of time, for example, that he may terminate the contract and recover damages. However, before deciding to rely on this remedy, the purchaser may wish to consider possible difficulties in enforcing an unsecured right to damages in a foreign country. Another approach is for the invitation to tender to require that a tender is to be accompanied by a certificate from an institution qualified to be a guarantor to the effect that, if the contract were concluded with the tenderer, the institution

would be prepared to give a performance guarantee of the kind required in the invitation to tender. However, under many legal systems the institution could not be compelled by the purchaser to give the guarantee if it subsequently refused to do so.

6. *Extent of liability under guarantee*

26. The liability of the guarantor is normally limited to a stated amount. In the case of a performance guarantee, this amount may be determined as a percentage of the contract price, and in the case of a repayment guarantee as a percentage of the advance payment. The exact percentage may be determined by an assessment of the risk of a failure to perform, of the losses likely to be suffered by a failure, and by a consideration of the limits which guarantors would usually observe when providing guarantees in respect of the construction of the type of works in question. A requirement of a very large guarantee sum may prevent smaller enterprises from tendering, as they might be unable to obtain guarantees for that sum. The parties may also wish to determine the currency in which payment is to be made under the guarantee. In the case of both repayment guarantees and performance guarantees, it may be the currency in which the contract price is to be paid. If the price is to be paid in more than one currency, a particular currency may have to be specified.

27. Where a guarantee is accessory (e.g., in the case of a performance bond), the law applicable to the guarantee may provide that the extent of liability of the guarantor under the guarantee is co-extensive with that of the contractor to the purchaser under the works contract (e.g., in respect of the types of losses which are compensable). If, therefore, under the works contract or the law applicable to the works contract the liability of the contractor to the purchaser is limited, the guarantor's liability would be limited to the same extent. If, however, the law applicable to the guarantee is not clear as to whether the guarantor's liability is coextensive with that of the contractor, the parties may wish to so provide in the guarantee.

28. The parties may also wish to consider whether the works contract and the guarantee are to provide that the amount of the guarantee is to be reduced after contract performance has progressed to a specified stage. In respect of performance guarantees one approach is to make no provision for a reduction. This may be justified by the view that a failure to perform even at a late stage of the construction may require for its compensation the full amount of the guarantee. Furthermore, the parties should be aware that some failures of performance, such as delay, tend to occur after construction is well under way, and not at the early stages. It may, however, be acceptable to provide for a reduction upon acceptance of the works by the purchaser, since the completion tests and performance tests held prior to acceptance (see chapter XIII, "Completion, acceptance and take-over", paragraphs 4 and 24) will have shown that performance by the contractor has been free of serious defects (see chapter XVIII, "Delay, defects and other failures to perform", paragraph 27).

29. In order to give the purchaser a comprehensive security, the guarantee may provide that liability under it arises upon any failure to perform an obligation to which the guarantee relates. Thus, in respect of a performance guarantee, liability under the guarantee may arise upon any defective performance or delay in performance.

7. *Effect of variation or termination of contract*

30. The parties may wish to consider the effect of a variation of the scope of obligations under the works contract (see chapter XXIII, "Variation clauses") on the obligations of the guarantor. A variation is of concern to the guarantor, since it may result in a substantial extension of the contractor's responsibilities and thereby increase the risk to which the guarantor is exposed. In the case of a performance bond, an extension may also affect the guarantor's capability to cure or complete defective or incomplete construction (see paragraph 11, above). Under some legal systems, unless otherwise provided in the guarantee, an alteration of the underlying contract may operate to release the guarantor; under others, the guarantee may be deemed to cover only obligations of the contractor existing at the date of the issuance of the guarantee. Since variations are frequently made during the performance of a works contract, it is advisable for the guarantee to determine the effect on it of a variation of the contract.

31. Different approaches may be adopted. If the amount of the guarantor's liability is limited to a stated amount, and the duration of the guarantee is also limited (see paragraphs 35 to 38, below), the guarantor may be prepared to assume the obligations as so limited even if variations to the contract may to some extent increase the likelihood that a failure to perform will occur. In those cases, the guarantee may provide that it remains valid as limited by its original terms despite any variation of the contract. Another approach may be for the guarantee to provide that it is to remain valid as limited by its original terms despite variation of the contract, provided that variations do not collectively result in an increase in the contract price by more than a stated percentage of the price. If the stated percentage is exceeded, the consent of the guarantor may be required for the guarantee to remain valid. Yet another approach may be to provide that the guarantee is to remain valid only in respect of the contractual obligations that are not varied; if the guarantee is to remain valid in respect of obligations that are varied, the consent of the guarantor may be required.

32. It is advisable to ensure that the provisions in the contract concerning variations and those in the guarantee concerning the effect of variations on the guarantee are in harmony. For example, if the contract gives the purchaser a unilateral right to order certain types of variations (see chapter XXIII, "Variation clauses", paragraphs 12 to 18), it is advisable for the guarantee to provide that it is not invalidated by the exercise of that right, and that the guarantee continues to apply to the obligations as varied. A lack of harmony may deter the purchaser from exercising his right.

33. Provisions in the guarantee which would maintain its validity despite a variation of the contract may not suffice to protect the purchaser in certain situations. The variation of the contract may extend the period for performance by the contractor, or impose greater responsibilities on him which in turn may increase the extent of his liability in the event of a failure to perform. The parties may therefore wish to provide in the works contract that in those cases the contractor is obligated to ensure that the guarantor makes appropriate modifications to the expiry date, amount or other relevant terms of the guarantee. The cost of arranging for such modifications may be borne by the party bearing the cost of the variations (see chapter XXIII, "Variation clauses", paragraph 8).

34. The parties may also wish to deal with the situation where the contract is terminated prior to the expiry date of the guarantee (see paragraph 36, below). The parties may wish to provide that claims may be made under the guarantee up to its expiry date despite the termination.

8. *Duration of guarantee*

35. It is in the interest of the purchaser that the guarantee cover the full period during which any obligation of the contractor guaranteed may be outstanding. Thus, a performance guarantee may cover not only the period during which the construction is to be effected, but also the period covered by the quality guarantee (see paragraph 12, above).

36. Institutions providing a guarantee may require it to have a fixed expiry date on which the obligations of the guarantee are to cease. Commercial banks, in particular, will generally insist that a fixed expiry date be specified in monetary performance guarantees furnished by them. One technique used to delimit the period covered by a monetary performance guarantee is to provide in the guarantee that claims may not be made under the guarantee after a specified date. In such cases, the parties may wish to agree at the time of entering into the contract upon a date to be inserted in the guarantee, calculated on the basis of an estimated period of time for the completion of performance of the obligations to be guaranteed. However, while such a fixed date may satisfy the interests of the guarantor, it may create difficulties for the purchaser, since for various reasons the period of time for the performance of the contractor's obligations may extend beyond the fixed date, e.g., because of delay in performance by the contractor, or by the operation of exemption clauses (see chapter XXI, "Exemption clauses", paragraph 8). Accordingly, it is advisable for the works contract to provide that, should the performance of the contractor's obligations be extended beyond the expiry date of the guarantee, the contractor is obligated, upon the request of the purchaser, to arrange within a reasonable time after the request, an extension of the period of validity of the guarantee for such further period as is necessary for the complete performance of the contractor's obligations. It is advisable for the purchaser's request to be made in sufficient time to enable the contractor to arrange for the extension before the date when the guarantee is to expire. The party responsible for the extension of the performance of the contractor's obligations may be obligated to bear the costs of the extension of the guarantee period.

37. If the guarantor under a performance bond does not insist on a fixed expiry date, the bond may continue to cover the obligations guaranteed until their complete performance. However, because of the accessory character of the bond, the guarantor will cease to be liable when the contractor has performed his obligations even if no expiry date had been specified in the bond. Another approach may be for the performance bond to provide that claims may not be made after the date of the payment to the contractor of the final instalment of the price. The final instalment would be paid only after the purchaser was satisfied that the contractor had performed his obligations, and that, accordingly, it would be reasonable to exclude the making of claims against the guarantor after that date (see chapter VII, "Price and payment conditions", paragraph 76).

38. The parties to the works contract should be aware that, under some legal systems, a guarantee may remain in force beyond the term stated in the guarantee if it is not returned or delivered up by the purchaser. It is therefore advisable for the contract to obligate the purchaser to return the guarantee promptly upon fulfilment of the guaranteed obligation.

39. Providing for expiry of a repayment guarantee on a fixed date may present the same difficulties as may arise in respect of the expiry of a performance guarantee on a fixed date (see paragraph 36, above), and the approaches adopted in relation to performance guarantees may be adopted in relation to repayment guarantees. If, however, the guarantor does not insist on a fixed expiry date, a possible approach may be to provide for the guarantee to expire when the contractor has supplied equipment, materials and services in the value of the guarantee amount. That supply may be proved either by a certificate of the consulting engineer or the purchaser, or by documents evidencing supply (e.g., invoices or transport documents certified by the purchaser, or site receipts from the purchaser's representatives).

C. Security for payment by purchaser: guarantees or letters of credit

40. The parties may wish to consider whether the contract should require security for the performance of the main obligation of the purchaser, i.e., the payment of the price (see chapter VII, "Price and payment conditions"). One approach that the parties might adopt is to provide in the works contract that the purchaser is obligated to pay the price, and to further obligate him to arrange for a guarantee to be furnished by a third person under which that third person undertakes to pay the price if the purchaser fails to pay it. If this approach is adopted, the parties may wish to consider the contents of section B, above, in deciding on the terms of the guarantee. The guarantee could consist of a standby letter of credit.

41. An alternative approach which would assure the contractor of payment is to provide that the price is to be paid under an irrevocable documentary letter of credit opened by a bank on the instructions of the purchaser. Such a letter of credit consists of an irrevocable written undertaking by a bank (the issuing bank) given to the contractor. The bank undertakes to effect payment up to a stated amount within a prescribed time-limit against the presentation by the contractor of stipulated documents. Under this approach, the contractor would be entitled to claim the price as it fell due direct from the bank.

42. The contractor may wish to determine in the contract the bank which is to open the letter of credit. One approach may be to provide that the letter of credit is to be opened by any recognized bank. The contractor may, however, obtain greater security if the contract requires the letter of credit to be opened by a bank in the contractor's country, or to be opened by a bank situated outside the contractor's country but confirmed by a bank in the contractor's country. Under a confirmation the confirming bank accepts a liability equivalent to that of the opening bank. Confirmation by a bank in the contractor's country would enable the contractor to recover payment under a letter of credit without facing administrative difficulties in the transfer of funds, or difficulties created by exchange control or other financial regulations in the purchaser's country. However, requiring such confirmation may increase the

costs to the purchaser of arranging for the issuance of the letter of credit. The parties may also wish to agree on the time when the letter of credit is to be opened. The contractor may prefer to have the letter of credit opened concurrently with the parties entering into the contract, as he will then have security covering the earliest instalments of the price to fall due. The parties may wish to agree on the contractor's rights under the works contract in case the letter of credit is not opened at the time agreed upon, for example, that he may terminate the contract and recover damages.

43. The terms of payment to be required by the works contract in the letter of credit may be agreed taking into account the commercial practices of banks in relation to letters of credit and the costs of different possible arrangements. It is important that the payment terms under the letter of credit be harmonized with the payment conditions under the contract (e.g., in respect of the currency of payment, the amount of each instalment payable, and the time of payment). The parties may wish to consider how the amount payable under the letter of credit should be quantified. The contract may specify the total amount which may be claimed under the letter of credit to be the full amount of the contract price. The various instalments of the price could be claimed from the bank as they fell due. An alternative approach which might be less expensive to the purchaser is to provide that the amount which may be claimed under the letter of credit is to remain constant during the period of validity of the letter of credit, so that whenever a claim is paid under the letter of credit that amount becomes immediately available again automatically. That amount could be fixed, not at the full amount of the contract price, but at a sum sufficient for the payment of any one of the instalments of the price falling due. The letter of credit would also limit the total amount cumulatively payable under it to the amount of the contract price.

44. It is advisable for the parties to agree clearly on the documents against which the bank is to make payment, and the wording and data content of those documents. The required documents may be such as would evidence the supply of equipment, materials or services under the works contract, and may accordingly be of different types (e.g., certificates of the consulting engineer evidencing the progress of construction, certificates of an inspecting organization, or site receipts by the purchaser's representatives in respect of the supply of equipment or materials).

45. It is advisable for the contractor to require that the letter of credit cover the full period during which any payment obligation of the purchaser may be outstanding. The bank opening the letter of credit may insist that it have a fixed expiry date. Determining the expiry date may present difficulties, for while the payment conditions in the contract may specify a date by which payment is to be completed, that date may be postponed for various reasons (e.g., delay in performance by the contractor, or exempting impediments preventing construction or payment). A possible approach may be to fix the expiry date of the letter of credit by adding to the date specified in the contract by which payment is to be completed a reasonable period for possible postponements of that date. Another possibility is for the contract to provide that, should the performance of the payment obligations of the purchaser be extended beyond the expiry date of the letter of credit, the purchaser is obligated, upon the request of the contractor, to arrange for an extension of the period of validity of the letter of credit for such further period as is necessary

for complete performance. The party responsible for the extension of the payment obligations may be obligated to bear the costs of the extension of the period of validity. If the purchaser fails to arrange for an extension, the contractor may be entitled to the same remedies to which he would be entitled in the event of a failure by the purchaser to pay the amount of the price to be covered by the extended letter of credit (see chapter XVIII, "Delay, defects and other failures to perform", paragraphs 57 and 58).

Footnote to chapter XVII

[1]Documentary letters of credit, including standby letters of credit that call for payment against a document, are usually governed by the Uniform Customs and Practice for Documentary Credits of the International Chamber of Commerce. The Uniform Customs and Practice set forth rules relating to the opening and operation of letters of credit. The Commission, at its seventeenth session in 1984 (A/39/17, paragraph 129) commended the use of the latest revision of the Uniform Customs and Practice (ICC Document No. 400).

Chapter XVIII. Delay, defects and other failures to perform

SUMMARY

This chapter deals with certain remedies to which the purchaser may be entitled for delayed or defective performance by the contractor. It also deals with the remedies to which the contractor may be entitled in respect of the following failures to perform by the purchaser: delay in payment of the price or in providing security for payment of the price; delay in taking over or accepting the works; and failure to supply design, equipment or materials for construction. It also deals with the remedies available to both parties for delay in payment of sums other than the price, or the failure to perform auxiliary obligations. It is advisable that the contract specify the remedies for the failures to perform mentioned above. In drafting contractual provisions on remedies, account should be taken of the remedies provided by the law applicable to the contract (paragraphs 1, 2, 6 and 7).

Delay in performance occurs when a party performs his contractual obligations later than the time stipulated in the contract for their performance, or does not perform them at all. Defective performance occurs when a party fails to comply with those contract terms which describe the technical characteristics of the construction to be effected (paragraph 4).

Because of the complex and long-term character of the performance undertaken by the contractor under a works contract, the purchaser needs a detailed system of remedies. The system of remedies set forth in this chapter emphasizes two elements: the initial remedy usually given to the purchaser is to require the completion or cure by the contractor of performance which is delayed or defective; and the remedy of termination is given as one of last resort (paragraphs 9 to 12).

It is sometimes recommended that the purchaser be given a choice of alternative remedies upon certain failures to perform by the contractor. The contract may provide that the purchaser may not alter a choice of remedy he has made unless the contractor consents to the alteration. When the contractor is required to cure defects, it may be provided that he is to have freedom as to the manner in which the cure is to be effected (paragraphs 14 and 15).

In view of the detailed character of the system of remedies given to the purchaser, this chapter sets out in paragraph 50 a summary of those remedies.

The purchaser may delay in payment of the price or in providing security for payment of the price (paragraph 52). The parties may wish to provide for the payment of interest if the purchaser delays in payment of the price (paragraphs 53 to 56). Where the purchaser is in delay in paying a specified percentage of the price, or in furnishing security for payment of a specified percentage of the price, the contract may entitle the contractor to grant the purchaser an additional period of time to perform, and if the

purchaser fails to perform within the additional period, to suspend the contract and, if the failure continues for a specified period after the suspension, the contractor may be entitled to terminate the contract. Alternatively, the contract may entitle the contractor to immediate termination of the contract, if the purchaser fails to pay or furnish security within the additional period (paragraphs 57 and 58).

The contract may provide that acceptance of the works by the purchaser is deemed to occur in certain circumstances. In cases where this approach is not feasible in regard to acceptance, and in all cases of take-over, the contract may provide that, where the purchaser is in delay in accepting or taking over, the contractor is entitled to require the purchaser to accept or take over within an additional period. If he fails to accept or take over within the additional period, the contract may provide that the consequences of acceptance or take-over arise as from the date when a written notice stating that the consequences are to arise is delivered to the purchaser (paragraphs 59 to 61).

The contract may specify the remedies to which the contractor may be entitled if the purchaser fails to supply a design, equipment or materials which he is obligated to supply, e.g., to require the purchaser to supply the design, equipment or materials within an additional period, and if the purchaser fails to do so, to terminate the contract (paragraphs 62 and 63).

The contract may specify the remedies to which a party may be entitled if the other party is in delay in payment of a sum other than the price, or fails to perform an auxiliary obligation (paragraphs 64 to 66).

A. General remarks

1. Strict adherence to contract terms relating to the performance of obligations is particularly important in works contracts, as a failure by a party to adhere to those terms could have serious financial repercussions for the other party. The issues of whether a failure of performance has occurred and, if so, what are the legal consequences of the failure, are frequently the cause of long and complicated disputes. It is therefore advisable to agree upon clear contractual stipulations defining the obligations to be performed, and the consequences of a failure to perform those obligations (see chapter IV, "General remarks on drafting" and chapter V, "Description of works and quality guarantee").

2. This chapter deals with some of the remedies which might be available under the contract to a party if the other party fails to perform his obligations under the contract or under the law applicable to the contract.

3. It may be noted that the *Guide* envisages that a failure to perform an obligation by a party usually gives the other party a right to recover damages, unless performance was prevented by an exempting impediment (see chapter XX, "Damages" and chapter XXI, "Exemption clauses"). The parties may also have provided for the payment of an agreed sum upon a failure to perform certain obligations (see chapter XIX, "Liquidated damages and penalty clauses"). The parties should note that the remedies discussed in this chapter may be supplemented by the recovery of damages or payment of an agreed sum.

4. As used in the *Guide*, the term "failure to perform" covers two situations, i.e., delay in performance and defective performance. Delay in performance

occurs when a party performs his contractual obligations later than at the time stipulated in the contract or in the law applicable to the contract, or does not perform them at all. A party will be in delay from the date when performance of an obligation is due until the date when he performs it, or until the date on which the contract is terminated or the obligation becomes otherwise extinct. However, the contract may provide that a party is not entitled to exercise the remedy given to him for delay by the other party if the delay is due to an act or omission of the first party or a person engaged by him (see pararaphs 16 and 66, below). Defective performance occurs when a party fails to comply with those contract terms which describe the technical characteristics of the equipment, materials and construction services to be supplied, and of the works to be constructed (see chapter V, "Description of works and quality guarantee", paragraphs 8 and 9, chapter VIII, "Supply of equipment and materials", paragraphs 6 and 7, and chapter IX, "Construction on site", paragraph 2).

5. For practical reasons, the contract may provide that the construction is to be considered as completed even if completion tests disclose that certain minor items are missing (e.g., items the absence of which does not prevent the operation of the works; see chapter XIII, "Completion, take-over and acceptance", paragraph 4). In respect of such missing items, the contract may give the purchaser the same remedies as it gives him for defects in the accepted works (see paragraphs 38 to 42, below).

6. It is advisable for the parties to consider what remedies are to be available for delay in construction by the contractor (see section B, 2, below), for defective construction by the contractor (see section B, 3, below), for delay by the purchaser in providing security for payment of the price, or in payment of the price (see section C, 2, below), for delay by the purchaser in taking over or accepting the works (see section C, 3, below) and for a failure by the purchaser to supply the design, equipment or materials for construction (see section C, 4, below). In addition, it is advisable that the parties consider what remedies are to be available for delay by the contractor in paying a sum of money due to the purchaser, and for delay by the purchaser in paying a sum of money other than the price (see section D, 1, below). The parties may also wish to consider the remedies that a party might have if the other party fails to perform an auxiliary obligation (see section D, 2, below). The parties may wish to provide that the engagement by a party of another person to perform his contractual obligations does not diminish or eliminate the liability of the party for a failure to perform those obligations (see also chapter XI, "Subcontracting", paragraph 27).

7. In determining the remedies to be provided in the contract for failure to perform, the parties should take into consideration the remedies provided under the law applicable to the contract (see chapter XXVIII, "Choice of law", paragraph 1). Some of these remedies may be mandatory, while others may be non-mandatory and capable of exclusion or modification. Where non-mandatory remedies under the applicable law are unsuitable, they should be clearly modified or excluded by the contractual provisions. It would also be advisable for the party to consider not only the remedies available to each party, but the relationship between those remedies (see section B, below).

8. Under the law applicable to the contract the purchaser may lose his remedies in respect of defects which he could have been expected to discover at the time of inspection or take-over of equipment or take-over or acceptance of

the works. Nevertheless, where permissible, it is advisable to stipulate in the contract that the purchaser does not lose those remedies in those cases (see chapter VIII, "Supply of equipment and materials", paragraph 20; chapter XII, "Inspections and tests during manufacture and construction", paragraphs 1 and 8, and chapter XIII, "Completion, take-over and acceptance", paragraph 12). The contract may, however, obligate the purchaser to inform the contractor without delay of defects which he did discover. The contract may provide that the purchaser bears any additional reasonable costs incurred by the contractor and attributable to the purchaser's failure to inform.

B. Purchaser's remedies

1. *Salient features*

9. The summary of the purchaser's remedies contained in paragraph 50, below, is intended to assist the reader in understanding the somewhat detailed system of remedies available to the purchaser set forth in this chapter. The summary does not deal with the remedies available to the contractor, as their structure and content are readily understandable. The detailed nature of the purchaser's remedies results from certain features of a works contract. The complete performance by the contractor of his contractual obligations occurs over a long term and covers more than one well defined period (e.g., the period of construction, the period covering the conduct of performance tests, and the guarantee period). The contractor's obligations are complex, including the supply of equipment and materials, and construction on site. Furthermore, both where the construction is delayed and where it is defective, the failures to perform may take different forms (e.g., in respect of delay, the delay may be in commencing construction or in completing construction, while in respect of defects, these may be serious or not serious, known to be incurable or not known to be incurable). Each form of failure may require a somewhat different set of remedies.

10. It is advisable for the purchaser's remedies to be set forth in the contract. This would result in greater certainty as to the consequences of the contractor's failure to perform than would result if the parties relied only on the remedies available to the purchaser under the law applicable to the contract. In addition, the remedies available under some legal systems may be inappropriate to a failure to perform a works contract by a contractor. However, it is extremely difficult for the parties to envisage a system of remedies which contains a remedy which is appropriate in every circumstance, in particular when it is noted that some remedies require that the contractor be willing and able to act in accordance with that remedy. Therefore, while the remedies set forth in the contract or contained in the law applicable to the contract establish the rights of the purchaser when the contractor fails to perform, in the event of such a failure the purchaser may in many cases find it desirable to negotiate with the contractor in the light of his rights before resorting to the procedures available to enforce them (see chapter XXIX, "Settlement of disputes", paragraphs 10 and 11).

11. The purchaser's remedies are dealt with in relation to three broad categories: delay in construction by the contractor; defective construction by the contractor; and defects for which the contractor is not liable. The remedies for defective construction by the contractor are linked to four sub-categories:

defects discovered during construction; construction which is deemed to be defective because performance tests are not conducted; defects discovered during performance tests; and defects discovered after acceptance and notified during the guarantee period.

12. In paragraph 50, below, the summary only sets out the various remedies in outline. However, cross-references are given to the sections in the chapter where they are treated in detail. Because of the difficulties that are caused to both parties by the termination of a long-term works contract, the system of remedies recommended by this *Guide* emphasizes two elements. Firstly, the initial remedy usually given to the purchaser is to require the contractor to complete or cure performance which is delayed or defective. However, under the contract or the law applicable to the contract, the purchaser may not be permitted to require performance during the period of time when performance is prevented by an exempting impediment (see chapter XXI, "Exemption clauses", pararaphs 9 to 26). Moreover, in some legal systems, a party cannot enforce performance by the other party in arbitral or judicial proceedings. Secondly, the remedy of termination is given as one of last resort (see also chapter XXV, "Termination of contract", paragraph 2).

13. In certain situations the contract may give the purchaser the remedy of claiming a price reduction. The purpose of this remedy is to restore an equivalence between the value of what the purchaser receives and the price he has to pay. The remedy is of particular value to a purchaser where defects in the works result from failures to perform due to exempting impediments and, under the contract, the contractor is not liable to pay damages for loss caused by such failures (see chapter XXI, "Exemption clauses", paragraph 8). Where the purchaser claims a price reduction, and the remedy of damages is also available, he should not be permitted to claim damages for the loss covered by the price reduction, since that would, in essence, give him double compensation for the same loss. The parties may also wish to note that the contract may permit the purchaser to claim a price reduction even if he has already paid the price. In such a case, the excess amount paid by the purchaser, taking the price reduction into account, may be reimbursable by the contractor to the purchaser directly, or by way of set-off against later sums payable to the contractor.

14. It is sometimes recommended in this chapter that the purchaser be given a choice of alternative remedies upon certain failures of performance by the contractor. The contract may provide that, after the purchaser chooses one of those remedies, he is not entitled to alter his choice without the consent of the contractor. However, where the purchaser is given a choice between the remedy of engaging a new contractor to cure defects at the expense and risk of the contractor, and certain other remedies, and the purchaser chooses the remedy of engaging a new contractor, the purchaser may be entitled to choose one of the other remedies (e.g., price reduction) if the defects prove to be incurable. The particular remedy he may exercise in the event of a failure by the new contractor is indicated below in relevant paragraphs of the chapter. It may be noted that some remedies might be available to a party concurrently (e.g., cure of defects and damages), while other remedies might be available successively (i.e., termination to be available only if cure of defects has been required and has not been effected).

15. It is usually recommended in this chapter that, where performance by the contractor is delayed or defective, the contract may require the purchaser to

grant to the contractor an additional period of time to complete the delayed construction or cure the defective construction (see paragraph 12, above). It is advisable that the contract not permit this additional period to be regarded as an extension of the time for performance so as to affect the purchaser's rights arising from the delayed or defective construction. Where cure is required, the contract may provide that the contractor is to have freedom as to the manner in which the cure is to be effected (e.g., by the repair or replacement of defective equipment or materials). The contract may provide that the costs incurred in effecting the cure are to be borne by the contractor even when the cost-reimbursable pricing method is adopted in the contract (see chapter VII, "Price and payment conditions", paragraphs 10 to 24).

16. The contract may provide that the purchaser is not entitled to exercise the remedies granted to him under the contract after the lapse of a specified period of time (for example, after the lapse of a specified period from the expiry of the quality guarantee period: see chapter V, "Description of works and quality guarantee", paragraphs 28 to 30). Such a provision will enhance certainty in the legal relationship between the parties. The contract may also provide that the purchaser is not entitled to exercise the remedies granted to him for the contractor's failure to perform if this failure is caused by an act or omission of the purchaser.

2. *Delay in construction by contractor*

(a) *Delay in commencing construction*

17. If the contractor fails to commence construction at the time stipulated in the contract, the contract may entitle the purchaser by written notice to require the contractor to commence construction within an additional period of a specified or reasonable length commencing to run from the date of the delivery of the notice. If the contractor does not commence within the additional period, the contract may entitle the purchaser to terminate the contract. However, the contract may entitle the purchaser to immediate termination of the contract if the contractor states to the purchaser that he will not commence construction. In addition to the remedies discussed in this paragraph, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

(b) *Delay in completing portion of construction by obligatory milestone date*

18. If the contractor fails to complete a portion of the construction by an obligatory milestone date set out in the construction time-schedule (see chapter IX "Construction on site", paragraph 21), the contract may entitle the purchaser by written notice to require the contractor to complete that portion within an additional period of a specified or reasonable length commencing to run from the date of the delivery of the notice. If the contractor fails to complete the portion within the additional period, the contract may entitle the purchaser to terminate the contract in respect of the portion of the construction in delay, or, in certain situations, in respect of the entirety of the uncompleted construction (see chapter XXV, "Termination of contract", paragraph 7). The parties may wish to consider whether the purchaser is to be entitled to terminate the contract only if certain additional conditions are satisfied, e.g.,

only if a specified limit of an agreed sum (see chapter XIX, "Liquidated damages and penalty clauses") has become due in respect of all delays in construction by the contractor. Such a limitation may prevent termination in cases where only a small portion of the construction has not been completed. In addition to the remedies discussed in this paragraph, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

(c) *Delay in completing entire construction*

19. If the contractor fails to complete the construction on the date for completion specified in the contract, the contract may entitle the purchaser by written notice to require the contractor to complete the construction within an additional period of a specified or reasonable length commencing to run from the date of the delivery of the notice. If the contractor does not complete the construction within the additional period, the contract may entitle the purchaser either to terminate the contract or to complete the construction by engaging a new contractor at the expense and risk of the contractor. The latter remedy, which is seldom exercised in practice, would usually involve an increase in the price owing to the substantially higher risk to be borne by the contractor. Under some performance bonds, the consent of the guarantor may be required for the engagement of a new contractor at the expense and risk of the contractor. In addition to the remedies discussed in this sub-section, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

(i) *Termination of contract*

20. The contract may entitle the purchaser to terminate the contract in respect of the uncompleted portion of the construction (see chapter XXV, "Termination of contract"). The payment of an agreed sum (see chapter XIX, "Liquidated damages and penalty clauses" or damages (see chapter XX, "Damages") may compensate the purchaser for the difference between the price that was to be paid to the contractor before termination of the contract and a reasonable price paid to a new contractor to complete the construction.

(ii) *Engagement of new contractor at expense and risk of contractor*

21. The contract may provide that, if the purchaser chooses to engage a new contractor at the expense and risk of the contractor, the choice of the new contractor and the terms agreed with him must be reasonable. The contract may obligate the purchaser, prior to engaging a new contractor, to notify the contractor in writing of the new contractor whom the purchaser intends to engage, and the terms of the new contract. By delivering a written notice to the purchaser, the contractor may be entitled to object to the intended new contractor, or to the contractual terms to be agreed with him by the purchaser, on the grounds that the new contractor is not a reasonable choice as a contractor (e.g., he lacks the necessary experience), or that the intended terms with the new contractor are not reasonable. The contract may nevertheless entitle the purchaser to engage the new contractor even though the contractor has objected to the new contractor or to the intended contractual terms, although at some potential risk to the purchaser, as described below.

22. The contract may provide that, when the purchaser decides to engage a new contractor, he remains obligated to the contractor for the price, including the price in respect of the portion of the works constructed by the new contractor. The contract may also provide that the contractor is obligated to pay to the purchaser the price that the purchaser must pay to the new contractor, which the purchaser may be entitled to set off against the price to which the contractor may be entitled under the contract. In addition, the contractor may be obligated to pay to the purchaser other reasonable costs incurred by him in connection with the engagement of the new contractor. However, when the purchaser has engaged the new contractor without notifying the contractor of the choice of the new contractor or of the contractual terms that the purchaser intends to conclude with the new contractor, or when the purchaser has engaged the new contractor despite valid objections by the contractor (see paragraph 21, above), the contract may entitle the purchaser only to the price and other costs that would have been incurred by him in connection with the engagement of the new contractor if the choice of the new contractor and the terms agreed with him had been reasonable.

23. The contract may provide that the contractor is liable for a failure by the new contractor to complete the construction to the same extent as if the new contractor were a subcontractor engaged by the contractor (see chapter XI, "Subcontracting", paragraphs 27 and 28). Alternatively, the contract may provide that the contractor is liable for any defect discovered in the completed works, but that he is entitled to exclude this liability by proving that the defect was caused by the new contractor. However, if the purchaser has engaged the new contractor without notifying the contractor of his intention to engage the new contractor or of the terms under which he is to be engaged, or when the purchaser has engaged the new contractor despite valid objections by the contractor (see paragraph 21, above), the risk connected with the engagement of the new contractor may be borne under the contract by the purchaser. The contract may also provide that, where the contractor is held liable by the purchaser for a failure of the new contractor to perform, the purchaser must transfer to the contractor any rights which the purchaser may have against the new contractor arising from that failure, if such a transfer is permitted by the applicable law.

24. It may be desirable to provide that, if the purchaser chooses the remedy of engaging a new contractor to complete the construction, the contractor must cease construction and leave the site so that it can be occupied by the new contractor. The contractor may be obligated to cease construction and leave the site at the time he is notified by the purchaser of the choice of this remedy, or at a later time to be specified in the notification by the purchaser. The contract may prohibit the contractor from removing from the site without the consent of the purchaser any of the contractor's construction machinery and tools, or equipment and materials to be incorporated in the works, since those items may be needed by the new contractor to complete the construction.

25. Where the purchaser chooses this remedy, it is advisable for him not to terminate the works contract with the contractor, since it is desirable that the liability of the contractor for the construction to be effected by the new contractor (see paragraph 23, above) not be eliminated by the termination of that works contract (see chapter XXV, "Termination of contract"). However, the works contract with the contractor may provide that the purchaser is

entitled to terminate it and to claim any remedies available upon termination if and when the works contract with the new contractor is terminated. The rights of the purchaser upon termination are discussed in chapter XXV, "Termination of contract", paragraphs 30 and 31. The purchaser will also be entitled to remedies against the new contractor under the works contract between him and the purchaser if the new contractor fails to perform.

3. *Defective construction by contractor*

26. Whether the works, or equipment and materials, contain defects for which the contractor is liable under the contract will depend on whether they are in conformity with the description in the contract of the technical characteristics of the works to be constructed, of the equipment and materials to be supplied, and of the construction processes to be used, taken together with the construction obligations assumed by the contractor. The description of the works, equipment and materials, and construction processes are dealt with in chapter V, "Description of works and quality guarantee", chapter VIII, "Supply of equipment and materials", paragraphs 6 and 7, and chapter IX, "Construction on site", paragraph 2. The contractual obligations which may be assumed by the contractor, which will be determined in part by the contracting approach chosen by the purchaser, are dealt with in chapter II, "Choice of contracting approach".

27. The remedies available to the purchaser where the construction is defective may depend on whether the defects are serious or not serious. It is advisable that the contract define what defects are serious, taking into consideration the nature of the works to be constructed and the expected performance parameters of the works specified in the contract. Serious defects may be defined as those which prevent the works from operating within certain parameters specified in the contract. Examples of serious defects would be those which reduce the production capacity of the works, lower the quality of the output of the works or increase the consumption of raw materials by the works outside the limits of tolerances specified in the contract which are acceptable to the purchaser.

(a) *Defects discovered during manufacture and construction*

28. The contract may entitle the purchaser to inspect during their manufacture, or upon shipment to the site, equipment and materials to be incorporated in the works (see chapter XII, "Inspections and tests during manufacture and construction", paragraphs 8 to 11 and 21). If they are found upon inspection to be defective, the contract may entitle the purchaser to require cure of defects, and to forbid the shipment of the defective equipment and materials to the site.

29. Equipment and materials supplied by the contractor may be discovered to be defective upon arrival at the site (e.g., upon inspection on arrival: see chapter XII, "Inspections and tests during manufacture and construction", paragraph 23) or at a later stage. In addition, construction services supplied by the contractor may be discovered to be defective at any stage during the construction. The contract may entitle the purchaser by written notice to require cure of the defects, to forbid the incorporation of the defective

equipment and materials in the works, to forbid the supply of the defective services, and to refuse to pay the price for the defective items. The contract may, in addition, entitle the purchaser to require the contractor to supply different equipment, materials and services which are in accordance with the contract. The contract may provide that, if the defects in equipment and materials are cured, the equipment and materials are deemed to have been supplied at the time when the cure is effected. If the defects are not cured by an obligatory milestone date for supply, the contractor may be in delay in the supply (see chapter IX, "Construction on site", paragraph 21). In addition to the remedies discussed in this paragraph, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

30. Disputes may arise between the parties as to the validity of claims made by the purchaser that equipment, materials or services being supplied are defective. The contract may obligate the contractor to comply with the directions of the purchaser (see previous paragraph) even if the contractor considers that the equipment, materials or services are not defective. If the contractor is forbidden to use equipment, materials or services for the purposes of the construction (see previous paragraph) and it is later determined in dispute settlement proceedings that the equipment, materials or services were not defective, the contractor may be given the same rights against the purchaser as in cases where the purchaser suspends the construction for his convenience (see chapter XXIV, "Suspension of construction", paragraph 4). If the contractor is, in addition, required to supply different equipment, materials or services (see previous paragraph), the contractor may be given the same rights against the purchaser as if the construction had been varied under a variation order (see chapter XXIII, "Variation clauses", paragraph 8).

31. If the contractor fails within a reasonable or specified period after the delivery of the notice (see paragraph 29, above) to stop the incorporation in the works of defective equipment or materials or the supply of defective construction services, or if he refuses to stop the incorporation or supply, and if the use of the equipment, materials or construction services would result in serious defects in the works, the contract may entitle the purchaser to terminate the contract (see chapter XXV, "Termination of contract").

32. The contract may provide that defective equipment or materials for which the purchaser has paid at least in part cannot be removed from the site without the purchaser's approval, or without being replaced by equivalent new equipment or materials. However, if, due to the nature of the defects, the contractor must take the defective equipment or materials from the site to be repaired, the contract might permit the contractor to do so on condition that, if no other guarantee is applicable, he arranges for a suitable third party to guarantee that in the event the equipment and materials are not returned, the guarantor will reimburse the purchaser for the price already paid by him for the equipment and materials.

33. It is advisable for the parties to pay particular attention to problems that could arise where a design supplied by a contractor is defective. In particular where other contractors are to construct some portions of the works in accordance with that design, the purchaser could suffer serious losses due to the need to suspend or vary contracts concluded with those other contractors. Accordingly, the contract might entitle the purchaser by written notice to

require the contractor to cure the design defects within an additional period of a specified or reasonable length commencing to run from the delivery of the notice, and to cure any defects which have been caused in equipment and materials supplied by him as a result of the design defects. If the contractor fails to do so within the additional period, the contract may entitle the purchaser to engage a new contractor to cure the defects at the expense and risk of the contractor, or, alternatively, to terminate the contract. In addition, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses" and chapter XX, "Damages".

(b) *Construction deemed defective because performance tests not conducted*

34. If the contractor fails to conduct performance tests within the period specified in the contract for conducting the tests, and the failure to conduct the tests was not due to causes for which the contractor was not responsible (see chapter XIII, "Completion, take-over and acceptance", paragraph 32), the contract may provide that the performance tests are to be deemed unsuccessful, and the works deemed to have serious defects. Accordingly, the purchaser would be entitled to the same remedies to which he is entitled when he refuses to accept the works due to the discovery of serious defects during the conduct of performance tests (see paragraphs 35 to 37, below).

(c) *Defects discovered during performance tests*

(i) *Refusal to accept works*[1]

35. If serious defects in the works are discovered during the conduct of any of the performance tests envisaged under the contract (see chapter XIII, "Completion, take-over and acceptance", paragraphs 24 to 28), the contract may entitle the purchaser to refuse to accept the works. If serious defects still exist after the conduct of the last performance tests envisaged in the contract, the purchaser may be entitled to certain remedies, depending on whether the defects are not known or known to be incurable at the time of the refusal to accept.

a. *Defects not known to be incurable at time of refusal*

36. If the defects are serious but not known to be incurable at the time of the refusal to accept, the contractor may be obligated to cure the defects and prove their cure through a repetition of the performance tests within a specified period of time. If the contractor fails to repeat the tests within this period of time, the contract may provide that they are to be deemed unsuccessful. If the tests are repeated, but the last performance tests envisaged under the contract are unsuccessful (see chapter XIII, "Completion, take-over and acceptance", paragraph 26), the purchaser may be entitled to terminate the contract, or to engage a new contractor to cure the defects at the expense and risk of the contractor. If the latter remedy is invoked, the legal position of the parties may be analogous to that where the purchaser chooses to engage a new contractor to complete the construction at the expense and risk of the contractor (see section B, 2 (c), (ii), above). In addition to the remedies discussed in this paragraph, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

b. *Defects known to be incurable at time of refusal*

37. If the serious defects are known to be incurable at the time of the refusal to accept, the purchaser may be entitled to terminate the contract. In addition, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

(ii) Acceptance of works despite defects[2]

38. If the defects in the works discovered during the conduct of performance tests are not serious, the contract may provide that the purchaser is to accept the works (see paragraph 26, above, and chapter XIII, "Completion, take-over and acceptance", paragraph 29). It may also entitle him to accept the works even if the defects discovered are serious. In either case, the contract may entitle the purchaser to the following remedies in respect of defects in the accepted works.

a. *Defects for which price reduction is sole agreed remedy*

39. The parties may wish to provide that for certain defects that are not serious defects (e.g., a loss of production capacity not exceeding a specified tolerance) the purchaser's sole remedy is to be price reduction. It is advisable to define these defects precisely in the contract. Furthermore, the parties may wish to agree upon a method of calculating the amount of the price reduction, if possible by the use of a mathematical formula.

b. *Defects for which price reduction is not sole agreed remedy*

i. *Defects not known to be incurable at time of acceptance*

40. The contract may provide that the purchaser is entitled to require the contractor, by written notice, to cure the defects within an additional period of a specified or reasonable length commencing to run from the delivery of the notice. If the defects are not cured within the additional period, the purchaser may be entitled either to a price reduction, or to engage a new contractor to cure the defects at the expense and risk of the contractor. In addition to the remedies discussed in this paragraph, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

41. If the purchaser chooses price reduction, the contract may provide that the amount of the reduction is to be the reasonable costs which would be incurred in curing the defects. If the failure to cure the defects was due to the discovery during the attempt to cure them (see previous paragraph) that the defects were incurable, the amount of the reduction might be the difference between a reasonable price which would have paid for the works without defects and a reasonable price which would have been paid for works with defects at the time when it is discovered that the defects are incurable. If the purchaser chooses the remedy of engaging a new contractor, the legal position of the parties may be analogous to that where the purchaser chooses to engage a new contractor to complete the construction at the expense and risk of the contractor (see section B, 2 (c), (ii), above).

ii. *Defects known to be incurable at time of acceptance*

42. If it is known at the time of acceptance that the defects are incurable, the purchaser may be entitled only to a price reduction. The contract may provide in these cases that the amount of the reduction is to be the difference between a reasonable price which would have been paid for the works without the defects and a reasonable price which would have been paid for the works with the defects at the time the defects are discovered. It may not be advisable for the amount of the price reduction to be calculated by comparing the prices prevailing at the time of the conclusion of the contract for works with and without defects, since changes in the price level occurring during the period of time between the conclusion of the contract and the discovery of the defects would not be taken into account. Similarly, if the amount of the price reduction were calculated by comparing the contract price with a reasonable price which would be paid for the works at the time the defects were discovered, changes in the price level which would have affected the contract price would not be taken into account. In addition to a price reduction the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses" and chapter XX, "Damages".

(d) Defects discovered after acceptance and notified during guarantee period

(i) Procedure for claims

43. This section deals only with the procedure for claims relating to defects discovered after acceptance and notified during the guarantee period. The procedure to be followed when defects are discovered during construction is discussed in chapter XII, "Inspections and tests during manufacture and construction". The procedure to be followed when defects are discovered during completion tests and performance tests is dealt with in chapter XIII, "Completion, take-over and acceptance".

44. The contract may require the purchaser to give written notice to the contractor as soon as possible of all defects which he discovers or could reasonably be expected to discover. The contract may provide that if the purchaser fails to notify the contractor of such a defect as soon as possible, but nevertheless notifies the contractor of the defect before the expiry of the guarantee period, he retains all his contractual rights and remedies in respect of the defect, but is liable to pay damages to the contractor for any loss suffered by the latter as a result of the failure to give timely notice of the defect. Alternatively, the contract may provide that the purchaser forfeits his remedies if he has failed to notify the contractor of the defects in time.

45. The contract may provide that the contractor is not liable for defects notified to him after the expiration of the guarantee period. However, the parties may wish to note that exceptions to this principle may exist under mandatory provisions of the law applicable to the contract (for example, the contractor may be liable for defects discovered and notified by the purchaser after the expiration of the guarantee period if the contractor had known of the defects at the time of acceptance and had fraudulently concealed them).

46. The contract may require the notice to specify the defects and the date of their discovery, and may give the contractor an opportunity to inspect the defects within a reasonable period of time after the notification. The contractor

may be obligated to inform the purchaser in writing, within a specified or reasonable period commencing to run from the date of the delivery of the notice, whether he admits or denies his liability for the defects. If the contractor denies his liability but the purchaser continues to assert it, the contract may require the contractor to cure the defects with all possible speed. If it is later determined in dispute settlement proceedings that the contractor is not liable for the defects, he may be entitled to a reasonable price for curing the defects. The contractor may be obligated to give the purchaser an estimate of the period of time needed to cure the defects, if this information is requested by the purchaser.

(ii) Liability for defects

a. *Defects not known to be incurable at time of discovery*

47. If the defects are not known to be incurable at the time of discovery, the purchaser may be entitled to require the contractor, by written notice, to cure the defects within an additional period of time of a specified or reasonable length commencing to run from the date of the delivery of the notice. If the defects are not cured within the additional period of time, the purchaser may be entitled either to a price reduction or to engage a new contractor to cure the defects at the expense and risk of the contractor. However, under some performance bonds the consent of the surety may be required for the engagement of a new contractor at the expense and risk of the contractor. The contract may provide that the amount of the reduction is to be equal to the reasonable costs that would be incurred in curing the defects. If the purchaser chooses the latter remedy, and the contract with the new contractor is terminated because the defects are incurable, the purchaser may be entitled to a price reduction. The contract may provide that the amount of the price reduction is to be the difference between a reasonable price that would have been paid for the works without the defects and a reasonable price that would have been paid for the works with the defects at the time when the new contractor fails to cure the defects. In addition to the remedies discussed in this paragraph, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

b. *Defects known to be incurable at time of their discovery*

48. If defects are known to be incurable at the time of their discovery, the purchaser may be entitled to a price reduction. The amount of the reduction might be the difference between a reasonable price that would have been paid for the works without the defects and a reasonable price that would have been paid for the works with the defects at the time the defects were discovered. In addition, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

4. *Defects for which contractor is not liable*

49. The contract may obligate the contractor, at the purchaser's request, to cure defects for which the contractor is not liable, provided they are notified before the expiry of the guarantee period. The contract may require the contractor to cure the defects within a reasonable period of time of the notification, and may entitle him to a reasonable price for doing so.

5. *Summary of purchaser's remedies*

50. The remedies for a failure by the contractor to perform that may be considered by the parties in drafting their contract, in addition to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages", can be summarized as follows:

1. *Delay in construction by contractor* (section B, 2)

   (a) *Delay in commencing construction* (paragraph 17)

   - require commencement;
     if contractor fails to commence within additional period,
   - terminate contract.

   (b) *Delay in completing portion of construction by obligatory milestone date* (paragraph 18)

   - require completion of portion;
     if contractor fails to complete portion within additional period,
   - terminate contract.

   (c) *Delay in completing entire construction* (paragraphs 19-25)

   - require completion of entire construction;
     if contractor fails to complete entire construction within additional period,
     either
   - terminate contract
     or
   - engage new contractor to complete construction at expense and risk of contractor;
     if contract with new contractor is terminated,
   - terminate contract with contractor.

2. *Defective construction by contractor* (section B, 3)

   (a) *Defects discovered during manufacture and construction* (paragraphs 28-33)

   i. *Defects in equipment and materials discovered during manufacture or upon shipment* (paragraph 28)
   - require cure of defects; and
   - forbid supply of the defective equipment and materials for the purposes of construction.

   ii. *Defects in equipment and materials discovered on arrival at site or later, and defects in construction services discovered during construction* (paragraphs 29-33)
   - require cure of defects in equipment and materials;
   - refuse to pay price for defective equipment, materials or services; and
   - forbid incorporation of defective equipment and materials in the works, or the supply of defective services;

if contractor does not cease incorporating defective equipment and materials in the works, or supplying defective services, and such incorporation or supply would cause serious defects in the works,

- terminate contract.

(b) *Construction deemed defective because performance tests not conducted* (paragraph 34)

- same remedies as on refusal by purchaser to accept works when defects are serious (see (c), below).

(c) *Defects discovered during performance tests* (paragraphs 35-42): purchaser may

- refuse to accept works if defects are serious, or
- accept works if defects are not serious, or accept despite serious defects.

(i) *Refusal to accept works if defects serious* (paragraphs 35-37)

a. if defects not known to be incurable at time of refusal,

- require cure of defects:

if serious defects discovered during last performance tests envisaged in contract

either

- terminate contract

or

- engage new contractor to cure defects at expense and risk of contractor;

if defects cannot be cured by new contractor,

- terminate contract with contractor

b. if defects known to be incurable at time of refusal,

- terminate contract.

(ii) *Acceptance if defects not serious, or despite serious defects* (paragraphs 38-42)

a. Defects which are not serious for which price reduction is sole agreed remedy

- claim price reduction.

b. Defects for which price reduction is not sole agreed remedy

i. if defects not known to be incurable at time of acceptance,

- require cure of defects:
if defects not cured within additional period,

either

- claim price reduction

or

- engage new contractor to cure defects at expense and risk of contractor;

if defects cannot be cured by new contractor,

- claim price reduction.

ii. if defects known to be incurable at time of acceptance,
   - claim price reduction.

(d) *Defects discovered after acceptance and notified during guarantee period* (paragraphs 43-48)

a. if defects not known to be incurable at time of discovery,
   - require cure of defects;
     if defects not cured within additional period,
     either
   - claim price reduction
     or
   - engage new contractor to cure defects at expense and risk of contractor;
     if defects cannot be cured by new contractor,
   - claim price reduction;

b. if defects known to be incurable at time of discovery,
   - claim price reduction.

3. *Defects for which contractor not liable* (paragraph 49)
   - require cure of defects at expense of purchaser.

C. Contractor's remedies

1. *Salient features*

51. In drafting provisions concerning the contractor's remedies, the parties should bear in mind the issues described in paragraphs 9 to 16, above, since some of them are also relevant in formulating the contractor's remedies.

2. *Delay in payment of price or in providing security for payment of price*

52. The payment conditions in the contract determine when the price or a portion thereof falls due (see chapter VII, "Price and payment conditions", paragraphs 63 to 79). The contract may also require security for payment of the price (e.g., a letter of credit) to be furnished at a specified time by the purchaser (see chapter XVII, "Security for performance", paragraphs 40 to 45).

(a) *Requiring payment of price and interest*

53. If the purchaser fails to pay the price or a portion of it on the date when it falls due, the contractor will, under the law applicable to the contract, be entitled to require payment; under many legal systems he may also be entitled to claim interest for the delay in payment. However, the parties may wish to include in the contract provisions dealing with the payment of interest. If they so decide, they should take into consideration any mandatory legal rules of the applicable law regulating the payment of interest, such as restrictions on the interest rate. They may also wish to consider whether interest should be payable in cases where an exempting impediment prevents the purchaser from

paying the price (see chapter XXI, "Exemption clauses"), and whether, in addition to interest, damages are to be payable for loss suffered by the contractor which is not compensated by an interest payment. If interest may not be claimed under the applicable law for delay in payment of sums due, the parties may wish the contract to contain an adequate remedy that could be permitted under that law, such as payment of an agreed sum (see chapter XIX, "Liquidated damages and penalty clauses").

54. If the parties decide to provide in the contract for the payment of interest, they may wish to agree upon the period of time during which the interest is to be payable. The parties may wish to provide that interest is payable from the date on which the price is due until the date on which the contractor receives payment.

55. The parties may decide either to determine the interest rate in the contract or to leave that issue to be resolved by the law applicable to the contract. However, the rules in some legal systems governing payment of interest for delay in payment of the price may not adequately resolve that issue. If the parties decide to determine the interest rate in the contract, it would be preferable to provide a formula for determining the rate of interest rather than to stipulate a specific rate, since it may not be possible to predict accurately what specific rate might be appropriate during the period that interest is due. One approach may be to base the interest rate on a bank rate (e.g., the London Inter-bank Offering Rate) for the time being prevailing during the period when the purchaser is in delay in payment.

56. Other possible approaches may be to provide that the interest rate is to be either a specified rate prevailing in the purchaser's country, or a specified rate prevailing in the contractor's country, during the period when the purchaser is in delay in payment. It may be advisable for the contract to determine which of several interest rates prevailing in the chosen country is to apply. One rate which might be adopted is the official discount rate. If a specified rate prevailing in the contractor's country is to apply, the purchaser might be tempted to delay payment when the rate he would earn on his funds on deposit in his own country, or at which he would have to borrow to finance the payment, is higher than the specified rate prevailing in the contractor's country. If a rate prevailing in the purchaser's country is to apply, there would be no such inducement. However, if the latter approach is adopted, and the rate prevailing in the contractor's country is higher than the specified rate prevailing in the purchaser's country, the contractor might suffer a loss due to his inability to earn the higher interest by putting the funds on deposit in his own country, or due to the necessity of borrowing the unpaid amount in his country and paying the higher interest rate on the loan. This may be prevented by permitting the contractor to claim damages for the loss caused by the difference in interest rates.

(b) *Suspension of construction and termination of contract*

57. If the purchaser is in delay for a specified period of time in paying a specified percentage of the contract price, or in furnishing security for payment of a specified percentage of the price, the contract may entitle the contractor to give written notice to the purchaser requiring him to make the payment or furnish the security within an additional period of a specified or reasonable

length commencing to run from the date of the delivery of the notice. The notice should state that the contractor will suspend the construction if the purchaser fails to pay or furnish the security within that additional period. The contract may entitle the contractor to suspend the construction if the purchaser fails to pay the price or specified portion of the price or furnish the security within the additional period (see chapter XXIV, "Suspension of construction", paragraph 6). The contract may further entitle the contractor to terminate the contract if the purchaser fails to pay the price or specified portion of the price or furnish the security within a specified period of time after the suspension.

58. An alternative approach may be to entitle the contractor to immediate termination of the contract if the purchaser fails to pay or furnish security within the additional period (see previous paragraph). However, it may be noted that termination of the contract by the contractor for a failure to pay the price is usually not of advantage to him after the completion of construction (cf. XV, "Transfer of ownership of property", paragraph 4, and chapter XXV, "Termination of contract", paragraph 32).

3. *Delay in taking over or accepting works*

59. When the construction has been completed, the contract may obligate the purchaser to take over and accept the works (see chapter XIII, "Completion, take-over and acceptance", paragraphs 21 and 29). The contract may provide for the legal consequences of the purchaser's delay in doing so. Due to the nature of the acts required of the purchaser in take-over and acceptance, it may not be possible or practical under many legal systems to compel the purchaser to perform those acts through the institution of arbitral or judicial proceedings. Moreover, since take-over or acceptance occurs only after the completion of the construction, terminating the contract for failure by the purchaser to take over or accept the works may not confer any advantage on the contractor.

60. If the purchaser is in delay in accepting the works, the contract may provide that acceptance is deemed to occur upon the completion of successful performance tests (see chapter XIII, "Completion, take-over and acceptance", paragraph 31). In the exceptional cases where this approach is not feasible (e.g., the contract does not require the conduct of performance tests), the contract may entitle the contractor to require the purchaser by written notice to perform the act of acceptance within an additional period of a specified or reasonable length commencing to run from the date of the delivery of the notice, and provide that if he fails to do so, the legal consequences of acceptance (e.g., the obligation of the purchaser to pay a portion of the price, or the commencement of the guarantee period) arise as from the date when a written notice stating that the consequences are to arise is delivered to the purchaser by the contractor. In addition to the remedies discussed in this paragraph, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

61. As conceived in the *Guide*, take-over consists of the purchaser taking physical possession of the works (see chapter XIII, "Completion, take-over and acceptance", paragraph 1), and it may be difficult to provide for a legal presumption that take-over has occurred. For this reason, if the purchaser is in delay in taking over the works, the contract may entitle the contractor to

require the purchaser by written notice to take over the works within an additional period of a specified or reasonable length commencing to run from the date of the delivery of the notice, and provide that, if he fails to do so, the legal consequences of take-over (e.g., passing of risk, commencement of the trial operation period) arise as from the date when a written notice stating that the consequences are to arise is delivered to the purchaser by the contractor. In addition, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

4. *Failure to supply design, equipment or materials for construction in time and free of defects*

(a) *Failure to supply design in time and free of defects*

62. Under some works contracts, the purchaser may be obligated to supply a design according to which the contractor is to construct the works (see chapter II, "Choice of contracting approach"). The contract may provide for the legal consequences if the purchaser fails to perform this obligation in time and free of defects. For example, the contract may provide that the period of time within which the construction is to be completed by the contractor commences to run only from the date that a design free of defects is supplied by the purchaser. The contractor may also be entitled to grant the purchaser an additional period of a specified or reasonable length to supply the design and, if the purchaser fails to do so within the additional period, the contractor may be entitled to terminate the contract. In addition to the remedies discussed in this paragraph, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

(b) *Failure to supply equipment and materials in time and free of defects*

63. Under some works contracts, the purchaser may be obligated to supply certain equipment and materials to be incorporated by the contractor in the works (see chapter VIII, "Supply of equipment and materials", paragraph 27). If the equipment and materials supplied by the purchaser are defective, and their incorporation results in defects in the works, the contract may exclude the liability of the contractor for those defects. If the purchaser fails to supply the equipment and materials in time or to supply them free of defects, the contractor may be entitled to suspend the construction affected by the failure (see chapter XXIV "Suspension of construction", paragraphs 6 and 7). In addition, the contract may entitle the contractor to require the purchaser by written notice to supply the equipment and materials, or to supply equipment and materials which are free of defects, within an additional period of time of a specified or reasonable length commencing to run from the date of delivery of the notice, and provide that if the purchaser fails to do so within the additional period, the contractor is entitled to obtain them himself and to claim from the purchaser all reasonable costs incurred by the contractor in doing so. If the equipment and materials cannot be obtained by the contractor, he may be entitled to terminate the contract in respect of those portions of the construction which cannot be effected without the equipment and materials. In addition to the remedies discussed in this paragraph, the purchaser may be entitled to remedies discussed in chapter XIX, "Liquidated damages and penalty clauses", and chapter XX, "Damages".

D. Remedies of both parties

1. *Delay in payment of sums other than price*

64. In some situations, the purchaser may be obligated under the contract or the law applicable to the contract to pay the contractor a sum of money other than the price, and the contractor may be obligated to pay a sum to the purchaser (e.g., reimbursement of insurance premiums paid by one party for the account of the other party). If these obligations are to be performed by separate payments and not by addition to or subtraction from the amount due as the price, the contract may entitle the party to whom such a payment is due to require payment, and, if payment is not made, entitle him to recover the amount due. If the parties wish to provide that interest is to be paid for the delay in payment, the issues related to the payment of interest may be settled in a manner similar to the settlement of issues related to the payment of interest for delay in payment of the price (see section C, 1, (a), above). The contract may provide that a party is not entitled to suspend performance of his obligations or to terminate the contract due to the delay by the other party in payment of sums other than the price.

2. *Failure to perform auxiliary obligations*

65. The contract may provide for the consequences of failure by a party to perform obligations of an auxiliary character (e.g., an obligation to notify). The contract may limit the consequences to a liability to pay damages (see chapter XX, "Damages" and chapter XXI, "Exemption clauses"). In some cases, they may wish to provide for the payment of an agreed sum (see chapter XIX, "Liquidated damages and penalty clauses"). Other additional consequences may include, for example, the loss by the party failing to perform an obligation of a particular right (e.g., loss of the right to invoke an exemption clause if a party fails to inform the other of the occurrence of an exempting impediment) or the occurrence of a presumption (e.g., the purchaser may be presumed to have given his consent to the engagement of a subcontractor proposed by the contractor if the purchaser does not approve of the subcontractor within a specified period of time of the proposal). Again, the contract may provide that when a party is in delay in taking over equipment or materials to be incorporated in the works the risk of loss of or damage to the equipment and materials is to pass to the party in delay as of the time when he ought to have taken them over. In addition, the contract may entitle a party to terminate the contract for specified failures by the other party; for example, the purchaser may be entitled to terminate the contract if the contractor fails to perform his obligation to extend a performance guarantee (see chapter XVII, "Security for performance", paragraph 36). Some of these cases are discussed in other chapters of the *Guide*. It may be advisable to specify those consequences in the contractual provisions dealing with the obligations in question. Consequences which may be appropriate to failures to perform particular auxiliary obligations are noted in the respective chapters of the *Guide* where those obligations are discussed.

66. In cases where the contract obligates a party to co-operate with the other party in order to make possible the performance of an obligation by the other

party, the contract may provide that the first party is not entitled to exercise the remedies given him for the failure of the other party to perform the obligation if this failure is due to a lack of the co-operation required of the first party by the contract.

Footnotes to chapter XVIII

[1]*Illustrative provisions*

"(1) If serious defects in the works are discovered during performance tests conducted under article . . ., the purchaser is entitled either to refuse to accept the works, or to accept the works.

"(2) If the purchaser exercises his right to refuse to accept the works, and the defects are not known to be incurable at the time of refusal, the contractor must cure the defects and prove that the works is free of serious defects through a repetition of the performance tests within . . . (indicate a period of time) after the conduct of the previous unsuccessful tests. If the contractor fails to repeat the tests within this period, the performance tests are deemed to be unsuccessful.

"(3) If the tests are repeated, but the last performance tests envisaged under article . . . are unsuccessful, the purchaser is entitled either to terminate the contract or to engage a new contractor to cure the defects at the expense and risk of the contractor.

(The article should include provisions mentioned in paragraphs 21 to 25 dealing with the rights of the parties where the purchaser chooses to engage a new contractor at the expense and risk of the contractor.)

"(4) If the defects are known to be incurable at the time of the refusal to accept, the purchaser is entitled to terminate the contract."

[2]*Illustrative provisions*

"(1) Where the purchaser accepts the works, he is entitled to the following remedies in respect of defects discovered during performance tests.

"(2) In respect of the defects described in this paragraph, the purchaser is only entitled to the price reduction indicated below:

Reduced production capacity of the works	Price reduction
1 per cent	. . . per cent of the price

(other defects and the consequent price reductions may be included).

"(3) If defects other than those noted in paragraph (2) of this article are not known to be incurable at the time of acceptance, the purchaser may deliver to the contractor a written notice requiring him to cure the defects within an additional [. . . days (period of time to be specified in contract)] [period of time of reasonable length to be specified in notice], and indicating that, if the contractor fails to cure the defects within the additional period, the purchaser intends either to claim a price reduction or to engage a new contractor to cure the defects at the expense and risk of the contractor.

"(4) If the contractor fails to cure the defects within the additional period indicated in paragraph (3) of this article, the purchaser is entitled in accordance with the notice given under that paragraph either to claim a price reduction or to engage a new contractor to cure the defects at the expense and risk of the contractor.

"(5) If the purchaser claims a price reduction, he is entitled to a reduction in an amount equivalent to the reasonable costs which would be incurred in curing the defects.

(The article should contain provisions modelled on those contained in note 1 dealing with the rights of the parties where the purchaser chooses to engage a new contractor at the expense and risk of the contractor.)

"(6) If defects other than those noted in paragraph (2) of this article are known to be incurable at the time of acceptance, the purchaser is only entitled to claim a price reduction. The purchaser is entitled to a price reduction in an amount equal to the difference between a reasonable price which would have been paid for the works without the defects and with the defects at the time the defects are discovered.

Chapter XIX. Liquidated damages and penalty clauses

SUMMARY

Liquidated damages clauses and penalty clauses provide that, upon a failure of performance by one party, the aggrieved party is entitled to an agreed sum of money from the party failing to perform. In works contracts, these clauses are usually included in respect of failures of performance by the contractor (paragraph 1).

The clauses have certain advantages. Since the agreed sum is recoverable without the need to prove that losses have been suffered, the expenses and uncertainty associated with the proof of losses are removed (paragraph 2). The sum may also serve as the limit to the liability of the contractor, who will be assisted by knowing the maximum liability to which he is likely to be exposed (paragraph 3).

Many legal systems have rules, which are sometimes mandatory, regulating liquidated damages clauses and penalty clauses. Under some legal systems, only clauses under which the agreed sum serves as compensation are valid. Under other legal systems, clauses under which the agreed sum serves as compensation, or is intended to stimulate performance, or has both those functions, are valid (paragraph 5). The parties may wish to provide that if the failure to perform is caused by an exempting impediment, the agreed sum is not due (paragraph 6).

The law applicable to the contract often regulates the relationship between recovery of the agreed sum and enforcement of the performance of obligations. That law also often regulates the relationship between the recovery of the agreed sum and the recovery of damages. The parties may, however, be permitted by the applicable law to regulate these relationships to some extent, and the parties may wish to do so to the extent permitted by the applicable law (paragraphs 7 and 8).

It is in the interests of both parties to delimit clearly the failure to perform upon which the agreed sum is payable (paragraph 9). In quantifying the agreed sum, if the applicable law so permits, the purchaser may find it beneficial to provide for an agreed sum in an amount which both provides reasonable compensation to the purchaser and puts a moderate pressure on the contractor to perform. Excessive sums should be avoided; under many legal systems those sums would be set aside or reduced (paragraphs 10 and 11).

The agreed sum to be paid is often fixed by way of increments, and a limit may be placed on the amount to which the increments can escalate. A limit may have advantages and disadvantages to the purchaser (paragraph 12). The parties may wish to consider whether the limit is to apply in all cases (paragraph 13), and the remedies which the purchaser might have after the limit is reached (paragraph 14).

In order to facilitate recovery of the agreed sum, the contract may authorize the purchaser to deduct the agreed sum from funds of the

contractor in the hands of the purchaser (paragraph 15). The contract may also provide for a guarantee to be given by a financial institution in respect of the agreed sum (paragraph 16).

When an agreed sum is stipulated for delay in performance, the date fixed for performance may become inapplicable in certain circumstances, and this may create difficulties in the operation of liquidated damages clauses and penalty clauses. The parties may wish to include in the contract a mechanism for determining a new date for performance, and provide that delay is to be measured by reference to the new date (paragraph 17).

The parties may wish to consider the circumstances in which the payment of an agreed sum is to be provided for delay by the contractor in completing a portion of the works. The quantification of the agreed sum will depend on those circumstances (paragraphs 18 and 19).

Where the payment of an agreed sum is stipulated by way of increments with a limit on the amount recoverable, the parties should determine the availability of the remedies of termination, damages and the recovery of the agreed sum, and also the relationships between those remedies (paragraph 21).

A. General remarks

1. Liquidated damages clauses and penalty clauses provide that, upon a failure to perform a specified obligation by one party, the aggrieved party is entitled to a sum of money agreed at the time the contract is entered into from the party failing to perform. Liquidated damages clauses and penalty clauses are most frequently provided for delay in performance.[1] The agreed sum may be intended to stimulate performance of the obligation, or to compensate for losses caused by the failure to perform, or both.[2] These clauses are inserted in respect of failures to perform construction obligations, rather than in respect of failure to make payment. Accordingly, in works contracts, they are usually included in respect of failure to perform by the contractor, although they may also be included in respect of failure to perform by the purchaser.

2. Agreement on a sum to be paid upon a failure to perform has certain advantages in the context of a works contract. Firstly, the sum constitutes agreed compensation for a failure to perform, and the expenses incurred in proving the extent of losses resulting from the failure are therefore eliminated. Those expenses might be considerable, especially if a purchaser had to establish his losses in legal proceedings held outside the country where the works is being constructed. Furthermore, because of difficulties sometimes encountered in proving the extent of losses under a works contract, the amount of damages which might be awarded in legal proceedings may be uncertain. An agreed sum is certain, and this certainty may be of benefit to both parties in assessing the risks to which they are subject under the contract.

3. Secondly, the agreed sum may serve as the limit to the liability of the contractor for the failure to perform a particular obligation (see section E, below). The contractor is assisted by knowing in advance the maximum liability to which he is likely to be exposed.

4. Liquidated damages clauses and penalty clauses (hereinafter referred to as clauses for the payment of an agreed sum) should be distinguished from two other types of clauses which are sometimes found in works contracts, i.e.

clauses limiting the amount recoverable as damages, and clauses providing alternative obligations. A clause limiting the amount recoverable as damages fixes a maximum amount payable if liability is proved. A plaintiff must prove the amount of his losses, and if the amount falls below the maximum, only the amount proved is recoverable. In the case of clauses for the payment of an agreed sum, in general the agreed sum is recoverable without proof of loss. A clause providing an alternative obligation in favour of a contractor gives him the option either of performing a specified obligation or paying an agreed sum. By exercising either option, he discharges his obligation and may become entitled to the performance promised to him by the purchaser in exchange. Under clauses for the payment of an agreed sum, the parties do not usually intend that payment of the agreed sum is to entitle the contractor to any performance in exchange, or that the payment is to constitute a discharge of the obligation to perform for which the agreed sum was provided (see also paragraph 7, below).

5. Many legal systems have rules, which are sometimes mandatory, regulating clauses for the payment of an agreed sum, and such rules will often restrict what the parties may achieve through those clauses. Under some legal systems, clauses by which the parties, at the time of contracting, fix an agreed sum payable as compensation for losses caused by a failure to perform are valid. In contrast, clauses fixing an agreed sum to stimulate performance are invalid, and the party who fails to perform is liable only for the damages recoverable under the general law. Under other legal systems, however, clauses fixing an agreed sum payable as compensation, or fixing an agreed sum to stimulate performance, or fixing a sum which has both these purposes, are in principle valid. The courts may have the power to reduce the agreed sum in specified circumstances, e.g., if the amount is grossly excessive in the circumstances, or there has been part performance. Parties are not permitted by agreement to derogate from the power to reduce the agreed sum. The choice by the parties of the law applicable to the contract (see chapter XXVIII, "Choice of law", paragraph 1) is therefore of particular importance in relation to clauses for the payment of an agreed sum.

6. The rule in many legal systems is that the agreed sum is not due if the failure to perform is caused by an exempting impediment (see chapter XXI, "Exemption clauses"), or by the acts or omissions of the other party. The parties may wish to maintain the applicability of this rule (Uniform Rules, article 5).

B. Relationship of recovery of agreed sum to enforcement of performance and to recovery of damages

7. The law applicable to the contract often regulates the relationship between recovery of the agreed sum and enforcement of the performance of obligations, though it generally does so by rules for interpreting the agreement between the parties. Under certain legal systems, enforced performance is not usually granted, and therefore the purchaser will be restricted to claiming the agreed sum. Where enforced performance is granted, however, it is advisable for the contract to clarify the relationship between enforcement of performance and recovery of the agreed sum. In respect of an agreed sum payable for delay in performance, for example, the agreed sum normally only compensates for the

losses suffered by the purchaser during the period of delay. Accordingly, the contract may provide that the purchaser can, in addition to the agreed sum, claim performance (Uniform Rules, article 6).[3]

8. The law applicable to the contract often regulates the relationship between the recovery of the agreed sum and the recovery of damages. Since one of the objectives of an agreed sum is to avoid the difficulties of an inquiry into the extent of recoverable damages (see paragraph 2, above), under some legal systems the purchaser is not permitted, in cases where recoverable damages under the rules relating to damages exceed the agreed sum, to waive the agreed sum and claim damages. Nor is the contractor permitted, in cases where the amount recoverable as damages is less than the agreed sum, to assert that he should only be liable for damages. Under some legal systems, however, where the losses exceed the agreed sum, the purchaser can prove this fact and, in addition to the agreed sum, recover damages to the extent of the excess, either unconditionally or subject to satisfying certain conditions (for example, that the failure of performance was negligent, or was committed with an intention to cause loss, or that there was an express agreement that damages for the excess is to be recoverable). Parties may therefore find it desirable to regulate these issues in the contract to the extent permitted by the applicable law (Uniform Rules, article 7).[4]

C. Delimiting failure of performance

9. It is in the interests of both parties to delimit clearly the failure to perform upon which the agreed sum is payable. Thus, when an agreed sum is payable if construction is not completed by a specified date, a clear definition of completion is needed in order to determine whether the agreed sum is payable after that date (see chapter XIII, "Completion, take-over and acceptance", paragraphs 1 and 4).

D. Quantification of agreed sum

10. Determining the appropriate amount for the agreed sum presents certain difficulties. In a long-term contract, it is extremely difficult to estimate at the time of contracting the losses which may be suffered at the time of a failure to perform, and accordingly it is difficult to determine at what amount the agreed sum should be quantified either to be truly compensatory or to stimulate performance. From the point of view of the purchaser, the agreed sum should not be fixed at such a low level that he will suffer serious uncompensated losses upon a failure to perform. Furthermore, a sum which is less than the amount the contractor would save by failing to perform would not act as a stimulus to the contractor to perform properly and on time.

11. If the applicable law so permits, the purchaser may find it beneficial for the contract to fix an agreed sum for a failure to perform by the contractor at an amount which both provides reasonable compensation to the purchaser and puts a moderate pressure on the contractor to perform. In determining what sum is reasonable, parties may consider such factors as the losses which might be caused to the purchaser by the failure, the possible effect of payment of the agreed sum on the financial position of the contractor, and the fact that the

sum should be substantial enough to induce the contractor to perform. Excessive sums should be avoided, as their stipulation in tender requirements or during negotiations may deter some reputable contractors from undertaking the construction, and may also have no special deterrent effect if it can be predicted that in all likelihood they will be declared invalid or reduced in legal proceedings. Furthermore, when accepting the provision of excessive sums in the contract, contractors may as a counterbalance increase their prices, or their safety margins in respect of the performances undertaken (e.g., by fixing later dates for completion, or lower guaranteed performance standards, or by over-designing the works). Where a legal system permits an agreed sum to serve only as compensation, parties should attempt to estimate as accurately as possible the losses which the purchaser is likely to suffer. Any records relating to the basis of the estimate and the calculations should be preserved as evidence that the sum was not fixed arbitrarily. The quantification of a sum due upon delay in completion of a portion of the works is dealt with in paragraph 18, below.

E. Limit on recovery of agreed sum

12. An agreed sum to be paid is often fixed by way of increments, a specified amount being due for a specified time unit of delay or for a specified unit by which performance standards are not met. Very often, however, the function of the payment of an agreed sum as imposing a limitation on liability is enhanced by placing a limit on the amount to which the increments can escalate.[5] The provision of a limit of liability may lead to a reduction of the price quoted by the contractor. A purchaser should, however, only agree to a limit after careful consideration, as he may suffer serious uncompensated losses after the limit is reached.

13. The parties may wish to consider whether the limit referred to in the previous paragraph is to apply under all circumstances, or is to be excluded in certain cases. Parties may wish to consider the insertion of a provision under which the limit is excluded, for example, where loss results from a failure committed with the intent to cause loss, or recklessly and with knowledge that loss would probably result.[6]

14. The parties may wish to consider what remedies the purchaser might have if the failure to perform continues after the limit is reached. If the law applicable to the contract permits enforced performance, the contract may provide that the purchaser may claim performance (see paragraph 7, above). With respect to the right to recover damages (see paragraph 8, above), a possible approach is to provide that, after the limit is reached, the purchaser is not entitled to recover either further increments in the liquidated damages or penalty, or damages for losses suffered by failure to perform after the date on which the limit was reached. An alternative approach is to provide that the purchaser is not entitled to recover further increments, but may recover damages for losses which he proves he has suffered after the date on which the limit was reached. Under either approach it is advisable to provide that the purchaser is entitled to terminate the contract once the limit is reached (see paragraph 21, below, and the illustrative provision referred to therein).

F. Obtaining agreed sum

15. While liquidated damages clauses or penalty clauses entitle the purchaser to recover from the contractor the agreed sum in the event of failure of performance, legal proceedings for recovery often entail time and expense. The need for the purchaser to institute legal proceedings may be reduced if the contract authorizes the purchaser to deduct the agreed sum from funds of the contractor in the hands of the purchaser (e.g., a deposit) or from funds due from the purchaser to the contractor (e.g., the price). It may be noted, however, that under some legal systems provisions authorizing deductions are regulated by mandatory rules. Furthermore, a deduction might later be invalidated by the operation of certain legal rules (e.g., if the agreed sum deducted was later held by a court to be excessive, and was reduced). Accordingly, provisions authorizing deductions should be formulated taking into account the relevant rules of the law applicable to the contract.

16. It is advisable for the clause to clarify that deduction is an optional mode of obtaining the agreed sum. Where the same purchaser and contractor have entered into more than one contract with each other, each contract might authorize deduction of the agreed sum from funds due under the other contract or contracts.[7] The purchaser can also enhance the chances of obtaining the agreed sum through a provision in the contract that the contractor must arrange for a financial institution to give the purchaser a guarantee in respect of the agreed sum. The purchaser could claim the agreed sum from the financial institution after proof of a failure to perform by the contractor (see chapter XVII, "Security for performance", paragraphs 10 to 12).

G. Agreed sum payable on delay: some issues

17. In works contracts the payment of an agreed sum is most commonly stipulated for delay in performance by the contractor. Under some legal systems, however, certain supervening circumstances may cause the date fixed for performance to become inapplicable, and this may create difficulties in the operation of these clauses. Such circumstances may consist of a failure to perform by the purchaser (e.g., by handing over the site late, or handing over necessary drawings or specifications late), or may consist of acts of the purchaser which are not failures to perform (e.g., ordering extra work under a variation clause), or of occurrences for which neither party is responsible (e.g., exempting impediments preventing the contractor from performing). The result under those legal systems is that the contractor is only bound to perform within a reasonable time, and that consequently the liquidated damages clause and penalty clause will be inoperative by reference to the date originally fixed for performance. Accordingly, if the parties wish to retain the applicability of the clause for the payment of an agreed sum despite the occurrence of such supervening circumstances, they may include in the contract a mechanism for determining a new date for performance, and provide that the agreed sum is payable if the contractor is in delay by reference to the new date for performance (see chapter XXIII, "Variation clauses", paragraph 8, and chapter XXIV, "Suspension of construction", paragraphs 13 and 18).

18. The parties may wish to consider the circumstances in which the payment of an agreed sum is to be provided for delay by the contractor in completing a portion of the works. The purchaser may wish to impose an obligation on the

contractor to complete portions of the works by specified dates to ensure steady progress in the construction, even though delay in completion of the portion does not by itself cause him losses (see chapter IX, "Construction on site", paragraphs 18 to 23). In those cases, the parties may wish to provide that an agreed sum becomes due upon a failure to complete portions by the specified dates, but that the agreed sum is repayable to the contractor if the date fixed for completion of the entire works is met by the contractor (i.e. through subsequent acceleration of the construction). The agreed sum will be imposed to stimulate performance and, if the law applicable to the contract permits the imposition of agreed sums for this purpose, the agreed sum may be quantified as a percentage of the value of the delayed portion.

19. The purchaser may also sometimes find it advantageous to impose an obligation to complete a particular portion by a specified date if he can enter and use that portion independently of the completion of the rest of the works. The imposition of such an obligation may also be advantageous where more than one contractor is engaged for the construction, and failure to complete a portion on schedule by one contractor may result in the purchaser having to pay damages to other contractors whose work cannot as a result be started at the time agreed. In those cases, the parties may wish to provide for the payment of an agreed sum which will compensate the purchaser for the losses caused by the delay.

20. The parties may wish to consider the situation when the payment of an agreed sum is only provided for delay in completion of the whole works, and on the date specified for completion certain portions are completed and may be operated by the purchaser, although the whole is still incomplete. In those circumstances one approach may be for the parties to provide that the agreed sum is to be reduced if the contractor can prove that the purchaser's losses are less than the agreed sum. The contractor may be able to prove this, for example, if the purchaser has entered upon the completed portions and is operating them. Another approach, however, is not to provide for any reduction of the agreed sum in such circumstances, since the quantification of the reduction may lead to those disputes and difficulties of proof which the agreed sum is intended to eliminate. Furthermore, if the agreed sum is to be reduced in such circumstances to accord with the actual losses suffered by the purchaser, it might be suggested that the agreed sum should also be increased if the actual losses suffered by the purchaser exceed that sum. The absence of certainty created by the possibility of an increase or reduction of the agreed sum could deprive it of much of its utility.

H. Termination of contract and clauses for payment of agreed sum

21. Parties may wish to provide that, where an agreed sum is payable by way of increments with a limit on the amount recoverable (see paragraph 12, above), the works contract may not be terminated by the purchaser on the ground of the failure of performance for which the agreed sum is provided until the limit is reached. The parties may also wish to provide that termination after the limit is reached is not to affect the payment of an agreed sum which has become due before the termination (see chapter XXV, "Termination of contract"). If, however, termination by the purchaser occurs before the limit is reached (e.g., if the purchaser terminates for a failure other than the one for

which the agreed sum has been stipulated), the parties may wish to provide that the termination does not affect the right to recover an agreed sum due on the date of termination, but that no amount becomes due as the payment of an agreed sum after the termination.[8] The purchaser may, however, be entitled to recover damages for losses suffered after the termination (see chapter XXV, "Termination of contract" and chapter XX, "Damages").

Footnotes to chapter XIX

[1]*Illustrative liquidated damages clause or penalty clause for delay in completion*

"(1) If the contractor fails to complete the works on the date fixed for completion, the purchaser is entitled to recover from the contractor . . . (insert currency and amount) for each day of delay which elapses from that date till the date of completion."

[2]Studies on the nature and operation of liquidated damages and penalty clauses in international contracts are contained in *Yearbook of the United Nations Commission on International Trade Law, Volume X: 1979*, Part Two, I, A, and *Ibid., Volume XII: 1981*, Part Two, I, B, 1. "Uniform rules on contract clauses for an agreed sum due upon failure of performance" adopted by the Commission are set forth in the *Report of the United Nations Commission on International Trade Law on the work of its sixteenth session* (A/38/17), Annex I (*Yearbook of the United Nations Commission on International Trade Law, Volume XIV: 1983*, Part One, I, A). By its resolution A/RES/38/135 of 19 December 1983, the General Assembly recommended that States should, where appropriate, implement the uniform rules in the form of either a model law or a convention. The uniform rules (hereinafter referred to as *Uniform Rules*) may be used to assist in resolving certain issues which arise in regard to liquidated damages and penalty clauses.

[3]*Illustrative provision (delay in completion)*

"(2) Without prejudice to any right to recover the sum referred to in paragraph (1) of this clause, the purchaser is entitled to require the contractor to complete the works."

[4]*Illustrative provision (delay in completion)*

"(3) Without prejudice to any right to recover the sum referred to in paragraph (1) of this clause, no damages are recoverable in respect of the delay in completion referred to in that paragraph for any period in respect of which the sum referred to in that paragraph is payable."

[5]*Illustrative provision (delay in completion)*

"(4) The amount payable under paragraph (l) of this clause cannot exceed a maximum of . . . (insert currency and amount)."

[6]*Illustrative provision (delay in completion)*

"(5) The maximum specified in paragraph (4) of this clause does not apply to a failure to perform with the intent to cause loss, or which occurred recklessly and with knowledge that loss would probably result."

[7]*Illustrative provision (delay in completion)*

"(6) Without prejudice to any other remedy to which the purchaser may be entitled to recover the sum referred to in paragraph (l) of this clause, he is entitled to deduct that sum, in whole or in part, from any sums due from him to the contractor, either under this contract, or under any other contract between the purchaser and the contractor."

[8]*Illustrative provision (delay in completion)*

"(7) (a) The purchaser is entitled to terminate the contract on the ground of the delay in completion specified in paragraph (l) of this clause after the sum payable under that paragraph reaches the maximum specified in paragraph (4).

(b) If the delay specified in paragraph (1) of this clause occurs, and the contract is terminated by the purchaser for reasons other than that delay before the sum payable under that paragraph reaches the maximum specified in paragraph (4), this clause will not apply after the time of termination, and the purchaser is entitled to recover damages from the contractor for losses suffered after that time by reason of the delay in completion. The purchaser is also entitled to recover the sum which is due under paragraph (1) at the time of termination."

Chapter XX. Damages

SUMMARY

The law applicable to the contract will determine the conditions under which, and the extent to which, a party who fails to perform a contractual obligation is liable to pay damages. The legal rules on some issues relating to liability may be mandatory, while on other issues the legal rules may be capable of modification by the parties. Most legal systems, however, permit the parties to settle through contract provisions issues relating to the extent to which damages may be recoverable (paragraph 1).

The parties may wish to leave to the applicable law the determination of the conditions under which, and the extent to which, damages are recoverable from a party who has failed to perform. However, if they adopt this approach, the parties should include in their contract the other remedies recommended in the *Guide* for a failure to perform only after careful consideration, since these remedies may be inconsistent with the rules governing the recovery of damages under the applicable law (paragraph 2).

Alternatively, the parties may provide in the contract that a party who fails to perform an obligation is liable to pay damages. They may also wish to include an exemption clause which would exclude this liability in specified circumstances. They may also wish to determine the extent to which the party who is aggrieved by the failure to perform is to be compensated (paragraph 3).

Damages may be distinguished in certain respects from payment of an agreed sum and from interest (paragraph 4). The purchaser may also arrange for security to compensate him in the event of a failure to perform by the contractor, or may take out insurance to obtain financial protection (paragraph 5). Moreover, the contract or the law applicable to the contract may provide that one party is to compensate the other in circumstances where there has been no failure to perform by the party from whom compensation is payable (paragraph 6).

Different approaches are available to identify the kinds of losses for which an aggrieved party is entitled to compensation (paragraph 7). In respect of compensation for lost profits, different approaches are available to delimit the amount of compensation payable (paragraph 8).

The contract may exclude the recovery of compensation for losses which the party failing to perform could not have been reasonably expected to foresee. The contract may specify whether foreseeability is to be determined at the time of entering into the contract, or at the time of the failure to perform. Furthermore, the contract may clarify whether the aspect to be foreseen is the kind or the amount of the losses suffered (paragraphs 9 and 10). The parties may also wish to decide on the mechanism by which losses which are causally remote from the failure to perform are excluded from compensation (paragraphs 11 and 12).

If benefits or savings are gained by the aggrieved party from a failure to perform, the parties may provide that they are to be deducted from losses resulting from the failure in determining the amount to be paid as compensation (paragraph 13). The parties may wish to consider whether the contract is to limit the amount of damages recoverable, and, if so, how the limitation is to be determined in the contract (paragraph 14).

The parties may wish to provide that the aggrieved party is obligated to mitigate his losses. They may provide that if he does not do so, he may not be entitled to compensation for losses which could have been prevented if he had fulfilled his obligation (paragraph 15).

Defective construction may result in death or personal injury to third persons, or damage to their property. Liability for damages to the third persons in those cases is often determined by mandatory extra-contractual legal rules. The parties may, however, wish to provide for the internal allocation of risks between them in respect of damages paid to third persons (paragraphs 16 to 18).

The parties may wish to determine in which currency or currencies damages are to be paid (paragraph 19).

A. General remarks

1. The law applicable to the contract (see chapter XXVIII, "Choice of law", paragraph 1) will determine the conditions under which, and the extent to which, a party who fails to perform a contractual obligation is liable to pay damages. The damages serve to compensate the aggrieved party for losses suffered as a result of that failure. The conditions under which the liability to pay damages arises differ under various legal systems. In addition, the legal rules on some issues relating to liability may be mandatory, while on other issues the legal rules may be capable of modification by the parties. Most legal systems, however, permit the parties to settle through contract provisions the issues discussed in this chapter relating to the extent to which damages may be recoverable. However, in formulating provisions regulating particular issues, the parties should make sure that they have the power to do so under the law applicable to the contract.

2. The parties may wish to leave to the law applicable to the contract the determination of the conditions under which, and the extent to which, damages are recoverable from a party who has failed to perform. Even when the rules of the law applicable to the contract are not mandatory, the parties may wish to adopt this approach if the rules of the applicable law settle in an appropriate manner the issues which arise in regard to the recovery of damages for failure to perform a works contract. However, if they adopt this approach, the parties should include in their contract the other remedies recommended in the *Guide* for a failure to perform only after careful consideration, since those remedies may in some instances lead to inconsistencies with the rules governing the recovery of damages under the applicable law.

3. In many cases, it may be advisable for the parties to deal in the contract with the issues that could arise in relation to damages. If they provide for an obligation to pay damages, they may also wish to include a clause (referred to in this *Guide* as an exemption clause: see chapter XXI, "Exemption clauses") which would negate this obligation in certain circumstances (e.g., if performance is

prevented by a specified kind of impediment). The parties may also wish to determine the extent to which a party who is aggrieved by a failure of the other party to perform is to be compensated. The latter issue is discussed in section C, below.

B. Damages distinguished from other remedies and compensation

4. Damages may be distinguished from obligations under clauses for payment of an agreed sum (see chapter XIX, "Liquidated damages and penalty clauses") in that the amount to be paid as damages is assessed after failure to perform has occurred so as to compensate for the losses proved to have been suffered by the aggrieved party; on the other hand, obligation under clauses for payment of an agreed sum involves payment of an amount agreed upon at the time the contract is entered into and payable by a party who fails to perform an obligation without proof of loss by the aggrieved party. Interest, which consists of a sum payable by a party whose failure to perform consists of the non-payment of money, is discussed in chapter XVIII, "Delay, defects and other failures to perform", paragraphs 53 to 56.

5. In addition to his potential rights under the contract to damages or to the payment of an agreed sum, the purchaser may arrange for some form of security upon which he can rely to compensate him in the event of a failure to perform by the contractor. This security is discussed in chapter XVII, "Security for performance", paragraphs 10 to 12. A party may also take out insurance to obtain financial protection against a failure to perform by the other party (see chapter XVI, "Insurance", paragraph 28). Other remedies which may be available upon a failure to perform are discussed in chapter XVIII, "Delay, defects and other failures to perform".

6. The contract or the law applicable to the contract may provide that one party is to compensate the other even in circumstances where there has been no failure to perform by the party by whom the compensation is payable. Instances where such compensation is payable are referred to in the *Guide.* For example, such compensation may be payable by a purchaser who suspends or terminates the contract for convenience (see chapter XXIV, "Suspension of construction", paragraphs 15 and 16, and chapter XXV, "Termination of contract", paragraphs 34 and 35).

C. Liability for damages

1. *Types of losses*

7. The parties may wish to provide that an aggrieved party is entitled to be compensated for all losses caused by a failure to perform, except for certain kinds of losses which are expressly excluded (see paragraphs 9 to 12, below). An alternative approach may be to provide that an aggrieved party is entitled to be compensated only for certain kinds of losses expressly mentioned in the contract. Provisions of both kinds may also operate as a limitation of the damages recoverable (see sub-section 5, below). The kinds of losses which the parties might wish to take into account in formulating provisions dealing with the recovery of damages are as follows:

(*a*) A diminution in the value of assets of the aggrieved party not supplied by the other, e.g., damage to property of a party not supplied by the other party resulting from defects in equipment supplied or construction effected by the other;

(*b*) Expenses reasonably incurred by the aggrieved party which would not have been incurred if the other party had performed his obligations, e.g., wages paid to personnel hired by the contractor to commence construction during a period in which construction cannot be commenced because of a failure by the purchaser to hand over the site;

(*c*) Payments which the aggrieved party makes to a third person by reason of a liability to make those payments arising as a result of a failure to perform by the other party;

(*d*) Loss of the profits which would have accrued to the aggrieved party if the contract had been properly performed.

8. It may often be difficult to determine the amount of lost profits; furthermore, this amount could potentially be very large. As a result, contractors are reluctant to assume unlimited liability for lost profits. In addition, such unlimited liability may not be insurable. One approach to limiting liability may be to provide under a clause for the payment of an agreed sum to compensate for lost profits (see chapter XIX, "Liquidated damages and penalty clauses"). Another approach may be to restrict liability for lost profits only to certain cases of delay or defective performance. Yet another approach may be for the contract to limit compensation for lost profits to a certain amount or to profits lost during a limited period of time after a failure to perform.

2. *Unforeseeable losses*

9. The parties may wish to exclude the recovery of compensation by the aggrieved party for losses which the party failing to perform could not have been reasonably expected to foresee. The relevant time for determining foreseeability may be either the time of entering into the contract or the time of the failure. The former time may be justified on the basis that, when he entered into the contract, the party failing to perform assumed those risks of loss which he could reasonably have foreseen at that time as the consequences of his failures to perform. Because of the long-term and complex character of a works contract, however, many losses which occur would not have been foreseeable at the time of entering into the contract. Accordingly, it may also be appropriate to fix the time at which the failure to perform occurs as the time relevant for determining foreseeability. Such a stipulation would expand the scope of recovery since a particular type of loss may become foreseeable between the time of entering into the contract and the time of the failure to perform. One drawback of the latter method, however, is that in cases other than delay it might sometimes be difficult to establish the time of the failure.

10. The parties may wish to clarify in the contract the aspect of the loss which must be foreseen to entail liability. For example, they may provide that the aspect to be foreseen is the kind of the loss suffered (see paragraph 7, above). Alternatively, they may provide that the aspect to be foreseen is the amount of the loss, and that no damages exceeding that amount are recoverable.[1]

3. *Losses causally remote from failure to perform*

11. As a result of a failure to perform, an aggrieved party may suffer losses whose causal connection with the failure to perform is remote. Most legal systems have rules for determining when compensation is not recoverable for losses because they are too remote. The parties may therefore wish to leave this issue to be resolved under the rules of the law applicable to the contract. In addition, if the parties have identified specific kinds of losses which they wish to exclude from compensation because they would be too remote, the parties may so provide.

12. Parties sometimes seek to resolve the issue of excluding compensation for remote losses by providing that no compensation is recoverable for "indirect" or "consequential" losses. However, the terms "indirect" and "consequential" are vague and could give rise to differing interpretations. The parties may therefore find it advisable not to adopt this approach, unless the law applicable to the contract uses these terms to resolve the issue of excluding compensation for remote losses.

4. *Benefits gained from failure to perform*

13. A failure to perform may result in some benefits or savings to the aggrieved party (for example, he may save certain costs in the operation of the works which he would have incurred if there were no failure). The parties may provide that those benefits or savings are to be deducted from losses in determining the amount to be paid as compensation. The parties may wish to provide that insurance indemnification received under a policy covering losses caused by a failure to perform do not have to be taken into account, as the indemnification is not a benefit resulting from the failure to perform. It may also be noted that when the aggrieved party receives insurance indemnification for the losses suffered, the claim for damages may be subjected to subrogation by, or assignment to, the insurer to the extent of losses indemnified. A reduction of the damages payable to the aggrieved party by the amount of the insurance payment received by him could prejudice the insurer's rights against the party failing to perform, and could be a violation of the insurance policy.

5. *Limitation of amount*

14. The parties may wish to consider whether the contract is to include an overall limit upon the amount of damages recoverable from the contractor in respect of all possible failures to perform by him. The amount of such a limit may be determined as a fixed sum. Alternatively, the amount may be determined as a percentage of the price of the works, as the amount recoverable by the party failing to perform under insurance covering that failure to perform, or as the latter amount together with a percentage of the price. In contracts in which the exact price is not known at the time of entering into the contract (for example, in the case of a cost-reimbursable contract) a combination of these approaches may be used, for example, by limiting damages to the greater of a percentage or a specified amount. A clause for the payment of an agreed sum can also serve as a limitation upon the extent of

recovery (see chapter XIX, "Liquidated damages and penalty clauses", paragraph 3). Parties may, however, wish to provide that a limitation of amount contained in the contract is inoperative if certain types of failures to perform occur (e.g., where the failure to perform consists of an act or omission done with the intent to cause loss, or recklessly and with knowledge that loss would probably result).

6. *Mitigation of losses*

15. Mandatory rules of the applicable law often require an aggrieved party to endeavour to mitigate the losses resulting from a failure to perform. If the applicable law does not contain such rules, or if the rules are unsuitable to a works contract, the parties may wish to provide in the contract that the aggrieved party must endeavour to mitigate his losses. The contract may further provide that, if the aggrieved party fails to fulfill his obligation to mitigate his losses, he is not entitled to compensation for losses which could have been prevented if he had fulfilled this obligation. However, the aggrieved party may be obligated under the contract to take only measures which can reasonably be expected to mitigate the losses and which are reasonable for a party in his position to take (for example, he need not take any measures which might endanger his own commercial reputation or which are too onerous). If the aggrieved party takes reasonable measures he may be entitled, subject to limitations contained in the contract or imposed by the law applicable to the contract, to recover compensation for his losses, including costs reasonably incurred in taking those mitigating measures. He may be so entitled even if the measures were unsuccessful.[2]

D. Personal injury and damage to property of third persons

16. Defective construction may result in the death of or personal injury to the employees of the purchaser or other third persons, or in damage to their property. The issues concerning damages to be paid to third persons in such cases are complex, and may be governed not by rules of the law applicable to the contract governing contractual liability, but rather by applicable legal rules governing extra-contractual liability. The latter rules are often mandatory. Moreover, the contract cannot limit the liability of the contractor or the purchaser to compensate third persons who are not parties to the contract. The parties may wish to provide for the internal allocation of risks between them in respect of damages to be paid to third persons due to death or personal injury or damage to their property, to the extent that this allocation is not governed by mandatory legal rules. The parties may also wish to provide for insurance against such risks (see chapter XVI, "Insurance", paragraph 36).

17. If a person suffers personal injury or damage to his property as a result of the construction, and brings a claim against the purchaser, the contract may obligate the contractor to indemnify the purchaser against such a claim to the extent of the purchaser's liability. Alternatively, the contract may provide for an obligation to indemnify only if the injury or damage was caused by the contractor's failure to use proper skill and care in constructing the works. The extent to which the contractor may be obligated to indemnify the purchaser

against claims arising from construction effected by subcontractors employed by the contractor is dealt with in chapter XI, "Subcontracting", paragraphs 27 and 28.

18. The purchaser against whom a claim is made in respect of injury or damage to property of a third person may be obligated to notify the contractor of that claim, at least in those instances where he proposes to rely on the contractor's indemnity (see previous paragraph). The contractor may be entitled, if he wishes, to participate in all negotiations for the settlement of the claim and to join in any legal proceedings which are instituted, to the extent permitted by the law of the country where the legal proceedings are instituted.

E. Currency of damages

19. As a general principle, the contract may require damages to be paid in the same currency in which the price is to be paid. However, in some cases, in particular if the price is to be paid in a currency which is not freely convertible, the contract may provide for damages to be paid in the currency in which the losses have been suffered (e.g., if, as a result of the failure to perform, the aggrieved party is obligated to pay compensation to a third person in a freely convertible currency, the damages in respect of the payment of such compensation may be paid to the aggrieved party in the freely convertible currency).

Footnotes to chapter XX

[1]*Illustrative provision*

"Subject to the other provisions of the contract, damages are recoverable [only in respect of a kind of loss] [only in the amount of the loss] which the party failing to perform foresaw or could have been reasonably expected to foresee at the time of [entering into the contract] [the failure to perform] in the light of the facts and matters of which he then knew or could reasonably have been expected to know, as a possible consequence of the failure to perform."

[2]*Illustrative provision*

"A party who suffers loss as a result of a failure to perform by the other party must take all measures which he can reasonably be expected to take to mitigate the loss. If he fails to take those measures, compensation is not recoverable for any loss which could have been prevented by those measures. If he takes those measures, he is, subject to limitations on recovery contained in this contract, entitled to recover compensaton for the full extent of his loss, including costs reasonably incurred by him in taking those measures, even if those measures were not successful in mitigating the loss."

Chapter XXI. Exemption clauses

SUMMARY

During the course of construction, events may occur which impede the performance by a party of his contractual obligations. The present chapter concerns clauses under which a party who fails to perform a contractual obligation due to an impediment is exempted from certain legal consequences of the failure. It would be in the interest of the purchaser if the scope of the exemption clause were limited, both as to the events which constitute exempting impediments and the legal consequences of exempting impediments. The parties may wish to enable both parties to invoke an exemption clause (paragraphs 1 to 4).

Rules in some legal systems concerning exemption from legal consequences of a failure to perform may lead to results which are incompatible with the circumstances and needs of international trade. The parties may, therefore, wish to include in the contract an exemption clause defining exempting impediments and specifying the legal consequences of those impediments (paragraphs 5 to 7).

In order to limit the scope of an exemption clause, the parties may wish to provide that a party failing to perform is exempt only from the payment of damages or of an agreed sum to the other party (paragraph 8).

The parties might also limit the scope of the exemption clause by adopting a restricted definition of exempting impediments. One approach may be to provide only a general definition of exempting impediments (paragraphs 10 to 12). Another approach may be to provide a general definition together with an illustrative or exhaustive list of events to be considered exempting impediments, or a list of events to be considered exempting impediments whether or not they come within the general definition (paragraphs 13 to 16). A third approach may be to provide an exhaustive list of events to be considered exempting impediments without a general definition (paragraph 17). The parties may wish to consider various types of events to be included in a list of exempting impediments (paragraphs 18 to 22).

The scope of an exemption clause might be further clarified by expressly excluding some events which might otherwise come within the scope of the clause. The parties may wish to consider whether certain acts of a State or of State organs, such as the denial or withdrawal of a licence or approval, are to be regarded as exempting impediments (paragraphs 23 and 24).

The parties may wish to provide in the contract the conditions under which a contractor is exempt when his failure to perform is due to a failure by a third person engaged by him (paragraphs 25 and 26).

It is desirable for the contract to obligate a party invoking an exempting impediment to give written notice of the impediment to the other party. The contract might provide that a party who fails to give such notice loses his right to invoke the exempting impediment. Alternatively, the contract may provide that the party remains entitled to invoke the exempting

impediment, but that he is liable to compensate the other party for losses resulting from the failure. The contract might also require verification of an impediment for it to be relied upon. Further, the parties may wish to provide that, upon notification of an exempting impediment, they are to meet and consider what measures to take in order to prevent or limit the effects of the impediment (paragraphs 27 and 28).

A. General remarks

1. During the course of construction, events may occur which impede the performance by a party of his contractual obligations. These impediments may be of a physical nature, such as a natural disaster, or they may be of a legal nature, such as a change in the law in the purchaser's country after the contract is entered into preventing the use of certain equipment specified in the contract. The impediments may prevent performance by a party permanently or only temporarily. Under the law applicable to the contract, a permanent impediment may result in the termination of the contract.

2. A works contract may contain various types of provisions to deal with impediments to performance. The present chapter concerns clauses under which a party who fails to perform a contractual obligation due to an impediment is exempted from certain legal consequences of the failure. Impediments which give rise to such an exemption are referred to in the *Guide* as "exempting impediments". A party who is faced with an impediment to performance might also have other rights under the contract. For example, the purchaser might be permitted to vary the contractual term affected by the impediment under a variation clause (see chapter XXIII, "Variation clauses", paragraphs 5 to 19); a party might be permitted to terminate the contract (see chapter XXV, "Termination of contract", paragraph 22); or a party might have rights under a hardship clause (for the relationship between hardship clauses and exemption clauses, see chapter XXII, "Hardship clauses", paragraph 2).

3. While the purchaser must usually perform only a single principal obligation (i.e., to pay the price), the contractor must normally perform a number of major obligations in the course of constructing the works. The contractor, therefore, will have more interest in an exemption clause than the purchaser. However, the financial consequences to a purchaser from a failure of the contractor to perform could be severe. It would, therefore, be in the interest of the purchaser if the scope of the exemption clause were limited, both as to the events which constituted exempting impediments (see paragraphs 9 to 23, below) and the legal consequences of exempting impediments (see paragraph 8, below).

4. Even though the performance of the contractor is more likely to be affected by an impediment than is the performance of the purchaser, cases could arise in which an impediment affects the purchaser's performance. The purchaser might, for example, be prevented by a legal impediment from making a payment to the contractor; or, he might be prevented by a physical impediment from performing certain limited construction obligations he has undertaken. The parties may therefore wish to enable both parties to invoke the exemption clause.

5. Many legal systems contain rules under which a party who fails to perform a contractual obligation is exempted from certain legal consequences of his failure. However, those rules may lead to results which are incompatible with

the circumstances and needs of international trade. Therefore, the parties may wish to include in their contract an exemption clause defining exempting impediments and specifying the legal consequences of those impediments. In structuring an exemption clause, the parties should consider whether and the extent to which mandatory rules of the law applicable to the contract limit their power to do so. It is advisable for the parties to take note of the fact that using in the clause the same terminology in relation to exemption that is used in the law applicable to the contract will often carry with it certain legal implications that may not be consistent with the parties' intentions.

6. The treatment in various legal systems of the subject of exemption differs with respect to the conceptual underpinnings of the subject and the terminology used. In relation to exemptions in the context of sales contracts, these differences have been bridged by the United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980), article 79.[1] The approach adopted in that Convention has been designed to take into account the particular circumstances and needs of international trade. The parties may find that approach to be a useful guide in formulating an exemption clause in a works contract. The discussion in this chapter of the legal consequences of exempting impediments and the definition of exempting impediments (sections B and C, below, respectively) is based upon the approach taken in the Convention.

7. The question of exemption, and its relation to remedies for a failure to perform, has implications with respect to a number of other issues discussed in the *Guide.* The discussion of those issues conforms to the approach taken in this chapter with respect to exemptions. To the extent that the parties adopt a different approach, the discussion of those other issues, and the suggested approaches for dealing with them, may not apply.

B. Legal consequences of exempting impediments

8. The parties may wish to provide that a party who fails to perform due to an exempting impediment is exempt from the payment of damages or an agreed sum to the other party. If the parties wish to treat differently other remedies for a failure to perform that might otherwise arise under the contract or the law applicable to the contract, such as enforcement of performance (see chapter XVIII, "Delay, defects and other failures to perform") or termination of the contract (see chapter XXV, "Termination of contract"), they should so provide in the contract. References to exempting impediments throughout this *Guide* assume that the exemption relates only to the payment of damages or of an agreed sum, and not to other remedies for failure to perform. Additional legal consequences that the contract may provide in cases of exempting impediments are discussed in other chapters (see, e.g., chapter VII, "Price and payment conditions", paragraph 53).

C. Definition of exempting impediments

9. The parties might also limit the scope of the exemption clause by adopting a restricted definition of exempting impediments. They may adopt one of several approaches in defining exempting impediments, for example:

(*a*) Providing only a general definition of exempting impediments;

(*b*) Combining a general definition with a list of exempting impediments;

(*c*) Providing only an exhaustive list of exempting impediments.

1. *General definition of exempting impediments*

10. A general definition of exempting impediments would enable the parties to ensure that all events having the characteristics set forth in the definition will be considered as exempting impediments. This approach would avoid the need to compile a list of exempting impediments, and would avoid the risk of excluding from the list events which the parties would have considered as exempting impediments. On the other hand, it could be difficult in some cases to determine whether or not a particular event was covered by the general definition. The parties may wish to consider including the following elements in a general definition.

11. As a first element, the parties may wish to stipulate that performance of a contractual obligation must be prevented by a physical or legal impediment (see paragraph 1, above), and not, for instance, only made inconvenient or more expensive. The parties may wish to provide that if an impediment prevents a party from performing his obligation during only a temporary period of time, he is exempt in respect of a failure to perform only during that period.

12. As an additional element, the parties may wish to provide that the impediment must be beyond the control of the party failing to perform and that he could not reasonably be expected to have taken the impediment into account at the time the contract was entered into or to have avoided or overcome the impediment or its consequences.[2]

2. *General definition followed by list of exempting impediments*

13. A general definition of exempting impediments might be followed by either an illustrative or exhaustive list of events which are to be regarded as exempting impediments.[3] This approach would combine the flexibility afforded by a general definition with the certainty arising from the specification of exempting impediments.

(a) *General definition followed by illustrative list*

14. Examples of exempting impediments to be included in an illustrative list may be chosen so as to clarify the scope of the general definition. Such an approach could give guidance to the parties and to persons or tribunals settling disputes under the contract as to the intended scope of the general definition. In addition, it could ensure that the events set forth in the list would be treated as exempting impediments if they met the criteria set forth in the general definition.

(b) *General definition followed by exhaustive list*

15. A general definition of exempting impediments might be followed by an exhaustive list of events which are to be regarded as exempting impediments if

they meet the criteria contained in the general definition. An exhaustive list may be inadvisable unless the parties are certain that they can foresee and list all events which they wish to be regarded as exempting impediments.

(c) *General definition followed by additional list of exempting impediments whether or not they come within definition*

16. A general definition of exempting impediments might be followed by a list of events which are to be regarded as exempting impediments whether or not they come within the general definition. This approach may be useful where parties choose a narrow general definition of exempting impediments, but wish certain events which do not fall within the scope of that definition to be regarded as exempting impediments. Since those events would constitute exempting impediments independently of the general definition, the remarks in paragraph 17, below, concerning safeguards which may be adopted when providing a list of exempting impediments without a general definition, are also applicable here.

3. *Exhaustive list of exempting impediments without general definition*

17. It is possible for an exemption clause simply to provide an exhaustive list of events which are to be considered exempting impediments, without a general definition. This approach has the disadvantage of not providing general criteria which the listed events must meet in order to be regarded as exempting impediments. If the approach is adopted, it would be advisable for the parties to set forth for each event criteria which must be met for the event to be regarded as an exempting impediment. For example, if the parties wish to specify "war" or "military activity" as an exempting impediment (see paragraph 20, below), it would be advisable to specify, for example, whether the commencement of hostilities involving the country where the construction site was located was sufficient or whether hostile action at the construction site must have occurred or be likely to occur.

4. *Possible exempting impediments*

18. If the parties set forth in the exemption clause a list of events which are to be considered exempting impediments, with or without a general definition, they may wish to consider whether it is desirable to include any of the following events in the list.

19. *Natural disasters.* Natural disasters such as storms, cyclones, floods or sandstorms may be normal conditions at a particular time of the year at the site. In such cases, the contract might preclude a party from invoking them as exempting impediments (see paragraph 12, above).

20. *War (whether declared or not) or other military activity.* It may be difficult to determine when a war or a particular military activity can be considered as preventing performance of an obligation. For instance, frequent air raids near the construction site may create a high risk to the safety of the contractor's employees, but may not actually prevent them from continuing with the construction. Moreover, it may be possible for a party to avoid a military

blockade by running the blockade, but in doing so he might face a high risk. It may be desirable, therefore, to specify clearly when a war or other military activity is considered to prevent performance (see, e.g., paragraph 17, above).

21. *Strikes, boycotts, go-slows and occupation of factories or premises by workers.* The parties may wish to consider whether and the extent to which these events are to be considered as exempting impediments. On the one hand, such events could in a real sense prevent the contractor from performing. On the other hand, the parties might consider that it was not advisable for a party to be exempted from the consequences of a failure to perform an obligation when the failure resulted from the conduct of his own employees. In addition, it may be difficult to determine whether or not strikes by employees and other labour disputes are avoidable by a party, and what measures the party might reasonably be expected to take to avoid or to end the strike or dispute (e.g., meeting the strikers' demands). In that connection, the parties may wish to provide that only strikes that do not arise from labour relations between the party and his employees (e.g., sympathy strikes) are to be regarded as exempting impediments. If, under the contract, the contractor is required to employ personnel of the purchaser, a strike by those personnel might in appropriate cases be regarded as an exempting impediment for the contractor.

22. *Shortages of raw materials needed for the construction.* The parties may wish to consider whether this is to be considered as an exempting impediment. They might, for example, wish to obligate the contractor to procure raw materials in time and to preclude his claiming an exemption if he fails to do so. In some cases, the contractor may fail to have the materials available on time due to a delay by his supplier. For those cases, however, it would be advisable for the contractor to ensure that under his contract with his supplier he is able to claim damages against the supplier for the delay.

5. *Exclusion of impediments*

23. Whichever approach to defining exempting impediments is adopted, the parties may wish further to clarify the scope of an exemption clause by expressly excluding some events which might otherwise come within the scope of the clause. For example, the parties may wish to preclude a party from claiming an exemption if he is prevented from performing due to his own adverse financial position. They may also wish to consider excluding from exempting impediments events which occur after a breach of contract by a party and which, but for the breach, would not have prevented performance by that party.

24. The parties may wish to consider whether certain acts of a State or of State organs are to be regarded as exempting impediments. A party may be required to secure a licence or other official approval for the performance of certain of his obligations. The contract might provide that if the licence or approval is refused by a State organ, or if it is granted but later withdrawn, the party who was required to obtain the licence or approval cannot rely on the refusal or withdrawal as an exempting impediment. The parties might consider that it is equitable for the loss caused by the failure to perform resulting from the absence of the licence or approval to be borne by the party who had the duty to obtain it, since that party undertook his obligations knowing of the

necessity to obtain the licence or approval and the possibility of its being refused. Moreover, it might be difficult for the other party to determine whether the measures taken to obtain the licence or approval were reasonable (see paragraph 12, above). The parties may wish to note that, under some legal systems, if a licence or approval is not granted, the contract is invalid, and the legal consequences of the failure of the party to obtain the licence or approval will be determined by the applicable law.

6. *Failure to perform by third person engaged by contractor*

25. It is common in a works contract for the contractor to engage third persons (e.g., subcontractors) to perform some of his obligations under the contract (see chapter XI, "Subcontracting"). Where the contractor fails to perform the obligation under the works contract due to a failure to perform by the third person, the question arises whether and to what extent the contractor is exempt from the payment of damages to the purchaser for that failure.

26. In general, the parties may consider it advisable to provide that the engagement by the contractor of a third person to perform the contractor's contractual obligation does not diminish or eliminate the contractor's liability to the purchaser for the performance of that obligation (see chapter XI, "Subcontracting", paragaphs 27 and 28). Consistently with that approach, the parties may wish to provide that a contractor is exempt from the payment of damages when his failure to perform is due to a failure by a third person engaged by him only if two conditions are satisfied: firstly, if the criteria for exempting the contractor under the exemption clause in the works contract are satisfied (for example, if the failure of the third person to perform was unavoidable and if the contractor could not reasonably be expected to have taken the failure into account at the time the contract was entered into or to have avoided or overcome the failure or its consequences); and secondly, if the third person would be exempt under the exemption clause in the works contract if that clause were contained in the contract between the contractor and the third person.[4]

D. Notification of impediments

27. It is desirable for the contract to obligate a party invoking an exempting impediment to give written notice of the impediment to the other party without undue delay after the party invoking the impediment learned or could reasonably have been expected to learn of the occurrence of the impediment. This notification could facilitate the taking of measures by the other party to mitigate the loss caused or which is likely to be caused by the failure of performance. The contract might require the notice to specify details of the impediment, together with evidence that performance by the party is prevented or is likely to be prevented, and, if possible, the anticipated duration of the impediment. The party invoking the exempting impediment might also be required to continue to keep the other party informed of all circumstances which may be relevant for an appraisal of the impediment and its effects, and to notify the other party of the cessation of the impediment. The contract might provide that a party who fails to notify in time the other party of the exempting impediment loses his right to invoke the exempting impediment. Alternatively,

the parties may provide that a party who fails to give the required notification in time remains entitled to invoke the clause, but is liable to compensate the other party for losses resulting from the failure. The contract might also require for an impediment to be relied upon that it be verified, for example, by a public authority, notary public, a consulate or chamber of commerce in the country where the impediment occurs.

28. Further, the parties may wish to provide that, upon notification of an exempting impediment, they are to meet and consider what measures to take in order to prevent or limit the effects of the impediment, and to prevent or mitigate any loss which may be caused by it. These measures might include variation of the contractual obligation affected by the impediment (see chapter XXIII, "Variation clauses"), or, in some cases, re-negotiation of the contract (see chapter XXII, "Hardship clauses").

Footnotes to chapter XXI

[1]*Official Records of the United Nations Conference on Contracts for the International Sale of Goods* (United Nations publication, Sales No. E.81.IV.3).

[2]*Illustrative provision*

(General definition of exempting impediments)

"(1) A party is exempt from the payment of damages, or of an agreed sum, in respect of a failure to perform an obligation under this contract if he proves that the failure was due to a physical or legal impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.

"(2) A party is exempt from the payment of damages or an agreed sum pursuant to the preceding paragraph in respect of a failure to perform only during the period of time when his performance was prevented by the impediment."

[3]*Illustrative provision*

(General definition followed by illustrative or exhaustive list)

"(1) [As fn. 2, para. (1)]

"(2) [*Illustrative list*]: The following are examples of events which are to be regarded as exempting impediments, provided they satisfy the criteria set forth in paragraph (1), above: . . . [*Exhaustive list*]: The following events are to be regarded as exempting impediments pursuant to paragraph (1), above, provided they satisfy the criteria set forth in that paragraph; and only those events are to be so regarded: . . .

"(3) [As fn. 2, para.(2)]."

[4] *Illustrative provision*

"If the party's failure to perform an obligation is due to a failure to perform by a third person whom he has engaged to perform that obligation, the party is exempt pursuant to paragraph (1), above, only if:

"(*a*) with respect to the party, the criteria set forth in paragraph (1) are satisfied; and

"(*b*) the third person would be exempt if the provisions of paragraph (1) were applied to him."

Chapter XXII. Hardship clauses

SUMMARY

Hardship is a term that is used in the *Guide* to describe a change in economic, financial, legal, or technological factors which causes serious adverse economic consequences to a contracting party, thereby rendering more difficult the performance of his contractual obligations. A hardship clause usually defines hardship, and provides for renegotiation to adapt the contract to the new situation created by the hardship (paragraph 1). Hardship clauses are to be distinguished from exemption clauses (paragraph 2).

A hardship clause may be considered to have the advantage that renegotiation under it might avert a disruptive failure of performance by the party affected by the changed circumstances. The clause may also facilitate renegotiation by providing a framework within which it may be conducted (paragraph 3).

A hardship clause has, however, several disadvantages which may outweigh the advantages described above. The possibility of renegotiation makes the contract to some degree unstable, the definition of hardship tends to be imprecise and vague, and the inclusion of the clause may induce the advancement of spurious claims that hardship exists to avoid the performance of obligations (paragraph 4). Furthermore, the purchaser may in particular be disadvantaged because the contractor will potentially have more opportunities to invoke the clause than the purchaser (paragraph 5). The *Guide* deals with other clauses which may be included in the contract and which may apply when a change of circumstances causes serious adverse economic consequences to a party. The purchaser may wish to consider whether the inclusion of those clauses renders a hardship clause unnecessary (paragraph 6).

If, despite its disadvantages, the parties wish to include a hardship clause in the contract, it is advisable to draft it so as to reduce the uncertainty it might create as to the obligations of the parties. It may be acceptable for the clause to define hardship, and in addition to include a list of events on one or more of which alone a party can rely to invoke the clause (paragraphs 7 and 12). A restrictive definition of hardship may be adopted under which all required elements must be satisfied before hardship is deemed to occur (paragraphs 8 to 11). The parties may wish to consider the inclusion of other limitations to invoking a hardship clause, since those limitations may reduce the instability introduced into the contract by the clause (paragraph 13).

The parties may wish to decide whether, in the event of hardship occurring, they are to be obligated only to participate in renegotiations with a view to adapting the contract, or are to be obligated to adapt the contract after renegotiations (paragraph 14).

The parties may wish to provide procedures for facilitating renegotiation (paragraphs 15 to 17). The contract may also determine the point of time at which a failure to agree on adaptation after renegotiations may be deemed to occur (paragraph 18).

The parties may wish to facilitate the implementation of a hardship clause by providing guidelines to assist them in reaching a fair adaptation of the contract (paragraph 19). Since the circumstances which had changed and created the hardship may change once more and approximate to their previous condition, thus alleviating the hardship, the contract may provide how the contract is to be re-adapted if circumstances return to their previous condition (paragraph 20).

The parties may wish to determine the status of the contractual obligations of the parties during renegotiations. Where the parties are obligated only to participate in renegotiations, they may provide that the performance of the obligations of the parties which are alleged to be affected by the hardship is to continue in accordance with the original terms of the contract during the renegotiations (paragraph 21). Where the parties are obligated to adapt the contract after renegotiations, they may provide that the performance of the obligations is to continue both during renegotiations and, if the parties fail to agree on adaptation, during the ensuing dispute settlement proceedings. Alternatively, they may provide that the party invoking the hardship clause is entitled to interrupt the performance of the obligations (paragraph 22).

Where the contract obligates the parties to adapt the contract after renegotiations, it is advisable for the contract to provide for the consequences of a failure to agree on adaptation (paragraph 23).

A. General remarks

1. The term "hardship" as used in the *Guide* means a change in economic, financial, legal or technological factors that causes serious adverse economic consequences to a contracting party, thereby rendering more difficult the performance of his contractual obligations. A typical hardship clause has two main aspects. Firstly, it would define hardship and, secondly, it would provide for renegotiation to adapt the contract to the new situation created by the hardship. The legal effect of hardship clauses may vary under different legal systems. While they are recognized under some legal systems, they are unknown in others; in still other legal systems their validity has not been tested in legal proceedings.

2. Hardship clauses are to be distinguished from exemption clauses (see chapter XXI, "Exemption clauses"). A hardship clause as conceived in the *Guide* would apply when a change of circumstances makes the performance of a party's obligations more onerous, but does not prevent that performance. An exemption clause as conceived in this *Guide* would apply only when a change of circumstances prevents performance. Thus, a hardship clause may apply where, after the contract is entered into, administrative regulations relating to environmental protection applicable to the construction change so as to introduce more stringent requirements which greatly increase the cost of construction. An exemption clause may apply where the regulations change so as to prevent further construction. The legal consequences resulting from the application of each type of clause as conceived in the *Guide* would also differ. A hardship clause would provide that, if hardship occurs, the contract is to be renegotiated (see previous paragraph). An exemption clause would provide that, if a failure to perform an obligation occurs as a result of exempting impediments, certain remedies, in particular the recovery of damages, are not available to the aggrieved party against the party who failed to perform.

3. The inclusion of a hardship clause may be considered to have the advantage that if a change of circumstances results in serious adverse economic consequences to a party, renegotiation of the contract under the clause might avert a disruptive failure of performance by the party affected by the changed circumstances. Although there is nothing to prevent parties from renegotiating even in the absence of a hardship clause, the clause may facilitate renegotiation by providing a framework within which the renegotiations may be conducted. Thus, the clause may include provisions which help to achieve an equitable outcome from the renegotiations (see paragraph 19, below) and may regulate the rights and obligations of the parties during renegotiations (see paragraphs 15 to 17 and 21 and 22, below).

4. A hardship clause has, however, considerable disadvantages which may outweigh the advantages mentioned above. The possibility of renegotiating the contract under a hardship clause makes the contract to some degree unstable. Furthermore, because of the nature of hardship, its definition tends to be imprecise and vague. Further disadvantages of a hardship clause are that the renegotiation may result in interruptions in the performance of obligations under the contract, and that the clause may induce the advancement of spurious claims that hardship exists as an excuse for avoiding the performance of obligations. In addition, where a hardship clause obligates the parties to adapt the contract after renegotiations (see paragraph 14, below), and the parties fail to reach agreement on the adaptation, there may be difficulties in securing an adaptation through dispute settlement proceedings (see paragraph 23, below).

5. A hardship clause may have particular disadvantages for a purchaser. While the purchaser has usually to perform only a single principal obligation (i.e., to pay the price), the contractor has to perform a number of obligations in the course of constructing the works. The contractor, therefore, will potentially have more opportunities to invoke the hardship clause than the purchaser. Accordingly, before agreeing to the inclusion of a hardship clause in the contract, the purchaser should carefully consider the possible adverse effects to him of that clause.

6. The *Guide* discusses other clauses which may be included in the contract and which may apply when circumstances change after the contract is entered into causing serious adverse economic consequences to a party. Of these other clauses, those having an objective closest to that of a hardship clause are index clauses and currency clauses. An index clause provides for the revision of the price when the cost of goods or services to be supplied by the contractor changes, and a currency clause provides for a revision of the price when there is a change in the exchange rate of the currency in which the price is to be paid in relation to a reference currency (see chapter VII, "Price and payment conditions", paragraphs 49 to 55, 58 and 59). These clauses deal with changes which are predictable and can be clearly identified in advance. Hence, the clauses can specify the modifications which are to be made to contract terms as a result of those changes, and the contract need not, as under a hardship clause, provide for renegotiation, with its attendant uncertainty of outcome. Where, as a result of changed circumstances, the purchaser wishes to alter the scope of the construction, he may do so within certain limits under a variation clause (see chapter XXIII, "Variation clauses", paragraphs 5 to 18). Where the changed circumstances make it advisable for the purchaser to suspend construction, he

may do so under a clause providing for suspension (see chapter XXIV, "Suspension of construction", paragraphs 3 and 4). Where the change is so drastic that the project ceases to be viable, the purchaser may, under a termination clause, terminate for convenience (see chapter XXV, "Termination of contract", paragraphs 17 and 18). The purchaser may therefore wish to consider whether the inclusion of the clauses mentioned above renders a hardship clause unnecessary. The discussion of hardship clauses in the *Guide* is not to be regarded as an indication that their inclusion in contracts is desirable.

B. Approach to drafting hardship clause

7. If, despite its disadvantages, the parties wish to include a hardship clause in the contract, it is advisable to draft it so as to reduce the uncertainty it might create as to the obligations of the parties. The use of open-ended and vague criteria (e.g., "changed circumstances", "upsetting the initial equilibrium of the contract", and "causing serious economic consequences") to determine the application of the clause is to be avoided. Providing a list of hardship events which is not exhaustive will also lead to uncertainty. An acceptable approach might be to set forth in the clause a definition of when hardship may be said to occur (see sub-section 1, below), together with an exhaustive list of the events on one or more of which a party can rely to invoke the clause (see sub-section 2, below). Under this approach, the clause can be invoked only if an event specified in the list occurs which results in the hardship defined in the clause.

1. *Definition of hardship*

8. The parties may find it advisable to adopt a restrictive definition of hardship under which all the following elements must be satisfied before hardship can be deemed to occur: (*a*) a change of the circumstances which existed at the time the contract was entered into; (*b*) the change being unavoidable and one which the party invoking the clause could not reasonably be expected to have taken into account; and (*c*) the change resulting in serious adverse economic consequences to that party.

(a) *Changed circumstances*

9. The scope of the hardship clause may be made more clear if, instead of merely requiring a "change of circumstances", the parties were to require that the changes occur in particular areas. For example, the parties may provide that the change must relate to specific economic, financial, legal, or technological circumstances.

(b) *Nature of change*

10. The parties may wish to provide that the change of circumstances must have been beyond the control of the party invoking the hardship clause and that he could not reasonably be expected to have taken the change of circumstances into account at the time the contract was entered into or to have avoided or overcome the change of circumstances or its consequences.

(c) *Serious adverse economic consequences*

11. The parties may wish to define what adverse economic consequences to the party invoking the hardship clause are to be regarded as serious. The purpose of that definition would be to seek to prevent a party from invoking a hardship clause upon the occurrence of adverse economic consequences the risk of which he must fairly be regarded as having assumed at the time he entered into the contract. One approach may be to use a general term to quantify the required degree of seriousness, e.g., that the change of circumstances must have caused "a substantial financial burden" or "undue prejudice" to the party invoking the clause. A preferable approach may be to quantify the seriousness in a more specific manner, e.g., by providing that the change of circumstances must result in cost increases which exceed a specified percentage of the price.

2. *Exhaustive list of events*

12. The parties may wish to provide that a party may invoke the hardship clause only if he establishes that one or more of the events enumerated in an exhaustive list has occurred and has resulted in hardship to him as defined in the clause. Illustrative examples of events which might be included in a list are a severe reduction in the size of the purchaser's anticipated market for the output of the works, or an increase in the cost of raw materials needed to produce the output of the works which results in a severe reduction in its profitability. Similar events may occur causing hardship to the contractor.

3. *Other possible limitations*

13. The parties may wish to consider the inclusion of a provision that the hardship clause cannot be invoked by a party in respect of an obligation imposed on him if, at the time the hardship occurs, he has already failed to perform that obligation. The application of the clause may also be restricted by providing that it cannot be invoked for a certain period of time after the date the parties entered into the contract. Furthermore, the parties may place a limit on the number of times that a party may invoke the clause, or agree that the clause may be invoked only a specified number of times during a specified time period. Such limitations may reduce the instability which a hardship clause introduces into the contract.

C. Renegotiation

14. The hardship clause may provide for the renegotiation of the contract if hardship occurs. The parties may wish to decide whether the contract should obligate them only to participate in renegotiations with a view to adapting the contract, or should obligate them to adapt the contract after renegotiations. The parties may at the time of entering into the contract, or subsequently, agree upon a conciliator who could assist them in an independent and impartial manner in their attempt to adapt the contract (see chapter XXIX, "Settlement of disputes", paragraphs 12 to 15). If the contract obligates the parties to adapt the contract after renegotiations, it may be desirable to provide that, upon a failure by the parties to reach agreement on adaptation, the contract is to be adapted by a court, arbitral tribunal or referee (see paragraph 23, below).

1. *Procedure for renegotiation*

(a) *Notification*

15. The contract may provide that a party may invoke the hardship clause only by notification in writing to the other party. It may be provided that the notification must be made within a specified period of time after the occurrence of the change of circumstances relied upon as constituting hardship, must set forth sufficient detail concerning the change of circumstances and its consequences to enable the other party to evaluate the effects of the change, and must indicate the nature of the adaptation sought by the party invoking the clause.

16. The party notified may be obligated to respond in writing within a specified period of time of the notification. It may be provided that, if he considers that the grounds set out in the notification are not sufficient to justify renegotiations, he must set forth in the response the reasons for that conclusion. If he is willing to participate in renegotiations, he may be obligated to indicate the nature of an adaptation of the contract which he considers to be appropriate.

17. The parties may wish to provide that, if the party entitled to invoke the hardship clause fails to give the required notification within the specified period, he loses his right to invoke the clause. This approach may reduce belated claims of hardship made with a view to avoiding the performance of obligations which have become onerous. Alternatively, the parties may provide that a party who fails to give the required notification in time remains entitled to invoke the clause, but is liable to compensate the other party for losses resulting from the delay in notification.

(b) *Time-limit for renegotiation*

18. It is advisable for the contract to determine the point of time at which a failure to agree on adaptation of the contract after renegotiations may be deemed to occur. The contract may provide that a failure occurs if no agreement is reached within a specified time period after notification of a hardship situation.

(c) *Guidelines for renegotiation*

19. The parties may wish to facilitate the implementation of a hardship clause by providing guidelines to assist them in reaching a fair adaptation of the contract. They may, for example, provide that the original terms of the contract are to be modified only to the extent required to rectify the imbalance in the contract created by the hardship event. Other guidelines which may be provided include the following: that the principle of good faith should apply in determining the required adaptation; that adaptation should seek to ensure full performance of contractual obligations to the extent possible; that there should be no undue prejudice to either party arising from the adaptation; and that the adaptation should seek to maintain the pre-existing balance of interests between the parties.

20. The circumstances which changed and created the hardship may change once more and approximate to their previous condition, thereby alleviating the hardship. The contract may provide that the likely duration of the change of circumstances is to be taken into account when adapting the contract, and that the adaptation should, to the extent possible, indicate how the contract is to be re-adapted if circumstances return to their previous condition.

(d) *Status of obligations during renegotiation*

21. The parties may wish to determine the status of the contractual obligations of the parties during renegotiations. Where the parties are obligated only to participate in renegotiations with a view to adapting the contract, they may wish to provide that the performance of the obligations of the parties which are alleged to be affected by the hardship is to continue in accordance with the original terms of the contract during the renegotiations. If the parties after renegotiations agree on an adaptation, the terms of the adaptation could make allowance for losses caused to the party affected by the hardship by reason of the continued performance of the obligations during renegotiations.

22. Where the parties are obligated to adapt the contract after renegotiations (see paragraph 14, above), one of two approaches may be adopted. The contract may provide that the performance of the obligations of the parties which are alleged to be affected by the hardship is to continue both during the renegotiations and, if the parties fail to agree on adaptation, during the ensuing dispute settlement proceedings, unless the court, arbitral tribunal or referee settling the dispute decides otherwise. The terms of the adaptation could make allowance for losses caused to the party affected by the hardship by reason of the continued performance of the obligations. Providing that performance is to continue may reduce the making of spurious claims of hardship by a party who wishes to avoid the performance of certain obligations. An alternative approach is for the contract to provide that the party invoking the hardship clause is entitled to interrupt the performance of the obligations alleged to be affected by the hardship. The terms of the adaptation could settle in what manner, if at all, those obligations are to be performed subsequent to the adaptation. If it is decided in dispute settlement proceedings that the party invoking the hardship clause had no right to invoke the clause, it may be provided that the other party is entitled to be compensated for losses caused to him by the interruption. Providing for the interruption of the performance of obligations might make it easier to adapt the contract, as continued performance may result in prejudice to the party affected by the hardship, and it may be difficult to remedy the prejudice by adaptation.

2. *Failure to fulfil obligation to adapt*

23. Where the contract obligates the parties to adapt the contract after renegotiations (see paragraph 14, above), it is advisable for the contract to provide for the consequences of a failure to agree on adaptation. The contract may provide that the party invoking the hardship clause is entitled to institute judicial or arbitral proceedings for the adaptation of the contract, or may provide that a referee is to decide whether and in what way the contract is to be adapted. These methods of resolving the dispute between the parties are dealt with in chapter XXIX, "Settlement of disputes". The parties should be aware that some legal systems do not permit adaptation in judicial or arbitral proceedings.

Chapter XXIII. Variation clauses

SUMMARY

As used in the *Guide*, the term "variation" refers to a change in an aspect of the construction of the works from that required under the contract documents. During the course of construction of the works, situations may be encountered which make it necessary or advisable to vary certain aspects of the construction. It is advisable for the contract to contain provisions setting out the circumstances under which a contractor is obligated to implement a variation. In formulating contractual provisions concerning variations, the parties should attempt to strike an appropriate balance among various interests (paragraphs 1 to 4).

The parties may wish to consider three basic approaches to variations sought by the purchaser. Under the first approach, the contract would obligate the contractor to implement a variation ordered by the purchaser, so long as the variation ordered met certain criteria set forth in the contract. Under the second approach, the contract would obligate the contractor to implement a variation ordered by the purchaser unless he objected to it upon reasonable or specified grounds. Under the third approach, a variation would require the written consent of the contractor. The contract could incorporate one or any combination of these approaches. It would be useful for the contract to contain provisions concerning the settlement of disputes between the parties as to whether the purchaser was entitled to order a variation (paragraphs 5 to 7).

The parties may, in some cases, consider it appropriate to provide in the contract for reasonable adjustments to be made in the contract price and in the time for completion by the contractor in the event of a variation. In such a case, the contract may contain a mechanism for the contractor to inform the purchaser of the contractor's contentions concerning the impact of the variation on the contract price and time for completion in order to enable the purchaser to consider whether, in view of the likely impact, he wishes to insist upon the variations. Whether or not such a mechanism is contained in the contract, the contract may obligate the parties to attempt to settle between themselves the amounts of the adjustments to be made in accordance with criteria set forth in the contract, and entitle either party to refer for settlement a dispute as to the amount of an adjustment (paragraphs 8 to 11).

With respect to variations which the contractor is obligated to implement, the parties may wish to consider restricting the scope of such variations (paragraphs 12 and 13). With respect to variations to which the contractor may object, the contract may entitle the contractor to object on reasonable grounds, or may specify particular grounds upon which he may object (paragraph 15). The contract may contain procedures with respect to the ordering and implementation of both of these categories of variations (paragraphs 14 and 16 to 18).

With respect to variations which require the consent of the contractor, the contract may provide that variations requested by the purchaser must be implemented by the contractor only if he consents to them in writing (paragraph 19).

It would be in the interest of the purchaser if variations proposed by the contractor were not to be implemented unless they were agreed to in writing by the purchaser (paragraphs 20 to 22).

The contract may contain particular provisions dealing with changes in construction in cases of unforeseeable natural obstacles and changes in local regulations (paragraph 23).

For cases in which a variation is to result in an adjustment of the contract price, it is desirable for the contract to provide that the adjustment is to be by a reasonable amount. It would be useful for the contract to contain guidelines to assist in the determination of what amount of adjustment is reasonable. These guidelines may vary depending upon the type of contract (paragraphs 24 to 32).

A. General remarks

1. As used in the *Guide*, the term "variation" refers to a change in an aspect of the construction of the works from that required under the original contract documents, such as a change in the scope of construction or technical characteristics of equipment or materials to be incorporated in the works or a change in construction services required under the specifications, drawings and standards of the works (see chapter V, "Description of works and quality guarantee", paragraphs 6 to 9). Adjustment or revision of the price because of cost changes or currency fluctuations, and revision of the payment conditions (see chapter VII, "Price and payment conditions") are not regarded in the *Guide* as variations, although a variation may lead to an adjustment of the price (see paragraph 8, below). Likewise, renegotiation of the contract in cases of hardship (see chapter XXII, "Hardship clauses", paragraph 1) and suspension of construction (see chapter XXIV, "Suspension of construction", pararaph 1) are not regarded in the *Guide* as variations.

2. During the course of construction of a complex industrial works project, it is common for situations to be encountered which make it necessary or advisable to vary certain aspects of the construction. These situations could arise, for example, from difficulties in obtaining raw materials needed for production, making it advisable to adapt the technological process incorporated in the works to the new situation; from unforeseen problems or events during construction, necessitating changes in the equipment, materials, or services used in the construction (see paragraph 23, below); from circumstances affecting the expected profitability of the works, making it advisable to change the scope of the works; or from the occurrence of technological innovations of which the purchaser or contractor wishes to take advantage. In addition, the contractor may seek variations to suit his construction processes.

3. As discussed in the following sections, the parties may wish to obligate the contractor to implement certain variations ordered by the purchaser; however, they may wish to obligate the contractor to implement other variations ordered by the purchaser only if the contractor does not object to a variation on reasonable or specified grounds. In both cases, it is advisable for the contract to

contain provisions setting out the circumstances under which the contractor is obligated to implement a variation ordered by the purchaser since, under most legal systems, the contractor would not be obligated to implement the variation in the absence of such provisions.[1] The parties may wish to note, however, that, in a few legal systems, a party may not be compelled to implement a variation unless he specifically consents to it after it is ordered, regardless of what is provided in the contract.

4. In formulating contractual provisions concerning variations, the parties should attempt to strike an appropriate balance between, on the one hand, the objectives of certainty with respect to the contractual obligations of the parties and the principle that a party to a contract should be bound by the terms to which he has agreed, and, on the other hand, the desirability of permitting necessary or desirable variations in order to meet situations which arise during the life of a complex and long-term contract. In addition, the parties should attempt to achieve an equitable balance between the interests of the purchaser and those of the contractor.

B. Variations sought by purchaser

1. *Basic approaches*

5. The contract may provide that, whenever the purchaser wishes to vary the construction, he must deliver to the contractor a written variation order setting forth the particulars of the intended variation. The parties may wish to consider three basic approaches to the obligations of the contractor in respect of such a variation order. Under the first approach (see paragraphs 12 to 14, below), the contract would obligate the contractor to implement a variation ordered by the purchaser, so long as it met certain criteria set forth in the contract. Under the second approach (see paragraphs 15 to 18, below), the contract would obligate the contractor to implement a variation ordered by the purchaser unless he objected to it upon reasonable or specified grounds. Under the third approach (see paragraph 19, below), a variation would require the written consent of the contractor.

6. The contract could incorporate one or any combination of the approaches mentioned in the preceding paragraph. If the contract were to incorporate two of the approaches, it could, for example, set forth criteria which a variation must meet in order to qualify as one which the contractor was obligated to implement (see, e.g., paragraph 13, below), and provide that variations which did not so qualify might be objected to by the contractor on reasonable or specified grounds, or, alternatively, would not be implemented unless the contractor consented in writing. If the contract were to incorporate all three approaches, it could set forth the criteria which must be met for variations which the contractor was obligated to implement and other criteria for variations to which the contractor might object on reasonable or specified grounds, and provide that variations which did not qualify as one of those two required the consent of the contractor.[2]

7. It would be useful for the contract to contain provisions concerning the settlement of disputes between the parties as to whether or not a variation ordered by the purchaser satisfied the criteria in the contract. The contract may provide for such disputes to be referrable for expeditious resolution by an

independent third person. The independent third person might be the consulting engineer, if he is authorized to exercise independent functions (see chapter X, "Consulting engineer", paragraphs 9 to 19), or a referee (see chapter XXIX, "Settlement of disputes", paragraphs 16 to 21). Alternatively, the parties may prefer the dispute to be referrable only to a court or arbitral tribunal. If the dispute is referrable to an independent third person, the authority of that person may be restricted to deciding the issue of whether or not the requested variation met the criteria specified in the contract, and not extend to the issue of the impact of the variation upon the contract price and time for completion. Even in the case where a criterion for a variation was whether or not the variation would exceed a specified percentage of the contract price (see paragraph 13, below), the decision of the independent third person need not quantify the impact of the variation on the price, but need only state whether or not the variation would cause the price to exceed the limit. The contract may specify the weight to be given, in the context of proceedings to determine the impact of the variation on the contract price, to findings of fact made by the independent third person in support of his conclusion (see chapter X, "Consulting engineer", paragraphs 9 to 19, and chapter XXIX, "Settlement of disputes", paragraphs 16 to 21).

2. *Impact of variation on contract price and time for completion*

8. In some cases, a variation sought by the purchaser may entail higher construction costs to the contractor from those anticipated when the contract was entered into. This may be due to the necessity to supply additional or more costly equipment, materials or services as compared to those provided for in the contract. The supply of different or additional equipment, materials or services could also make it unreasonable to expect the contractor to be able to complete the construction within the time originally agreed to by him in the contract. In other cases, a variation may result in lower construction costs or enable the contractor to complete the construction earlier than specified in the contract. Accordingly, the parties may, in some cases, consider it appropriate to provide in the contract for reasonable adjustments to be made in the contract price and in the time for completion by the contractor in the event of a variation (see section E, below; cf. paragraph 23, below).

9. The purchaser will wish to know the likely impact of a variation sought by him upon the contract price and the time for completion before the contractor becomes obligated to implement it. If the impact is likely to be excessive, the purchaser may decide not to insist upon the variation. In some cases, the purchaser's own engineering staff or his consulting engineer might be able to estimate for the purchaser the likely impact of the variation. In other cases, this might not be feasible. Therefore, the parties may wish to consider whether to include in the works contract a mechanism for the contractor to inform the purchaser of the contractor's contentions concerning the impact of the variation on the contract price and time for completion. The contract may, for example, obligate the contractor, after delivery to him of a variation order, to deliver to the purchaser a written statement setting forth the contractor's contentions as to the impact, if any, of the variation upon those terms (see, also, section E, below). The parties may wish to consider whether the contract should specify the period of time after delivery to the contractor of the

variation order within which the contractor must deliver his statement to the purchaser, or whether the contract should merely obligate the contractor to do so within a reasonable period of time. On the one hand, the amount of time which the contractor will need to evaluate the impact of the variation will vary depending upon the nature and extent of the variation. On the other hand, if the contract were to require the statement to be delivered only within a reasonable period of time, in cases where the obligation to implement the variation arose upon the expiry of that period of time (see, e.g., paragraphs 14 and 17, below), uncertainty would exist as to the time when that obligation arose. One approach may be to specify in the contract a period of time sufficiently long to enable the contractor to evaluate the impact of the variation. Another approach may be to provide in the contract for the purchaser to specify in the variation order a period of time within which the contractor must deliver his statement to the purchaser, and to provide that the period of time must be reasonable. A mechanism such as the one just described may not be necessary in the case of variations which require the written consent of the contractor (see paragraph 19, below).

10. The parties may wish to consider the consequences of a failure of the contractor to deliver the statement to the purchaser within the time specified in the contract. Under one approach, the contract may provide that the contractor is not entitled to claim an increase in the price or a prolongation of the time for completion; however, the purchaser may still be allowed to claim a reduction of the price or of the time for completion, if warranted by the variation. Under another approach, the contractor might be permitted to claim adjustments of the contract price and the time for completion notwithstanding his failure, but entitle the purchaser to be compensated by way of damages for any loss suffered as a result of the failure.

11. Whether or not the contract contains a mechanism such as the one described in paragraph 9, above, if the contract provides for an adjustment of the contract price and time for completion in the event of a variation, it may obligate the parties to attempt to settle between themselves the amount of the adjustment in accordance with criteria set forth in the contract (see section E, below). It may entitle either party to refer a dispute as to the amount of the adjustment for resolution in accordance with the dispute settlement provisions of the contract. However, it would be desirable for the absence of agreement by or the existence of a dispute between the parties not to postpone an obligation of the contractor to implement the variation.

3. *Contractual provisions relating to each basic approach*

(a) *Variations ordered by purchaser which contractor is obligated to implement*

12. An obligation of the contractor to implement any variation, whatever its nature or scope, ordered by the purchaser, could unduly interfere with the interests of the contractor. For example, a contractor may suffer prejudice if he is compelled to implement a variation which involves such a substantial departure from the obligations which he undertook in the contract that he does not have the capability to implement the variation; if the scope of the construction is varied to such a degree that other contractual provisions (e.g., those relating to passing of risk, payment conditions or performance

guarantees) become inappropriate; or if a variation involving additional work results in a prolongation of the time for completion of construction such that it interferes with the performance of construction obligations in other projects which the contractor has undertaken. A contractor who has supplied the design for the works and guaranteed the output of the works could be prejudiced by being compelled to implement a variation which is inconsistent with the design. A variation which substantially reduces the scope of the works could cause the project to become financially unattractive to the contractor.

13. Accordingly, if the parties contemplate adopting the first approach referred to in paragraph 5, above, they may consider it desirable to include in the contract certain provisions to take into account the legitimate interests of the contractor (see, also, paragraph 8, above). For example, the parties may wish to consider restricting the scope of the variations which could be ordered by the purchaser and which the contractor would be obligated to implement. There are various ways in which they may do this. For example, the contract might entitle the purchaser to order such variations only if the impact of the variations on the contract price would be less than a certain percentage of the price set forth in the contract, or it might entitle the purchaser to order such variations only as to specific aspects of the construction. It might also provide quantitative limits to certain types of variations in this category, e.g., by permitting the purchaser to order variations in this category which lead to changes in the production capacity of the works from that envisaged in the contract only if the change would not exceed a certain percentage of that capacity.

14. If the contract incorporates a mechanism such as that described in paragraphs 9 to 11, above, the contract may provide that, unless, within a specified period of time after delivery to the purchaser of the contractor's statement as to the impact of the variation, the purchaser notifies the contractor in writing not to implement the variation, the contractor is obligated to implement the variation as ordered by the purchaser. If the contractor does not deliver a statement to the purchaser, the contract may obligate the contractor to implement the variation upon the expiration of the period of time for the delivery of the statement. If the contract does not incorporate such a mechanism, it may obligate the contractor to implement the variation upon delivery to him of the purchaser's variation order.[3]

(b) *Variations subject to objection by contractor on reasonable or specified grounds*

15. Under the second approach mentioned in paragraph 5, above, the contract may permit the contractor to object on certain grounds to a variation ordered by the purchaser. The contract may refer only to "reasonable" grounds (other possible formulations of such a standard may refer to "substantial prejudice" or "undue inconvenience" to the contractor if he were compelled to implement the variation), or it may specify particular grounds which would entitle the contractor to object. If the parties decide to specify particular grounds, in formulating those grounds they may wish to take into consideration that, to the extent that the concern of the contractor relates to the price or time for completion, he may be protected by providing in the contract for an adjustment of those elements of the contract (see paragraph 8, above). It is advisable for the contract to indicate whether the enumeration of grounds entitling the contractor to object to a variation is illustrative or exhaustive. The following are possible examples of such circumstances:

(*a*) If the variation is beyond the capability of the contractor to implement;

(*b*) If implementation of the variation would prevent the contractor from performing any of his other obligations under the contract or unduly interfere with his performance of those obligations;

(*c*) If the variation would prevent the achievement of output targets guaranteed by the contractor.

16. The contract may specify a period of time within which the contractor must deliver any objection he may have against the variation to the purchaser, and may require the objection to be in writing. If the contract provides a mechanism such as that described in paragraphs 9 to 11, above, and, whether or not the contractor objects to the variation, the contract may obligate the contractor to deliver to the purchaser a written statement as to the impact of the variation. It is advisable for the period of time after delivery to the contractor of the variation order within which the contractor must deliver his statement of impact to be not less than the period of time within which the contractor must deliver his objection to the variation.

17. In cases where the contractor does not deliver to the purchaser a timely objection to the variation, but delivers a statement as to its impact, the contract may provide that the contractor is obligated to implement the variation unless, within a specified period of time after delivery of the contractor's statement to the purchaser, the purchaser notifies the contractor in writing not to implement the variation. If, being obligated to do so, the contractor does not deliver a statement to the purchaser, the contract may obligate the contractor to implement the variation upon the expiration of the period of time for delivery of the statement. If the contract does not require the contractor to deliver a statement as to the impact of the variation, it may obligate the contractor to implement the variation no later than the expiration of the period of time for delivery of his objection to the purchaser.[4]

18. A dispute between the parties concerning the validity of the grounds asserted by the contractor for objecting to the variation might be referrable to the independent person, court or arbitral tribunal referred to in paragraph 7, above. As to whether or not the contractor should be obligated to implement the variation pending the decision on whether the grounds for the contractor's objection were valid, it might unduly prejudice the contractor if he were compelled to implement the variation and it were later determined that the grounds for his objection were valid. Therefore, the parties may consider it desirable to provide that the contractor is not obligated to implement the variation until it is decided that the grounds asserted by him were not valid.

(c) *Variations which require consent of contractor*

19. With respect to the third approach mentioned in paragraph 5, above, the contract may provide that variations requested by the purchaser must be implemented by the contractor only if he consents to them in writing. The contract may also provide that the variations are not to result in a change in the contract price or the time for completion unless otherwise agreed in writing by the parties.

C. Variations sought by contractor

20. It would be in the interest of the purchaser if variations proposed by the contractor were not to be implemented unless they were agreed to in writing by the purchaser.[5] In this case, too, the contract may provide that the variations are not to result in a change in the contract price or the time for completion unless otherwise agreed in writing by the parties.

21. It is possible that a potential contractor might submit an offer to construct the works at a low price by omitting certain necessary equipment, materials or services from his offer or by basing his price on inadequate or substandard equipment, materials and services, expecting to seek variations during construction, and commensurate increases in the price. Requiring all variations sought by the contractor to be subject to the approval of the purchaser may help to avoid this situation, but only to a limited extent. A purchaser in such a case would be faced with the choice either of agreeing to a variation which may be necessary or advisable in order for the construction and the works to meet his expectations, or to refuse to agree to the variation and rely on his right, if any, to claim against the contractor for any resulting defects in the works or for the contractor's bad faith.

22. The best way for a purchaser to guard against such a situation is by employing appropriate procedures for concluding the contract (i.e., tender procedures or procedures for negotiation with prospective contractors; see chapter III, "Selection of contractor and conclusion of contract"). It would help, for example, if the provisions in the tender documents concerning the scope of the construction and the technical characteristics of equipment, materials and construction services were complete and sufficiently precise so as to preclude a potential contractor from submitting an offer based upon inadequate or substandard elements (see, also, chapter V, "Description of works and quality guarantee" and chapter VIII, "Supply of equipment and materials", paragraphs 6 and 7). It would also help if the tender procedures were designed so as to enable the purchaser to identify and exclude disreputable or otherwise unacceptable firms. It would also be advisable for the criteria and practices for the evaluation of tenders to be such as to enable the purchaser to identify unrealistic offers, and for the offers to be evaluated for the purchaser by personnel of the purchaser, or by a consulting engineer engaged by him (see chapter X, "Consulting engineer"), who has the necessary expertise.

D. Changes in construction in cases of unforeseeable natural obstacles and changes in local regulations

23. During construction, natural obstacles such as hydrological or subsurface conditions may be encountered which could not reasonably have been discovered by the contractor prior to entering into the contract. In addition, during the course of construction, legal rules of an administrative or other public nature concerning the scope or technical aspects of the works may come into force or be changed. The contract may allocate the risk of those circumstances either to the contractor or to the purchaser (see chapter VII, "Price and payment conditions", paragraphs 44 to 46). In some cases, the construction may need to be changed in order for it to progress. In cases where the risk of such circumstances is borne by the contractor, the contract may

obligate him to notify the purchaser in writing of the necessary change and to implement the change unless, within a specified period of time after delivery of the notice of the change, the purchaser notifies the contractor in writing not to do so. In cases where the risk is borne by the purchaser, the contract might obligate him to order the necessary variation. However, in the case of a change in the construction necessitated by changes in mandatory rules of an administrative or other public nature, or by new rules, a refusal by the purchaser to order the change in construction might be considered as an impediment to the continuation of the construction. The contract might further provide that, if the contractor rightfully objects (see paragraph 15, above) or fails to consent (see paragraph 19, above) to a variation, the purchaser may terminate the contract (see chapter XXV, "Termination of contract"). Whether or not the variation should result in a commensurate increase in the contract price or a prolongation of the time for completion might depend upon whether or not the contractor bears the risk of the circumstances necessitating the variation.

E. Determination of impact of variations on contract price and time for completion

24. As noted in paragraph 8, above, the parties may wish to provide in the contract for reasonable adjustments to be made in the contract price and the time for completion in the event of a variation. An adjustment of the price may be desirable, in particular, in the case of a lump-sum contract, in which the contract price would remain unchanged unless the contract expressly provided for adjustments of the price (see chapter VII, "Price and payment conditions", paragraph 2). Similarly, unit prices in a unit-price contract may need to be changed in the event of a variation (see paragraph 30, below), and this would usually not be possible without an express provision in the contract. The parties may also consider it desirable to include such a provision in some cost-reimbursable contracts which contain a price ceiling since, under such contracts, when a variation results in higher construction costs, those costs would be reimbursable to the contractor only to the extent that they did not cause the contract price to exceed the ceiling (see paragraph 32, below).

1. *Contract price*

25. For cases in which a variation is to result in an adjustment of the contract price, it is desirable for the contract to provide that the adjustment is to be by a reasonable amount. It would be useful for the contract to contain guidelines to assist in the determination of what amount of adjustment is reasonable. These guidelines could assist the parties in settling this issue (see paragraph 11, above), and could provide criteria to be applied by a court or arbitral tribunal when the parties cannot agree. Such guidelines may be practicable in respect of variations of the nature and quantity of equipment, materials and construction services, but may not be practicable in respect of variations of the design.

(a) *Lump-sum contract*

26. If the contract contains a schedule of prices for particular types of equipment, materials or construction services, it may provide that any variation in the quantity required of those items occasioned by the variation in

construction is to be valued in accordance with the prices set forth in the schedule. However, it might not always be appropriate to use those prices. For example, prices specified for particular types of construction services may be based upon the work being performed in a particular sequence, and a variation in that sequence may make the prices inappropriate. Therefore, if variations in the quantity required of items whose prices are specified in a contract schedule are to be valued in accordance with those prices, it may be desirable to permit departures from them in cases where, for reasons similar to those just discussed, the prices would be inappropriate.

27. If the contract contains a schedule of prices for equipment, materials and construction services and variations in the quantity required occur in respect of items which are not specified in the schedule, the prices designated in the schedule may be usable as a basis for the valuation of the variation when the items which are the subject of the variation are analogous to items specified in the schedule.

28. When the contract does not contain a schedule, or when the schedule is not employed to determine the adjustment in the contract price, the contract may provide for the adjustment to be based upon changes in costs of the items involved, and on the following additional factors:

(*a*) Increments for overhead and profit in respect of varied work may be added or deducted, as appropriate.

(*b*) A variation of one aspect of the construction may affect the prices of other aspects. For example, a variation in a piece of equipment to be installed in the works may require different and more costly construction services to install the equipment from those originally anticipated in the contract. Such effects may also be taken into consideration.

(*c*) Other losses and expenses incurred by the contractor, such as losses resulting from an interruption of construction, and expenses incurred for terminating subcontractors if work is omitted, may be taken into consideration.[6]

29. Where construction costs are relevant to determining the impact of a variation on the contract price, it may be desirable for the contract to obligate the contractor to keep accurate records relating to costs incurred by him in connection with the implementation of a variation, and to produce them at the request of the purchaser.

(b) *Unit-price contract*

30. Unit prices in a unit-price contract may be predicated upon the supply of particular quantities of the items which are priced according to that method. Therefore, the contract may provide for reasonable adjustments to be made in the unit prices of such items if the quantities of those items to be supplied are substantially changed. In some cases, it may be possible for the parties to quantify in the contract the extent of the change in the items which would result in an adjustment in the unit price, and, perhaps, the amount of the adjustment.

31. In contracts that include civil engineering, the purchaser frequently has the right to require the contractor to perform additional civil engineering up to a certain proportion of the original civil engineering without an adjustment in the unit prices.

(c) Cost-reimbursable contract

32. As mentioned above (paragraph 24), a cost-reimbursable contract might also provide for adjustment in certain aspects of the price in the event of a variation. Thus, the contract might provide that, in the event of increases or decreases of a specified magnitude in equipment, materials or services to be supplied, the target cost and cost ceiling, if any, and the fee are to be adjusted in accordance with a specified formula (cf. chapter VII, "Price and payment conditions", paragraphs 15 and 22).

2. *Time for completion*

33. The impact of a variation on the time for completion is discussed in chapter IX, "Construction on site", paragraphs 24 and 25.

Footnotes to chapter XXIII

[1]*Illustrative provisions*

"(1) The term 'variation' as used in this contract means any change in the scope of construction or technical characteristics of the equipment, materials or construction services to be supplied by the contractor.

"(2) Any variations ordered by the purchaser must be implemented by the contractor in accordance with the provisions of this article.

"(3) The contractor shall not implement any variation unless it has been ordered by the purchaser in accordance with this article, or agreed to by the purchaser in writing."

[2]*Illustrative provisions*

"(1) The purchaser may deliver to the contractor a written order for a variation setting forth all relevant particulars of the variation.

"(2) If, in accordance with paragraph [ ] of this article [see note 4, below], the impact upon the contract price of the variation as set forth in the written variation order does not exceed [ ] per cent of the price set forth in article [ ], the contractor must implement the variation upon delivery to him of the variation order.

"(3) (*a*) If, in accordance with paragraph [ ] of this article, the impact upon the contract price of the variation as set forth in the written variation order exceeds [ ] per cent of the price set forth in article [ ] but is less than [ ] per cent of that price, the contractor may, within [ ] days after delivery to him of the variation order, deliver to the purchaser a written objection to the variation specifying [reasonable grounds] [one or more of the following grounds: . . .].

(*b*) If the contractor does not deliver to the purchaser an objection in accordance with the preceding sub-paragraph, he shall commence to implement the variation no later than the expiration of the period of time set forth in that sub-paragraph.

(*c*) Any dispute between the parties as to the validity of the grounds set forth by the contractor in an objection to the variation may be referred by either party to [indicate dispute settlement mechanism]. The contractor must implement the variation if and when it is determined in such proceedings that the grounds set forth by the contractor were not valid.

"(4) (*a*) The contractor shall not be obligated to implement any variation ordered by the purchaser which does not meet the criteria set forth in paragraphs (2) or (3) of this article unless the contractor consents to the variation in writing.

(*b*) Any dispute between the parties as to whether a variation ordered by the purchaser meets the criteria set forth in paragraphs (2) or (3) of this article may be referred by either party [indicate dispute settlement mechanism]."

[3]See footnote 2.

[4]See footnote 2.

[5]See footnotes 1 and 2.

[6]*Illustrative provisions*

[For lump-sum contract]

"(1) Except as otherwise provided in this contract, in the event of a variation the price set forth in article [ ] shall be adjusted by a reasonable amount, taking into account the criteria set forth in paragraph (2) of this article. However, the price shall not be adjusted if, taking account of those criteria, no adjustment is reasonable.

"(2) The criteria referred to in the previous paragraph are the following:

(*a*) If the equipment, materials or services to be supplied as a result of a variation are identical in character to, and supplied under the same conditions as, equipment, materials or services specified in [the contract schedule], then the prices therein for such equipment, materials or services shall be applied, unless it is unreasonable to apply those prices, in which case the effect of the variation on the contract price shall be based upon such of the factors in sub-paragraph (c), below, as may be appropriate.

(*b*) If the equipment, materials or services to be supplied as a result of a variation are not of such identical character or supplied under such same conditions, the prices in [the contract schedule] shall be applied whenever reasonable. If it is not reasonable to apply such prices, then the effect of the variation upon the contract price shall be based upon such of the factors in sub-paragraph (c), below, as may be appropriate.

(*c*) The factors referred to in sub-paragraphs (a) and (b), above, are the following:

(i) The actual cost of equipment, materials or services to be supplied as a result of a variation (or, in the case of omitted equipment or materials, the market cost thereof);

(ii) Reasonable profit;

(iii) Any financial effects of a variation upon other aspects of the work to be performed by the contractor;

(iv) Any costs and expenses accruing to the contractor from an interruption of work resulting from a variation;

(v) Any other costs and expenses accruing to the contractor as a result of the variation;

(vi) Any other factors which it would be equitable to take into consideration with respect to the variation."

Chapter XXIV. Suspension of construction

SUMMARY

This chapter deals only with the suspension of construction and not with the suspension of any other obligations under the contract. As no developed doctrine of suspension exists in most legal systems, the parties may wish to consider the inclusion of a clause in the contract permitting suspension of construction, defining the circumstances in which suspension may be invoked and describing its legal effects (paragraphs 1 and 2).

The parties may agree to permit the purchaser to order the suspension of construction only upon grounds specified in the contract (paragraph 3). Alternatively, the parties may consider including a provision enabling the purchaser to order suspension of the construction of works for his convenience (paragraph 4).

The contract may give the contractor the right to suspend construction in two specific circumstances. The contractor may be entitled to suspend construction firstly as an alternative to the more drastic remedy of termination in cases where the failure to perform an obligation by the purchaser is serious enough to justify such termination, and secondly when a failure of performance on the part of the purchaser makes it unreasonably difficult for the contractor to proceed with the construction (paragraphs 5 to 7).

The contract may settle the procedure to be adopted for suspension. Thus, the suspending party may be required to deliver a written notice of suspension to the other party. The purchaser may be required to deliver a written notice of suspension to the contractor specifying the effective date of the suspension and the construction activities to be suspended (paragraph 8). Furthermore, the parties may wish to consider whether the exercise of the right to suspend by the contractor for failure of performance by the purchaser should be conditioned upon a written notice being given to the purchaser requiring him to perform within a specified time and what exceptions there are to be to this (paragraph 9). The contract may also provide a method of determining what the duration of the suspension is to be (paragraphs 10 and 11).

The contract may provide that when suspension of construction has been ordered, all the construction activities to which the order relates are to cease, but that the construction of other parts of the works is to continue (paragraph 12). The contractor may be entitled by the contract to an extension of time to complete the construction in order to make up for the period of suspension and the time required to remobilize personnel and equipment (paragraph 13).

The contract may provide for the application of its terms to the resumed construction following the period of suspension. However, other contract terms, in addition to those directly affected by the suspension, may need to be harmonized with the suspension clause (paragraph 14).

Suspension may have a considerably disruptive effect on the construction of the works by the contractor and may put into question the financial viability of the contract to the contractor. Accordingly, the contract may make the purchaser accountable to the contractor for any losses suffered by him. It may be difficult after suspension has occurred to determine the losses to be compensated by the purchaser. It may therefore be desirable for the contract to list the losses to be compensated (paragraphs 15 and 16).

In certain circumstances the contract might permit the contractor to terminate the contract rather than to continue the suspension (paragraph 17). The contract may obligate the contractor to resume work only after a reasonable period of time has elapsed since the ending of the suspension (paragraph 18).

A. General remarks

1. This chapter deals only with the suspension of construction of the works, and not with the interruption of other obligations under a works contract, such as the obligation of the purchaser to pay the contractor. As conceived in the *Guide*, suspension is an interruption of the construction by the purchaser for his convenience or on grounds specified in the contract, and by the contractor in the event of a failure of performance by the purchaser. The concept of suspension does not cover interruptions of construction under a hardship clause, in order to enable the parties to re-negotiate particular terms of the contract (see chapter XXII, "Hardship clauses", paragraphs 14 and 22), or where an event occurs that makes it impossible to proceed with the construction (see chapter XXI, "Exemption clauses"). In addition, the concept of suspension does not cover the situation in which the purchaser is entitled to order the contractor to stop construction that is defective (see chapter XVIII, "Delay, defects and other failures to perform", paragraphs 28 to 31).

2. Most legal systems contain no developed doctrine of suspension. Where the parties wish to provide for the possibility of suspension, it is therefore advisable to include a provision in the contract describing the circumstances in which construction may be suspended and the legal effects which are to result from the suspension.

B. Suspension by purchaser

3. The parties may wish to enable the purchaser to suspend construction of the works in order to permit him to deal with problems he may have but which do not arise from a failure by the contractor to perform. The parties may wish to provide that the purchaser is entitled to order suspension only upon certain grounds specified in the contract.[1] For example, the contract may permit the purchaser to suspend construction in the case of an anticipated change in economic policy in order to give the purchaser time to assess the situation. The specified grounds should not include those that would be regarded under the exemption clause as exempting impediments. To avoid any uncertainties in interpretation and to reduce the possibility of disputes, it is desirable that the grounds on which the purchaser may suspend construction be clearly set out in the contract.

4. The parties may wish to consider the possibility of providing that the purchaser may suspend the construction for his convenience, i.e., without giving any reason. Although the scope of the right to suspend for convenience is wide, it is unlikely that the purchaser would invoke the right capriciously, both because he may suffer high costs if he orders suspension (see paragraphs 15 and 16, below) and because the date for completion of the works may thereby be postponed (see paragraph 13, below). If the right to order suspension were not available, the purchaser might have to resort to the more drastic remedy of termination in situations in which he would have desired only to suspend the construction had he been permitted to do so (see the discussion of termination for convenience in chapter XXV, "Termination of contract", paragraphs 17 and 18).

C. Suspension by contractor

5. The right of the contractor to suspend construction may differ in scope from the corresponding right of the purchaser, reflecting the obligations which the contractor has assumed, i.e., to continue construction without interruption and to complete it within the agreed time-schedule despite the difficulties he may face, financial or otherwise. Nevertheless, there are two situations in which the parties may find it desirable to entitle the contractor to suspend construction.[2]

6. Firstly, in cases where a failure to perform an obligation by the purchaser is serious enough to justify unilateral termination by the contractor (see chapter XXV, "Termination of contract"), the parties might wish to enable the contractor to suspend construction as an alternative to the remedy of termination. An example of such a failure may be the case of the non-payment of a substantial percentage of the price due from the purchaser.

7. Secondly, the parties may consider it desirable to permit the contractor to suspend construction when a failure of performance on the part of the purchaser affects the construction of the works so as to make it unreasonable for the contractor to proceed with the construction. For example, where the purchaser supplies a defective design, and the construction based on it endangers the safety of the works or the construction personnel, it may be desirable to permit the contractor to suspend the construction until the design defect is rectified.

D. Procedure for suspension

8. With respect to the procedure for the suspension of construction by the purchaser, the contract might require him to deliver a written notice of suspension to the contractor, specifying the effective date of the suspension and the construction activities to be suspended. If the contract permits suspension by the purchaser only on specified grounds, it may also require the notice of suspension by the purchaser to state the grounds for the suspension.

9. The parties may wish to provide that the right of the contractor to suspend is conditional upon his giving written notice to the purchaser requiring him to perform the obligation in question within a period to be specified in the notice. The period specified should be reasonable in the circumstances, and may

commence to run from the delivery of the notice. If the purchaser fails to perform within the specified period, the contractor may suspend construction after the delivery of a notice to the purchaser stating that he is suspending construction. If this approach is adopted, it may be desirable for the contract also to provide that, in cases where a failure of performance on the part of the purchaser makes it necessary to suspend the construction immediately (e.g., where to continue construction on the basis of a defective design supplied by the purchaser would endanger the contractor's personnel), the contractor may do so by giving written notice of immediate suspension to the purchaser.

10. The parties may wish to consider various possibilities with respect to the duration of the suspension. If the suspension is based upon a ground specified in the contract, the contract may provide for the suspension to be effective until that ground ceases to exist. For example, if the contract permits the contractor to suspend construction due to non-payment by the purchaser, it may provide for the suspension to terminate when the payment in question is made.

11. In the case of suspension by the purchaser for his convenience, the contract might obligate the purchaser to specify in his notice of suspension a date when the suspension is to terminate. In such a case, it may be desirable to enable the purchaser to extend the period of suspension by delivering a further written notice of suspension to the contractor. In all cases, it may be desirable to enable the purchaser to terminate the suspension earlier than the time provided for in the contract or that provided for in the notice of suspension by delivering written notice to the contractor that the suspension is terminated, provided that the contractor is appropriately compensated by the purchaser for any damage or cost incurred by reason of such earlier termination. (For resumption of work after the termination of suspension, see paragraph 18, below).

E. Effects of suspension

12. With regard to the obligations of the parties when construction has been suspended, the contract may provide that all construction activities to which an order of suspension relates are to cease for the period of the suspension, but that construction of other parts of the works not affected by the suspension order is to continue. In the case of suspension ordered by the purchaser, the contract might obligate the contractor to cease the affected construction activities by the date specified in the notice ordering suspension (see paragraph 8, above). The contract may also provide that the resort of either party to suspension of construction will not deprive him of other remedies he may have under the contract.

13. As a consequence of the approach described above, the contract may provide that the performance of obligations which have been suspended does not fall due during the period of the suspension and, accordingly, failure to perform those obligations does not constitute delay in performance (cf. chapter XVIII, "Delay, defects and other failures to perform", paragraph 4). The contract may also provide for the time-schedule for the completion of construction to be extended by a period of time at least equal to the duration of the suspension, or perhaps for that period together with an additional, reasonable amount of time to enable the contractor to remobilize his personnel and

construction equipment in order to resume construction. It may be desirable to require the contractor to notify the purchaser in writing of the additional period of time he considers necessary to complete the construction, giving details which justify the length of the period he considers necessary.

14. The contract might provide that when construction resumes, unless otherwise stipulated, its terms are to apply as they did before the suspension. Some contract provisions, however, may need to be adapted so as to conform to circumstances brought about by the suspension. For example, the contract may require the parties to extend their respective securities for performance when suspension is ordered so as to cover the additional time required for construction (see chapter XVII, "Security for performance", paragraph 36). The contract should also provide which party is to bear the costs of the extension of security.

15. While the mechanism of suspension can be valuable, it may also have a disruptive effect on the construction of the works by the contractor. For example, if the contractor employs several subcontractors in the construction, a suspension may prevent him from co-ordinating their various tasks. The financial viability of the contract to the contractor may also be jeopardized due to the cost of stopping and re-starting the construction. The contract may therefore obligate the purchaser to compensate the contractor for losses suffered as a result of suspension in the circumstances envisaged in sections B and C above.

16. It may be difficult after suspension has occurred to determine the losses to be compensated by the purchaser. It may be desirable, therefore, for the contract to include a list, either exhaustive or illustrative, of the types of losses to be compensated or, alternatively, the types of losses to be excluded from compensation. Such an itemization could also assist the purchaser in estimating beforehand the financial implications should he wish to order suspension. The types of losses to be compensated might include some or all of the following: losses to the contractor arising by reason of delays in performing other contracts entered into by him; costs incurred in the maintenance and protection of the works and the equipment and materials required for construction; costs of the demobilization of personnel, including expenses incurred by the contractor's personnel (e.g., advance rent paid by such personnel for accommodation not required due to the suspension and the cost of transportation); any increase in the costs of equipment and materials between the date of the contract and the resumption of construction after the suspension period; costs of rented construction equipment which is maintained at the site; costs incurred in the resumption of work and the remobilization of personnel, including costs in transportation; additional overhead costs; compensation payable to subcontractors due to delays caused to their performance or to termination of their contracts due to the suspension; and costs incurred as a consequence of the postponement of the completion of the works (for example, the contractor may have to employ another subcontractor at a higher cost to replace one whose contract was terminated due to the suspension). The contract may also require the contractor to take all reasonable steps to mitigate the losses and expenses resulting from the suspension, and obligate the parties to consult each other on how to do so.

17. The contract might permit the contractor to terminate the contract (see chapter XXV, "Termination of contract") if the suspension or an accumulation of suspensions extends beyond a period to be specified in the contract.[3]

18. The contract may obligate the contractor to resume work within a reasonable period of time after the suspension terminates, since the immediate resumption of the construction may be difficult. For example, the contractor may have cancelled an order for materials because of the suspension and may have to re-order them.

Footnotes to chapter XXIV

[1]*Illustrative provision*

"The purchaser may at any time upon any of the grounds hereinafter specified order suspension of the construction of the works or any portion thereof by delivering a written notice to the contractor specifying the construction or portion thereof to be suspended, the grounds for the suspension, and the effective date of suspension. The suspension does not affect the validity of the contract. The grounds upon which the purchaser may order suspension are as follows: . . ."

[2]*Illustrative provisions*

"(1) Subject to paragraphs (2) and (3) of this article, the contractor may suspend the construction of the works or any portion thereof when the purchaser fails to perform any of the following obligations: . . .

"(2) The suspension does not affect the validity of the contract. The contractor must give the purchaser a notice in writing informing him of the failure of performance justifying any proposed suspension, requiring him to perform within a specified period, and specifying the construction or portion thereof to be suspended. If the purchaser fails to perform within the specified period, the contractor may suspend the construction after the delivery of a notice to the purchaser stating that he is suspending construction in accordance with his previous notice.

"(3) If, however, a failure of performance on the part of the purchaser makes it necessary to suspend the construction of the works or any portion thereof immediately, the contractor may do so after delivery of a written notice of the suspension to the purchaser. The written notice must inform the purchaser of the failure of performance justifying the suspension."

[3]*Illustrative provision*

"If the suspension or an accumulation of suspensions extends for a period exceeding ___ days, the contractor is entitled to terminate the contract and is entitled to be compensated for loss caused by the termination to the same extent as in the case of termination of the contract for convenience by the purchaser. By an accumulation of suspensions is understood the totality of the periods of suspension occurring at different times, whether such periods are in respect of the same portion of the construction or different portions of the construction."

Chapter XXV. Termination of contract

SUMMARY

It is desirable for the contract to include a termination clause in order to provide for an orderly and equitable procedure in the event of circumstances which make it prudent or necessary to terminate the contract. Before the contract is terminated, it would be in the interests of both parties to resort to other measures or remedies provided by the contract in order to deal with the circumstances. In addition, it may, in many cases, be desirable for the contract to require that a party wishing to terminate the contract notify the other party that there exists a situation which justifies termination and to allow the other party a period of time to overcome or cure the situation before entitling the first party to terminate (the two-notice system). In drafting a termination clause, the parties should take account of any mandatory legal rules on the subject of the law applicable to the contract, and should be aware of any non-mandatory rules (paragraphs 1 to 6).

The parties may wish to provide for termination of the contract in respect of obligations which have not yet been performed, as well as in respect of obligations which have been performed defectively (paragraph 7).

The contract might entitle the purchaser to terminate in certain situations involving a failure of the contractor to perform, a violation by the contractor of restrictions on the transfer of the contract and, possibly, a violation of restrictions on subcontracting (paragraphs 8 to 10).

It may be advisable for the contract to entitle the purchaser to terminate the contract in the event that the contractor is adjudicated bankrupt. The parties may wish to consider whether the institution of bankruptcy proceedings in respect of the contractor should entitle the purchaser to terminate the contract (paragraphs 11 to 14). The parties may also wish to consider whether the purchaser should be entitled to terminate the contract in the event of proceedings similar or related to bankruptcy proceedings in respect of the contractor, or in the event of bankruptcy or similar or related proceedings in respect of a guarantor (paragraphs 15 and 16).

The parties may wish to consider whether the purchaser should be entitled to terminate the contract for his convenience (paragraphs 17 and 18).

The contract might entitle the contractor to terminate in certain situations involving a failure of the purchaser to perform, the purchaser's interference with or obstruction of the contractor's work, and bankruptcy or similar or related proceedings in respect of the purchaser (paragraphs 19 to 21).

If the performance of obligations under the contract is prevented by an exempting impediment, the parties may wish to entitle either party to terminate if the impediment persists for a specified amount of time, or if the cumulative duration of two or more impediments exceeds a specified amount of time (paragraph 22).

The contract may specify the rights and obligations of the parties upon termination. It would be desirable for the contract to provide that, upon termination by either party, the contractor must cease construction and vacate the site. The contract might give the purchaser the option to use the contractor's construction equipment and tools, perhaps upon payment of a reasonable rental, and to purchase from the contractor equipment and materials to be incorporated in the works (paragraphs 23 to 25).

In the event of termination, the contract may obligate the purchaser to take over the portions of the works which have already been constructed and which are not subject to the termination. However, an exception may be made in some cases where the contractor terminates due to failure by the purchaser to perform (paragraph 26).

The parties may wish to consider obligating the contractor to transfer to the purchaser his contracts with subcontractors and suppliers, in cases where the contract is terminated for grounds attributable to the contractor. It may be desirable for the contract expressly to authorize the purchaser to make payment of sums owed by the contractor directly to subcontractors and suppliers, and entitle the purchaser to recover those payments from the contractor (paragraphs 27 and 28).

In some cases, where the contract is terminated by the purchaser for reasons other than those attributable to the purchaser, the contract may obligate the contractor to deliver to the purchaser such drawings, descriptive documents and similar items relating to the works as are in his possession, and provide for the production of items which have not yet been produced and delivery of them to the purchaser (paragraph 29).

The contract may specify the payments which are to be made by one party to the other in the event of termination. Whether payments are to be made, and the extent of the payments, may depend on the cause for the termination (paragraphs 30 to 35).

The contract may specify those provisions which are to survive the termination and continue to bind the parties (paragraph 36).

A. General remarks

1. Circumstances may arise which make it prudent or necessary to terminate a works contract before it has been completely performed. It is desirable for the contract to include a termination clause in order to provide for an orderly and equitable termination in the event that such circumstances arise. This chapter deals with possible provisions of a termination clause in the contract. In addition to the situations dealt with in the present chapter, other situations where the contract may be terminated are discussed elsewhere in the *Guide*.

2. Termination of a works contract may be regarded as a remedy of last resort. Even when a situation occurs which may justify termination, it would be in the interest of both parties to attempt to deal with the situation by resorting to other measures or remedies provided by the contract (such as requiring performance in accordance with the contract, suspending performance of the contract, requiring defects to be cured, re-negotiating and varying contractual provisions or claiming damages). In addition, it may, in many cases, be desirable for the contract to require that a party wishing to terminate the

contract notify the other party that there exists a situation asserted as justifying termination, and to allow the other party a period of time to overcome or cure the situation before entitling the first party to terminate (see, e.g., paragraphs 9, 19 and 20, below; cf. paragraphs 12 and 17, below). It is advisable for the contract to require that a termination of the contract for any reason be in writing.

3. In drafting a termination clause, the parties should take account of any mandatory rules on the subject in the law applicable to the contract. The parties should also be aware of any non-mandatory rules of the law applicable to the contract relative to termination, and should consider whether those rules are sufficient and appropriate to regulate termination of their contract.

4. General legal rules on termination of contracts have often developed in connection with sales and other types of contracts which are substantially less complex and of shorter duration than works contracts, and those rules may be ill-suited to the termination of works contracts. As discussed in various chapters of the *Guide*, there may be situations where it would be appropriate to permit a party to a works contract to terminate the contract in circumstances additional to the ones recognized by those legal systems. On the other hand, there may be situations where it would be appropriate to limit the possibility of termination permitted by general legal rules. Furthermore, general legal rules often do not provide appropriate procedures for an orderly termination of a works contract, nor deal with other issues, such as the rights and obligations of the parties upon termination, in a manner which satisfactorily meets the needs of parties to a works contract.

5. If the parties include in the contract provisions dealing with termination of the contract, it would be desirable for the contract to specify whether the grounds for termination set forth in those provisions are in addition to, or are a substitute for, the grounds for termination provided in the law applicable to the contract.

6. In some legal systems, a contract can be terminated only with judicial consent unless the contract expressly authorizes a party to terminate without that consent. In those legal systems, if it is desired that a party be able to terminate the contract without judicial consent, the contract should so specify.

B. Extent of termination

7. The parties may wish to provide for termination of the contract in respect of obligations which have not yet been performed, as well as in respect of obligations which have been performed defectively. In cases where the contractor is in delay in completing a portion of the construction by an obligatory milestone date (see chapter IX, "Construction on site", paragraph 21), the contract may entitle the purchaser to terminate in respect of the portion of the construction delayed. Alternatively, in cases where, due to the nature of the construction, it would not be advisable to separate the delayed portion of the construction from the rest of the construction to be completed, the contract may entitle the purchaser to terminate the contract in respect of the entire construction remaining to be completed.

C. Grounds for termination

1. *Termination by purchaser*

(a) *Failure of contractor to perform*

8. The circumstances under which the contract may permit the purchaser to terminate the contract in the event of a failure by the contractor to perform are discussed in other chapters, in particular in chapter IX, "Construction on site", paragraph 22, and chapter XVIII, "Delay, defects and other failures to perform".

9. In some cases of a failure of the contractor to perform, the contract may give the contractor a period of time to remedy this failure before the purchaser is entitled to terminate. In such cases, the contract might adopt a two-notice system. Under this system, the contract may require the purchaser to deliver a notice to the contractor specifying the contractor's failure to perform, and informing him that the purchaser will terminate the contract if the contractor does not remedy the failure within a reasonable period of time or a period of time specified in the contract. If the contractor has not remedied the failure upon the expiration of that period, the purchaser may be entitled to terminate the contract by delivering a written notice of termination to the contractor. However, it is desirable that the granting of such a period of time not be regarded as an extension of the time specified in the contract for the performance of the obligation in question, nor prejudice the purchaser's rights and remedies for delay by the contractor in performing that obligation.[1] In other cases of termination for failure of the contractor to perform (e.g., where the contractor does not commence construction on the date fixed for commencement, and states that he will not do so), nothing would be gained by requiring the purchaser to wait before terminating; he might be permitted to terminate immediately upon the contractor's failure to perform by delivering to the contractor a written notice of termination. The cases in which the two-notice system might be required and those when the purchaser might be permitted to terminate immediately are also indicated in chapter XVIII, "Delay, defects and other failures to perform".

(b) *Violation by contractor of restrictions on transfer of contract and on subcontracting*

10. Termination for violation by the contractor of contractual provisions on the transfer of the contract or of specific contractual rights and obligations is discussed in chapter XXVII, "Transfer of contractual rights and obligations", paragraph 12. With respect to contractual restrictions on subcontracting by the contractor (see chapter XI, "Subcontracting", paragraphs 7 to 9), the parties may wish to consider whether the purchaser should be able to terminate the contract if the contractor subcontracts in violation of those restrictions. The contract may preclude the purchaser from terminating if, notwithstanding that the contractor has entered into a subcontract in violation of provisions of the contract, the purchaser has agreed to the subcontract.

(c) *Bankruptcy or insolvency of contractor*

11. The contract and its performance will be subject to mandatory legal rules in the event of the bankruptcy of a party. It is important for the parties to take account of those legal rules in drafting contract provisions on termination. For

example, some legal systems may prevent one party from terminating the contract solely on the ground that the other party is bankrupt.

12. Under most legal systems, the assets of a person or firm that has been adjudicated bankrupt, including, in the case of a contractor, his rights under the works contract, will pass from his control to that of an officer designated under the rules of the relevant legal system. That officer will usually cease carrying on the business of the bankrupt in the ordinary course, except to the extent necessary to protect the assets of the bankrupt and the rights of creditors. Therefore, it may be advisable for the contract to entitle the purchaser to terminate the contract in the event that the contractor is adjudicated bankrupt, if such termination is not inconsistent with mandatory rules of the applicable law. The contract might permit the purchaser to terminate the contract immediately upon the adjudication of bankruptcy by delivering a written notice of termination to the contractor.

13. Even before an adjudication of bankruptcy, the mere institution of bankruptcy proceedings may, under some legal systems, restrict the ability of the contractor to subcontract or to purchase from third parties materials or supplies needed to effect the construction, to make payments which fall due, or otherwise to carry on his business. The parties may, therefore, wish to consider whether the institution of bankruptcy proceedings in respect of the contractor should entitle the purchaser to terminate the contract. On the one hand, when bankruptcy proceedings are instituted involuntarily against the contractor by another firm or person, the contractor might successfully defend against an adjudication of bankruptcy; the parties may, therefore, consider it appropriate to require the purchaser to wait for the adjudication of bankruptcy before being able to terminate the contract. In the case of voluntary proceedings instituted by the contractor himself, it may be possible for an adjudication of bankruptcy to be issued within a short period of time, and the purchaser might suffer no prejudice if he were required to wait for the adjudication. On the other hand, if the institution of bankruptcy proceedings seriously restricts the ability of the contractor to perform the contract, the parties might consider it appropriate even for the institution of such proceedings to entitle the purchaser to terminate the contract.

14. If the parties decide to permit the purchaser to terminate the contract when bankruptcy proceedings are instituted by or against the contractor, they may wish to consider whether the purchaser should have the right to terminate immediately upon the institution of the proceedings, or whether termination in those cases should be subject to the two-notice system (see paragraph 9, above). In the case of bankruptcy proceedings instituted involuntarily against the contractor, the contractor would have an opportunity to have the proceedings dismissed if the purchaser were entitled to terminate only after a specified period of time following notice to the contractor. It may be noted, however, that such an approach could result in loss to the purchaser in some cases, e.g., due to his inability to engage another contractor until the lapse of the period of time. In the case of voluntary bankruptcy proceedings instituted by the contractor himself, the contract might permit the purchaser to terminate immediately upon the institution of the proceedings.

15. In addition to bankruptcy, there is a variety of similar or related proceedings under many national laws (e.g., receivership, liquidation, insolvency, assignment of assets, reorganization) which could interfere with the contractor's

performance of the works contract. The parties may wish to consider whether the purchaser should be entitled to terminate the contract in the event of such proceedings. In that connection, many of the issues considered in paragraphs 11 to 14, above, in relation to bankruptcy, will also be relevant in respect of those other proceedings.

16. When the contract requires the contractor to furnish a performance guarantee (see chapter XVII, "Security for performance", paragraphs 10 to 12), the parties may wish to consider entitling the purchaser to terminate the works contract when the guarantor is engaged in bankruptcy or similar or related proceedings and the contractor fails to arrange for a substitute performance guarantee by another guarantor acceptable to the purchaser within a reasonable or specified period of time.

(d) *Termination for convenience*

17. A purchaser which is a Government or Government enterprise may wish to be entitled by the contract to terminate the contract for its convenience, that is, without having to establish any grounds otherwise specified in the contract. Under some legal systems, such a purchaser may terminate the contract for reasons other than those specifically provided in the contract even without a provision in the contract permitting him to do so, as long as he fully compensates the other party for losses due to the termination. Under other legal systems, however, such a purchaser may not be permitted to do so unless the contract provides for such a termination. Also, even when the contract is governed by a legal system of the type first mentioned, the parties may wish to exclude some types of compensation (e.g., lost profits; see paragraph 34, below) from the compensation otherwise payable to the contractor by a purchaser who terminates the contract for convenience. For reasons such as these, the parties may wish to consider including in their contract provisions dealing with termination for convenience by such a purchaser. If the purchaser is to be permitted to terminate at his convenience, the contract may permit the termination to be effective immediately upon notice of termination to the contractor.[2]

18. The consequences of the exercise by the purchaser of a right to terminate the contract for his convenience may differ from the consequences of his termination on other specified grounds (see paragraph 34, below). In particular, the cost to the purchaser of the exercise of this right may be such as to discourage him from doing so except in exceptional circumstances.

2. *Termination by contractor*

(a) *Failure of purchaser to perform*

19. The purchaser's principal obligation under the contract is to pay the agreed price. However, he may also have obligations which are related to the contractor's right to receive payment, such as arranging for a letter of credit, or taking over or accepting completed construction. The purchaser may have additional obligations under the contract, such as supplying the design or equipment and materials. The circumstances under which the contract might permit the contractor to terminate the contract in the event of a failure by the

purchaser to perform those obligations are discussed in chapter XVIII, "Delay, defects and other failures to perform". The contract might require the two-notice system (see paragraph 9, above) with respect to termination by the contractor for a failure by the purchaser to perform.

(b) *Interference with or obstruction of contractor's work*

20. The contract may entitle the contractor to terminate the contract if the purchaser seriously interferes with or obstructs the contractor's work. In such cases, the contract might require the two-notice system (see paragraph 9, above).

(c) *Bankruptcy or insolvency of purchaser*

21. The parties may wish to consider whether the contractor should be able to terminate the contract if the purchaser becomes subject to bankruptcy, insolvency or similar proceedings. Many of the considerations discussed in paragraphs 11 to 15, above, concerning termination by the purchaser due to the bankruptcy or insolvency of the contractor, are also relevant in this context.

3. *Prevention of performance due to exempting impediment*

22. During the course of construction, events may occur which prevent a party from performing his obligations under the contract. The contract might provide that, if the events constitute exempting impediments (see chapter XXI, "Exemption clauses", paragraphs 9 to 26), the party is exempt from the payment of damages for his failure to perform. It might also obligate the party to notify the other party of the occurrence of an exempting impediment, and provide for the parties to deliberate on what measures should be taken to deal with it (see chapter XXI, "Exemption clauses", paragraphs 27 and 28). The parties may wish to provide in the contract that, if the exempting impediment persists for a specified amount of time, or if the cumulative duration of two or more exempting impediments exceeds a specified amount of time, the contract may be terminated immediately by either party by delivering a written notice of termination to the other party. The contract may quantify the period of time which would entitle a party to terminate. In that connection, the parties may wish to specify a length of time which is likely to result in a serious delay in completing the works. If only a portion of the construction is affected by the exempting impediment, the contract might permit the party to terminate only the part of the contract dealing with that portion.

D. Rights and obligations of parties upon termination

1. *Cessation of construction by contractor and vacation of site*

23. It would be desirable for the contract to provide that, upon termination by either party, the contractor must cease construction. In many instances, however, it will not be feasible or advisable for the contractor simply to cease construction and leave the site at the moment the termination takes effect.

Certain operations in progress may have to be completed, and measures may have to be taken to protect or secure various elements of the partially completed works. If the parties agree that the contractor should be obligated to take such measures, it is advisable for the contract to contain an express provision to that effect. With respect to the question of which party is to bear the cost of such measures, see sub-section 5, below. The contract may also expressly obligate the contractor to vacate the site without delay once all construction has finally stopped, or, alternatively, when ordered to do so by the purchaser, and to require him to ensure that persons or firms engaged by him also vacate the site in those circumstances.

24. The contractual provision obligating the contractor to vacate the site, or the order to vacate given by the purchaser, might also obligate the contractor to remove his construction equipment and tools, and equipment and materials to be incorporated in the works which are owned by the contractor. If the contractor fails to remove those items, the contract could empower the purchaser to have them removed and stored at the contractor's expense. If the contract is terminated for grounds attributable to the contractor, the contract may also give the purchaser the option to use the contractor's construction equipment and tools in order to continue the construction, perhaps upon payment of a reasonable rental, and to purchase at a reasonable price equipment or materials to be incorporated in the works which are on the site. Parties should be aware, however, that these approaches may be subject to or restricted by mandatory rules of applicable law.

25. In some cases, the parties may consider it desirable to provide that the right of the purchaser or of a new contractor to use the contractor's construction equipment and tools is subject to the rights of third persons (e.g., lessors) in those items. In other cases, however, the parties may consider it preferable not to include such a condition, and, in effect, require a contractor who agrees to give the purchaser or a new contractor the option to use the contractor's construction machinery and tools to satisfy himself that to do so would not interfere with the rights of third persons, and to bear the risk of any such interference.

2. *Take-over of works by purchaser*

26. With the exception noted below, the contract may, in the event of termination of the contract, obligate the purchaser to take over portions of the works which have already been constructed and which are not subject to the termination. The contract may specify a short period of time after the termination becomes effective within which the contractor must hand over the works to the purchaser and the purchaser must take it over. However, in the case of termination by the contractor due to a failure by the purchaser to perform, the contract may provide that the purchaser is not entitled to take over the works if such take-over would be inconsistent with the rights of the contractor arising from the purchaser's failure (e.g., rights of the contractor under a reservation of ownership clause; see chapter XV, "Transfer of ownership of property", paragraph 8).

3. *Transfer of contracts with subcontractors and suppliers and payment by purchaser of sums due to subcontractors and suppliers*

27. When a works contract is terminated, there may exist outstanding contracts which the contractor has entered into with subcontractors and suppliers. In some cases, the purchaser will have no interest in those contracts as a result of the termination of the works contract. In other cases, however, for example, where the construction is to be completed by the purchaser or by a new contractor engaged by the purchaser, the purchaser or the new contractor may wish to take over some of those contracts. Alternatively, he or the new contractor may wish to enter into new contracts with those subcontractors or suppliers. This may be the case if the original contracts are not transferable, or if the purchaser or new contractor does not wish to assume all of the obligations due from the terminated contractor to the subcontractors or suppliers by taking a transfer of the contracts (see, also, paragraph 28, below). The conclusion of new contracts may be practicable only if the subcontractors or suppliers are released from their contracts with the contractor. Therefore, in cases where the contract is terminated for grounds attributable to the contractor (i.e., due to a failure of the contractor to perform or his bankruptcy or insolvency), the parties may wish to consider obligating the contractor to transfer the contracts to the purchaser or to the new contractor, or to terminate them, if the purchaser requests him to do so in his notice of termination and if transfer or termination is possible. It may be desirable for the works contract to obligate the contractor to include in his contracts with subcontractors or suppliers a provision permitting him to terminate those contracts if the works contract is terminated.

28. When the transfer of a contract or a new contract with a subcontractor or supplier is contemplated, difficulties may arise because of sums owed to those third persons by the contractor. The third person may not wish to continue his participation in the construction unless past sums owed to him by the contractor are paid. Furthermore, the third person might refuse to deliver items which prior to termination he had undertaken to supply but for which payment has not yet been made, or might even take back equipment and materials which have already been delivered. The purchaser may therefore want the authority to pay to the third person sums owed to the latter by the contractor, and to recover those payments from the contractor. If the purchaser accepts a transfer of the contract with the third person, he will, under some legal systems, be obligated to pay the past due sums. It may be desirable for the works contract expressly to authorize such direct payments and to entitle the purchaser to recover them from the contractor.

4. *Drawings, descriptive documents and similar items*

29. If the purchaser intends to complete the work left unfinished by the terminated contractor, the purchaser may wish to obtain the designs, drawings, calculations, descriptions, documentation for know-how and engineering and other such items relating to the construction which has been completed by the contractor, as well as for construction yet to be completed. Obtaining that documentation or information may be important if the construction or technology is known only to the contractor, or if, for other reasons, the items

cannot be produced by an engineer or a new contractor. The parties may wish to provide, therefore, that, if the contract is terminated by the purchaser for reasons attributable to the contractor, or, more generally, for reasons other than those attributable to the purchaser (i.e., his failure to perform or his bankruptcy or insolvency), the contractor is obligated to deliver to the purchaser such of those items as are in the possession of the contractor. In undertaking such an obligation, the contractor may have to obtain the consent of third persons who have industrial property or other intellectual property rights in respect of the items to be delivered to the purchaser. In addition, it might be desirable for the contract to obligate the contractor to arrange for the production of drawings and documents (e.g., operation manuals) which have not yet been produced and for their delivery to the purchaser, particularly when it would be difficult or impossible for another contractor to produce them.

5. *Payments to be made by one party to other*

(a) *Termination for grounds attributable to contractor*

30. The parties may wish to provide that, if the contract is terminated for grounds attributable to the contractor (i.e., a failure by the contractor to perform or his bankruptcy or insolvency), he is not entitled to payment for construction which he has not yet performed. However, the contract might entitle him to receive the portion of the price which is attributable to construction which he satisfactorily performed prior to termination. In a cost-reimbursable or unit-price contract, the determination of this price should present no unusual difficulties. In a lump-sum contract, the determination of the price attributable to construction which has been performed would be facilitated if the contract allocated portions of the price to specific elements of the construction (see chapter VII, "Price and payment conditions", paragraph 7).

31. When the purchaser terminates the contract, he may incur expenses and suffer losses which he would not have incurred or suffered had the contract not been terminated and had the construction been completed by the contractor. If the contract is terminated due to a failure of the contractor to perform, the contract may provide for the purchaser to be compensated for those expenses and losses by way of damages (see chapter XX, "Damages"). In the case of termination due to the bankruptcy or insolvency of the contractor, it would be desirable for the contract to specify the types of expenses and losses for which the contractor must compensate the purchaser. For example, the contract may obligate the contractor to compensate the purchaser for his expenses in connection with securing or protecting the partially completed works until construction could resume with a new contractor, and penalties or expenses incurred due to the termination of contracts with other contractors or suppliers. In addition, the contract may obligate the contractor to compensate the purchaser for the amount by which the cost of completing the construction with a new contractor exceeds the amount which, under the contract, would have been due to the contractor in respect of that construction. The contract might also obligate the contractor to compensate the purchaser for losses suffered from a delay in the completion of the construction due to the termination and the necessity of engaging a new contractor to complete the construction.

(b) *Termination for grounds attributable to purchaser*

32. If the contract is terminated for grounds attributable to the purchaser (i.e., a failure by the purchaser to perform or his bankruptcy or insolvency), the contract may entitle the contractor to receive the portion of the price which is attributable to the construction which he has satisfactorily performed. In the case of termination due to a failure of the purchaser to perform, the contract may provide for the contractor to be compensated by way of damages for his expenses and losses arising from the termination (see chapter XX, "Damages"). In the case of termination due to the bankruptcy or insolvency of the purchaser, it would be desirable for the contract to specify the types of expenses and losses for which the purchaser must compensate the contractor. These could include, for example, the costs of any measures required to be taken or requested by the purchaser to secure or protect the works, the cost of repatriating the contractor's personnel and construction equipment and tools, to the extent that this is not included in amounts paid or to be paid to the contractor, and penalties or expenses payable by the contractor due to terminating contracts with subcontractors or suppliers.

(c) *Termination based on circumstances not attributable to either party*

33. The contract might provide that, if the contract is terminated for circumstances not attributable to either party (e.g., an exempting impediment), the contractor is entitled to receive the portion of the price which is attributable to the construction which he has satisfactorily performed. The parties should consider, however, the most equitable way to deal with their respective expenses and losses occasioned by the termination. One possibility is to share these expenses and losses equally or in accordance with an agreed formula. Another possibility is for each party to bear his own expenses and losses.

(d) *Termination for convenience*

34. If the contract permits the purchaser to terminate at his convenience, it might, in the event of such a termination, require the purchaser to pay to the contractor the portion of the price which is attributable to the construction satisfactorily performed, as well as for expenses and losses incurred by the contractor arising from the termination (see paragraph 33, above). The parties may wish to consider whether the contractor should be entitled to compensation for his lost profit on the portion of the contract which has been terminated for convenience. On the one hand, the contractor might have foregone other contracting opportunities in anticipation of completing the contract in its entirety. On the other hand, an obligation of the purchaser to compensate the contractor for his lost profit might make it financially prohibitive for the purchaser to exercise his right of termination for convenience. One approach may be for the contract to establish a scale of payments to be made by the purchaser to the contractor as compensation for lost profits, the amount of the payments depending upon the stage of construction which has been completed when the contract is terminated for convenience. Such amounts would be payable without the necessity of the contractor proving the amount of his lost profits. Issues arising in relation to the recovery of compensation for lost profits are discussed in chapter XX, "Damages", paragraph 8.

35. At the time when the contract is terminated for convenience, the purchaser might have received the design for the works from the contractor, but the value of the design might not yet be adequately reflected in the price which the purchaser has already paid or which would be due to the contractor on the basis of the construction which the contractor has satisfactorily performed. To deal with these cases, the contract may specify that the purchaser must compensate the contractor for the design to the extent that such compensation is not otherwise reflected in the price already paid or due to the contractor.

E. Survival of certain contractual provisions

36. In some legal systems, termination of the contract might be interpreted as bringing to an end all contractual provisions, including those which the parties might wish to survive, such as those regulating the rights and obligations of the parties upon termination, quality guarantees for construction performed, remedies for defective performance, and provisions such as those concerning settlement of disputes and the preservation of confidentiality. It is advisable for the parties to take care to ensure that rights, obligations and remedies which they wish to survive do not lapse upon termination. To do so, the parties may specify in the contract those provisions which are to survive and continue to bind the parties even after termination of the contract.

Footnotes to chapter XXV

[1]*Illustrative provisions*

"(1) The purchaser may, without the authorization of a court or any other authorization, terminate this contract in respect of obligations which have not yet been performed, in accordance with the following provisions:

"(a) If the contractor fails to commence construction at the time set forth in article .. of this contract, the purchaser may deliver to the contractor written notice requiring him to commence and specifying that, if the contractor fails to do so within [a reasonable time] [... days] after delivery of the notice, the purchaser will terminate this contract. If the contractor fails to commence construction by the expiry of that period of time, the purchaser may terminate this contract by delivering to the contractor a written notice of termination. However, the purchaser is entitled to immediate termination of the contract if the contractor states to the purchaser that he will not commence construction.

"(b) If the contractor fails to complete a portion of the construction by an obligatory milestone date set forth in article [ ] of this contract, the purchaser may deliver to the contractor written notice requiring him to complete that portion of the construction and specifying that, if the contractor fails to do so within [a reasonable time] [. . . days] after delivery of the notice, the purchaser will terminate this contract. If the contractor fails to complete that portion of the construction by the expiry of that period of time, the purchaser may terminate this contract [in respect of the portion of construction delayed] [in respect of the entire construction remaining to be completed] by delivering to the contractor a written notice of termination.

"(2) The granting to the contractor of the additional periods of time to perform set forth in paragraph (1)(a) and (b), above, is not to be regarded as an extension of the times specified in article [ ] for the performance of the obligations in question, nor to prejudice the purchaser's rights and remedies for delay by the contractor in performing those obligations.

"(3) The grounds for termination enumerated in this article [are in addition to] [substitute] any grounds for termination which may be available to the purchaser under the law applicable to this contract."

[2]*Illustrative provisions*

"The purchaser may, at any time, and without the authorization of a court or any other authorization, terminate this contract or any part thereof for any reason other than those set forth in article [ ] by delivering a written notice of termination to the contractor."

Chapter XXVI. Supplies of spare parts and services after construction

SUMMARY

After construction is completed and the works has been taken over by the purchaser, the purchaser will have to obtain spare parts to replace those which are worn out or damaged, and to maintain, repair, and operate the works. He may wish to obtain from the contractor the spare parts and the repair, maintenance and operation services which he may need. The degree of assistance from the contractor needed by the purchaser in regard to the supply of spare parts and services after construction will depend on the technology and skilled personnel possessed by or available to the purchaser (paragraphs 1 to 3).

It is advantageous for a purchaser from a developing country to acquire or to have available locally the spare parts and the technology and skills necessary to maintain, repair and operate the works. To this end, he may seek in his contract with the contractor to obtain a transfer of the technology and skills required for the manufacture of spare parts and the carrying out of the services. The transfer of technology and skills to the personnel of the purchaser may be effected under training obligations undertaken by the contractor. Such a transfer may be of value to the developing country itself as it may promote its industrialization process (paragraphs 4 and 5).

The planning of the parties with regard to the supply of spare parts and services after construction would be greatly facilitated if the parties were to anticipate and provide in the works contract for the needs of the purchaser in that regard. Other approaches will have to be adopted if this is not possible (paragraphs 7 to 9). The continued availability of spare parts for the operational lifetime of the works is of considerable importance to the purchaser (paragraphs 10 and 11).

A person offering to construct the works may be required to indicate the spare parts which will be needed over a specified period of operation, and the prices at which and the period of time during which he can supply them (paragraphs 12 and 13). The continued availability of spare parts is of crucial importance to a purchaser from a developing country and, accordingly, it may be necessary for him to take steps, through appropriate contractual provisions, to secure a supply of these either from the contractor or from the suppliers of them (paragraph 14). If spare parts are manufactured not by the contractor but for the contractor by suppliers, the purchaser may prefer to enter into contracts with those suppliers rather than obtain them from the contractor or, alternatively, he may wish to have the contractor procure them as his agent (paragraphs 15 and 16).

The parties in their contract may address issues connected with the ordering and delivery of spare parts. The contract may describe the specifications of the spare parts to be supplied, and provide for a quality guarantee in respect of them (paragraphs 18 to 20).

A prospective contractor may be required to indicate the maintenance services he is prepared to supply and the duration for which he is prepared to supply them. The contractor may be required to submit a maintenance programme designed to ensure the proper operation of the works over its lifetime, and the maintenance obligations of the contractor may be defined on the basis of that programme (paragraphs 22 to 24).

The standards to be observed by the contractor when performing maintenance work may be specified in the contract. The contractor may be required to furnish a report on each maintenance operation. The contract may describe how the price for the provision of the maintenance services is to be determined and the payment conditions applicable (paragraphs 25 to 28).

The contract should clearly define the extent of the contractor's repair obligations. It is in the purchaser's interest to enter into contractual arrangements that will ensure that the works will be repaired expeditiously in the event of a breakdown (paragraphs 29 and 30). To ensure that repairs may be undertaken speedily, the procedure for notifying the contractor of the need for repairs and for the contractor to advise the purchaser of any further necessary repairs should be agreed upon in the contract. The contractor may be required to furnish the purchaser with a report of the repairs carried out. The contractor may also be required to give a guarantee under which he assumes responsibility for defects in repairs (paragraphs 31 to 35).

It is advisable for the contract to define carefully the scope of any obligations imposed on the contractor with regard to the technical operation of the works. This may be done on the basis of an organizational chart which shows the functions to be allotted to the personnel of the contractor in carrying out such a technical operation. The division of control between the purchaser and contractor during the operation of the works should be clearly described (paragraphs 37 and 38). The contract may provide how the price for such services is to be determined and the payment conditions applicable (paragraph 39).

The contract may require the purchaser to facilitate the maintenance, repair and operation of the works by the contractor. The purchaser may wish to consider supplying locally available equipment and materials needed for maintenance and repairs (paragraph 40).

The contract should specify when the contractor's obligations regarding the supply of spare parts, maintenance, repair and operation are to commence and may also determine the duration for which they are undertaken by the contractor or establish some mechanism for determining the duration at some later time. Where the contract imposes obligations on the contractor over a long duration, it may be desirable to include mechanisms for the modification of the obligations imposed on the contractor, in particular, as to the scope of those obligations and the price payable by the purchaser. Where the duration of the obligations is short, the agreement may be made to renew automatically (paragraphs 41 and 44).

The parties may wish to deal in the contract with the termination of the obligations as to the supply of spare parts, maintenance, repair and operation. The contract may entitle the purchaser to terminate upon giving notice of a specified period (paragraph 45). The parties may also wish to provide for a system of remedies other than termination for the failure by a party to perform his contractual obligations with respect to the supply of spare parts, maintenance, repair and operation (paragraph 46).

A. General remarks

1. After construction is completed and the works has been taken over by the purchaser (see chapter XIII, "Completion, take-over and acceptance", paragraph 1), he will have to obtain spare parts to replace those which are worn out or damaged, and to maintain, repair and operate the works. In some cases, the purchaser may wish to obligate the contractor to provide some or all of the spare parts and the maintenance, repair and operation services which may be needed. In respect of the supply of spare parts and the repair of the works, the purchaser may need the assistance of the contractor for the operational lifetime of the works, while in respect of the maintenance and operation of the works, such assistance may be required for only a limited period after the works commences to operate.

2. Although the supply of spare parts and the maintenance, repair and operation of works are each dealt with in separate sections in this chapter, the subjects are, in certain respects, interrelated. For example, periodic maintenance has primarily a preventative function. It helps prevent costly breakdowns which require the repair of portions of the works or items of equipment. Accordingly, the purchaser has a vital interest in seeing that maintenance is performed regularly, so that fewer repairs need to be carried out. In addition, spare parts are needed both for the maintenance and the repair of the works and of items of equipment.

3. The degree of assistance from the contractor needed by the purchaser in regard to the supply of spare parts and services will depend on the technology and skilled personnel possessed by or available to the purchaser. For example, when the works is taken over by the purchaser he may not have personnel sufficiently skilled for the technical operation of the works. In that event, the purchaser may wish to obtain the contractor's assistance in operating the works, at least for an initial period. The purchaser may, in some cases, wish the contractor to provide the personnel to man many of the technical posts in the works, while in other cases he may wish the contractor only to provide technical experts to collaborate in an advisory capacity with the purchaser's personnel in the performance of a few highly specialized operations. With regard to the supply of spare parts and repair and maintenance services, these may not be available locally or from any other source, and the purchaser may have to depend on the contractor to supply them.

4. It is advantageous for a purchaser in a developing country to acquire, or have available from local sources, the technology and skills necessary to manufacture spare parts which may be needed to maintain and repair the works. This will, in the long term, reduce the purchaser's expenditure of foreign exchange and his dependence on the contractor. Accordingly, the purchaser may find it advisable to enter into contractual arrangements under which the necessary technology and skills are transferred either to his own personnel, or to enterprises located in his country specializing in the manufacture of spare parts. Such a transfer will also be of more general assistance to the developing country itself, for it will increase its self-reliance through the mastery of technology and the diffusion of industrial skills, and may so promote its industrialization policy.

5. The transfer of technology and skills to the personnel of the purchaser may be effected under training obligations undertaken by the contractor. In some contracts, the contractor may be obligated to train the purchaser's personnel in

maintaining and operating specified portions of the works or specified items of equipment (see chapter VI, "Transfer of technology", paragraphs 26 to 32). In other contracts, the contractor's obligations may go even further. For example, under a product-in-hand contract, the contractor may be obligated not only to train the purchaser's personnel but also to show that the works can be operated and agreed production targets achieved by the purchaser's personnel, using the raw materials and other inputs specified in the contract (see chapter II, "Choice of contracting approach", paragraph 7).

6. The parties should be aware that in the country where the works is situated legal regulations of a mandatory character may exist governing certain issues connected with the supply of spare parts and the maintenance, repair and operation of the works (e.g., for the purpose of ensuring that the works operate safely). The parties should take such regulations into account when formulating contractual provisions on these issues.

B. Contractual arrangements

7. The planning of the parties with respect to the supply of spare parts and services after construction would be greatly facilitated if the parties were to anticipate and provide in the works contract for the needs of the purchaser in that regard. The purchaser may find that he can secure the agreement of the contractor on the extent of the spare parts and services to be supplied by the latter, the duration of the obligation to supply them and the prices to be paid for them, more easily during the negotiations which precede the entering into of the contract than at a later time.

8. In many cases, however, the spare parts and services that will be needed by the purchaser will be uncertain at the time of the negotiations (e.g., the skilled personnel which will be locally available at the time of the completion of construction, or the exact quantity of the spare parts which will be required, may not be predictable). In such cases, a possible approach is for the contract to identify the types of assistance which might be needed and to provide that, if assistance of those types is requested by the purchaser before the completion of the construction, the contractor is obligated to supply it to the extent that he has the capacity to do so. The contract may specify the means by which the price payable by the purchaser for those services is to be determined. It is desirable for the contract to include provisions on those issues on which agreement can be reached at the time the contract is entered into (e.g., the quality of spare parts or services, and conditions of payment). If contractual terms on certain matters are to be agreed upon in the future, the contract may determine the procedure to be followed if the parties fail to reach agreement (see chapter XXIX, "Settlement of disputes", paragraph 3).

9. An alternative approach to dealing with the uncertainty concerning the purchaser's needs as regards spare parts and services at the time the works contract is entered into is for the parties to enter into a separate contract regulating these matters. Such a contract may be entered into closer in time to the completion of construction, when the purchaser may have a clearer view of his requirements.[1] Separate contracts will be necessary when the contractual arrangements for the supply of spare parts or of maintenance or repair services are not with the contractor, but are with the suppliers of the spare parts or services (see sections C and D, below).

C. Spare parts

10. The continued availability of spare parts for the operational lifetime of the works is of great importance to the purchaser. This availability is particularly important to purchasers from developing countries where works are often expected to have a longer operational lifetime than in developed countries. Accordingly, the purchaser may require an enterprise submitting a tender, or with which he is negotiating, to include in its tender or in its offer a proposal concerning the kinds and the quantities of spare parts which will be needed over a specified period of time (e.g., over the course of two years' operation of the works), the period of time after the commencement of operation of the works during which the enterprise is prepared to supply the spare parts, the prices at which it is prepared to supply them and the time for which it is prepared to maintain those prices. The purchaser may also require the enterprise to identify the spare parts which it will manufacture itself and those which it will obtain from suppliers, and to name those suppliers. In certain circumstances it may, however, not be possible for the contractor to predict with certainty the kinds or quantities of spare parts which a purchaser may need. These requirements may vary depending upon the manner in which the works is operated. In addition, while fairly accurate estimates might be made of the quantities of spare parts required in respect of parts which are routinely subject to wear and tear and which, therefore, will have to be replaced periodically, it will be difficult to predict which and how many spare parts will have to be replaced for exceptional reasons (e.g., breakages due to accidents or faulty use of equipment).

11. The contract may contain provisions seeking to protect the purchaser from the consequences of an inaccurate estimate given by the contractor of spare parts required for routine replacement. For example, the contract may require the contractor to accept the return at cost of excess spare parts acquired on the basis of the contractor's estimate. Conversely, the contract may also provide that the purchaser is entitled to buy additional spare parts at the prices at which they were originally supplied, or at a discount, to make up any shortfall between the quantities estimated by the contractor and those actually required.

12. Spare parts usually fall into two categories. The first category consists of standard parts which are obtainable both from the contractor and from several other sources. The second category consists of non-standard parts manufactured by the contractor, or by another enterprise to the contractor's specifications, and which are suitable only for the equipment installed in the particular works being constructed for the purchaser. Standard spare parts may, in many cases, be obtained more cheaply and more conveniently from sources other than the contractor. However, the purchaser may find it desirable to obligate the contractor to supply, at the time of the completion of construction, a limited stock of those parts to cover the period of time between the commencement of operation of the works and the establishment by the purchaser of his own sources of supply. The contract may require the contractor to inform the purchaser of the names of suppliers who can supply the various standard parts and of the advantages of purchasing from those suppliers. The contract may further obligate the contractor to provide the specifications of the parts and other information which might enable the purchaser to obtain the best possible prices and service from the suppliers.

13. As regards non-standard spare parts, the purchaser may find it advisable to require the contractor to supply an adequate stock of such parts (e.g., sufficient for two years' operation of the works) by the time the construction is completed. Those spare parts could then be produced at the same time that the equipment to be incorporated in the works is produced, and they could be transported to the site together with the equipment, usually resulting in savings in production and transport costs. The purchaser may wish to obtain a larger stock of such spare parts if the contractor's prices are likely to increase substantially after the contract is entered into. In deciding on the quantity of spare parts to be supplied, the purchaser may wish to take into account their shelf life.

14. Because the continued availability of spare parts is of crucial importance to a purchaser from a developing country, it may be necessary for him to take steps to secure a supply of these parts at the time the contract is entered into. In particular it is advisable for the purchaser to secure the continued availability of non-standard spare parts (see paragraphs 12 and 13, above). The purchaser may need to guard against the possibility of the contractor ceasing production of those parts. One means of assuring such availability may be for the contract to obligate the contractor to supply the parts for a period of relatively long duration, perhaps even for a period covering the operational lifetime of the works. Alternatively, the purchaser may seek to obligate the contractor to supply him with the drawings, specifications, technical information and licences necessary to enable the purchaser to manufacture or have manufactured for him the non-standard parts. This latter approach may, however, be inappropriate where the purchaser is from a developing country whose enterprises do not have the capacity to manufacture such parts (see paragraph 17, below). As regards non-standard spare parts manufactured by suppliers to the contractor's specifications, the purchaser may seek to obligate the supplier to supply the parts for a period of relatively long duration or, alternatively, seek to obtain the drawings, specifications, technical information and licences necessary for their manufacture.

15. With respect to non-standard spare parts manufactured by suppliers to the contractor's specifications (see paragraph 12, above), the works contract may still obligate the contractor to supply the spare parts. The contractor will perform that obligation by obtaining the spare parts from suppliers. In such a case, it is advisable for the contract to provide that the contractor is liable in respect of such spare parts to the same extent as he is liable in respect of equipment manufactured and supplied by him (see chapter VIII, "Supply of equipment and materials"). The advantage of this approach is that the contractor, whose financial worth is known to the purchaser and with whom the purchaser has had a long-standing contractual relationship by the time the spare parts are supplied, will be liable if the parts prove defective. Alternatively, the purchaser may wish to enter into his own contracts with those suppliers (as to some of the obligations which may be included in such contracts, see paragraph 14, above). Where the contractor has provided the suppliers with the specifications for non-standard parts, his consent may be required to enable the purchaser to deal direct with those suppliers. In such a case, the contractor may be obligated by the contract not to withhold his consent unreasonably.

16. Where the purchaser wishes to contract with suppliers, he may wish to have the contractor act as his agent in procuring the spare parts from them. The works contract may set out the services to be supplied by the contractor in

respect of the procurement. These services could include, for example, contacting possible suppliers, determining the quantities of spare parts which may be required, obtaining competitive offers, evaluating the offers, making recommendations as to purchase, arranging for delivery, and training the purchaser's personnel in stock management. The contractor may also be authorized to enter into contracts with suppliers on behalf of the purchaser.

17. In exceptional cases, the purchaser or other enterprises in his country may have the technical expertise required to manufacture spare parts for the works. In such cases, the contract may require the contractor to furnish to the purchaser the specifications, drawings and technical data necessary for such manufacture. This approach may not be feasible with respect to an item which has been manufactured for the contractor by a supplier, in particular if the supplier has industrial property rights in regard to that item which are enforceable in the country of the contractor or in the country of the purchaser. In such cases, it is advisable for the purchaser to obtain a licence to manufacture the spare parts, or the consent of the supplier to such manufacture, prior to the entry into force of the contract. It may be noted that the contractor's quality or other guarantees may be invalidated by the purchaser's use of spare parts other than those whose use has been authorized by the contractor.

18. The works contract may address issues connected with the ordering and delivery of spare parts. For example, it may determine when delivery is to take place (e.g., it may require some spare parts to be delivered automatically at specified intervals, and others to be delivered upon order by the purchaser). The contract may also specify the manner in which orders are to be communicated and the period of time following the order when delivery is to be made (e.g., within one month of the receipt of the order). The purchaser may wish to provide that an agreed sum is to be payable for any delay in delivery (see chapter XIX, "Liquidated damages and penalty clauses"). The contract might provide for issues such as the passing of risk, packaging, payment of customs duties and taxes, and other incidents of the delivery of the spare parts, to be settled in accordance with a well-recognized trade term (e.g., f.o.b., C.I.F.).[2] The prices for the spare parts may be agreed upon on the basis of the prices quoted by the contractor (see paragraph 11, above). The parties may also agree upon the payment conditions applicable (e.g., the currency, time and place of payment; see chapter VII, "Price and payment conditions").

19. The contract may describe the technical specifications of the spare parts to be supplied, or it may provide that the parts are to have the same specifications as the parts originally incorporated in the works. In addition, the contract may include a guarantee in respect of the spare parts under which the contractor assumes liability for defects discovered and notified to him before the expiry of a guarantee period (see chapter XVIII, "Delay, defects and other failures to perform"). Since spare parts supplied on a particular date may not be put to use until some time later, the determination of the length of the guarantee period and the time when the period commences to run may present difficulties. A possible approach may be to provide for a relatively short guarantee period commencing on the date the parts are put to use, and to provide further that, whether or not the spare parts are put to use, the guarantee expires at the end of a longer period commencing to run from the date of delivery of the spare parts. Different periods may be specified in respect of different kinds of spare parts, depending on the nature of the parts and the use to which they will be put. A simpler approach may be to provide for a single

guarantee period commencing to run from the date of delivery of the spare parts, although, again, a different period might be specified in respect of different kinds of spare parts.

20. After the works is constructed, the contractor may improve or re-design some of the items which he manufactures and which he has undertaken to supply as spare parts. Each party may have an interest in substituting the improved or re-designed items for the ones originally supplied. It may be advisable for the contract to require the contractor to inform the purchaser whenever improvements or re-designings are made, so that, if the purchaser so wishes, negotiations may take place for the supply of the improved or re-designed spare parts instead of the parts originally agreed to be supplied.

21. It is desirable for the purchaser's personnel to develop the technical capacity to install the spare parts. For this purpose, the contract may obligate the contractor to supply the necessary instruction manuals, tools and equipment. The instruction manuals should be in a format and language readily understood by the purchaser's personnel. The contract may also obligate the contractor to furnish "as built" drawings indicating how the various pieces of equipment interconnect and how access can be obtained to the different pieces of the equipment to enable the spare parts to be installed, and also to enable maintenance and repairs to be carried out. In certain cases, it may be appropriate for the contractor to be obligated to train the purchaser's personnel in the installation of spare parts.

D. Maintenance

22. In order to assist the purchaser in maintaining the works, the contract may obligate the contractor to submit, prior to the completion of the construction, a maintenance programme designed to keep the works operating over its lifetime at the level of efficiency required under the contract. A maintenance programme would include matters such as periodic inspection of the works; lubrication, cleaning and adjustment; and replacement of defective or worn-out parts. Maintenance may also include operations of an organizational character, such as establishing a maintenance schedule or maintenance records. The contractor may also be required by the contractor to supply maintenance manuals setting out appropriate maintenance procedures. These manuals should be in a format and language readily understood by the purchaser's personnel.

23. The purchaser may require a tenderer or an enterprise with which a contract is being negotiated to indicate whether it is prepared to supply the maintenance services necessary for the proper functioning of the works, the period of time for which it is prepared to supply them, and the price at which it is prepared to do so.

24. The purchaser may wish a consulting engineer to review the maintenance programme and procedures submitted by the contractor (see chapter X, "Consulting engineer"). The consulting engineer's report may enable the purchaser to determine, on the one hand, what part of the maintenance the purchaser will be able to undertake himself, taking into account the skilled personnel he has available, the training obligations assumed by the contractor (see chapter VI, "Transfer of technology", paragraph 26 to 32), and the maintenance equipment he possesses, and, on the other hand, the maintenance work which will require the contractor's assistance. It is desirable for the contractual provisions dealing with maintenance to specify the items to be maintained by the contractor

(e.g., the entire works, or only specified items of equipment) and to describe the maintenance obligations which the contractor is undertaking. If major items of equipment have been manufactured for the contractor by suppliers, the purchaser may find it preferable to enter into independent maintenance contracts with the suppliers, as they may be better qualified to maintain the items. To enable the purchaser to enter into such contracts, the works contract may obligate the contractor to disclose to the purchaser, prior to the completion of construction, the identities of the suppliers of equipment which needs maintenance.

25. It is desirable for the works contract to specify the standards to be observed by the contractor when performing maintenance work. If maintenance norms or standards established by professional bodies are available, the contractor's obligations may be described by reference to those norms or standards. Where such norms or standards are not available, the contract may specify that the maintenance is to be effected in accordance with the standards which would be observed by a professional engineer when carrying out such maintenance in the country of the contractor. Another approach may be to specify the results which are to be achieved as a result of the maintenance. For example, the contract may require the contractor to carry out maintenance of the works (or a portion of the works) to such a standard as will ensure that the works (or that portion) operates in accordance with the contract for a specified percentage of its anticipated operating time over a fixed period. Failure of the works to operate due to causes for which the contractor is not responsible (e.g., faulty operation by the purchaser's personnel) may be excluded from the scope of such an undertaking.

26. The contractor may undertake to furnish a report on each maintenance operation immediately following the operation. The contract may require the report to describe the maintenance activities undertaken and to be supported by records evidencing the time expended by various categories of personnel and the processes used. The contract may also require the report to contain a description of any defects discovered in the works and any repair or maintenance work needed which is outside the scope of the contractor's obligations, together with an estimate of the costs of carrying out the repair or maintenance work if it can be carried out by the contractor.

27. Proof of proper maintenance of the works may be facilitated by providing in the contract that the personnel of the purchaser are to be associated with the personnel of the contractor in carrying out the maintenance. This may also serve as an effective means of training the purchaser's personnel in maintenance procedures. The price payable by the purchaser for the maintenance may be a lump sum payable for all the obligations undertaken and costs incurred by the contractor in respect of the maintenance operations. This approach may be appropriate when the maintenance operations are of a routine character. Another approach may be for the parties to agree on unit rates for units of time expended on the various work processes involved in the maintenance. Yet another approach may be for the contract to provide that the contractor is to be paid a fee to cover his overhead and profit, and that he is to be compensated for his expenses on a cost-reimbursable basis. In such a case, it is desirable for the contract to specify clearly the expenses in respect of which the contractor is to be reimbursed (see chapter VII, "Price and payment conditions", paragraphs 16 to 20).

28. The contract may set out payment conditions in respect of the price payable for maintenance. Such issues as the currency, time and place of payment may be settled in the contract (see chapter VII, "Price and payment conditions"). With

regard to the time of payment, the contract may require payment to be made within a specified period of time after the submission by the contractor of an invoice following the completion of each maintenance operation, accompanied by the report mentioned in paragraph 26, above.

E. Repairs

29. It is in the purchaser's interest to enter into contractual arrangements that will ensure that the works will be repaired expeditiously in the event of a breakdown. In many cases, the contractor is better qualified than a third person to effect repairs. In addition, if the contract prevents the purchaser from disclosing the technology supplied by the contractor to third persons, this may limit the selection of third persons to effect repairs to those who provide assurances regarding non-disclosure of the contractor's technology which are acceptable to the contractor. On the other hand, if major items of equipment have been manufactured for the contractor by suppliers, the purchaser may find it preferable to enter into independent contracts for repair with the suppliers, as they may be better qualified to repair the items. In defining the repair obligations imposed on the contractor, it is advisable to do so clearly, and to distinguish them from obligations assumed by the contractor under quality guarantees to cure defects in the works (see chapter V, "Description of works and quality guarantee", paragraphs 26 to 31).

30. The extent of the repair obligations to be imposed on the contractor may depend on whether the purchaser wishes to undertake certain repair operations himself (e.g., replacement of minor items of defective equipment). Furthermore, repair obligations to be imposed on the contractor during the period of the quality guarantee may be less extensive than those to be imposed after the expiry of this period since many malfunctions will be covered by the obligation to cure defects (see previous paragraph). The obligations of the contractor cannot be described in terms of specific repair operations, since the repair operations needed will depend on the nature of a particular breakdown. Even where the purchaser himself carries out repairs, he may still need the assistance of the contractor in starting up the works after the repairs have been carried out. Accordingly, the purchaser may wish to consider including a provision requiring the contractor to render such assistance after a repair undertaken by the purchaser is completed.

31. Because some repairs may need to be undertaken speedily, it is advisable for the contract to settle clearly the procedures by which the purchaser may call upon the contractor to effect them. The contract may specify the means by which the contractor is to be notified of a breakdown (e.g., telex, telephone), and the periods of time after notification within which the contractor must inspect the breakdown and commence repairs. The parties may agree that the repairs are to be effected on a cost-reimbursable basis, i.e., that the contractor is to be paid reasonable costs incurred by him in effecting the repairs, plus a fixed amount as a fee. The contract may also provide that, pending the carrying out of the repairs, the purchaser is entitled to use the works or portions of the works to the extent that they remain capable of operation and to the extent that the operation does not unreasonably interfere with the repair work.

32. Certain repairs may not have to be carried out immediately if the works remains operative despite the existence of defects. In such cases, the contract may require the contractor to furnish a report describing the repairs which are needed,

estimating the costs and setting out a time-schedule for the repair (see paragraph 26, above). On the basis of that report, the parties will be able to agree on the terms under which the repairs are to be effected. The parties may find it desirable to provide in the contract that, where disagreement on technical issues prevents the parties from agreeing on the time-schedule for the repairs, the time-schedule is to be determined by a referee (see chapter XXIX, "Settlement of disputes", paragraphs 16 to 21). If the parties fail to reach agreement on the price payable to the contractor for effecting the repairs, the contract may provide for payment to be made on a cost-reimbursable basis. It is advisable that any agreement between the parties in relation to repairs be reduced to writing.

33. The works contract may set out payment conditions in respect of the price payable for repairs. Such issues as the currency, time and place of payment may be settled in the contract (see chapter VII, "Price and payment conditions"). With regard to the time of payment, the contract may provide that payment is to be made within a specified period of time after the submission by the contractor, subsequent to the completion of repairs, of an invoice accompanied by a repair report (see paragraph 34, below). If the contractor is to be obligated to inspect a breakdown within a short period after notification of a breakdown, the parties may wish to agree on which party is to bear the contractor's costs of having personnel in constant readiness for such an inspection. The parties may wish to specify the standards to be observed by the contractor when effecting repairs (see, also, paragraph 25, above).

34. It would be desirable for the purchaser to receive proof that the repairs have been duly carried out, and the parties may agree on how such proof is to be furnished. The contract may obligate the contractor to furnish a report after the completion of repairs describing the causes of the breakdown, the work done, and the materials employed in the repairs. It may require the report to be supported by records evidencing the time expended by various categories of personnel and the processes used. In some cases, proper repair may be proved through a joint inspection of the repairs by the parties, while in others, the contractor may furnish such proof through the successful operation of the works. In other cases, the association of the purchaser's personnel with the contractor's personnel during the repair operations, as described in respect of maintenance in paragraph 27, above, may serve to prove proper repair. The contract may provide that, if the parties fail to agree on whether a repair has been properly carried out, the issue is to be referred for settlement by a referee (see chapter XXIX, "Settlement of disputes", paragraphs 16 to 21).

35. The contract may also obligate the contractor to provide the purchaser with a guarantee under which he assumes responsibility for defects in repairs he has carried out, which are discovered and notified to him before the expiry of a specified guarantee period for the repairs. Furthermore, where, as part of a repair, new equipment is installed or new parts are installed in existing equipment, a quality guarantee may be provided by the contractor in respect of that new equipment or part (see paragraph 19, above). It may be desirable to provide that, if, while carrying out repairs, the contractor discovers that further repairs are needed, he must furnish a report to that effect to the purchaser.

36. While repairs are normally carried out at the site, or elsewhere in the country where the works is situated, it may be necessary in some cases to send an item to the contractor's country for repair. The contract may obligate the purchaser to arrange for the transport of the item to the contractor's country,

and for any necessary insurance of the item until the time of its delivery to the contractor. The contract may obligate the contractor to assist the purchaser in making such arrangements (e.g., by advising on proper packing, or obtaining import permits which may be necessary in his country). The contractor may be obligated to arrange for the transport of the repaired item to the purchaser's country, and for any necessary insurance. It is desirable for the contract to determine which party is to bear the risks and expenses involved in the transport, and the expenses incurred in insuring against those risks. The contract may also require the parties to co-operate with one another in the various matters ancillary to transportation (e.g., customs clearance).

F. Operation

37. It is advisable for the contract to define carefully the scope of any obligations imposed on the contractor with regard to the technical operation of the works. To assist in this purpose, the purchaser and contractor may find it useful to prepare, in consultation with each other, an organizational chart showing the key personnel required for the technical operation of the works, and the functions to be discharged by each person. The positions to be occupied by the personnel employed by the contractor can then be identified, and the qualifications and experience of such personnel specified. The functions allotted to posts to be filled by employees of the contractor need to be defined with particular care. In determining what personnel is to be supplied by the contractor, the parties should take account of any mandatory regulations which may exist in the country of the purchaser regulating the employment of foreign personnel.

38. In order to avoid friction and inefficiency, it is desirable that the authority to be exercised by the personnel of each party over the personnel of the other be clearly described. It may, for example, be necessary for a general manager at the works employed by the purchaser to give certain policy directives to engineers who are employees of the contractor. Conversely, an engineer employed by the contractor may have to issue directions to subordinate engineers who are employees of the purchaser. The parties may wish to agree upon a procedure whereby a party may contest, on specified grounds, instructions given to its personnel by personnel of the other party. Furthermore, the parties may wish to agree on a procedure for dealing with complaints by one party against the other (e.g., incompetence, inefficiency, failure to follow directions). The procedure may, for example, consist of an investigation by a panel composed of a senior executive officer of each party. The contract may provide that, if specified serious complaints against employees are proved, those employees must be replaced at the expense of the party who engaged them, within a specified period of time. In addition, the contract may entitle the purchaser to require the contractor to replace any of his employees, even in the absence of a proven complaint against that employee. The parties may wish to determine how the expenses of such a replacement are to be allocated between the parties.

39. If, prior to entering into the contract, a reasonable estimate can be made of the costs to be incurred by the contractor in providing the operation services required of him, the price for such services may be specified in the contract as a lump sum payable for all the obligations undertaken by him over a specified period of time. Another approach to determining the price may be to combine the payment of fixed amounts with the cost-reimbursable method (see

chapter VII, "Price and payment conditions", paragraph 2). Fixed amounts may be payable in respect of items for which reasonable cost estimates can be made (e.g., the salaries of the personnel who are to operate the works, the cost of their accommodation and travel) and the cost-reimbursable method provided for the remaining items of expenditure. In cases where the operational functions performed by the contractor are closely linked to the productivity and profitability of the works, the purchaser may wish to consider payment to the contractor of an incentive fee (e.g., a specified percentage of the value of the yearly turnover), provided that incentive fees are also payable by the purchaser to his own employees. It is advisable that applicable payment conditions (e.g., with regard to issues such as the currency, time and place of payment) be settled in the contract (see chapter VII, "Price and payment conditions").

G. Facilitation by purchaser of provision of services by contractor

40. The purchaser may undertake to facilitate in specific ways the maintenance, repair and operation of the works by the contractor. For example, he may agree to assist the contractor in obtaining visas or work permits for the contractor's personnel, provide safe access to the works, inform the contractor of alterations to the original construction of the works which may influence its maintenance, repair, and operation, and inform the contractor of the mandatory and other safety regulations which the parties must observe during maintenance, repair and operation, and inform the contractor of the supplying locally available equipment and materials needed for maintenance and repairs, as this may reduce the costs involved. If so, the contract may identify the equipment and materials which the purchaser undertakes to supply. In addition, the purchaser may consider providing other facilities to the contractor's personnel, such as accommodation and transport. If he wishes to provide such facilities, it is desirable for the contract to determine how the costs of the facilities are to be allocated between the parties.

H. Commencement and duration of obligations of parties

41. It is advisable for the contract to specify when the obligations undertaken by the contractor as to the supply of spare parts, maintenance, repair and operation are to commence. With respect to the supply of spare parts, see paragraphs 13 and 14, above. The date of commencement of the maintenance obligations may depend on other obligations undertaken by the contractor. For example, if the contractor has undertaken complete responsibility for the operation of the works for a specified period of time after acceptance of the works by the purchaser, and such responsibility includes maintenance, additional maintenance obligations may commence upon the expiry of that period. Repair obligations may commence on the date of take-over of the works by the purchaser. The date of commencement of the obligations of the contractor in regard to operation of the works may be fixed having regard to the other conditions which have to be satisfied before the works can commence to operate (e.g., availability of the staff to be employed by the purchaser).

42. The parties may sometimes find it difficult to determine the duration of the obligations to supply spare parts and of maintenance, repair and operation. One approach may be to provide that these obligations are to continue for a fixed

period of a relatively long duration, perhaps even for a period covering the operational lifetime of the works. This approach might be adopted when the purchaser does not expect that he or other enterprises in his country will develop the capacity to manufacture spare parts or provide services within a short period after the take-over of the works. A second approach is to provide that the obligations are to continue for a fixed period of a relatively short duration and that they are to be renewed automatically for further periods of the same duration, unless the renewal is prevented (see paragraph 44, below). If the contractor's obligations extend over a short period and the purchaser wishes the obligations to continue after the expiry of that period, he would have to negotiate for their extension for a further period. That approach may, however, result in hardship for the purchaser if the contractor does not agree to an extension of the obligations.

43. It may be desirable for the contract to include mechanisms for a modification of the obligations imposed on the contractor with respect to spare parts, maintainance, repair and operation, in particular as to the scope of those obligations and the price payable by the purchaser. The purchaser may increase his own capabilities, and may wish to assume responsibility for the supply of certain spare parts or services originally provided by the contractor. Conversely, it may transpire during the operation of the works that the purchaser cannot provide certain spare parts or services which he had earlier assumed he could provide, and he may wish the contractor to provide those spare parts or services. Any change in the scope of obligations undertaken by the contractor will usually require an adjustment of the price. Accordingly, the contract may provide that the scope of obligations and the price are to be reviewed periodically and agreed upon by the parties (e.g., every two years for the duration of the obligations, or at each renewal of the obligations) and that the purchaser is entitled at the review to request a reduction or increase in the scope of the obligations. The contract may provide that the contractor is not obligated to comply with a request for increased services if he does not have the capacity to provide them.

44. Even in cases where the scope of the contractor's obligations is not changed at a periodic review, a revision of the price payable may be required due to a change in the cost of the goods and services necessary to discharge those obligations. The parties may wish to provide that, at each periodic review, changes in costs are to be taken into account, and a new price agreed upon, if necessary. Alternatively, the parties may link the price payable to an appropriate price index, if one is available. The price would then be revised automatically in accordance with changes in the index (see chapter VII, "Price and payment conditions", paragraphs 49 to 55). The index should be structured in accordance with the particular circumstances of the obligation in question. It is usually not suitable to adopt in respect of the obligations of the contractor dealt with in this chapter the same index as is used for revision of the price for the construction of the works.

I. Termination

45. The parties may also wish to deal with the termination of the obligations as to the supply of spare parts, maintenance, repair and operation. Where the duration of the obligations is a fixed period of a relatively long duration (see paragraph 42, above), the contract may permit the purchaser to terminate the obligations prior to the end of that period upon giving the contractor notice in writing. The contract may provide for the obligations in question to terminate

upon the expiry of a specified period of time after delivery of the notice by the purchaser. The period of time should be sufficiently long for the contractor to be able to phase out the arrangements he has made to fulfil his obligations without suffering loss. As a further protection to the contractor, it may be provided that the obligations may be terminated only after the contractor has supplied the service for a specified length of time. Where the duration of the obligations is a fixed period which is subject to automatic renewal (see paragraph 42, above), the contract may provide that the purchaser can prevent that renewal by giving written notice of non-renewal not later than a specified period of time prior to the end of the initial or of a renewed period of the contractor's obligations, as the case may be. Whether the duration of the obligations consists of a single specified period of time of relatively long duration or of shorter periods of time which are successively renewed, the purchaser may, in addition, be given the right to terminate the obligations for convenience at times other than those mentioned above, subject to the payment of compensation for any loss suffered by the contractor as a result of the termination (see chapter XXV, "Termination of contract", paragraphs 17 and 18). The purchaser may wish to have such a right to deal with a situation where he is unexpectedly able to obtain the spare parts and services at lesser cost from other sources; however, he should not be entitled to cancel orders that have already been placed at the date of termination (see paragraph 18, above). The contract may also provide for termination by either party for specified failures of performance by the other party, such as delay in performance for a specified period of time or the non-attainment of designated performance standards. In addition, the contract may provide for termination by either party for the bankruptcy or insolvency of the other party, or where performance by the other party is prevented for a specified period of time by exempting impediments (see chapter XXV, "Termination of contract", paragraph 22).

J. Remedies other than termination

46. The parties may also wish to provide in their contract for a system of remedies other than termination for the failure by a party to perform obligations as to the supply of spare parts, maintenance, repair and operation. They may wish to select such remedies as are appropriate to the obligations in question out of those which are described in the *Guide* in connection with a failure to perform construction obligations (see chapter XVIII, "Delay, defects and other failures to perform", chapter XIX, "Liquidated damages and penalty clauses" and chapter XX, "Damages"). Alternatively, they may leave the remedies to be determined by the law applicable to the contract.

Footnotes to chapter XXVI

[1]The Economic Commission for Europe (ECE) has prepared a *Guide on Drawing Up International Contracts for Services Relating to Maintenance, Repair and Operation of Industrial and Other Works* which will assist parties in drafting a separate contract or contracts dealing with maintenance, repair and operation (ECE/TRADE/154).

[2]The trade term may be identified by reference to the *International Rules for the Interpretation of Trade Terms (INCOTERMS)* prepared by the International Chamber of Commerce (ICC) (ICC publication No. 350, 1980).

Chapter XXVII. Transfer of contractual rights and obligations

SUMMARY

The transfer of contractual rights and obligations as considered in this chapter includes, firstly, the transfer of the contract in its entirety, whereby a new party is substituted for one of the original parties to the contract, as well as the transfer of certain specific rights and obligations under the contract (paragraphs 1 to 4).

The parties may find it advisable for the contract to permit a party to transfer the entire contract or specific contractual obligations only with the written consent of the non-transferring party (paragraphs 5 and 6). The parties may also wish to make the transfer of contractual rights subject to the consent of or, alternatively, the absence of an objection by, the other party. An exception may be made for the transfer of certain contractual rights, for example, a transfer by the contractor of his right to receive payments from the purchaser (paragraph 7).

The contract may contain provisions which seek to safeguard the interests of the non-transferring party in the event of a transfer, such as a provision that a transfer by the contractor of his right to receive payments from the purchaser is subject to the same rights of set-off that the purchaser had under the works contract in respect of payments to be made to the contractor. Also, when a transfer may be made only with the consent of the non-transferring party, the parties may wish to provide that, in making the transfer, the transferring party must conform to any conditions subject to which the consent is given. The contract may require the transferring party to give written notification to the non-transferring party of the transfer (paragraphs 8 to 11).

It may be desirable for the contract to specify the consequences of a transfer in violation of the provisions of the contract (paragraph 12).

A. General remarks

1. The transfer of contractual rights and obligations as considered in this chapter includes, firstly, the transfer of the contract in its entirety, whereby a new party is substituted for one of the original parties to the contract, as well as the transfer of certain specific obligations and rights under the contract. In the *Guide*, a distinction is drawn between the transfer of the entire contract or specific obligations under it, on the one hand, and the transfer of contractual rights, on the other.

2. Most legal systems contain rules governing the right of a party to make such transfers, as well as defining the legal effects of the transfers. It is usually possible for the parties to set forth in their contract the terms and conditions under which a transfer may be made; nevertheless, in doing so, the parties ought to bear in mind any mandatory provisions of the applicable law (e.g., a

requirement that any transfer be subject to the approval of a State authority) which may circumscribe the right to make a transfer or regulate its legal consequences.

3. This chapter deals with the voluntary transfer by a party of the contract or of rights and obligations arising under it, and not with transfers effected by operation of law. Issues such as the succession, merger and re-organization of parties, which involve transfers of contractual rights and obligations, are usually settled under the applicable law, and therefore are not dealt with in this chapter. Furthermore, where a State is a party to a contract, it will decide which State enterprise is to implement the contract, and no transfer will occur on the appointment or change of the implementing State enterprise. The subject of subcontracting, as conceived in the *Guide*, is not a transfer of obligations, and is discussed separately (see chapter XI, "Subcontracting", paragraph 1).

4. In considering the terms and conditions governing the transfer of the contract or rights and obligations arising under it, the parties should bear in mind the effect of such a transfer on contractual rights and obligations which either party may have in relation to third persons. For example, if a guarantee has been given by a third person as security for performance by the contractor, a transfer of the contractor's obligations which are the subject matter of the guarantee, without the consent of the guarantor, may invalidate the guarantee. It is therefore advisable to obtain the consent of the guarantor before the contractor's obligations are transferred.

B. Transfer of entire contract or of obligations under contract

5. The contractual relationship between parties to a works contract is usually based upon mutual confidence between them. In particular, the purchaser normally selects a contractor because of the contractor's skill and experience, his reputation, his financial strength, and similar factors personal to the contractor. Significant problems could arise for the purchaser if, for example, the contractor were able to transfer the contract or certain of his obligations to a third person who did not possess the same degree of skill and expertise as the contractor. Similarly, the purchaser could suffer if the contractor made such a transfer to a subsidiary which had no assets or financial resources of its own from which damages could be paid to the purchaser in the event of a failure to perform. For the contractor's part, he could be put at a disadvantage if the contract, or the purchaser's contractual obligation in respect of the payment of the price, were to be transferred by the purchaser to a transferee who was not able to continue making the required payments.

6. For the foregoing reasons, the parties may find it advisable for the contract to permit a party to transfer the contract, or specific contractual obligations, only with the written consent of the non-transferring party. In such a case, the contract may obligate the transferring party to deliver to the non-transferring party a written notice of his intention to make the transfer, specifying either that the entire contract is to be transferred or the specific obligations to be transferred, the name and address of the proposed transferee and the date when the proposed transfer would become effective. The contract may prohibit the transferring party from making the transfer unless the non-transferring party consents in writing to the transfer.

C. Transfer of rights under contract

7. The parties may also wish to provide that the written consent of the non-transferring party is required for the transfer of specific contractual rights (cf. paragraph 6, above). Alternatively, the contract may permit the transferring party to make the transfer unless the non-transferring party, within a specified period of time of the delivery to him of a written notice of the intention of the transferring party to make the transfer, delivers to the transferring party a written objection to the proposed transfer, specifying reasonable grounds for the objection. Reasonable grounds for objecting to the transfer of rights under the contract might arise because the non-transferring party may be impeded by the transfer in the performance of his corresponding obligation or because the right transferred may be so closely linked to an obligation that the transfer of the right places the performance of the obligation in jeopardy. A dispute between the parties as to whether the grounds are reasonable might be resolved under the dispute settlement provisions of the contract (see chapter XXIX, "Settlement of disputes"). The parties may, however, wish to specify exceptions to the requirement of consent or the absence of a reasonable objection for the transfer of certain contractual rights. In some instances, the contract might provide that the purchaser's consent is not necessary for the contractor to transfer his right to receive payments from the purchaser.[1] Contractors often find it necessary to make such transfers in order to borrow funds or obtain the financing needed to purchase equipment and supplies, to pay labour or cover other costs of performing the contract, or to benefit from an export credit guarantee scheme.

D. Other provisions to safeguard interests of parties

8. There are various other provisions which might be incorporated in the contract in order to safeguard the interests of the parties in the event of a transfer of the entire contract or specific rights or obligations under it. Examples of such provisions are discussed in the following paragraphs.

9. When the contract or certain specific contractual rights and obligations are transferred, there may be cases in which under the applicable law the non-transferring party does not have the same rights against the transferee which he had against the transferring party under the works contract. Therefore, the contract may include provisions which seek to ensure that, in respect of the contract or of the rights or obligations transferred, the position of the non-transferring party is not prejudiced by the transfer. For example, the works contract may provide that a transfer by the contractor of his right to receive payment from the purchaser is subject to the same rights of set-off that the purchaser had under the works contract in respect of payments to be made to the contractor. It may be desirable to include such provisions in the works contract whether or not a transfer is subject to the consent of, or, in the case of the transfer of rights, the failure to object by, the non-transferring party.

10. Secondly, when the contract does not permit a transfer without the prior consent of the non-transferring party, the non-transferring party may wish to make his consent subject to certain conditions. For example, where, under the applicable law, a transfer of the contract relieves the transferring party from the performance of his contractual obligations, the non-transferring party may

wish to grant his consent only upon the condition that the transferring party guarantee the performance of those obligations by the transferee. The parties may wish to provide in their contract that any transfer to which consent is granted subject to conditions must conform to those conditions.[2]

11. It is important for the non-transferring party to know when a transfer has been made, Whether or not a proposed transfer is subject to the consent or failure to object by the non-transferring party, it is advisable that he receive confirmation that the transfer has, in fact, been made. The contract may therefore require the transferring party to notify the non-transferring party in writing of the transfer, of the date on which it has or is to become effective, and of the identity of the transferee. The contract may further provide that, until the non-transferring party receives the notice, he is entitled to treat the transferring party as the only person entitled to the rights or bound to perform the obligations under the contract.[3]

E. Consequences of transfer in violation of contract

12. It may be desirable for the contract to specify the consequences of a transfer in violation of the provisions of the works contract. The contract may provide that the transfer shall be of no effect as between the transferring and non-transferring parties, and, in respect of the rights or obligations purported to be transferred, that the transferring party remains subject to all the obligations required of him and all the rights of the non-transferring party under the works contract.[4] Alternatively, the parties may wish to include in their contract a provision entitling the non-transferring party to terminate the contract where the transferring party has violated contract provisions governing transfer. The contract might also permit the non-transferring party to claim damages from the transferring party for any loss suffered as a result of a transfer in violation of the contract (see chapter XX, "Damages").

Footnotes to chapter XXVII

[1]*Illustrative provisions*

"(1) Neither party may transfer any of his rights or obligations under this contract to a third person except as hereinafter provided.

"(2) A party desiring to transfer any of his rights or obligations under the contract shall deliver to the non-transferring party a written notice of his intention to make the transfer, specifying the rights or obligations to be transferred, the name and address of the proposed transferee and the date when the proposed transfer would become effective.

"(3) [Alternative 1] The party desiring to make a transfer of any obligations [or rights] under the contract shall be entitled to do so only if and as of the time when the non-transferring party consents in writing to the proposed transfer.

"[Alternative 2] The party desiring to make a transfer of any of his rights under the contract shall be entitled to do so upon the expiration of [ ] days after delivery of the notice referred to in paragraph (2) of this article to the non-transferring party, unless, within the said [ ] day period, the non-transferring party delivers to the party desiring to make the transfer a written objection to the transfer specifying reasonable grounds for the objection. Any dispute between the parties as to the reasonableness of the grounds for the objection may be submitted by either party for settlement in accordance with [the dispute settlement provisions of this contract].

"(4) However, the contractor may transfer his right to receive payments from the purchaser under this contract for the purpose of borrowing funds or obtaining financing from a bank or other financial institution, or to benefit from an export credit guarantee scheme, or for similar purposes, without regard to the provisions of paragraph (2) or (3) of this article."

[2]*Illustrative provision*

"When, under this contract, a transfer by a party is not permitted without the consent of the non-transferring party, the non-transferring party may specify that the transfer may be made only if the transferring party fulfills certain conditions, and, in making the transfer, the transferring party must conform to those conditions."

[3]*Illustrative provision*

"Where a party transfers any of his rights or obligations under this contract, he must notify the non-transferring party of the rights or obligations to be transferred, the name and address of the transferee and the date on which the transfer has or is to become effective, and, until the non-transferring party receives the said notice, he is entitled to treat the transferring party as the only person entitled to the rights or bound to perform the obligations under this contract."

[4]*Illustrative provision*

"If a party transfers any of his rights or obligations under this contract in violation of its provisions, the transfer is of no effect as between the transferring and non-transferring parties, and, in respect of the rights purported to be transferred, the transferring party remains subject to all the obligations imposed on him, and to all the rights of the non-transferring party, under this contract."

Chapter XXVIII. Choice of law

SUMMARY

The parties may, within certain limits, choose the legal rules which are to govern their mutual contractual obligations (paragraphs 1 to 3). In the absence of a choice, uncertainty as to those rules may arise from two factors. The courts of several countries may be competent to decide the disputes between the parties. Since each court will apply the rules of private international law of its own country, there may be several possible systems of private international law which could determine the law applicable to the contract. Secondly, even if it is known which system of private international law will determine the law applicable to the contract, the rules of that system are sometimes too general to enable the applicable law to be determined with reasonable certainty (paragraphs 4 to 6).

The parties may therefore wish to provide in the choice-of-law clause that the law of a particular country is to govern their contract. Some difficulties may arise if the parties choose the general principles of law or the principles common to some legal systems as the law applicable to their contract, instead of the law of a particular country (paragraph 9).

In many cases, the parties may wish to choose as the applicable law the law of the country where the works is to be constructed. In some cases, they may wish to choose the law of the contractor's country, or of a third country (paragraph 11). In the case of countries where there are several legal systems applicable to contracts (e.g., some Federal States), it may be advisable to specify which one of those systems is to be applicable (paragraph 12). Certain factors may be relevant in making a choice of law (paragraph 13).

Even in cases where the rules of private international law permit the parties to provide that the legal rules of different legal systems are to apply to different rights and obligations under the contract, it may be preferable to choose a single legal system to govern all the rights and obligations (paragraph 14). If the parties wish the law applicable to the contract to consist of the rules existing at the time the contract is entered into, unaffected by later changes to those rules, they may expressly so provide. Such provisions will, however, be ineffective if the changes have a retroactive character which is mandatory (paragraph 15).

Different approaches are possible to drafting a choice-of-law clause. One approach may be merely to provide that the contract is to be governed by the chosen law. Another approach may be to provide that the chosen law is to govern the contract, and also to include an illustrative list of the issues which are to be governed by that law. Yet another approach may be to provide that the chosen law is to govern only the issues listed in the chosen law (paragraph 16).

If several contractors are to participate in the construction, it is advisable for the purchaser to choose the same law as the law applicable to the contracts concluded by him with all the contractors. It is also advisable for the contractor to choose that same law as the law applicable to all contracts concluded by him with sub-contractors and suppliers (paragraph 19).

The parties may wish to note the possible application to a works contract of the United Nations Convention on Contracts for the International Sale of Goods, and to make appropriate provision for that possibility (paragraphs 20 and 21).

In addition to legal rules applicable to the contract by virtue of a choice of law by the parties or by virtue of the rules of private international law, certain mandatory rules of an administrative or other public nature in force in the countries of the parties may affect certain aspects of the construction. The parties should take those rules into account in drafting the contract (paragraphs 2 and 22). Certain of those rules concern technical aspects of the works to be constructed, others prohibit or restrict exports, imports, the transfer of technology and the payment of foreign exchange, and yet others impose customs duties and taxes on activities connected with the construction of the works (paragraphs 23 to 25).

A. General remarks

1. The legal rules which govern the mutual contractual obligations of the parties are referred to in the *Guide* as "the law applicable to the contract". The parties may exercise a degree of control over the application of these rules, since they are permitted under many legal systems to choose by agreement the law applicable to the contract. Under some legal systems there are certain restrictions on this choice (see paragraph 7, below).

2. Particular aspects of the construction may be affected by legal rules of an administrative or other public nature in force in the countries of the parties and in the country where the works is being constructed (if that country is different from the country of the purchaser), whatever be the law applicable to the contract. Those legal rules may regulate certain matters in the public interest, for example, safety standards to be observed in construction, protection of the environment, import, export and foreign exchange restrictions, and customs duties and taxes (see paragraphs 22 to 25, below).

3. In addition, the extent to which the parties may designate particular issues to be governed by the chosen law may be limited. For example, regardless of the choice by the parties of the law applicable to the contract, the law of the country where equipment or materials are situated may govern the transfer of ownership of that property, and the law of the country where the site is situated may govern the transfer of ownership of the works (see chapter XV, "Transfer of ownership of property", paragraph 3). The question of which legal system's procedural rules are to govern arbitral or judicial proceedings for the settlement of disputes arising in connection with the contract is discussed in chapter XXIX, "Settlement of disputes", paragraphs 8, 33 and 52.

B. Choice of law applicable to contract

4. It is advisable for the parties to choose the law applicable to the contract. If they do not do so, there may be uncertainty as to what law applies, making it difficult for the parties to comply with the appropriate legal rules during the performance of their contractual obligations. The uncertainty in the absence of a choice of law arises from two factors.

5. First, the law applicable to the contract is determined by the application of rules of private international law of a national legal system. When a dispute arises concerning the contract or its performance which is to be settled in judicial proceedings, the rules of private international law applied by the court settling the dispute will determine the law applicable to the contract. A court will apply the rules of private international law of its own country. If there is no exclusive jurisdiction clause agreed upon in the contract (see chapter XXIX, "Settlement of disputes", paragraph 52), the courts of several countries may be competent to decide disputes arising between the parties, and there may therefore be several possible systems of private international law which could determine the law applicable to the contract. When disputes are to be settled in arbitral proceedings, the arbitral tribunal will determine what law is applicable. Unless the parties have chosen the law applicable to the contract, it may sometimes be difficult to predict what law will be determined to be the law applicable to the contract on the basis of a system of private international law which the arbitral tribunal will consider to be appropriate.

6. The second factor producing uncertainty as to the law applicable to the contract is that, even if it is known which system of private international law will determine the law applicable to the contract, the rules of that system may be too general or vague to enable the law applicable to a works contract to be determined with reasonable certainty.

7. The extent to which the parties are allowed to choose the law applicable to the contract will be determined by the rules of the relevant system of private international law. Under some systems of private international law, the autonomy of the parties is limited and they are only permitted to choose a legal system which has some connection with the contract, such as the legal system of the country of one of the parties or of the place of performance. Since a court which is to settle a dispute will apply the rules of private international law in force in its country, the parties should agree upon a choice of law which would be upheld by the rules of private international law in the countries whose courts might be competent to settle their disputes. If the parties agree upon an exclusive jurisdiction clause, they should be particularly sure that a court in the chosen jurisdiction will uphold their choice of law.

8. Under other systems of private international law, the parties are permitted to choose the law applicable to the contract without those restrictions. If a dispute is settled in arbitral proceedings, the law chosen by the parties will normally be applied by the arbitrators.

9. In general, it is advisable for the parties to choose the law of a particular country to govern their contract. The rules of private international law of a country where legal proceedings may be instituted in the future may not recognize the validity of a choice of general principles of law or of principles common to several legal systems (e.g., of the countries of both parties). Even if such a choice would be valid, it may be difficult to identify principles of law which could resolve disputes of the type arising in connection with a works contract. Nevertheless, such a choice may be practical and feasible in certain circumstances.

10. In many legal systems, a choice-of-law clause is interpreted as not to include the application of the rules of private international law of the chosen legal system even if the clause does not expressly so provide. However, if that interpretation is not certain, the parties may wish to indicate in the clause that

the substantive legal rules of the legal system they have chosen are to apply to the contract. Otherwise, the choice of the legal system may be interpreted as including the private international law rules of that legal system and those rules might provide that the substantive rules of another legal system are to apply to the contract.

11. In many cases, the parties may wish to choose as the law applicable to the contract the law of the country where the works is to be constructed, or the law of the purchaser's country, if that country is different from the country where the works is to be constructed. In some works contracts, the parties may wish to choose the law of the contractor's country. In other contracts, the parties may prefer to choose the law of a third country which is known to both parties and which deals in an appropriate manner with the legal issues arising from works contracts. If the contract provides for the exclusive jurisdiction of the courts of a particular country to settle disputes arising under the contract, the parties may wish to choose the law of that country as the law applicable to the contract. This could expedite judicial proceedings and make them less expensive, since a court will normally have less difficulty in ascertaining and applying its own law than the law of a different country.

12. In the case of countries where there are several legal systems applicable to contracts (as in some federal States), it may be advisable to specify which one of those legal systems is to be applicable in order to avoid uncertainty.

13. The parties may also wish to take the following factors into consideration in choosing the law applicable to the contract:

(*a*) The parties' knowledge of, or possibility of gaining knowledge of, the law;

(*b*) The capability of the law to settle in an appropriate manner the legal issues arising from a works contract;

(*c*) The extent to which the law contains mandatory rules which would prevent the parties from settling in the contract, and in accordance with their needs, issues arising from the contract.

14. Under the rules of private international law of some legal systems, the parties are permitted to provide that the legal rules of different legal systems are to apply to different legal issues or different rights and obligations under the contract. Parties sometimes do so because they believe that certain issues are handled in a better way under one legal system than under another or because substantial portions of the contract are to be performed in different countries. If the parties do so, however, difficulties may arise, since the legal rules of the different legal systems may not be in harmony, producing gaps or inconsistencies in the application of the rules to the contract. Therefore, the parties may wish to choose a single legal system to constitute the law applicable to the contract and govern all their contractual rights and obligations, unless the countervailing factors are particularly important.

15. Changes in the legal rules which govern the rights and duties of parties to a contract may or may not be retroactive; if they are not retroactive, contracts entered into before the changes come into force are not affected by the changes. If the parties wish that only the legal rules existing at the time the contract is entered into are to apply to the contract, they may expressly so provide in the contract. However, parties should be aware that such a restriction will not be effective if the retroactive character of the changes is mandatory.

16. Different approaches are possible with respect to the drafting of a choice-of-law clause. One approach may be merely to provide that the contract is to be governed by the chosen law.[1] This approach may be sufficient if it is clear that the body chosen to settle disputes between the parties will apply the chosen law to all the issues which the parties desire to be regulated by it. A second approach may be to provide that the chosen law is to govern the contract, and also to include an illustrative list of the issues which are to be governed by that law.[2] This approach may be useful if the parties consider it desirable to ensure that the issues contained in the illustrative list in particular will be governed by the chosen law. A third approach may be to provide that the chosen law is to govern only the issues listed in the clause.[3] This approach may be used if the parties wish to delimit clearly the issues to be governed by the chosen law. Under this approach, the issues not set forth in the clause will be governed by a law determined by the applicable rules of private international law (see paragraph 5, above).

17. Under the systems of private international law of some countries, a choice-of-law clause may be considered as an agreement separate from the rest of the contract between the parties. Under those systems, the choice-of-law clause will remain valid even if the rest of the contract is invalid, unless the grounds for invalidity also extend to the choice-of-law clause. Where the contract is invalid but the choice-of-law clause remains valid, the formation, the lack of validity, and the consequences of the invalidity of the contract will be governed by the chosen law.

18. Under some systems of private international law, the chosen law may govern the prescription of rights, while under other systems rules relating to prescription (limitation of actions) are of a procedural character and cannot be chosen by the parties in their contract; in those cases, the procedural rules of the place where the legal proceedings are brought will apply.

19. The choice by the parties of the law applicable to the contract relates only to the legal rules governing their mutual contractual rights and obligations; that choice will usually not directly affect the law applicable to rights and duties of persons who are not parties to the works contract (e.g., subcontractors, personnel employed by the contractor or the purchaser, or the creditors of a party). If several contractors are to participate in the construction (see chapter II, "Choice of contracting approach", paragraphs 17 to 25) it may be desirable for the purchaser to choose the same law as the law applicable to each of the contracts concluded with all the contractors in order to harmonize and co-ordinate the performances by the contractors under those contracts, and to harmonize the legal results of a failure to perform. For similar reasons, it is advisable for the contractor to choose that same law as the law applicable to all contracts relating to the construction of the works concluded by him with subcontractors and with suppliers.

20. The parties may wish to note that the United Nations Convention on Contracts for the International Sale of Goods[4] applies to contracts of sale of goods when the parties have their places of business in different States and those States are parties to the Convention, or when the rules of private international law lead to the application of the law of a Contracting State, e.g., when the parties choose the law of a Contracting State (article 1). Article 3 of the Convention provides that contracts for the supply of goods to be manufactured or produced are to be considered as sales contracts, subject to

two exceptions. Firstly, the Convention does not apply to contracts in which the preponderant part of the obligations of the contractor consists in the supply of labour or other services. Secondly, the Convention does not apply to contracts for the supply of goods to be manufactured or produced if the party who orders the goods undertakes to supply a substantial part of the materials necessary for such manufacture or production. By virtue of these articles, it may be considered that the Convention can apply to some works contracts. If the application of article 3 to the circumstances of a particular works contract leaves it uncertain whether the Convention will apply to the contract, the parties may wish expressly to resolve that uncertainty.

21. While the Convention does not settle special issues connected with a works contract, it gives a framework for solving many of the general issues arising under such contracts. Furthermore, under the Convention the parties are permitted to exclude the application of the Convention and, except to a very limited extent, to derogate from or to vary the effect of any of its provisions (article 6). Accordingly, the parties are free to adapt the provisions of the Convention to the needs of their contract.

C. Mandatory legal rules of public nature

22. In addition to legal rules applicable by virtue of a choice of law by the parties, or by virtue of the rules of private international law, certain rules of an administrative or other public nature in force in the countries of the parties and in other countries (e.g., the country of a subcontractor) may affect certain aspects of the construction. These rules, which are often mandatory, are usually addressed to all persons resident in or who are citizens of the State which issued the rules, and sometimes to foreigners transacting certain business activities in the territory of the State. They may be enforced primarily by administrative officials. Their purpose is to ensure compliance with the economic, social, financial or foreign policy of the State. The parties should therefore take them into account in drafting the contract.

23. Certain of these legal rules concern technical aspects of the works to be constructed. They often relate to safety requirements for the operation of the works, environmental protection and health and labour conditions. The rules should be taken into consideration in designing the works. If the rules are changed, or new rules are issued after the contract is entered into, a variation of the construction may be needed (see chapter XXIII, "Variation clauses"). In addition, there may exist legal rules which concern only the construction process, e.g., safety standards for machinery, tools and facilities to be used for effecting construction. These issues are dealt with in chapter IX, "Construction on site", paragraph 3.

24. Other legal rules prohibit or restrict exports, imports, the transfer of technology and the payment of foreign exchange. As a result of the operation of those rules, a contract may be invalid, terminated, or legally impossible to perform (see chapter XXI, "Exemption clauses", paragraph 1, and chapter XXV, "Termination of contract", paragraph 22). Issues concerning the obtaining of licences needed for the supply of equipment and materials are discussed in chapter VIII, "Supply of equipment and materials", paragraphs 17 and 18, issues concerning foreign exchange restrictions in chapter VII, "Price and

payment conditions", paragraph 4, and issues concerning transfer of technology in chapter VI, "Transfer of technology", paragraph 8. The obligation to obtain an official approval needed for using the site for construction is discussed in chapter IX, "Construction on site", paragraph 8.

25. Legal rules also exist imposing customs duties and taxes on activities connected with the construction of the works. These rules could have important financial implications for the construction. Customs duties are dealt with in chapter VIII, "Supply of equipment and materials", paragraphs 15 and 16, and taxes in chapter VII, "Price and payment conditions", paragraph 5.

Footnotes to chapter XXVIII

[1]*Illustrative provision*

"The law of . . . (specify a country, or, when a country has more than one territorial unit each with its own laws, a particular territorial unit) [as in force on . . . (specify date the contract is entered into)] is to govern this contract. [The rules of private international law of . . . (specify same country or territorial unit as specified above) do not apply.]"

[2]*Illustrative provision*

"The law of . . . (specify country or territorial unit) [as in force on . . . (specify date the contract is entered into)] is to govern this contract, and in particular the formation of the contract, the validity of the contract and the consequences of its invalidity."

[3]*Illustrative provision*

"The law of . . . (specify country or territorial unit) [as in force on . . . (specify date the contract is entered into)] is to govern [the formation of the contract] [the validity of the contract and the consequences of its invalidity] [the interpretation of the contract] [the rights and obligations of the parties arising from the contract] [the passing of risk of loss or damage] [the failure to perform the contract and the consequences of a failure] [the prescription of rights] [the variation of contractual rights and obligations] [the suspension of contractual rights and obligations] [the transfer and extinction of contractual rights and obligations] [the termination of the contract]."

[4]See United Nations Convention on Contracts for the International Sale of Goods, *Official Records of the United Nations Conference on Contracts for the International Sale of Goods* (United Nations publication, Sales No.E.81.IV.3).

Chapter XXIX. Settlement of disputes

SUMMARY

Disputes that arise under works contracts frequently present problems that do not often exist in disputes arising under other types of contracts (paragraphs 1 to 3). The mechanisms provided in the contract for the settlement of disputes might include negotiation (section B), conciliation (section C), arbitration (section E) or judicial proceedings (section F). A referee may also be authorized to settle disputes (section D).

It may be desirable for the contract to provide some means to facilitate the settlement of two or more related claims in the same proceedings (paragraph 4).

The most satisfactory method of settling disputes is usually by negotiation between the parties (paragraphs 10 and 11). If the parties fail to settle their dispute through negotiation, they may wish to attempt to do so through conciliation before resorting to arbitral or judicial proceedings. The parties may wish to provide for conciliation under the UNCITRAL Conciliation Rules (paragraphs 12 to 15).

The parties may wish to provide for disputes that cannot legally or conveniently be settled in arbitral or judicial proceedings to be referred to a referee. The procedure followed by the referee may be quite informal and expeditious. However, there may exist only limited legal safequards to ensure that the proceedings are conducted impartially and with due care. In addition, in contrast to an arbitral award or judicial decisions, it may not be possible to enforce a decision by a referee (paragraphs 16 to 21).

Disputes arising from works contracts are frequently settled through arbitration. Arbitration may be conducted only on the basis of an agreement by the parties to arbitrate. Such an agreement may take the form of an arbitration clause included in the contract (paragraph 24). The parties may wish to compare the advantages and disadvantages of arbitral proceedings with those of judicial proceedings (paragraphs 22 and 23).

It would be advisable for the contract to indicate what disputes are to be settled by arbitration. It might also authorize the arbitral tribunal to order interim measures. It is desirable for the arbitration agreement to obligate the parties to implement arbitral decisions (paragraphs 25 to 27).

The parties may select the type of arbitration that best suits their needs. They may establish by agreement the procedural rules to govern their arbitral proceedings, such as the UNCITRAL Arbitration Rules (paragraphs 30 to 36). In addition, they may wish to settle various practical matters relating to the arbitral proceedings, including the number and appointment of arbitrators, the place of arbitration and the language of the proceedings (paragraphs 37 to 49).

Where the parties wish their disputes to be settled in judicial proceedings, it may be advisable for the contract to contain an exclusive jurisdiction

clause to reduce the uncertainties connected with judicial settlement. The validity and effect of the exclusive jurisdiction clause should be considered in the light of the law of the country of the selected court, as well as the law of the countries of the two parties (paragraphs 50 to 53).

A. General remarks

1. Disputes that arise under works contracts frequently present problems that do not often exist in disputes arising under other types of contracts. This is due to the complexity of works contracts, the fact that they are to be performed over a long period of time and the fact that a number of enterprises may participate in the construction. In addition, disputes under works contracts may concern highly technical matters connected with the construction processes and with the technology incorporated in the works. Disputes that arise during the construction must be settled speedily in order not to disrupt the construction. These considerations ought to be taken into account by the parties in determining the dispute settlement mechanisms to be provided in the contract.

2. The issue that most frequently gives rise to disputes under a works contract is whether a party has failed to perform his contractual obligations and, if so, the legal consequences of his failure. However, other questions often arise for which it is advisable to provide an appropriate settlement mechanism in the contract. For example, the contract may provide for its terms to be changed or supplemented in certain circumstances. Questions may arise as to whether those circumstances have occurred and, if so, how the contractual terms should be changed or supplemented (see chapter XXII, "Hardship clauses" and chapter XXIII, "Variation clauses"). The contract may also provide for a party to give his consent to certain actions by the other party. If the party improperly withholds his consent, the question may arise whether an arbitral tribunal or court can substitute its own consent for that of the withholding party. Questions may also arise whether interim measures should be taken pending the final settlement of certain disputes (see paragraphs 21 and 26, below).

3. Under some legal systems, courts and arbitrators are not competent to change or supplement contractual terms or to substitute their own consent for a consent improperly withheld by a party. Under other legal systems, courts and arbitrators may do so only if they are expressly so authorized by the parties. Under yet other legal systems, arbitrators may do so but courts may not. Where the law applicable to the contract or to the proceedings does not permit courts or arbitrators to change contractual terms, the parties may wish to provide other means of changing certain terms, when it is feasible to do so. For example, they may provide for the contract price to change automatically by means of an index clause when the price levels of equipment, materials or labour change (see chapter VII, "Price and payment conditions", paragraphs 49 to 55). They may provide for other contractual terms to be changed or supplemented by means of procedures before a referee (see section D, below). Where courts or arbitrators do not have the power to substitute their consent for a consent improperly withheld by a party, the contract may provide that a party may withhold his consent only upon specified grounds, and that, in the absence of those grounds, the consent is deemed to be given. Courts or arbitrators would then have to decide only whether the specified grounds existed.

4. Disputes involving several enterprises may arise in connection with the construction. For example, where the purchaser alleges that the construction is defective, it may be uncertain which of several contractors engaged by him is liable. If the purchaser pursues individual claims against each contractor and those claims are settled in separate proceedings by different courts or arbitrators, those proceedings may result in inconsistent decisions. This could occur even if the same law governs all of the contracts and could result, for example, from the application of different procedural rules or from different evaluations of the relevant evidence. Settlement of all related claims in the same proceedings could prevent inconsistent decisions, facilitate the taking of evidence, and reduce costs. However, multi-party proceedings tend to be more complicated and less manageable, and a party may find it more difficult to plan and present his case in such proceedings. Many legal systems provide a means for disputes involving several parties to be settled in the same multi-party judicial proceedings. In order to enable disputes involving several enterprises to be settled in multi-party judicial proceedings, it may be desirable for all contracts entered into by the purchaser for the construction of the works to contain a clause conferring exclusive jurisdiction on a court which has the power to conduct multi-party proceedings (see paragraphs 51 to 53, below). It is more difficult to structure multi-party proceedings when arbitration is to be used for the settlement of disputes. However, some of the benefits of multi-party proceedings might be achieved if the same arbitrators were appointed to settle disputes arising under all contracts concerning the construction of the works.

5. In general, it is desirable for the parties initially to attempt to settle their disputes through negotiation (see section B, below). The parties could, if they so desired, continue to negotiate even after other means of dispute settlement had been initiated. In some cases in which the parties have referred a dispute to conciliation (see section C, below) and arbitral or judicial proceedings are thereafter initiated, they might still find it useful to continue with the conciliation.

6. It is often desirable for disputes arising under a works contract to be settled by arbitration: a process by which parties refer disputes that might arise between them or that have already arisen for binding decision by one or more impartial persons (arbitrators) selected by them (see section E, below). In general, arbitral proceedings may be initiated only on the basis of an arbitration agreement. Generally, the parties are obligated to accept the arbitrator's decision (arbitral award) as final and binding. The arbitral award is usually enforceable in a manner similar to a court decision. In the absence of an arbitration agreement, disputes between the parties will have to be settled in judicial proceedings (see section F, below).

7. Disputes may arise under a works contract that are not within the legal competence of courts or arbitral tribunals (see paragraph 3, above) or that cannot conveniently be settled in arbitral or judicial proceedings (for example, disputes of a technical nature that need to be resolved more speedily than is possible in arbitral or judicial proceedings). The parties may wish to provide for such disputes to be settled by a third party (referred to in the *Guide* as "a referee"; see section D, below; see also paragraph 3, above).

8. In considering which method or methods of dispute settlement to provide in the contract, the parties should carefully consider the law that would govern the methods being considered. In particular, they should ascertain the scope of the authority that may be exercised by judges, arbitrators or a referee under the

law applicable to the procedures. They should also consider the extent to which a decision of a referee, arbitral award or judicial decision is enforceable in the countries of the parties. The fact that one party to the works contract is a State or State enterprise may also be a factor influencing the method of dispute settlement to be provided.

9. The implementation of a works contract usually includes on-going discussions between the parties that may permit many problems and misunderstandings to be resolved without recourse to dispute settlement proceedings. The parties may wish to require that, if a party intends to have recourse to dispute settlement proceedings other than negotiation, he must notify the other party in writing of that intention.

B. Negotiation

10. The most satisfactory method of settling disputes is usually by negotiation between the parties. An amicable settlement reached through negotiation may avoid disruption of the business relationship between them. In addition, it may save the parties the considerable cost and the generally greater amount of time that are normally required for the settlement of disputes by other means.

11. Even though the parties may wish to attempt to settle their disputes through negotiation before invoking other means of dispute settlement, it may not be desirable for the contract to prevent a party from initiating other means of settlement until a period of time allotted for negotiation has expired. Furthermore, if the contract provides that other dispute settlement proceedings may not be initiated during the negotiation period, it is advisable to permit a party to initiate other proceedings even before the expiry of that period in certain cases, e.g., where a party states in the course of negotiations that he is not prepared to negotiate any longer, or where the initiation of arbitral or judicial proceedings before the expiry of the negotiation period is needed in order to prevent the loss or prescription of a right. It is advisable for the contract to require a settlement reached through negotiation to be reduced to writing.

C. Conciliation

12. If the parties fail to settle a dispute through negotiation, they may wish to attempt to do so through conciliation before resorting to arbitral or judicial proceedings. The object of conciliation is to achieve an amicable settlement of the dispute with the assistance of a neutral conciliator respected by both parties. In contrast to an arbitrator or judge, the conciliator does not decide a dispute; rather, he assists the parties in reaching an agreed settlement, often by proposing solutions for their consideration.

13. Conciliation is non-adversarial. Consequently, the parties are more likely to preserve the good business relationship that exists between them than in arbitral or judicial proceedings. Conciliation may even improve the relationship between the parties, since the scope of the conciliation and the ultimate agreement of the parties may go beyond the strict confines of the dispute that gave rise to the conciliation. On the other hand, a potential disadvantage of

conciliation is that, if the conciliation were to fail, the money and time spent on it might have been wasted. That disadvantage might be reduced to some extent if the contract did not require the parties to attempt conciliation prior to initiating arbitral or judicial proceedings, but merely permitted a party to initiate conciliation proceedings. Conciliation would take place only in cases where there existed a real likelihood of reaching an amicable settlement.

14. If the parties provide for conciliation in the contract, they will have to settle a number of issues for the conciliation to be effective. It is not feasible to settle all of those issues in the body of the contract; rather, the parties may incorporate into their contract, by reference, a set of conciliation rules prepared by an international organization, such as the UNCITRAL Conciliation Rules.[1]

15. In a variation of conciliation, the parties may wish to consider appointing before the commencement of construction one or more persons with expertise and experience in resolving questions normally encountered in the construction of a works. These persons may be furnished with periodic reports on the progress of construction and informed immediately of differences arising between the parties on matters connected with the construction. They may meet with the parties on the site, either at regular intervals or when the need arises, to consider differences that have arisen and to suggest possible ways of resolving those differences. In such a conciliation process, the parties may be free to accept or reject the suggestions of the body and to initiate judicial or arbitral proceedings at any time, especially if such initiation is needed in order to prevent the loss or prescription of a right. The establishment of such a body may prevent misunderstandings or differences between the parties from developing into formal disputes requiring settlement in arbitral or judicial proceedings.

D. Proceedings before a referee

16. The parties may wish to consider providing for certain types of disputes to be settled by a referee. Proceedings before a referee can be quite informal and expeditious, and tailored to suit the characteristics of the dispute that he is called upon to settle. Many legal systems do not regulate proceedings before a referee; others regulate them only to a very limited extent. In particular, the law applicable to the proceedings may provide only limited legal safeguards to ensure that the proceedings are conducted impartially and with due care. In addition, under many legal systems, the referee's decision cannot be enforced, since it does not have the status of an arbitral award or a judicial decision. A few international organizations and trade associations have developed rules concerning the use of a referee in the settlement of disputes, but those rules generally deal with only some aspects of the matter. Therefore, if the parties contemplate providing for proceedings before a referee, it will be necessary for them to settle various aspects of those proceedings in their contract.

17. It is advisable for the contract either to name the referee, or to set forth the procedure by which he is to be appointed. That procedure may be similar to the procedure for the appointment of arbitrators (see paragraph 40, below). In some cases, the consulting engineer may be named or appointed as referee (see chapter X, "Consulting engineer").

18. It would be desirable for the contract to delimit as precisely as possible the authority conferred upon the referee. It may specify the functions to be performed by him, and the type of issues with which he may deal. It is desirable to restrict the referee's authority to issues of a predominantly technical character. A possible way of expressing such a restriction in the contract is to include a list of technical issues with which the referee is authorized to deal.

19. With regard to the nature of the referee's functions, the contract might authorize him to make findings of fact and to order interim measures. The contract might also authorize him to change or supplement terms of the contract when he may be permitted to do so under the law applicable to the contract (see paragraph 3, above). The parties may wish to consider whether the referee should be authorized to decide on the substance of certain types of disputes (e.g., disputes as to whether completion tests or performance tests were successful, or as to grounds asserted by the contractor for objecting to a variation ordered by the purchaser), or whether the settlement of those disputes should be left to arbitrators or courts.

20. To the extent they are permitted to do so by the law applicable to the proceedings, the parties might wish to deal in the contract with the relationship between proceedings before a referee and proceedings before a court or arbitral tribunal. For example, the contract might provide that disputes within the scope of the referee's authority must first be submitted to him for resolution and that arbitral or judicial proceedings cannot be initiated until the expiration of a specified period of time after submission of the dispute to the referee.

21. The law governing arbitral or judicial proceedings may determine the extent to which the parties may authorize arbitrators or a court to review a decision of the referee. Excluding such review has the advantage that the referee's decision would be immediately final and binding. However, permitting such a review gives the parties greater assurance that the decision will be correct. The advantages of both approaches may be combined to some extent by providing that the referee's decision is binding on the parties unless a party initiates arbitral or judicial proceedings within a short specified period of time after the referee's decision is delivered to him. If they are permitted to do so, the parties might specify that findings of fact made by a referee cannot be challenged in arbitral or judicial proceedings. The contract might also obligate the parties to implement a decision by the referee concerning interim measures or a decision on the substance of certain specified issues; if the parties fail to do so, they will be considered as having failed to perform a contractual obligation.

E. Arbitration

1. *Considerations as to whether to conclude arbitration agreement*

22. There are various reasons why arbitration is frequently used for settling disputes arising under international works contracts. Arbitral proceedings may be structured by the parties so as to be less formal than judicial proceedings and better suited to the needs of the parties and to the specific features of the disputes likely to arise under the contract. The parties can choose as arbitrators persons who have expert knowledge of international construction contracts. They may choose the place where the arbitral proceedings are to be conducted.

They can also choose the language or languages to be used in the arbitral proceedings. In addition, the parties can choose the law applicable to the contract, and that choice will almost always be respected by the arbitrators; the same is not always true of judicial proceedings (see chapter XXVIII, "Choice of law", paragraphs 7 and 8). Where parties agree to arbitration, neither party submits to the courts of the State of the other party. Arbitral proceedings may be less disruptive of business relations between the parties than judicial proceedings. The proceedings and arbitral awards can be kept confidential, while judicial proceedings and decisions usually cannot. Arbitral proceedings tend to be more expeditious and, in some cases, less costly than judicial proceedings. It may be noted, however, that some legal systems provide for summary judicial proceedings for certain types of disputes (e.g., those involving a sum of money not exceeding a certain amount), although many disputes arising under a works contract will not qualify for settlement under such proceedings. Finally, as a result of international conventions that assist in the recognition and enforcement of foreign arbitral awards, those awards are frequently recognized and enforced more easily than foreign judicial decisions.[2]

23. On the other hand, an arbitral award may be set aside in judicial proceedings. The initiation of those proceedings will prolong the final settlement of the dispute. However, under many legal systems, an arbitral award may be set aside only on a limited number of grounds, for example that the arbitrators lacked authority to decide the dispute, that a party could not present his case in the arbitral proceedings, that the rules applicable to the appointment of arbitrators or to the arbitral procedure were not complied with, or that the award was contrary to public policy. It may also be noted that, in some legal systems, it is not possible for parties to preclude courts from settling certain types of disputes.

2. *Provisions of arbitration agreement*

(a) *Scope of arbitration agreement and mandate of arbitral tribunal*

24. In general, arbitral proceedings may be conducted only on the basis of an agreement by the parties to arbitrate. The agreement may be reflected either in an arbitration clause included in the contract or in a separate arbitration agreement concluded by the parties before or after a dispute has arisen. Since it may be more difficult to reach an agreement to arbitrate after a dispute has arisen, it is advisable either to include an arbitration clause in the contract or to enter into a separate arbitration agreement at the time of entering into the contract. However, under some legal systems, an agreement to arbitrate is procedurally and substantively effective only if it is concluded after a dispute has arisen.

25. It would be advisable for the contract to indicate what disputes are to be settled by arbitration. For example, the arbitration clause may stipulate that all disputes arising out of or relating to the contract or the breach, termination or invalidity thereof are to be settled by arbitration. In some cases, the parties may wish to exclude from that wide grant of jurisdiction certain disputes that they do not wish to be settled by arbitration.

26. If permitted under the law applicable to the arbitral proceedings, the parties may wish to authorize the arbitral tribunal to order interim measures pending the final settlement of a dispute. However, under some legal systems,

arbitral tribunals are not empowered to order interim measures. Under other legal systems, where interim measures can be ordered by an arbitral tribunal, they cannot be enforced; in those cases, it may be preferable for the parties to rely on a court to order interim measures. Under many legal systems, a court may order interim measures even if the dispute is to be or has been submitted to arbitration.

27. It is desirable for the arbitration agreement to obligate the parties to implement arbitral decisions, including decisions ordering interim measures. The advantage of including such an obligation in the contract is that under some legal systems, where an arbitral award is not enforceable in the country of a party, a failure by the party to implement an award when obligated to do so by the contract might be treated in judicial proceedings as a failure by the party to perform a contractual obligation.

28. If judicial proceedings are instituted in respect of a dispute that is covered by an arbitration agreement that is recognized to be valid, upon a timely request the court will normally refer the dispute to arbitration. However, the court may retain the authority to order interim measures and will normally be entitled to control certain aspects of arbitral proceedings (e.g., to decide on a challenge to arbitrators) and to set aside arbitral awards on certain grounds (see paragraph 23, above).

29. It is advisable for the parties to be cautious about authorizing the arbitral tribunal to decide disputes *ex aequo et bono* or to act as *amiable compositeur,* since arbitrators are not permitted to do so under some legal systems. In addition, such authorizations may be interpreted in different ways and lead to legal insecurity. For example, the terms might be interpreted as authorizing the arbitrators to be guided either only by principles of fairness, justice or equity, or, in addition, by those provisions of the law applicable to the contract regarded in the legal system of that law as fundamental. An additional source of uncertainty may be whether the arbitrators, applying the principles mentioned above, may disregard certain terms of the contract. If the parties wish to authorize the arbitral tribunal to decide disputes without applying all legal rules of a State to the contract, they may wish to specify the standards or rules according to which the arbitral tribunal is to decide the substance of the dispute and to obligate the arbitral tribunal to apply the terms of the contract and the relevant usages of international trade.

(b) Type of arbitration and appropriate procedural rules

30. The parties are able to select the type of arbitration that best suits their needs. It is desirable that they agree on appropriate rules to govern their arbitral proceedings. There is a wide range of arbitration systems available, with varying degrees of involvement of permanent bodies (e.g., arbitration institutions, courts of arbitration, professional or trade associations and chambers of commerce) or third persons (e.g., presidents of courts of arbitration or of chambers of commerce). At one end of the spectrum is the pure *ad hoc* type of arbitration, which does not involve a permanent body or third person in any way. This means, in practical terms, that no outside help is available (except, perhaps, from a national court) if, for example, difficulties are encountered in the appointment or challenge of an arbitrator. Moreover, any necessary administrative arrangements have to be made by the parties or

the arbitrators themselves. At the other end of the spectrum there are arbitrations fully administered and supervised by a permanent body, which may review terms of reference and the draft award and may revise the form of the award and make recommendations as to its substance.

31. Between these two types of arbitration there is a considerable variety of arbitration systems, all of which involve an appointing authority but differ as to the administrative services that they provide. The essential, although not necessarily exclusive, function of an appointing authority is to compose or assist in composing the arbitral tribunal (e.g., by appointing the arbitrators, deciding on challenges to an arbitrator or replacing an arbitrator). Administrative or logistical services, which may be offered as a package or separately, could include the following: forwarding written communications of a party or the arbitrators; assisting the arbitral tribunal in establishing and notifying the date, time and place of hearings and other meetings; providing, or arranging for, meeting rooms for hearings or deliberations of the arbitral tribunal; arranging for stenographic transcripts of hearings and for interpretation during hearings and possibly translation of documents; assisting in filing or registering the arbitral award, when required; holding deposits and administering accounts relating to fees and expenses; and providing other secretarial or clerical assistance.

32. Unless the parties opt for pure *ad hoc* arbitration, they may wish to agree on the body or person to perform the functions that they require. Among the factors worthwhile considering in selecting an appropriate body or person are the following: willingness to perform the required functions; competence, in particular in respect of international matters; appropriateness of fees measured against the extent of services requested; seat or residence of the body or person and possible restriction of its services to a particular geographic area. The latter point should be viewed in conjunction with the probable or agreed place of arbitration (see paragraphs 41 to 47, below). However, certain functions (e.g., appointment) need not necessarily be performed at the place of arbitration, and certain arbitral institutions are prepared to provide services in countries other than those where they are located.

33. In most cases, the arbitral proceedings will be governed by the law of the State where the proceedings take place. Many States have laws regulating various aspects of arbitral proceedings. Some provisions of these laws are mandatory; others are non-mandatory. In selecting the place of arbitration (see paragraphs 41 to 47, below), the parties may wish to consider the extent to which the law of a place under consideration recognizes the special needs and features of international commercial arbitration and, in particular, whether it is sufficiently liberal to allow the parties to tailor the procedural rules to meet their particular needs and wishes while at the same time ensuring that the proceedings are fair and efficient. A recent trend in this direction, discernible from modern legislation in some States, is being enhanced and fortified by the UNCITRAL Model Law on International Commercial Arbitration.[3] The UNCITRAL Model Law is becoming increasingly accepted by States of different regions and different legal and economic systems.

34. Since the procedural rules in the arbitration laws of some States are not necessarily suited to the particular features and needs of international commercial arbitration, and since, in any case, those laws do not contain rules settling all procedural questions that may arise in relation to arbitral

proceedings, the parties may wish to adopt a set of arbitration rules to govern arbitral proceedings under their contract. When the parties choose to have their arbitrations administered by an institution, the institution may require the parties to use the rules of that institution, and may refuse to administer a case if the parties have modified provisions of those rules that the institution regards as fundamental to its arbitration system. Most arbitral insitutions, however, offer a choice of two or sometimes more sets of rules and usually allow the parties to modify any of the rules. If the parties are not required by an institution to use a particular set of arbitration rules or to choose among specified sets of rules, or if they choose *ad hoc* arbitration, they are free to choose a set of rules themselves. In selecting a set of procedural rules, the parties may wish to consider its suitability for international cases and the acceptability of the procedures contained in them.

35. Of the many arbitration rules promulgated by international organizations or arbitral institutions, the UNCITRAL Arbitration Rules[4] deserve particular mention. These Rules have proven to be acceptable in the various legal and economic systems and are widely known and used in all parts of the world. Parties may use them in pure *ad hoc* arbitrations as well as in arbitrations involving an appointing authority with or without the provision of additional administrative services. A considerable number of arbitration institutions in all regions of the world have either adopted these Rules as their own institutional rules for international cases or have offered to act as appointing authority. Most of them will provide administrative services in cases conducted under the UNCITRAL Arbitration Rules.

36. Where a model clause accompanies the arbitration rules to govern arbitrations under the works contract or is suggested by an arbitral institution, adoption of that clause by the parties may help to enhance the certainty and effectiveness of the arbitration agreement. Some model clauses, such as the one accompanying the UNCITRAL Arbitration Rules, allow the parties to settle certain practical matters by agreement. These include the involvement of an appointing authority, as well as the number of arbitrators (see paragraphs 37 to 39, below), the appointment of arbitrators (see paragraph 40, below), the place of arbitration (see paragraphs 41 to 47, below) and the language or langugages to be used in the arbitral proceedings (see paragraph 48, below).[5]

(c) *Practical matters to be settled by parties*

(i) *Number of arbitrators*

37. The parties may wish to specify in the arbitration clause the number of arbitrators who are to comprise the arbitral tribunal. If the parties fail to do so, the chosen arbitration rules or, in some cases, the applicable arbitration law, will either specify that number or the manner by which it is to be determined. Agreement by the parties on the number of arbitrators will enable the parties to ensure that the number conforms to their particular needs and wishes, and will provide certainty in respect of that aspect of the appointment process. However, parties should be aware that some national laws restrict their freedom to agree upon the number of arbitrators by, for example, prohibiting an even number of arbitrators.

38. Other than the possible legal restriction just referred to, the considerations that may be relevant to the question of the number of arbitrators are essentially

of a practical nature. In order to ensure the efficient functioning of the arbitral proceedings and the taking of decisions, it is usually desirable to specify an uneven number, i.e., one or three, although in practice parties sometimes specify two-member panels, coupled with a mechanism for calling in a third arbitrator, "umpire" or "referee", to overcome any impasse between the two.

39. As to whether one or three arbitrators should be specified, the parties may wish to consider that arbitral proceedings conducted by a sole arbitrator are generally less costly and tend to be more expeditious than proceedings where the fees of three arbitrators have to be paid and where three time-schedules have to be accommodated. On the other hand, three arbitrators may bring a wider range of expertise and background to the proceedings. Since the desirable expertise and background can be of different types, different methods of appointing the arbitrators may be envisaged.

(ii) *Appointment of arbitrators*

40. On the one hand, in an international case, each party may want to have one arbitrator of his choice who would be familiar with the economic and legal environment in which that party operates. Therefore, the parties might agree on a method by which each party appoints one arbitrator and the third arbitrator is chosen by the two thus appointed or by an appointing authority. On the other hand, in complex disputes involving legal, technical and economic issues, it may be of considerable advantage to have arbitrators with different qualifications and expertise in the relevant fields. Where parties attach particular importance to this aspect, they may wish to entrust an appointing authority with the appointment of all three arbitrators and, possibly, specify the qualifications or expertise required of the arbitrators.

(iii) *Place of arbitration*

41. The parties may wish to specify in the arbitration agreement the place where the proceedings are to be held and where the arbitral award is to be issued. The selection of an appropriate place of arbitration may be crucial to the functioning of the arbitral process and to the enforceability of the arbitral award. The following considerations may be relevant to the selection of the place of arbitration.

42. Firstly, the parties may consider it desirable to choose a place of arbitration such that an award issued in that place would be enforceable in the countries where the parties have their places of business or substantial assets. In many States, foreign awards are readily enforceable only by virtue of multilateral or bilateral treaties, and often only on the basis of reciprocity. The parties may thus wish to choose a place of arbitration in a State that is in such a treaty relationship with the States where enforcement might later be sought.

43. Secondly, the parties may consider it desirable to choose a place where the arbitration law provides a suitable legal framework for international cases. Some arbitration laws might be inappropriate because, for example, they restrict the autonomy of the parties or fail to provide a comprehensive procedural framework to ensure efficient and fair proceedings.

44. Considerations of a more practical nature include the following: the convenience of the parties and other persons involved in the proceedings; the

availability of necessary facilities, including meeting rooms, support services and communication facilities; the availability of administrative services of an arbitral institution or chamber of commerce, if so desired by the parties; relevant costs and expenses, including expenses for accommodation, meeting rooms and support services; and the ability of the parties' counsel to represent the parties without the need to retain local lawyers.

45. Another relevant consideration is that it may be advantageous for the arbitral proceedings to be held in a place which is near to the subject-matter in dispute. For example, if the arbitration were to be held in or near the country of the site, the taking of evidence at the site would be facilitated.

46. Yet other considerations often lead parties to agree on a place other than in the States where they have their places of business. For example, the parties may select a third State because each party may have misgivings about arbitrating in the other party's country; a party in whose State the proceedings are conducted might be thought by the other party to benefit from a familiar legal and psychological environment and from other circumstances facilitating the presentation of the case.

47. Instead of specifying one place of arbitration for all disputes arising under the works contract, the parties may, in some cases, wish to provide that the arbitration is to take place in the country of the party against whom a claim is brought. The enforcement of an award against a party in his own country that was rendered in that country would not encounter the problems associated with the enforcement of a foreign award. If institutional arbitration is to be used, the parties may agree upon two arbitration institutions, one located in the country of each party, and provide that the arbitration is to be administered in respect of particular disputes by the institution in the country of the party against whom a claim is brought (the so-called "mixed arbitration clause"). The parties may wish to adopt this approach if they cannot agree upon a single arbitral institution to administer the arbitration. Arrangements involving two places of arbitration could, however, give rise to difficulties in some cases. The legal rules applicable to arbitral proceedings in the respective countries may differ, and they could be more burdensome or otherwise less satisfactory to a party in one country than in the other. In addition, arbitral proceedings conducted in the respective countries will be controlled by different courts, which may exercise differing degrees of control over the proceedings.

(iv) *Language of proceedings*

48. The parties may also wish to specify the language to be used in the arbitral proceedings. The choice of the language may influence the efficiency with which the proceedings are conducted and the cost of the proceedings. Whenever possible, it is desirable to specify a single language, such as the language in which the contract is written. When more than one language is specified, the costs of translation and interpretation from one language to the other are usually considered to be part of the costs of arbitration and apportioned in the same way as the other costs of arbitration.

49. The parties may wish to specify the types of documents or communications that must be submitted in or translated into the specified language. They may, for example, require the written pleadings, oral testimony at a hearing, and any award, decision or other communication of the arbitral tribunal to be

in the specified language. The tribunal may be given the discretion to decide whether and to what extent documentary evidence should be translated. Such discretion may be appropriate in view of the fact that documents submitted by the parties may be voluminous and that only a part of a document may be relevant to a dispute.

F. Judicial proceedings

50. If the parties do not agree to refer their disputes to arbitration, the disputes will have to be settled in judicial proceedings. Courts of two or more countries may be competent to decide a given dispute between the parties, and the legal position of the parties to a dispute may differ depending upon which court decides the dispute. For example, the validity and effect of a choice by the parties of the law applicable to the contract will depend upon the rules of private international law in the country of the court deciding the dispute in which the question arises (see chapter XXVIII, "Choice of law", paragraphs 7 and 8).

51. The uncertainties that arise when more than one court is competent to decide a dispute may be reduced by including in the contract an exclusive jurisdiction clause, obligating the parties to submit disputes that arise between them under the contract to a specified court in a specified place in a specified country. It is advisable for the clause to specify a court in the selected country, rather than to refer simply to a competent court in that country, in order to avoid questions as to which court was to decide a given dispute. The clause may specify the types of disputes that are subject to it in a manner similar to the specification in an arbitration agreement (see paragraph 25, above).

52. Under many legal systems, a clause conferring exclusive jurisdiction on a court is valid only if the selected court has authority to decide the disputes that are submitted to it under the clause. Therefore, in selecting a court, the parties should ascertain that the court is legally competent to decide the types of disputes that are to be submitted to it. The enforceability in the countries of the parties of a decision issued by the selected court will also be relevant to the choice of a court (see paragraph 42, above).

53. While an exclusive jurisdiction clause may reduce uncertainties with respect to matters such as the law applicable to the contract and the enforceability of a decision, and may facilitate the multi-party settlement of disputes (see paragraph 4, above), it may also have certain disadvantages. If a court in the country of one of the parties is given exclusive jurisdiction, and the exclusive jurisdiction clause is invalid under the law of the country of the selected court, but valid under the law of the country of the other party, difficulties may arise in initiating judicial proceedings in either of the countries. Difficulties connected with initiating judicial proceedings may be magnified if the parties confer exclusive jurisdiction on a court in a third country.

Footnotes to chapter XXIX

[1]Report of the United Nations Commission on International Trade Law on the work of its thirteenth session, *Official Records of the General Assembly, Thirty-fifth Session, Supplement No. 17* (A/35/17), para. 106 (*Yearbook of the United Nations Commission on International Trade Law*, Vol. XI: 1980, part one, II, A (United Nations publication, Sales No. E.81.V.8)). The UNCITRAL Conciliation Rules have also been reproduced in booklet form (United Nations publication, Sales No. E.81.V.6). Accompanying the Rules is a model conciliation clause, which reads: "Where, in the event of a dispute arising out of or relating to this contract, the parties wish to seek an amicable settlement of that dispute by conciliation, the conciliation shall take place in accordance with the UNCITRAL Conciliation Rules as at present in force." The use of the UNCITRAL Conciliation Rules has been recommended by the United Nations General Assembly in its resolution 35/52 of 4 December 1980.

[2]See "Convention on the recognition and enforcement of foreign arbitral awards", *United Nations Treaties Series*, Vol. 330, p. 38, No. 4739 (1959), reproduced in *Register of Texts of Conventions and other Instruments concerning International Trade Law*, Vol. II (United Nations publication, Sales No. E.73.V.3).

[3]Report of the United Nations Commission on International Trade Law on the work of its eighteenth session, *Official Records of the General Assembly, Fortieth Session, Supplement No. 17* (A/40/17), para. 332 and Annex I. The United Nations General Assembly, in its resolution 40/72 of 11 December 1985, recommended "that all States give due consideration to the Model Law on International Commercial Arbitration, in view of the desirability of uniformity of the law of arbitral procedures and the specific needs of international commercial arbitration practice".

[4]Report of the United Nations Commission on International Trade Law on the work of its ninth session, *Official Records of the General Assembly, Thirty-first Session, Supplement No. 17* (A/31/17), para. 57 (*Yearbook of the United Nations Commission on International Trade Law*, Vol. VII: 1976, part one, II, A (United Nations publication, Sales No. E.77.V.1)). The UNCITRAL Arbitration Rules have also been reproduced in booklet form (United Nations publication, Sales No. E.77.V.6). The use of the UNCITRAL Arbitration Rules has been recommended by the United Nations General Assembly in its resolution 31/98 of 15 December 1976.

[5]*Illustrative provisions (arbitration clause)*

The following clause is recommended in the UNCITRAL Arbitration Rules:

"Any dispute, controversy or claim arising out of or relating to this contract, or the breach, termination or invalidity thereof, shall be settled by arbitration in accordance with the UNCITRAL Arbitration Rules as at present in force.

Note—Parties may wish to consider adding:

"(*a*) The appointing authority shall be ... (name of institution or person).

(*b*) The number of arbitrators shall be ... (one or three).

(*c*) The place of arbitration shall be ... (town or country).

(*d*) The language[s] to be used in the arbitral proceedings shall be . . ."

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