

# Continuity of Supply or Service: Step-in and Similar Rights

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## SUMMARY

*The economic imperatives of complex modern economies have made supply chains more inter-independent. One aspect of this has been the need to maintain supply to government and to the public of various services, including infrastructure, which have been contracted out by, or franchised by, government. Various techniques which may be used to maintain supply are identified. However, those techniques are largely embryonic and will no doubt be further developed over time. In this paper I have sought to place the issues in context and to emphasise the significance of the commercial and public policy questions against which contractual and legal solutions are to be derived.*

## INTRODUCTION

One apparent trend in economic activity in the late 20th century is the focus by most businesses on their core activities. This entails an emphasis upon whether it is more appropriate to acquire (externally) some item of economic value in the production process or produce that item internally. At its simplest, this is a decision whether to make or buy a particular product: should the manufacturer buy the component for the widget or manufacture the component with the resources under the immediate control of the manufacturer?

However, the issues underlying the decision to make or buy are complex.

A number of examples are instructive in this respect:

1. Many corporations are outsourcing what hitherto have been seen as key internal competencies. Information technology, once seen as an area that should be developed internally, is often outsourced. Again some corporations have acquired some of the characteristics of “virtual” corporations. They call upon a range of organisations to provide staff and resources for particular projects, on the basis that those people and resources are only required for that task.

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2. In the mining area, in particular, the outsourcing of supply means that contract mining might be seen as a major growth area, where many of the key implementation requirements of mine plans are placed in the hands of contract miners. Again it is only a short step from contract mining to vest ownership of, as well as the operation of, a portion of the economic activity in a total mining or petroleum project in the hands of a third party owner operator who contracts to deliver supply. Power generation may be outsourced entirely, secured only by a contractual arrangement. Other infrastructure, such as transportation infrastructure, may be outsourced. Again one may question the need for a mining company to seek ownership and operation of downstream processing, provided there is an appropriate capture of economic benefit from the exploitation of the mineral or petroleum deposit.
3. The increased complexity (and analysis) of the components of economic activity has led to a breaking up of many hitherto aggregated economic activities. The electricity supply industry, and its disaggregation, is one example of this. The concept that a unified system, such as the electricity supply system, might be broken up into its constituent activities is based upon concepts of discrete markets. This leads to a separation of economic activities. These concepts are of comparatively recent origin. Similar concepts are being developed in the gas industry. This is reinforced by open access to "essential facilities" required by the application of Pt IIIA of the *Trade Practices Act 1974* (Cth).
4. A further factor is the recognition by government that it does not have to be the provider of social services and other infrastructure requirements. Government does not have to provide the service or the infrastructure, but it does have to ensure that the service or the infrastructure is provided. Government may, therefore, increasingly be seen as contractual purchaser of the relevant services or a procurer of the infrastructure but not itself the owner of the infrastructure or the provider of the service.

There are a number of issues which will be apparent from the foregoing descriptive analysis:

1. Increasingly there is an interdependence with third parties for the provision of key inputs to the economic activities of a discrete economic entity.
2. This interdependence is immediate. There is no desire or capacity (in the case of services) to stockpile in order to mitigate the effects of any failure to supply.
3. Government, with its move toward contractual acquisition of services rather than the supply of infrastructure and services itself, has an immediate interest in the continued satisfactory supply of services to the community or sections of the community.
4. Often the arrangements are not simply bilateral. They often require a number of parties to perform satisfactorily and with understanding of

each other's position. The complex multilateral operation of a deregulated disaggregated electricity supply industry is a prime example of the complex multilateral nature of supply arrangements.

## TECHNIQUES FOR ENSURING CONTINUITY OF SUPPLY

Typically, the mutual needs and benefits of the parties to supply arrangements, which these issues reflect, have found their way into detailed contractual arrangements. While the language of "partnership" is used of these arrangements, and is truly descriptive of many of these outsourcing or supply arrangements, in our Anglo-Australian jurisprudence we are dependent upon the reduction of the arrangements to specific contractual rights and obligations, enforced ultimately by a court system. Philosophically that court system is motivated by the proposition that the court is concerned to ascertain and enforce the arrangements the parties have reached. What happens when, as is apparent in many cases, the parties acknowledge that the contractual form is an inadequate means of reflecting the symbiotic long-term relationship which is intended among them?

Again, often these arrangements take place against the background of some legislative intervention. Many mining and infrastructure developments have taken place in the context of requiring legislative assistance (as in the case of some mining projects) or are themselves the express product of some franchise or right granted by government, such as the franchise to conduct a toll road project.

Against this background it may be said that there are a number of tools available for ensuring the continuity of supply or service. These may be generally summarised as follows:

- (a) establishing the arrangements such that lack of supply or service is extremely unlikely to arise;
- (b) utilising existing legal concepts so as to ensure that there is security of supply or the capacity to enforce continuity of supply; and
- (c) seeking legislation to ensure continuity of supply — this technique is especially relevant in the context of dealings with government and the supply of social infrastructure or services.

## ESTABLISH THE RIGHT ENVIRONMENT

Arrangements entered into for the long term and which depend for their commercial dynamics on all parties receiving benefit from them over that period of time must of their nature retain an element of flexibility. Those arrangements must also recognise that all parties must at all times over the course of the contract anticipate economic benefit.

It may be said that the focus on competitive tendering, and seeking to derive maximum economic value for the party in the superior economic position at the time of the contract negotiation, does not guarantee a satisfactory outcome over the long term. Such conduct may indeed be calculated to produce, over the long term, an unsatisfactory outcome to the party who engages in that conduct.

Whilst, no doubt, perceptions may differ, it may be said that the recent toll road transactions represent a means of addressing in a flexible even-handed way some of the issues that arise from long-term supply obligations.

In the Melbourne City Link Project a number of underlying philosophies lay behind the contractual approach. These were as follows:

1. The private sector should receive a market rate of return for its investment.
2. It should be clear in which circumstances a party was to bear the ultimate risk of an event. In certain areas of risk (for example, construction and operation), the risks were, clearly, largely to be borne by the private sector. However, changes in State government policy specific to the project should be seen as the responsibility of the State government. On the other hand, external events, such as a Commonwealth government change in law, should be seen as essentially a risk for the patrons of the toll road. There may be an increase in the toll or an extension of the concession period to compensate the private sector investors, but if the users will not sustain the increase in the toll, for example, then the private sector should bear the cost. It may be said that this is ultimately the case with any private sector commercial investment, independent of government involvement.
3. Again, the issue of dispute resolution is an important one. The arrangements should, as far as possible, encourage negotiation among the parties and seek to provide incentives for the parties to find a solution themselves. A formal court-centred dispute resolution process should be difficult to access, for the outcome of such a process is typically an all-or-nothing result which is unlikely to encourage compromise among the parties.
4. A legal regime permitting step-in by the State to ensure the continued operation of the road is seen as being activated in remote and extremely unlikely circumstances. The private sector's economic incentive to ensure early, safe and consistent operation of the tollway in the interests of earning revenue is almost itself sufficient guarantee, without any need for an independent step-in right, except in extreme circumstances. This economic incentive is very real in the case of a tollway and largely arises from the low operational costs and high sunk capital costs of the tollway which stand to be serviced.

## USE EXISTING LEGAL CONCEPTS

The contract itself will specify the basis upon which supply is to be maintained. The consequences of failing to observe a contract will be well known and familiar to this audience.

The usual court processes are available. However, “naked” contractual rights are usually not sufficient. One cannot typically use an order for specific performance (or an injunction) to ensure a contract for supply is performed. This is especially true if the contract is not one for the supply of a particular item but rather is a contract for the supply of services. For the non-technically minded, a moment’s thought will verify this proposition. Most supply or service arrangements of the type being discussed involve a dynamic ongoing interaction among the parties. The court is in no position to supervise that relationship.

It is not unusual, therefore, to seek some further reassurance that the obligations of supply will be maintained.

This may take a number of forms. Many of these forms will be familiar to you. They include, for example:

- (a) a bank guarantee or performance bond;
- (b) a deposit or right of set off as a guarantee of performance; and
- (c) the ability to substitute suppliers quickly in the event of default.

More draconian, and more difficult to achieve, the recipient of the supply or recipient of the service might seek to “step-in” to the position of the supplier to ensure the maintenance of supply. This might be done by seeking those rights of step-in contractually from the supplier, or by taking security over these assets to, among other things, secure the rights of step-in.

It will be seen that each of these techniques has certain limitations.

Naked contractual rights, conferring specific step-in entitlements, may be defeated by the actions of third party creditors and security holders.

The taking of security itself raises issues as to the way in which such securities will be treated by the financiers of the suppliers. Will those financiers be willing to finance the supplier if the assets are subject to secured rights of step-in granted to a purchaser? What is the interaction between the security rights of a supplied party and the security rights of the other secured creditors?

Again, assuming that there is a step-in, what are the obligations of the party stepping in in such a case. Must the step-in party behave with care to maintain the assets of the supplier? Does the income stream provided for under the contract still continue to be paid to the supplier? What expenses may legitimately be taken by the party which has stepped in? In what circumstances is “step out” to take place?

It may be said that many of these questions arise in the case of many security enforcements. That is true. However, the interlinking webs of supply contracts and financing arrangements make the issue doubly difficult in the case of outsourcing or supply arrangements. The primary asset of the supplier is often the contractual arrangement with the party being supplied, and this contract is the subject matter of the enforcement by the supplier.

A moment's reflection will bring home the significance of this circumstance.

The act of step-in is often so final that one may doubt whether the supply arrangement has any basis upon which it may continue. What arrangements can be made to introduce another supplier, and may the assets and intellectual property of the old supplier be made available to the new supplier? A minefield of legal and commercial issues is opened up by these questions.

In situations where these issues have been addressed in detail, they have inevitably been time consuming and in many respects unsatisfactory in outcome.

Loy Yang B (Mark I) is perhaps a prime example of this.

In that case, concern about the economic significance of Loy Yang B and its key role in generating power in the State of Victoria led the negotiators for the State agencies to seek a range of step prices in entitlements. These step-in rights ran the range from step-in to ensure construction of the power station, to stepping in to ensure the generation of electricity, to stepping in to ensure payment for coal supplies delivered by agencies of the State.

Further, as may be expected, specifying the existence of step-in rights gave rise to a whole range of additional questions. The number of outcomes negotiated became manifold, the negotiations became very protracted, and it may be said that both outcomes and negotiations ultimately, in many respects, had insufficient relationship to the reality of the issues they addressed. Detailed plans were developed to overcome a range of remote events occurring at the power station.

The Latrobe Regional Hospital (LRH) Project in Victoria is perhaps a more successful example of the outcome of the interplay of the commercial forces relevant in a step-in situation.

The LRH Project involved the State of Victoria establishing a long-term contract for the supply of public health services in the Latrobe Valley in Victoria. This required the construction of a new privately owned acute hospital in the Latrobe Valley, to be the major referral and acute hospital in the Latrobe Valley. The hospital was also to be a key teaching hospital for the Monash University medical and health services faculties.

A long-term contract was entered into by the State with the contracted supplier of services. The finance for the private contractor of services was provided largely in the form of long-term CPI-linked bonds.

On the one hand the State had an interest in the continuity of supply of health services from the new site. On the other hand the bond holders and the private sector operator had a key vested interest in ensuring the maintenance of the contract over the longer term.

The negotiated outcome was that the State retained a right under legislation to step-in in an emergency threatening the health or well-being of the patients.

The State was also given a contractual right to step-in on default.

However, the contract was not to be terminated for such default until after the bond holders had been given every opportunity to appoint a replacement operator able to cure any default. Further, the State was given the right, on step-in, to occupy the new hospital for only a finite period, after which time it would be obliged to procure the health services from another site. Of course the State may have been able to reach subsequent agreement with the owner of the new hospital as to continued occupation.

## LEGISLATION

It is well acknowledged that in many cases government may seek to have (and may legitimately hold) the rights to step-in to the operation of private assets (in particular infrastructure assets) to ensure that they are used to provide continuing services or supply satisfactorily. The State of Victoria, for example, has DISPLAN which, in conjunction with emergency services legislation, gives the State of Victoria a role in taking over private property for the period of an emergency.

Many other States also have essential services legislation which is concerned with providing a basis upon which government might intervene to ensure the supply of essential services. This is accepted as part of the legislative framework within which both government and the private sector operates. It is, if you like, a question of sovereign risk which parties accept when they choose to do business in a particular jurisdiction.

However, with the increasing outsourcing of infrastructure by government (and the government role in outsourcing services generally), issues about the philosophical basis for legislative intervention arise to be considered.

It may be said that government has sought to have the right to step-in on legislative bases only where public policy would support intervention or step-in generally, irrespective of whether the recipient of supplies is the government or is the private sector.

For example, as set out above, all hospitals in Victoria are subject to government step-in if there is a danger to the health of patients in that hospital. This extends to public and private hospitals and to private hospitals that are providing services to public patients under contractual arrangements with the State.

On the other hand, government in Victoria has not sought a legislative basis for intervention to support the failure to observe contractual obligations. That has fallen to be addressed by the rights under contract and not by legislation.

## CONCLUSION

The economic imperatives of complex modern economies have made supply chains more inter-independent. One aspect of this has been the need to maintain supply to government and to the public of various services, including infrastructure, which have been contracted out by, or franchised by, government. Various techniques which may be used to maintain supply are identified. However, those techniques are largely embryonic and will no doubt be further developed over time. In this paper I have sought to place the issues in context and to emphasise the significance of the commercial and public policy questions against which contractual and legal solutions are to be derived.