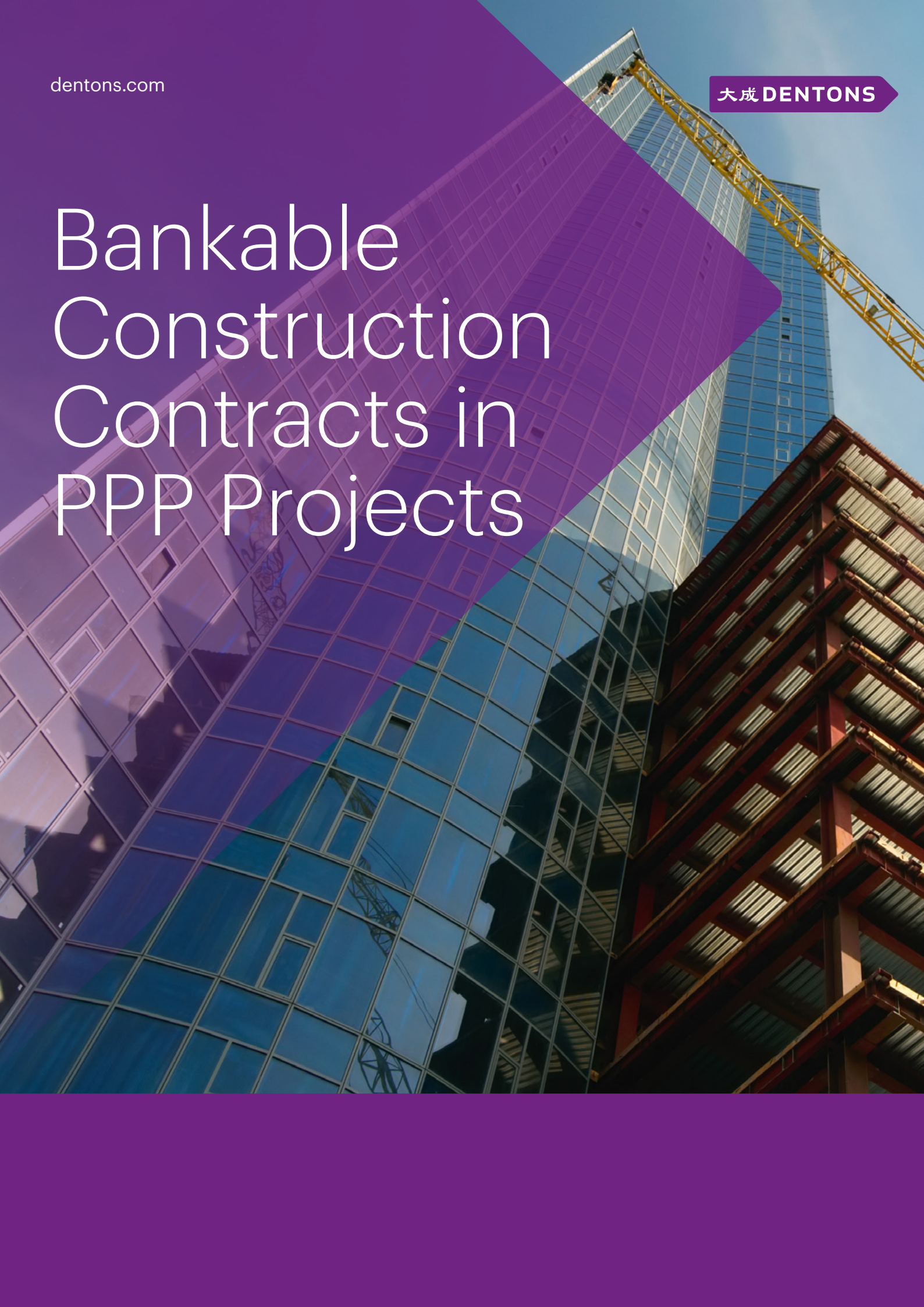


# Bankable Construction Contracts in PPP Projects







Bankability as a whole is a very broad concept made up of various strands. A key strand is the construction contract(s) and is the focus of this article. Bankability considerations for construction contracts can vary between different types of project procurement methods. This article considers the topic from the perspective of a concession-based project, where a private sector party has been granted a concession to design, finance, construct and operate an infrastructure asset.

In most concession-based PPP projects, the construction contract is one of the most important agreements that will be entered into. The price to be paid to the contractor under the construction contract is generally the largest capital expenditure and as such is one of the key areas of focus for all stakeholders in PPP projects, not least the lenders.

**a. Sponsors** – sponsors’ involvement in the project is motivated largely by the return on their equity contributions. They want to balance achieving a competitive price for the construction works with protecting their expected returns by ensuring that construction risk is borne by the contractor to the greatest extent possible and not borne by their project vehicle, the project company.

**b. Lenders** – lenders will carefully check the terms and risk allocation under the construction contract and the experience of the contractor before committing to financing the project. They will also look to minimise the construction risk taken on by the project company, given that repayment of the project loans could be directly impacted where the project company takes on a greater level of risk than it should. This is even more so where the contractor is an affiliate of one of the sponsors.

**c. Grantor** – the concession grantor/ employer obviously has an important interest in the construction contract as the relevant infrastructure asset is the whole purpose of the project and it will be relying on it to function and produce the relevant output during the concession period (and after handover to the grantor at the end of the concession period in the case of a BOT type PPP).

**d. Contractor** – as the party charged with constructing the facility, the contractor needs to ensure that the contract is crafted in such a way that it is only bearing risks which it can control and manage and which generally limit its exposure. Mechanisms for doing so are discussed below.

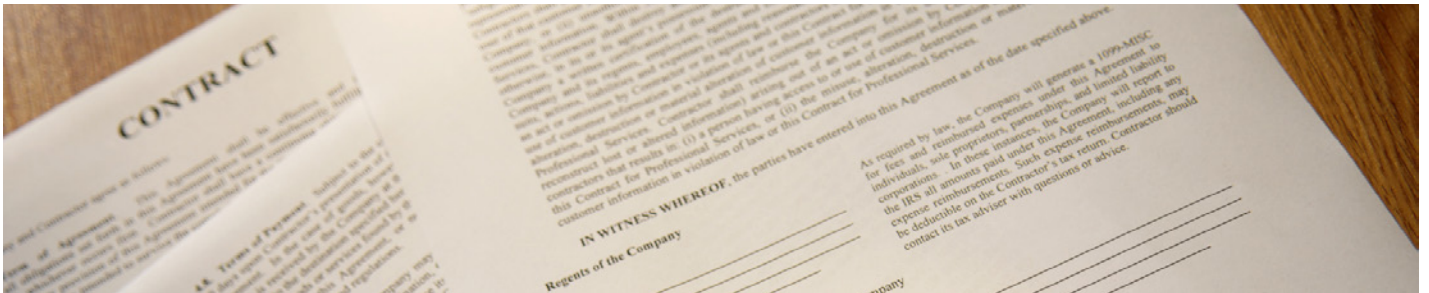
The requirements for a project to be bankable are not fixed and it is

common to see different approaches to bankability, whether it be from sector to sector or between different jurisdictions or regions of the world. The purpose of this article is to explore some of the common/ generic aspects of bankability and the usual base position for negotiation of construction contracts when it comes to those aspects.

A key premise to be mindful of is that the parties to a project tend generally to agree that project risks (including construction risk) should be allocated to those parties that are best in a position to manage that risk or at least make a reasonable determination of that risk. Where the lenders are required to take on a greater degree of risk, thereby rendering the project less bankable, the cost of financing is likely to be higher than it otherwise would be and/or the lenders will look to the sponsors to provide additional security or support. This is likely to impact on the project’s viability.

### The “back-to-back” principle

Under a typical BOT style PPP project the concession agreement (or off-take agreement) will be the overarching agreement which sets out the rights and obligations of the grantor and the project company. The primary obligation of the project company is to construct and operate the relevant facility, be it a power



plant, toll road, water desalination plant or otherwise. The project company will, through separate agreements such as the construction contract, pass through various risks to third parties, including of course the construction contractor. In order to ensure that the risks and obligations are properly passed down, the project company will seek to ensure that the obligations that it passes down under the construction contract are “back to back” with the corresponding obligations it has under the concession agreement, so that there are no gaps between the obligations being taken on by it and those delegated by it to third parties.

Ensuring that the “back-to-backing” is undertaken properly is a key priority for lenders. After all, the project company is usually a special purpose vehicle and financing will be provided on a limited recourse basis (such that the lenders only have recourse to the project company and the project assets). As such, a bankable construction contract is usually one under which the back-to-back principle has appropriately been applied and which ensures that minimal risks are parked with the project company.

One of the key clauses that lenders will look for in this regard is an

“equivalent relief” clause, which ensures that the contractor will only receive any time or costs relief from the project company for risks that are ultimately borne by the grantor (such as political force majeure relief) if the project company has received such relief from the grantor. In effect this transfers to the contractor the risk of the project company receiving an unfavourable outcome in respect of a disputed claim for relief from the grantor.

### Key risk issues

In order to understand what constitutes a bankable construction contract, one must consider a number of bankability factors from the perspective of the various key stakeholders in the project. The following are some of the important aspects of construction contracts that are carefully considered by lenders, the project company, the contractor and the grantor alike when structuring the project.

#### a. General structure of the construction contract – the single point “turnkey” contract

While the construction contracting arrangements can take any form that the parties are able to negotiate and document (from a structural perspective), the “single point turnkey contract” is generally

considered to be the most bankable in large-scale infrastructure projects.

Construction arrangements can be very complex and involve numerous parties carrying out unique elements in construction of the facility. The premise of a turnkey construction contract is that the lead contractor (appointed by the project company) bears the risk and responsibility for delivery of the entire facility (or, where the contractor is comprised of a consortium, on a joint and several basis). Any arrangements between the contractor and its subcontractors, suppliers and other third parties will be the responsibility of the contractor alone. The other parties to the project (project company, lenders and grantor) will not want to or need to look too far into the arrangements the contractor has with those third parties unless, perhaps, these are significant sub-contracts.

It is from this sole responsibility of the contractor that the term “single-point” originates. This is the preferred approach (and usually the required approach) for (i) the project company, which wants to have a single point of responsibility in the event issues arise in relation to construction and a single point of liaison when it comes to construction management, and

(ii) lenders, who want to ensure that as few construction-related risks as possible are parked with the project company and whose interests align closely with those of the project company and sponsors.

For completeness it should be noted that the turnkey contract is not necessarily suitable for all types of PPP projects. Petrochemicals, refineries and offshore wind projects are examples of where contractors have generally been unwilling to accept turnkey arrangements without adding prohibitive risk premiums, and therefore alternative structures have been developed and are now commonly accepted as bankable owing to the type and structure of such projects.

#### **b. Fixed price**

A bankable construction contract is generally one which is for a fixed price (subject to common “re-openers” (see below)) plus provisional sums, being amounts allocated for work which cannot be accurately priced at the time of entry into the contract.

A fixed price is of importance to both the sponsors and the lenders. From the sponsors’ perspective their financial model for the project is established on the basis of certainty around the key capital expenditures, which include the price of the construction contract. Any variances to this budgeted expenditure on construction will likely have a significant impact on the financial model generally and, most importantly, will likely have a negative

impact on sponsors’ expected rate of return for the project.

From the lenders’ perspective the entire debt repayment profile will be based on a fixed amount of lending – any further advances which need to be made to the project could compromise the economics on which they have agreed to finance the project. These economics are often very precise and leave little room to manoeuvre, meaning sponsors cannot usually rely on lenders to agree to advance further amounts. In cases where there are significant cost overruns, the entire financing arrangements may need to be restructured, whether it be through additional sponsor equity injections or perhaps even selling an interest in the project, both of which have significant drawbacks.

As for the contractor, any cost savings it is able to make during the construction phase are usually for its own account, thus incentivising it to complete construction with maximum efficiency.

Typical “re-openers” (instances where the fixed price can be adjusted after the contract has been entered into) include the following:

- i. Change orders – where there has been a request from the grantor or project company to change the scope of construction work.
- ii. Political force majeure events such as change in law – where there is a change in law which causes the contractor’s costs to increase beyond those that were originally

provided for. Introduction of new taxes (as is currently occurring throughout the GCC countries) or changes to health and safety laws are common examples of changes in law which could trigger the right for the contractor to seek additional amounts under the contract.

iii. Unforeseen ground conditions – where there are unforeseen defects in the land on which the facility is being constructed, leading to the contractor incurring costs which were unforeseeable at the time of entry into the contract. Examples include pipework, drainage, cables, contamination or antiquities being discovered once construction has commenced.

#### **c. Fixed time**

Time for completion of construction is an important aspect of construction contracts which is focused on by all key project parties.

Lenders, the project company and the grantor will expect to see a fixed completion date for construction. From the grantor’s perspective, there will likely be an imminent need for operation of the facility. Any delays will have consequences for the grantor, which can be financial and/or political in nature. Its completion date requirements under the concession agreement will be back to back with those in the construction contract.

From a bankability perspective, the impact of delays on lenders and the project company must be carefully considered. Failure to achieve the fixed completion date can have

various ramifications which they want to avoid, for example:

- i. Delays in repayment of loans – if the facility is not completed on time, there will be a delay in its ability to operate and therefore generate revenues. As these revenues will be the key source of repayment of the loans, the original loan repayment timetable may need to be rescheduled where there are delays in construction completion.
- ii. Additional interest payments – additional payments of interest will likely be required where the construction period is longer than anticipated. This will lead to an increase in the total cost of the project and may be beyond lenders' appetite for the particular project.
- iii. Penalties – the inability of the facility to be operational on time may lead to penalties under the relevant concession or offtake agreements although there are measures to protect against this (see below).

Given the direct and significant impact delays to construction completion can have on a project's financing arrangements, lenders will require that the consequences for the contractor are sufficiently prohibitive. The primary form of recourse against the contractor is that of delay liquidated damages being payable. The formulation of the amount of delay liquidated damages is usually such that the other project parties are "made whole" for any losses incurred as a result of the delays. Completion guarantees procured by the contractors are another typical requirement of lenders and employers. These are discussed further below.

There are usually only very limited circumstances in which the

contractor will be permitted to an extension of time without penalty, e.g. the occurrence of a force majeure event, variations to the scope of work, changes in law or the discovery of unforeseen ground conditions at the project site.

#### **d. Completion**

A clear definition of when completion of construction is deemed to have occurred is a vital aspect of a bankable construction contract in a PPP project. This is because the point of completion of the facility usually triggers various actions, including the following:

- i. Commencement of the commissioning process of the facility.
- ii. Transfer of ownership of the facility to the grantor (in the case of a BTO project), and, with it, ownership risks associated with the facility.
- iii. Output payments, where applicable, becoming payable to the project company under the concession agreement.
- iv. Commencement of repayments under the financing agreements.
- v. Insurance requirements transitioning into the next phase, e.g. contractors' all risk insurances will be replaced with property all risk insurances.

Given the importance of the construction completion milestone, completion parameters are often very heavily negotiated. Lenders want to ensure that there is a thorough completion testing regime (as does the grantor) and that a specialist appointed by the lenders has the final say in when completion has occurred; a standard requirement is for the lenders' technical adviser to

certify that completion has occurred. Some or all of the other parties to the project (project company, lenders and grantor) may require the obligations of the technical adviser to be supported by a collateral warranty, such is the importance of its advice on the matter, and this of course leads to additional project costs.

On the other hand, contractors often seek to limit completion requirements and ensure they are as liberal as possible. They have a competing interest in ensuring that completion occurs at the correct time and before the point where delay liquidated damages become payable.

The project company will want to ensure that the completion mechanics under the construction contract are back to back with those set out in the concession agreement. In particular the project company and the lenders will often insist that the contractor cannot achieve completion under the construction contract prior to the project company receiving the completion certificate from the client, even if this is delayed for reasons not attributable to the contractor.

#### **e. Liquidated damages for delay**

As mentioned above, one of the key remedies for sponsors (which is also a requirement of lenders for a construction contract to be bankable) is the requirement that the contractor pays delay liquidated damages where construction completion does not occur by the agreed time.

The amount of damages that are payable have traditionally been required to be a "genuine pre-estimate of loss or damages" that would be suffered and more recently the courts have looked to whether they are "proportionate to the legitimate interests" of the party that



will receive the liquidated damages. In practice, delay liquidated damages are usually payable by reference to a daily rate for each day that completion is delayed, which is calculated from the financial model to compensate for the forgone revenue, increased financing costs and other losses that the project company will suffer as a result of such delays.

There are certain circumstances where delays not attributable to the contractor will fall outside the scope of the delay liquidated damages regime. Typical examples include where there has been a variation to the scope of work or an event of force majeure. Such are the competing interests of the contractor, sponsor and lenders in relation to these events that this is often a key area of negotiation, with the lenders seeking to keep the categories of events as limited as possible and the contractor seeking to keep the list as broad as possible.

#### **f. Liquidated damages for performance**

Distinct from delay liquidated damages is a separate category of liquidation damages for lack of performance of the facility, e.g. the power plant does not produce power to specifications or the toll road is not available for use. Where this means the project company cannot deliver the required level of output under the concession and faces penalties, these need to be passed down to the contractor through the construction contract.

The formulation of these damages must be carefully considered. They will usually be set at a level that will compensate the project company for the net present value of the revenue that it will lose throughout the concession period as a result of the under-performance and any penalties it will incur under the concession agreement. Alternatively, they may take account of the likely cost of improvements to the facility to overcome the performance shortfalls, although this will often be too difficult to assess in advance.

In some cases lenders may permit or require proceeds of the liquidated damages to be used in reduction of the loan to a level that can be serviced by the lower performing asset.

#### **g. Payment of the contract price**

The precise times when payments are to be made to the contractor and the method of payment are a key bankability issue. The contractor wants to get its hands on funds as soon as possible in order to pay its costs and release profits, whereas lenders do not want to release funds until there is commensurate value in the facility. As for sponsors, they want to fund as late as possible given that some of their cost of funding decreases the later that payments need to be made.

The following are some of the key aspects related to payments under a bankable construction contract:

i. Staged payments – payments of the contract price are usually

made in instalments on a staged basis upon the achievement of pre-agreed construction milestones and in accordance with the pre-agreed construction timetable. Lump sum (on completion) arrangements are not favoured by contractors as they have to carry payment risk and bear the financing costs of construction until they are paid.

ii. Requests for the staged payments are made with supporting evidence in the form of a payment certificate certified by an engineer and subject to confirmation from the lender-appointed technical adviser.

iii. Retention guarantees – the staged payments referred to above are generally subject to a retention amount being withheld by the employer (typically up to 10 per cent of the relevant payment). The retention is a form of security held by the employer to secure future performance of the construction contract, to avoid, for example, the contractor walking away once it has received a certain portion of the contract price. However, often the contractor will require the full amount of each payment in order to pay outstanding costs of its own. Where this is the case, the project company may accept a retention guarantee from a reputable bank (procured by the contractor) in lieu of making the retention.

iv. Advanced payment guarantees – these guarantees are accepted by the project company in the event that the contractor is seeking an advanced payment under the construction contract. Typically the contractor is required to procure key high-value items of plant or acquire raw materials and incur other costs prior to when it is due a milestone payment. As such it can seek an advanced payment of the contract price by giving security to

the project company in the form of an advanced payment guarantee.

#### **h. Performance security**

As the contractor is the payee of the project's largest capital expenditure, its standing is of key importance to lenders. Lenders want to ensure that the contractor is reputable, experienced and capable of delivering the asset on time, within budget and to specification and also of withstanding any unforeseen events that it may encounter during the construction period.

However, notwithstanding the extent of comfort lenders are able to get in relation to contractors before approving their appointment, there are mechanisms employed by lenders and sponsors to ensure contractors perform as expected.

First there are parent company guarantees. These are guarantees by the parent company of the contractor of the obligations which the contractor has undertaken under the construction contract. Often the nature of the parent company guarantee is such that the parent will guarantee performance of obligations under the construction contract, whereas under a performance bond (see below) the issuer is only guaranteeing payment of amounts following the guarantee being called.

The second type of performance security is a performance bond/guarantee. Banks will often expect to see the value of the performance bond matching the cap on liquidated damages, although this varies

depending on the type of project and jurisdiction. Performance bonds are usually required to be procured from banks or financial institutions with a minimum credit rating or, alternatively, insurance companies (although this is less common). Performance bonds are considered to be more secure than parent company guarantees; however, there is also a cost implication for the contractor in procuring the bond, which is a common reason for resistance.

#### **i. Design responsibility**

In concession-based projects, design responsibility and risk lie primarily with the project company under the concession agreement. As with most construction-related risks, the project company will generally pass this risk down to the contractor (who may separately subcontract this work to a design contractor or consultant).

However, there is a fine line between design responsibility being passed down entirely and the grantor being able to ensure that the facility is prepared in accordance with its requirements. The usual position therefore is that the grantor will clearly define its required specifications and the functional outputs that it requires in the concession agreement. It is then for the project company (through the contractor) to show that it is able to deliver a facility which meets them.

Failure of the design to meet the grantor's specifications will likely lead to consequences under the concession agreement (through penalties of the kind discussed below).

#### **j. Insurance arrangements**

In keeping with the theme of the project company divesting itself of as many risks as possible, lenders will require the project to maintain certain levels/types of insurance. The challenge in large-scale projects is that certain insurances can be very costly or insurance is not always available to cover all types of risk. As such, the stakeholders must find a middle ground which is reasonable and, of course, bankable.

Typical types of insurances for PPP projects include:

- i. Construction all risks insurance.
- ii. Third party liability insurance.
- iii. Professional indemnity insurance.
- iv. Employee liability insurance.

Depending on the type and jurisdiction of the project, other more specialised categories of insurance may be required, such as delay in start-up insurance, terrorism insurance and marine cargo insurance. Where there is a key risk, for example terrorism and sabotage cover, for which lenders require insurance cover, but it is not available or prohibitively costly, the host government may agree to insure against the risk to assist with bankability.

In addition to the insurances being maintained, lenders will require certain measures to be taken in connection with them.



#### For example they may:

- i. Require to be named on the policies as a co-insured party.
- ii. Require to be named as co-loss payee (or sole loss payee).
- iii. Require the insurance policy to include endorsement wording noting the interest of the lenders in the insurance proceeds.

The above requirements will be supplemented in the financing agreements with detailed provisions setting out how proceeds of insurance claims are to be applied, i.e. in early repayment of the loan, reinstatement of the facility or otherwise, and the lenders will also take a security assignment over the policies (if permitted) and the proceeds of insurance.

#### k. Liability caps

Contractors typically seek to limit their liability under the construction contract to the greatest extent possible. The lenders, of course, want to maximise the potential liability of the contractor as a means of protecting the creditworthiness of the project company, which is the beneficiary of claims under the contract.

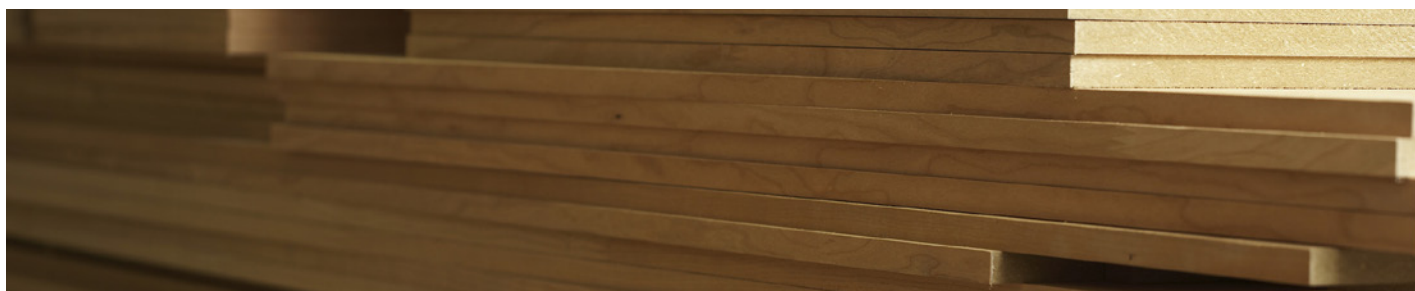
A common outcome in these negotiations is that the parties will agree to limit the contractor's liability to an amount that represents a certain percentage of the value of the contract. While the amount of the cap is open to negotiation, a typical EPC contract may include a cap of 100 per cent of the contract value. Within this overall cap there are usually sub-caps limiting the amount of delay liquidated damages and performance liquidated damages. The cap will be subject to certain exceptions which operate on an uncapped basis. These include liability for death/injury, third party liability, where gross negligence or wilful misconduct has occurred on the part of the contractor or where the contractor has failed to pass clear title to assets to the project company.

#### l. Ground risk

The three main ways ground risk is allocated in concession-based projects are:

- i. Contractor is responsible for ground risk.
- ii. Grantor is responsible for ground risks.
- iii. Contractor is responsible for ground risk, except in the case of unforeseeable risks.

The allocation of ground risk is usually driven by what (if any) ground risk the grantor is prepared to accept, which varies significantly from region to region. The third option mentioned above (contractor is responsible for ground risk, subject to unforeseeable risks) is generally considered a fair and practical approach. The procurer of the project will often undertake feasibility studies on the project site and enable the project company to rely on them. Alternatively, the project company/sponsors will be permitted to conduct their own feasibility studies before they submit their bid for the project. In both cases, it is generally accepted that there are certain ground risks which will not be foreseeable regardless of the extent of any feasibility studies undertaken prior to construction commencement. The usual position is that, where unforeseeable risks are realised, the contractor under the construction contract (and the project company under the concession agreement) will be given time relief, i.e. by way of an extension on time for completion. Of course, the concept of whether something is "foreseeable" can be very subjective so considerable challenges can be faced in ensuring that extensive feasibility studies are carried out to avoid "unforeseeable" risks being



encountered and the contractor simply relying on “unforeseeability” as a fail-safe.

Any costs involved in remedying unforeseen risks are usually borne by the grantor (often on a deferred basis).

### **m. Consents**

PPP projects rely to varying extents on legal/regulatory consents and permits being issued by governmental authorities of the jurisdiction where the project is being undertaken. Failure of the consents to be in place can have dire consequences for the project and the key stakeholders, i.e. if it means the facility must cease or suspend operation or additional expenses are to be incurred.

Given the above, obtaining the required consents for the entire project is a condition precedent to financing being made available, i.e. lenders are unwilling to fund (or sign off on the construction contract) until and unless they are comfortable that the required consents are in place.

In addition to the condition precedent requirement, lenders will usually require that consents are transferable from one party to another (in the event the project needs to be restructured) and that scope of the consent cannot be varied.

Responsibility for obtaining consents generally falls squarely on the project company. However, given the nature of PPP projects, it is common for the concession agreement (or an implementation agreement signed by sponsors and the host government) to include assurances or assistance

obligations on the part of the government in obtaining the required consents.

### **n. Termination and the role of direct agreements**

The project company will ordinarily be permitted to terminate the construction contract following the occurrence of any of the pre-agreed termination events. The right to terminate will typically be subject to a cure period in favour of the contractor, although the most serious termination events may not be subject to such cure period.

Termination by the project company is very much a remedy of last resort and generally only comes about where there have been serious failures on the part of the contractor. The scale and nature of infrastructure projects are such that the common interest is for construction to be completed by the incumbent contractor. From the project company’s perspective, replacement of the contractor will likely lead to increased costs and time. From the contractor’s perspective, hefty financial penalties will likely ensue where the contract has to be terminated for a “contractor fault” termination event.

Separate from project company termination rights there are also circumstances in which the contract can be terminated by the contractor. Termination by the contractor can have dire consequences for the project generally, and, in the case of lenders, their ability to be repaid is jeopardised. A key tool lenders employ to protect against this is entry into a construction direct

agreement, which (similar to the direct agreements that lenders will seek to enter into with other major parties involved in the project) is a tripartite agreement between the lenders, the project company and the contractor. Its purpose is to protect the lenders against the loss of their investment if the project company defaults under the construction contract. Direct agreements can be very complex in nature; however, their main function is to permit the lenders to step in and cure any defaults made by the project company under the contract (to prevent termination by the contractor) or to step into the project entirely in replacement of the project company (usually through a lender-controlled company) to ensure that the facility gets completed.

Agreeing to enter into a direct agreement is a considerable undertaking for a contractor. Over time, however, contractors have become accustomed to direct agreements as they are a firm requirement of lenders and failure to have direct agreements will almost certainly render the project not bankable.

### **o. Rejection**

Since lenders will only receive a return on their investment from the project revenues, they will be particularly concerned about the possibility that the project may be cancelled because of a failure by the construction contractor to complete the works. To protect against this, lenders will often insist on the project company having a right to “reject” the works

and recover all sums paid to the contractor throughout the project in the event that the contractor does not complete the works and achieve the minimum performance guarantees by a specified long-stop date, or otherwise causes a cancellation of the project. The lenders will then be able to enforce their security and use these rejection payments to repay their debt. While in practice it is almost unheard of for a rejection right to be invoked on a major project, the inclusion of such a clause is sometimes a very contentious issue for contractors because of the huge financial exposure involved.

## Conclusion

It is without doubt that interest in the PPP model will continue to grow rapidly, particularly in emerging markets such as many in the Middle East that have long relied on government balance sheets to fund infrastructure needs. Conceptually the PPP model makes for a win-win situation for all the key project stakeholders.

As a consequence, many projects are enthusiastically pursued on an accelerated or 'fast-track' basis. However, those looking to participate in PPPs will need to ensure that the process of risk identification, allocation and mitigation is as thorough and robust as ever. More investment in this stage of the procurement process can prove invaluable many years into the life of the project. However, many have been and continue to be caught short for failure to devote adequate time and resources to the process, leading to lengthy and costly disputes between parties arising.

In most large scale projects, construction risks will be one of, if not the key risk that lenders and sponsors will focus on. The lenders' position in relation to these risks is of critical importance, as the parties need to find bankable solutions to construction risk allocation in order for financing for the project to be made available. This requires the contractors and sponsors to clearly understand the lenders'

requirements when it comes to construction risk allocation – failure to do so has been one of the reasons why many PPP projects have taken far longer to reach financial close than intended.

Experienced contractors with track records of successful completion of large scale projects will always find favour with project lenders. However, even with experienced contractors, if lenders see weaknesses in the construction arrangements and how construction risks have been allocated, they will look to the shareholders/sponsors to step in and cover these risks. Of course, the more guarantees the shareholders/sponsors have to give, the less attractive the project financing model becomes for them. Ultimately, there is a fundamental balance to be achieved between risk and reward.

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