



Memorandum from the Office of the Inspector General

June 29, 2007

Jacky D. Preslar, SP 6A-C

FINAL REPORT – INSPECTION 2007-508I – REVIEW OF FORCE MAJEURE POLICIES AND PROCEDURES

Attached is the subject final report for your review and action. As discussed with you and your staff on June 20, 2007, the subject report is being issued in presentation format. Your informal comments to the draft report have been incorporated into the final report. Please advise us of your planned actions in response to our findings within 60 days of the date of this report.

Information contained in this report may be subject to public disclosure. Please advise us of any sensitive information in this report which you recommend be withheld.

If you have any questions, please contact Michael A. Driver, Project Manager, at (423) 751-8158 or Gregory C. Jaynes, Deputy Assistant Inspector General, Inspections, at (423) 751-7821. We appreciate the courtesy and cooperation received from your staff during this review.

for Ben R. Wagner
Assistant Inspector General
(Audits and Inspections)
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Attachment
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OIG File No. 2007-508I



Review of Force Majeure Policies and Procedures

2007-5081

June 29, 2007



Summary

Our objective was to review (1) vendor compliance with contract force majeure (FM) provisions and (2) the adequacy of coal contract terms and conditions related to FM.

Our review of 13 mine contract files and 2 rail transportation contract files found:

- ◆ No documented instances in which (1) a vendor did not provide formal notification of a FM event and (2) the FM justification was not in accordance with FM contract language.
- ◆ Standard contract language exists for the development of a contract FM clause, however, the FM clause is often modified either in initial contract negotiations or subsequent contract supplements. This variation could result in increased cost to TVA.
- ◆ Most of the FM events were not verified.

Additionally, we found:

- ◆ No policies and/or procedures specifically governing how to manage FM events.
- ◆ No central depository for documenting FM events declared and the impact resulting from these FM events.
- ◆ Limited and/or inconsistent documentation pertaining to FM events and Fuel Supply actions.



Background

- ◆ As of February 2007, Tennessee Valley Authority (TVA) had 59 contracts in place for the procurement of coal and utilized six rail companies for transportation of coal.
- ◆ During calendar year (CY) 2005 and CY 2006, TVA coal purchases totaled approximately \$2.4 billion excluding transportation and other costs.
 - Approximately \$762 million was purchased from the 13 coal contracts reviewed during this time period.
- ◆ TVA's target inventory level of coal for fiscal year (FY) 2006 averaged between 21 and 24 days supply at full burn.
- ◆ TVA has set forth standard contract FM language that is used when drafting coal contracts.
 - The FM clause is subject to change during contract negotiations.
 - TVA does not have standard FM contract language for rail contracts because rail companies draft the contracts, not TVA.



Background (continued)

- ◆ Key clauses contained in the standard FM language include the following:
 - *Neither party shall be liable to the other for failure to deliver or accept delivery of coal if such failure was due to supervening causes beyond its control and not due to its own negligence. Some examples include:*
 - ◆ *Acts of God, Strikes, Partial or total outages of coal fired units, Major breakdown of equipment or facilities, and Industry-wide carrier delays or shortage of carrier's equipment.*
 - *TVA shall have the right, but not the obligation, to require the Contractor to make up any tonnage not delivered.*
 - *Party failing to deliver or take coal shall give written notice to the other of such failure and furnish full information as to the cause and probable extent thereof within ten (10) calendar days after the failure first occurs.*
- ◆ “When suppliers have mine-production problems, TVA must buy more expensive replacement coal on the spot market.”¹
 - According to Fuel Supply, TVA spent approximately \$494 million on 88 spot contracts during FY 2005 and FY 2006. However, the amount of spot purchases resulting from FM could not be determined.

¹Quote was taken from article titled “TVA To Change Fuel Cost Adjustment Amount in January” (TVA Today dated December 1, 2006).



Objective and Scope

Objective:

- ◆ Review (1) vendor compliance with contract FM provisions and (2) the adequacy of coal contract terms and conditions related to FM.

Scope:

- ◆ FM language in TVA coal contracts with vendor mines and rail companies that were active during CY 2006 and related FM events which occurred from January 1, 2005, through March 1, 2007.



Methodology

To achieve our objective, we:

- ◆ Reviewed policies and procedures identified by Fuel Supply pertaining to coal contract administration.
 - CA&S.01.250, Managing Transportation Contract Administration
 - CA&S.01.040, Managing Coal Contract Administration
 - CA&S.01.330, Managing the Sale of Surplus Coal
 - CA&S.01.210, Managing Terminal Contract Administration
- ◆ Reviewed two internal presentations titled “Coal and TVA” and “Coal Risk Management & Reporting” to obtain information on coal procurement, management, and risk.
- ◆ Interviewed Fuel Supply personnel to gain an understanding of processes and any key control activities applicable to FM events.
- ◆ Reviewed other information on TVA coal procurement including OIG audits, inspections, and investigations.



Methodology (continued)

- ◆ Judgmentally selected a sample of 13 mine contracts and 2 rail transportation contracts for review. Specifically, we reviewed contracts, supplements, memorandums/correspondence and other documentation maintained in the contract files to:
 - Identify differences between the actual and standard FM contract language.
 - Identify FM events documented in the contract file and the actions and processes followed by Fuel Supply, including whether FM events were verified.
 - Determine if FM events were in accordance with contract terms. However, we did not attempt to verify the validity of any claimed FM event.
 - Identify the impact of FM events, including the renegotiation of contract terms.

The selected mine contracts represented approximately 31 million tons (33 percent) of the approximate 94 million tons of coal delivered to TVA from January 1, 2005, through December 31, 2006.

This review was conducted in accordance with the “Quality Standards for Inspections.”



Finding 1 – Contract Language and FM Declarations

For the 15 contracts reviewed, we found FM events identified in the contract files were generally documented through vendor letters and cited an event contained in the contract FM language. However, the FM contract language varied, and most of the FM events were not verified.

- ◆ For the 2 rail transportation contracts reviewed, we:
 - Noted 25 FM events in the contract files which were documented by vendor notification letters. Cited causes were:
 - ◆ Derailments – 17
 - ◆ Weather related – 6
 - ◆ Bridge fire – 1
 - ◆ Congested shared track – 1



Finding 1 – Contract Language and FM Declarations (continued)

- Standard TVA FM language does not exist for transportation contracts due to the fact it is usually drafted by the railroad. Specifically, events considered FM varied between the 2 contracts. Both contracts contain FM events such as acts of God, derailments, and adverse weather conditions. However:
 - ◆ The first contract included causes such as war, insurrection, destruction of or damage to right-of-way including bridges, boycotts, and/or any other causes beyond its control.
 - Also, for purposes of determining shortfall tons, the contract included events such as (1) delays in loading or unloading, (2) inability of shipper’s mine operator to load coal or inability at destination to unload coal, and (3) delays attributable to other rail carriers involved in the route of movement.
 - ◆ The second contract included causes such as storms, landslides, floods, washouts, earthquakes, lightning, acts of military authorities, and shortages of fuel for locomotives.
- ◆ For the 13 mine contracts reviewed, we:
 - Noted 19 FM events in the contract files which were documented by vendor notification letters pertaining to 8 of the 13 mine contracts. Cited causes were:
 - ◆ Adverse mining conditions, including roof-falls; presence of combustion gases; and flooding – 12
 - ◆ Mechanical Breakdown – 4
 - ◆ Transportation limitations – 3
 - Based on information in the contract files, the tonnage affected by 7 of the 19 identified FM events was at least 2.8 million tons. No information was found on the impact of the other 12 FM events we identified from information reviewed in the contract files.



Finding 1 – Contract Language and FM Declarations (continued)

- FM contract language differed from TVA standard FM contract language in all 13 contracts. The key difference was 9 of the 13 contracts contained a variation in contract language stating:²
 - ◆ “Any tonnage not delivered in accordance with this section will only be made up by mutual agreement.” TVA standard contract language states, “TVA shall have the right, but not the obligation, to require Contractor to make up any tonnage not delivered.” This contract language variation could result in increased cost to TVA.
 - A FM was declared for a total of 473,771 tons of coal for 1 contract stating tonnage will be made up by mutual agreement. The renegotiation for the tonnage resulted in TVA purchasing the coal at a higher price for a total cost increase of approximately \$5.8 million.
 - Tonnage lost, due to FM events reviewed from 1 contract, totaled over 350,000 tons. This contract originally contained the standard contract language but was modified by a contract supplement to contain language stating tonnage will be made up by mutual agreement.
 - A FM was declared on 1 contract which stated tonnage will be made up by mutual agreement. The FM totaled approximately 1.4 million tons of coal at a contract price of approximately \$19 per ton. The contractor did not wish to make up the deficient tonnage. A proposal was submitted by the contractor seven months later, during the re-opener period, for 1.6 million tons of coal estimated to have been unshipped from the contract at a price of \$30 per ton.

² Of the 9 contracts, 2 contained the standard TVA contract language but were later modified.



Finding 1 – Contract Language and FM Declarations (continued)

- According to Fuel Supply, market conditions, including coal availability; transportation considerations; and/or market pricing can lead to negotiated changes in the FM contract language.
- ◆ Fossil Fuels reported that 5 of the 44 FM events identified in the contract files were verified.
 - None of the rail transportation FM events were verified. However, Fossil Fuels stated that rail transportation FM events are more readily identifiable due to publicity of major events, and some of the events were known.
 - Of the 19 FM mine events, 5 were verified.



Finding 2 - Policies and Procedures

We found no policies or procedures governing how to manage FM events declared by vendors. Specifically, no policies and/or procedures address:

- ◆ Procedures to follow once a FM declaration is received.
- ◆ Steps taken and documentation required to verify or assess a FM.
- ◆ If applicable, steps taken to evaluate potential actions and reconcile the FM.
- ◆ Maintenance of documentation associated with the FM to include documentation of decisions made, as well as the impact of the FM.

We found policies and procedures addressing FM declarations by TVA.

- ◆ An example of a TVA FM declaration is partial or total outage of coal-fired units. This would result in the coal vendor being notified that TVA may need reduced or no coal deliveries.



Finding 3 – Limited Documentation/Tracking

During our review, we found no central depository documenting FM events declared or the impact resulting from these FM events. We also noted limited and/or inconsistent documentation in the contract files.

- ◆ Because information is only maintained in the contract file or by the contract administrator, it is difficult to:
 - Identify all FM events.
 - Track or determine the reliability of vendors.
 - Compile a scorecard of vendors to use in future contract decisions.
 - Compile and adequately support reports on FM information.

- ◆ During our review of the sample contracts, we noted limited and/or inconsistent documentation of:
 - Field representative site visits to verify FM events.
 - Input from the Office of General Council on FM actions including contract modifications.
 - Impact of FM events. In addition, we could not determine the tonnage and cost from spot purchases related to FM.
 - TVA's acceptance or rejection of FM events.



Recommendations

The General Manager, Fuel Supply, should:

- Consider requiring that a justification for any deviation from the standard contract language be included in the contract file when the deviation does not equally protect TVA's interests.
- Establish written policies and procedures addressing vendor FM events, which include (1) procedures to follow once declarations are received and (2) evaluation of potential actions including whether FM event verification is warranted.
- Establish a process and related criteria to adequately track and document FM events including the financial and business impact to TVA.

