

Cogeneration - Legal Considerations

presented by P Bowler & N Wells, Russell McVeagh McKenzie Bartleet & Co, PO Box 10-214, Wellington

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Abstract

Capital investment programmes involve an assessment of future markets and values. They are risky and complex when they involve one asset and one market.

Cogeneration projects involve two investors, two assets and two markets, each with different dynamics and risks. By definition they are complex and risky. Many project sponsors do not realise this until it is too late.

Generally a cogeneration development will begin with a tendering process. This process needs to be carefully considered as the approach taken can impact significantly on project viability. From the generators view point the decision of whether to balance sheet or project finance will impact heavily on the methodology adopted.

Cogeneration requires the host and generator to operate in close proximity. Given this high level of integration a carefully considered programme must be put in place. One that is capable of withstanding and adapting to foreseen and unforeseen developments. Issues such as environmental risks, new taxes, price fluctuations and the possible failure of one or both of the parties must be addressed.

As part of the development the parties need to consider what will occur at the end of the life of the project and potentially the place of Build, Own, Operate, Transfer (BOOT), Build, Operate, Transfer (BOT) or Build, Own, Operate (BOO) agreements.

Also considered are the component parts of cogeneration agreements including issues related to development, consents and host responsibility. General issues such as liability of the parties, assignment and the place of force majeure provisions are all addressed within the course of the paper.

A well thought out development and cogeneration agreement should ensure a beneficial long-term relationship. All too often hastily constructed long term agreements end, instead, in court. The purpose of this paper is to raise the issues and discuss alternatives to ensure a successful development.

How to Approach Cogeneration

Cogeneration projects involve significant investment. To make a cogeneration project financially attractive a long term horizon is taken. While simple long term agreements can be beneficial they can also be hazardous to the unwary, for example:

1. Under a 1927 agreement the Gore District Council are still buying power for the equivalent of "one penny per unit"¹.
2. Long term leases have often been entered into with no rent review clause. Generally those lessors have been liquidated or bankrupted. Yet when the parties signed those agreements they had negotiated an agreement they were happy with. However, those arrangements ended, years down the track, in litigation.

Over time, often through no fault of either party, the market or economy moves with one party left in the cold and carrying losses due to an unforeseen change of circumstances. The bargain is no longer quite as sweet. This will cause tension as the aggrieved party tries to cut their losses and escape their obligations. In this situation neither party is an absolute "winner".

With foresight and careful planning a robust, dynamic and rewarding agreement can be put in place for all parties avoiding the potential for this tension.

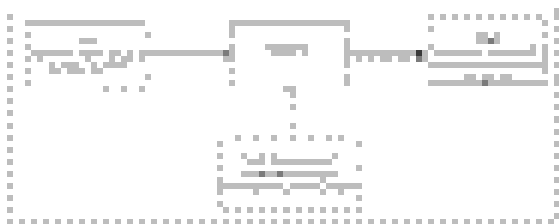
Cogeneration is by its nature complex and fiddly. Parties dealing in just one market often have trouble agreeing terms that are to last them more than even a couple of years. In cogeneration there are at least three markets to consider:

1. The input fuel market;
2. Electricity market;
3. The host's "product" market.

Despite its complexity, a secure and profitable transaction is possible by planning ahead, being flexible and remembering the transaction drivers.

In a "good" transaction the legal drafting should follow the commercial drivers. Looking at a cogeneration project in terms of host and supplier this can be represented as:

Host	Supplier
<ul style="list-style-type: none"> • Competitive price for host's own product and supply from supplier • Site compatibility • Integrated operations • Quality and continuity of supply • Secure relationship • 	<ul style="list-style-type: none"> • Long term return • Continued operation • _at site • _resource consents • Avoid credit risk • Secure relationship



For the supplier the simplest and least-risk approach will always be to match, or back to back, its obligations to provide electricity and steam with its obligations to purchase fuel.

To ensure security of cash flow for the supplier the host may be obliged to make minimum annual or monthly payments. Supplier arrangements like these tend to be attractive as they can be project financed more easily.

The host, however, will be driven by its desire to secure a lower price than its competitors. This model is unlikely to guarantee that competitive position over the long term as the host's "product" market and its electricity market are unlikely to follow the fixed escalator used by the supplier to price its cogeneration outputs.

The resolution of the tension between these positions will be the result of complex negotiation, involving pricing variations such as discounts to market, PPI based pricing, the use of caps, floors and periodic reviews. The key to a successful negotiation is for each party to understand the risks each option presents to its business and for each party to limit that risk. That all risk is taken by one party is generally not an acceptable

solution.

Getting a Cogeneration Project Underway

Tendering is going to play an integral part in any cogeneration project. The host is likely to tender for a supplier and the supplier in turn will tender for contractors, equipment suppliers, a fuel supplier, and even legal advisors.

There is really nothing new about tender processes, but there is now a far greater expectation of fair play. A great deal of effort and expense is often put into tenders. If a tenderer has complied with the rules, and made a competitive tender, they expect to be fairly considered and have a reasonable opportunity to get the contract.

The Courts are increasingly willing to review a tender process to ensure "fair play" (particularly in respect of public entities). This has led to the development since the 1980s of the "two contract" position:

1. A "tendering contract" (effectively setting out the rules of the tender process) is made. The principal and each tenderer must comply with it. The courts may imply terms to this contract.
2. A "supply contract" is created as a result of the tender process.

The following general legal rules apply to tenderers in the 1990s:

1. If a principal has policies or criteria that it will apply (eg to participation or evaluation), they should be disclosed at the start. Any change should be promptly disclosed and tenderers given a fair chance to make their tender in light of it.
2. If a principal makes rules, the principal and each tenderer must comply with them (eg use a specified form of tender and submit it by a certain time).
3. Complaint tenders must be considered.
4. If a rule is that tenders can not be withdrawn, or are to be valid, for a certain period, even if a tender contains a mistake, the tenderer can be held to it.
5. Unless a principal clearly (by word or conduct) commits to create a supply contract by or during a tender process, freedom to contract with anyone will prevail and the principal does not have to accept any tender, nor buy or sell by tender process.
6. Negotiations may be conducted with tenderers or other persons where the principal's desired result is not achieved by any tender as submitted. It is recognised that "tuning" negotiations are generally required in most tender processes.
7. Factors other than highest or lowest price may be used to determine who is to get a contract.
8. The prohibition on misleading and deceptive conduct in trade in the Fair Trading Act 1986 applies to a tender process. This can include not disclosing a change of intention.
9. Delay by an aggrieved tenderer in bringing a claim, and the difficulties in unwinding a contract already in place, can be strong factors against a claim succeeding.
10. Damages may be awarded for breaches, including:
 1. the tenderer's cost of preparing its tender;
 2. for lost profits and opportunities (despite not having to perform or supply);
 3. legal costs; and
 4. exemplary damages (to punish and set an example).

There is now greater scope for successful challenges by tenderers, but also greater scope for principals to minimise this risk if they get it right from the start.

A principal should either keep the process very simple and say very little, or use comprehensive rules to cover itself. The use of comprehensive rules is prudent, as the principal has the opportunity to minimise risk, and control the process, by setting the rules at the start. Rules of tender, may include provisions that make it very clear that the principal may at any time:

1. change any date in the process (ie extend or shorten time frames);
2. apply, or change, any policy or criteria relating to participation in the tender process or evaluation of tenders;
3. exclude any person from the process (whether on the grounds of capability, country of origin, price, Government policy or otherwise);
4. suspend or cancel the process by notice;
5. reject any non-compliant tender;
6. not give any reason for rejection of a tenderer or tender, or for any suspension or cancellation of the tender process;
7. liaise or negotiate with any tenderer or other person without disclosing this to, or involving, any other tenderer or person (whether before, during or after the tender process);
8. change any rule of the tender process by notice;

9. not supply, nor allow any access to, any of the principal's information or property;
10. disclose any information to any person unless otherwise required by law; and
11. not have any liability for any information it provides or for any cost or loss to any one if they are unsuccessful or the process is delayed or cancelled.

Tenderers need to examine any rules of tender. A tenderer's non-compliance can lead to exclusion from the process. It is a commercial risk to stray from any rules. Tenderers should ask questions if any thing is unclear, and carefully check for mistakes, before they submit their tender.

Evaluation of tenders, and selection of the successful tender, need to be done with care and due regard to compliance with the principal's stated or known policies and criteria, and the rules of tender. This process should be well documented.

Challenges to tender processes should be done promptly.

A well structured tender process, conducted with integrity, can produce significant benefits with low risks for principals.

The commercial risks for tenders will always exist, but fair play is now more likely in the 1990s.

Host and Generator Programme

Prior to the tender process some consideration will need to be given to the terms of the parties agreement.

There are a huge variety of issues that will need to be considered. Given the capacity constraints for this paper we will focus only on those issues that recur frequently in the cogeneration process.

In particular these include:

1. types of contract;
2. site security and host responsibility;
3. clouding of difficult issues;
4. beyond reasonable control; and
5. failure to perform.

Site Security and Host Responsibility

For a supplier the ultimate in site security will be the ownership of the land on which their plant sits. In practical terms, the host is unlikely to sell a site in the middle of their industrial premises, if only for reasons of emotional attachment.

In most cases the supplier will require a lease. The implication of a lease is that the supplier alone has the right to occupy the land on which the plant is situated.

This may not reflect the integrated operation between the supplier and the host. Also, if the lease is likely to exceed 20 years then RMA requirements may oblige the host to subdivide. This will involve council consent and may lead to other resource management considerations such as the dedication of a marginal strip along an adjoining river or foreshore. The loss of that land can make the transaction unattractive to the host.

It may be that a non-exclusive licence to occupy will be sufficient for a supplier to adequately reflect the integrated nature of the host and the suppliers relationship. In the case of a licence the supplier can access the site, however, it is shared with the host. This, however, is unlikely to be acceptable to a Project Financier.

In order to secure its site the supplier needs to ensure it will obtain appropriate resource consents or the use of those consents from the host.

Often the host holds consents for the existing site so that simplest procedure will be to allow the supplier to utilise those consents. Most consents are not specific to the individual but tend to relate to a defined area or activity and as a consequence as long as the supplier is on the relevant site and complies with the activity those consents can be used. Much depends on specific conditions and consents and these will need to be carefully reviewed.

Usually one party will indemnify the other from the implications of a breach of resource consent. However, it is not possible to indemnify a person from criminal liability. Consequently should the host hold the consents which are breached due to an action of the supplier it may be the host who is criminally liable. In a practical world we would hope the Court would take this into account in sentencing, however it remains a real legal risk.

In many agreements if the parties are unable to agree they may cloud an issue by stating that they will use reasonable or best endeavours. This is particularly likely in a long term agreement where, due to future uncertainty, an open ended "reasonable endeavours" or "best endeavours" obligation will be all that a party is prepared to give. What is meant by each phrase and when should they be used?

The phrase "best endeavours" and other similar phrases such as "best efforts" and "all necessary steps" are generally interpreted by the courts using the ordinary meaning of the words².

This is a high and potentially expensive level of commitment. It is not a test which is met by the efforts of the parties concerned (which may be limited in some way) but by a reasonable person in the circumstances.

There has been a lot of case law on "reasonable endeavours".

Most recently an Australian Court considered the matter in *Graeme Webb Investments Pty Limited v Soepyk Limited* (1993) NSW ConvR 55-661. The defendant was the developer of a subdivision, which contracted to sell a factory property. The contract was conditional on registration of the plan of subdivision and also provided that the vendor was to make "all reasonable endeavours" to procure registration of the plan. To obtain registration the defendant had to pay \$270,000 which the defendant failed to do.

The Court required the defendant to pay the sum of \$270,000 and held it was within the requirement of reasonable endeavours because:

1. it was a regular practice for registration and the amount of that payment was based on publicly available principles;
2. this payment practice was widely known amongst developers and could not be outside the contemplation of the parties; and
3. \$270,000 was not out of all proportion to the total value of the transaction (in this case \$3-3.5 million).

It would appear that if an event is within the contemplation of the parties, or likely, then it will be included within the term "reasonable endeavours". Given the high cost of cogeneration projects it is likely that the cost "threshold" for reasonable endeavours will be high.

Both reasonable and best endeavours have developed high thresholds and they should be used with caution by any party. They certainly can not be used by a party to escape liability merely because performance has become expensive.

Types of Contract

Depending on what is to happen at the end of the cogeneration contract most arrangements can be classified as a BOOT, BOT or BOO.

Like all jargon BOOT (Build, Own, Operate and Transfer) and BOT (Build, Operate and Transfer) projects are difficult to define precisely.

First: their development. A three tier structure of development contracts has evolved:

1. Traditional (Payment from host up front or as works undertaken);
2. Turnkey (Payment when works complete);
3. BOOT/BOT (Payment for plant and equipment (if any) on transfer of asset).

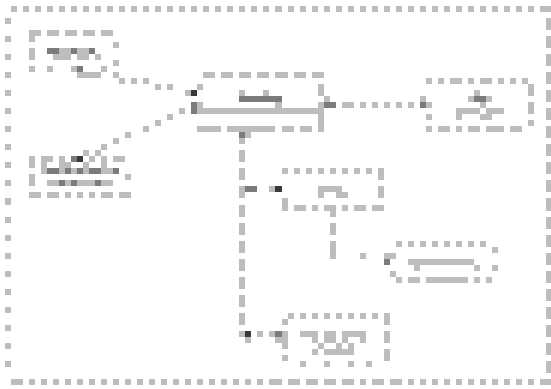
From the host's standpoint, development under a traditional contracting methodology is characterised by the host's immediate ownership of the plant and the need to pay on a cash up front or as works continue basis.

The intermediate tier is the turnkey construction which, from the contractor's point of view, is characterised by a greater involvement of the contractor in terms of risks and obligations and resulting rewards (higher price) with the price not being paid until completion of construction. From the host's stand point the position is the reverse; less risk, less obligation in terms of administration, design, certification etc but higher cost. The turnkey contract, with greater contractor involvement, is a logical development preceding BOOT and BOT contracts.

In a BOOT project the involvement of the parties is significantly different. Instead of a single construction contract there may be multiple agreements. There will be a construction contract but in a BOOT model there may also be:

1. A central concession contract between the host and the project development company (or supplier) which is not necessarily the contractor.
2. Finance agreements between lenders and the supplier to provide funding for the project.
3. Agreements (eg the supplier's constitution and any securities issues) which govern the rights of equity investors in the supplier (shareholders).
4. Agreements between the supplier and "contractors" (eg a consultancy) for the purposes of a feasibility study relating to preliminary design, construction and economic viability of the project.
5. The construction contract between the supplier and the builder or contractor.
6. A contract between the supplier and the operator of the plant once constructed and commissioned.
7. A contract or contracts between the supplier and suppliers of resources necessary for the plant's operation.
8. Contracts between the supplier and plant's "off takers" ie customers of the facility (including the host) once constructed.

The following structure emerges:



In a cogeneration situation this produces the contract structure as shown:



There will be a number of rationales for a project as shown on the previous pages and many variations of this structure.

These may include:

1. Payment for the project from revenues it generates once complete and in operation. For example, the contractor is paid with borrowed funds by the supplier which, in turn, services and repays its borrowings from plant revenue channelling remaining profits as dividends to equity funders.
2. Equity participation at some level by the host (eg, the host holds shares in the supplier).
3. Careful co-ordination of all agreements (all must workably interrelate).
4. Political risk (even in New Zealand) which is made worse by the long term nature of the arrangements.
5. Strong incentives for careful planning and execution.
6. Step in/step out rights. Lenders may, in certain cases, step in and assume the rights and obligations of the supplier (ie not merely appoint a receiver). Equally, lenders who have exercised the right to step in may "step out". Hosts require some control over the ability of lenders to participate in the operation of the cogeneration plant or have their own step-in rights in certain circumstances.

The BOOT model above is essentially a "horses for courses" concept and many variations exist, for example:

There may well be no contract with off takers since the off takers are the public.

There may be no ownership by the supplier during the period of operation. Hence the BOT (Build Operate and Transfer) model. Here "transfer" may be a misnomer. Nothing is "transferred" in the legal property sense, the facility is merely handed back following the expiry of whatever right previously existed to occupy the site and construct the facility.

There may be no obligation to transfer at all as in a Build Own Operate (BOO) contract. For as long as the facility is viable the supplier owns it and operates it and any subsequent transfer comes about as a result of some later negotiation.

There may be BLT projects (Build, Lease and Transfer) where there is no ownership but a legal right to occupy, and the facility once built is leased to the supplier for period of operation.

Beyond Reasonable Control

In many contracts there are "outs" where the parties escape liability for events beyond their reasonable control. To most, these events are expected to be "acts of God" such as lightning, flooding, tidal waves, cyclones, strikes, epidemics or civil emergencies.

However, force majeure clauses often set out what happens after an event occurs that is beyond the control of the party affected. These clauses are often used by parties to long term agreements when subsequent events "move against them". Consequently, they should be considered carefully by parties to any cogeneration agreement.

Courts construe force majeure clauses according to the actual words of the clause and in light of the contract as a whole. Therefore it is often difficult to extract specific rules of construction since many cases turn on the particular wording of the relevant force majeure clause. However, there are some general principles.

The rule of strict construction: It is for the party relying on the clause to show that their situation is squarely within the clause.

Burden of proof/causation: The party who seeks to rely on the force majeure clause must prove that an event of the kind specified has happened, and that it has had the specified affect on its ability to perform the contract³. The party must also show that there were no other means of performing the contract.

A party cannot rely on their own act, negligence or default as a force majeure event. If negligence is the cause of the event, then that event is within the control of the party.

A person will also not be excused merely because performance has become more expensive⁴. For example, a Court⁵ held that a force majeure clause does not excuse a seller of goods from supplying the goods when export regulations in the relevant country has made the cost of the goods greater than the contract price. However, Denning LJ said that the position may be different if the price has increased 100-fold⁶.

The question will often be asked "what is beyond the reasonable control of a party?" For example, the parties need to consider whether failure of a fuel supplier or construction contractor will be construed as a force majeure event. In particular, where mechanism such as liquidated damages apply on default there is a real incentive for a party to cry "force majeure".

At a practical level, a host should consider detailing only specific events as giving rise to force majeure while a supplier will usually prefer a "beyond reasonable control" approach as they are typically the most likely party to default.

Failure to Perform

Often the greatest incentive for a party to perform under a contract is the spectre of liquidated damages.

Legally, liquidated damages are an agreed amount of loss that one party will suffer, and the other party will pay, if there is a failure to perform. Practically, they are of benefit in that the parties know what the consequence of failure will be ahead of time. Liquidated damages can, but do not necessarily, limit the liability of the party in default. In the event of a contractual breach, liquidated damages are intended to avoid the necessity of the aggrieved party having to prove it has suffered loss although this is not always assured. To this extent they are both:

1. an incentive for a party to perform; and
2. a method of simplifying legal procedures if one party fails.

Liquidated Damages clauses are upheld by the courts provided they are:

1. a genuine pre-estimate of loss at the time the contract was made; and
2. not excessive and unconscionable when measured against the greatest conceivable loss⁷.

If a party defaults it may be that while liquidated damages are to be paid the other party will need the contract to be performed.

Specific performance is a decree issued by the court which forces a contracting party to do that which it promised to do. Specific performance is often provided where an award of damages would be inadequate and would defeat the just and reasonable expectations of the aggrieved party.

The grant of specific performance is not an automatic right for a person seeking relief, but a discretion of the court. On occasion, the court has granted both specific performance and liquidated damages⁸. Recent cases have moved away from treating specific performance as a secondary alternative to damages and have looked instead at the appropriateness of the remedy in each particular situation.

Whether liquidated damages excludes specific performance depends on the intention of the parties. However, the High Court has the power to award damages either in addition to, or in substitution for an order for specific performance. As a consequence it will often be desirable to allow an aggrieved party to obtain both liquidated damages and specific performance and to make this specific in the cogeneration agreement.

Conclusion

There are many variations and methods of approaching cogeneration projects. We have only sought to discuss the major points that recur in these projects. The way those issues are dealt with by the parties will always be a matter for commercial negotiation between the parties. However, as a general observation: those that plan best win.

Footnotes

1 *Power Company Ltd v Gore District Council* [1997] 1 NZLR 537

2 Justice Lawrence in *Sheffield District Railway Company v Great Central Railway Company* (1911) 27 TLR 451 at 452:

... "best endeavours" means what the words say; they do not mean second best endeavours ... they do not mean that the limits of reason must be overstepped with regard to the cost ... the words mean that [they] must, broadly speaking, leave no stone unturned

3 *Tradax Export SA v Andre & Cie SA* [1976] 1 Lloyds Rep 416; *Thomas D Gonzalez Corp v Miller's Muhle* [1980] 1 Lloyd's Rep 445.

4 Trietal, p267.

5 *Brauer & Co (Great Britain) Limited v James Clark (Brush Materials) Limited* [1952] 2 All ER 497.

6 *Brauer & Co (Great Britain) Limited v James Clark (Brush Materials) Limited* [1952] 2 All ER 497, at 501.

7 *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79.

8 See *Nicholson & Yong v Anor* (unreported, High Court, Christchurch, CP130-95, 7 August 1996, Morgan J).

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25. Maritime National Fish Limited v Ocean Trawlers Limited [1935] AC 524.
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29. Nicholl v ANZ Banking Group New Zealand Ltd [1995] 3 NZ ConvC 192,127.
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44. Tradax Export SA v Andre & Cie SA [1976] 1 Lloyd's Rep 416.
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Authors

Pat Bowler and Nick Wells are both lawyers practicing in Russell McVeagh's Commercial/Corporate Group specialising in energy law and with particular expertise in the area of cogeneration. Pat is a partner in the firm's Wellington office and has 28 years experience in all aspects of corporate and commercial law. Nick was previously in-house counsel with Mobil and is now a Senior Solicitor in the firm's Wellington office.