
Construction risks, delivery structures and risk mitigants from a financier's perspective

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1 'Bankability' – a dynamic concept

- (a) In any project financing, recourse for repayment of debt is limited principally to the project's revenue stream. Accordingly, the financiers stand to lose substantially if the project fails. Before committing funds to a project, financiers will, therefore, thoroughly review the project structure, including all risks involved in the project.
- (b) "Bankability" is a term commonly used to describe the suitability of a project's structure for project financing. Given that each project will have its own particular risks and requirements, it is not possible to universally define a concept of the project structure necessary to achieve bankability. It is a dynamic concept that is constantly evolving as market practice changes.
- (c) Bankability may also be dependent on the particular financiers involved; some financiers are more risk averse than others. Also, financiers may not perform an exhaustive review of all risks associated with a project's structure, due to time and financial constraints, and may commit themselves to a project based on their perception of the market and the reputation of the project sponsors and other parties involved.
- (d) However, in almost all cases, financiers will pay close attention to the project documents and the parties relating to both the construction and operation phases of the project, to ensure they satisfy a risk profile that the financiers require for the project to be bankable.
- (e) A project's construction phase is the most difficult to secure against, given that the risk of completion of construction is key to the success of the project and, after the commencement of construction, the amount at risk increases rapidly as the financiers advance funds. For this reason, financiers take great interest in the risks associated with the construction phase of a project.
- (f) This paper focuses on the key risks that will be of primary importance to financiers in respect of a project's construction phase, in particular, the allocation of risks under the construction contract. It also addresses the types of guarantees and undertakings normally required of the construction contractor as additional credit support during the construction phase to ensure a bankable project.

2 Construction contracts and the key issues for financiers

2.1 Cost overruns

- (a) In any project financing, one of the key concerns for financiers is the cost of construction of the works being greater than originally estimated. Obviously, if the assumed cost of the project is exceeded, this could jeopardise the ability of the project's revenue to cover operating costs and service debt.

- (b) Financiers will require a large part of the risk of cost overruns to be allocated to a construction contractor under a fixed price construction contract. The effect of this being that any increase in the cost of construction resulting from such risks will be to the account of the construction contractor.
- (c) Under the construction contract, the financiers will expect the construction contractor to be responsible for:
 - (1) the design and construction of the works;
 - (2) completion of the works in accordance with the specification and performance criteria required by the construction contract; and
 - (3) completion of the works within a specified time.
- (d) Only in limited circumstances will the financiers allow the project company to retain cost overrun risk.
- (e) This is in contrast to general principles of risk allocation that attempt to strike a “fair and balanced” allocation of risks between the project company and construction contractor. Many standard form contracts adopt such an approach. However, from the financiers’ perspective, this allocation of risk does not provide sufficient price certainty for the project and is not one that financiers are normally prepared to lend to. If standard forms are to be used for a project financing, financiers expect to see significant amendments to limit the grounds for price adjustment and extensions of time for the construction contractor’s completion obligations.
- (f) Nonetheless, project companies and contractors are developing ways to share more cost overrun risk and structure the risk sharing mechanisms in ways that are acceptable to financiers. These risks are normally of low magnitude, but are ones that are likely to eventuate and cannot be priced by the construction contractor in a way that provides “value for money” for the project. An example of an approach for dealing with such risks is to make provisional allowances in the fixed price contract sum that are only payable if the risks eventuate and that act as a limit on the project company’s liability in respect of such risks. By treating such allowances as a cap on the project company’s liability, financiers are more likely to allow the project company to bear such risks, since it provides sufficient price certainty to enable the financiers to establish if there is adequate contingency for such risks in the project’s financial model, or if the project company has the capacity to fund these risks by additional equity contributions or other means if, and when, they arise.
- (g) Financiers will also control cost overrun risk by ensuring that the advance of funds during the construction phase is conditional upon their own technical advisers certifying that progress payments to the construction contractor are properly due and payable and that there are sufficient funds to complete construction (commonly referred to as a “cost to complete” assessment). In contrast, under the construction contract the contractor’s payment claims are normally assessed by an independent certifier on a “value of works” basis. The effect of this difference in assessment methods could, theoretically, create a funding “gap” for the project company where there are cost overruns encountered by the contractor and the “cost to complete” construction is greater than the un-drawn amounts under the

loan. Despite the difference in assessment methods, normally the financiers' technical adviser and the independent certifier responsible for assessing progress claims under the construction contract consult with each other prior to issuing their respective certificates to ensure that no such gap is created. However, construction contractors are alive to this potential "conflict" and are increasingly requiring measures be put in place to ensure the independence of the financiers' technical adviser and the independent certifier.

2.2 Design and construction

- (a) Ordinarily, for a construction contract to be bankable, the contractor will be expected to warrant that:
 - (1) it will develop the design documentation in accordance with the specification and performance criteria required by the construction contract;
 - (2) the design documentation will be fit for purpose; and
 - (3) if the design is defective, it will be responsible for making the design and the project work within the terms of the fixed price contract (thus creating a single point of responsibility for the design and construction of the works).
- (b) If the project company bears the design risk, any additional work required to overcome deficiencies in the design documentation will result in additional costs to the project and will not be covered by the contractor's fixed price. For this reason, many financiers insist on the allocation of responsibility of both the design and construction of the works to the contractor (especially where complex design and construction is involved).
- (c) However, in recent years, some financiers' attitudes to such risks have shifted. In one particular project involving civil works, the financier allowed the project company to retain design risk, partly because:
 - (1) the design was complete;
 - (2) the design had been "tried and tested" on a similar project;
 - (3) the same contractor was involved in the earlier project (and, therefore, presumably had a thorough understanding of the design); and
 - (4) the contractor agreed to accept all site condition risk.
- (d) The financiers were also influenced by the fact that:
 - (1) the contractor would not accept a transfer of the design risk (effected through a novation of the project company's design consultants) without a significant risk premium built into its construction price; and
 - (2) the sponsors of the project were long-standing customers of the financier and were not receptive to such a risk premium.
- (e) In another similar project, the financiers allowed the project company to retain design risk on the condition that the key design consultants (namely, structural, architectural and services) entered into direct agreements with the financiers to ensure the financiers had sufficient "step-in" rights in the event of default by the project company to keep the consultant agreements

on foot and the project alive (see discussion below at section 3.2 on direct agreements). Other factors influencing the financiers' decision were:

- (1) the design was not overly complex;
 - (2) the project company was reluctant to pay a premium for the novation of the design risk to the construction contractor (which was one of the proposals initially floated by the financiers);
 - (3) the reputation of the project sponsors; and
 - (4) at the time of the project, there were not many projects of a similar nature in the "deal pipeline" for financiers to lend to.
- (f) It is important to note, however, that it would be extremely unlikely (in similar circumstances) for a financier to allow design risk to be retained by a project company where the revenue stream for the project is dependent on the achievement of certain levels of performance (for example, power stations or other industrial plant). Similarly, where the project involves a government concession for the project company to design, construct and operate the project for a specified period, the financiers will expect the design and construction risk to be passed through to the construction contractor.
- (g) However, there have been examples of mechanical and process engineering projects where financiers have not insisted on a single point of responsibility for the design and construction of the works. In a recent project involving the engineering, procurement and construction of a gas-fired power station, the financiers allowed the project company to let separate fixed price "turnkey" construction contracts for two integral components of the power station: one being the main plant, and the other being the gas pipeline necessary to fuel the power station. The financiers, however, allowed the project company to retain the integration risk of managing the two separate contracts, primarily on the basis that the target completion date for the gas pipeline was significantly earlier than the target completion date for the main plant. There were also strict coordination and integration obligations imposed on the two construction contractors.

2.3 Completion and performance

- (a) Financiers will require the construction contract to clearly define when the project will be complete.
- (b) In respect of construction contracts involving mechanical or process engineering works, the risk of completion is generally assessed by including performance criteria in the construction contract and a requirement for the works to pass specified performance tests demonstrating that the works meet such performance criteria.
- (c) If the works fail such tests, the construction contractor will normally be exposed to performance liquidated damages, which are calculated by reference to the results of the performance tests (the rationale for performance liquidated damages being that where the contractor has delivered a substandard plant that does not meet the performance criteria, the project company has overpaid and requires a rebate on the construction price).

- (d) It is not uncommon for the contractor's liability to pay performance liquidated damages to be subject to a cap. Financiers will normally insist on the right to reject the non-complying works if that cap is reached.

2.4 Time

- (a) The completion of a project on time, and the risk of late completion, will be an extremely sensitive issue for financiers.
- (b) If completion of the project is delayed, the revenue stream will also be delayed. At the same time, interest on the debt continues to run, resulting in an increase in the cost of the project. The delay to the project may also impact on supply and off-take arrangements.
- (c) Given the potential impact of late completion, financiers will require a large part of late completion risk to be borne and managed by the construction contractor. However, as a general rule, the construction contract must allow the contractor to claim extensions of time for delays to the progress of the works caused by the project company (commonly referred to as "acts of prevention"). This is necessary to ensure the enforceability of the liquidated damages regime.
- (d) It is also commonly accepted in project finance transactions that the construction contractor will not be responsible for delays caused by "force majeure" events (which typically include events such as war, strikes and other industrial action, not caused by the contractor, riots and blockades).
- (e) Financiers may also be prepared to allow the contractor extensions of time for other "neutral" events (that is, causes of delay outside the control of both parties) where the financiers can satisfy themselves through their due diligence process to allow the project company to bear such risks, or that such risks are not material. (For example, the financiers may be prepared to allow the project company to take certain site condition risk, where they can be satisfied that, through appropriate site condition investigations and reports, the risk is low.)

2.5 Late completion and liquidated damages

- (a) In the event of late completion resulting from delays in respect of which the contractor is not entitled to an extension of time, financiers will insist on liquidated damages, being imposed on the contractor, which represent a genuine pre-estimate of the damage likely to be suffered by the project company arising from the contractor's late completion.
- (b) Such pre-estimate of damages should include holding costs and damages imposed by suppliers and off-takers, damages payable under any concession agreement and debt servicing costs.
- (c) Construction contracts often provide that for each day completion is delayed beyond the contractual date for completion, the contractor must pay liquidated damages calculated based on a daily rate. This amount is normally payable on demand or capable of being set off against future payments to be made by the project company to the contractor.
- (d) For more complex construction projects, the construction contractor will normally require a cap on its liquidated damages liability (generally in the range of 10% to 20% of the construction price). Financiers often insist on

the construction contract including termination rights for the project company where the cap has been reached.

2.6 Limitation of the contractor's liability

- (a) In addition to limitations on liability to pay liquidated damages, construction contractors will often seek to limit their overall liability under the construction contract. This limit normally takes the form of:
 - (1) an aggregate limitation of liability (normally no less than an amount equal to 100% of the construction price, although there are exceptions, in particular with high value projects (\$1 billion plus) where the aggregate limitation on liability can be in the range of 50% to 70% of the construction price); and
 - (2) an exclusion of liability for economic and consequential loss.
- (b) Generally, financiers will want to ensure that the limitations and exclusions of the contractor's liability are sufficient to satisfy the risks that the contractor has accepted under the construction contract. Financiers will also give careful consideration to the extent of the contractor's liability on termination for a default by the construction contractor and the potential cost of having to engage a replacement contractor to complete construction.
- (c) Financiers will normally expect that the limitation and exclusion of liability will not apply, to the extent that such amounts are recoverable under the project insurances, or in respect of liability arising out of the fraudulent misconduct or gross negligence of the contractor. The exclusion of liability should also have no application, to the extent that the amounts contemplated by the liquidated damages amounts can be construed to cover consequential or economic loss.
- (d) Another issue that requires careful consideration by financiers is the impact of proportionate liability legislation on the liability of the construction contractor. Proportionate liability legislation has the effect of limiting a party's liability to its proportionate share of responsibility for a claimed loss or liability. Thus, by relying on this legislation, a construction contractor may effectively limit its liability in respect of a particular breach of the construction contract by pointing to its subcontractors as being proportionately responsible.
- (e) In some jurisdictions (namely, Queensland, Western Australia and Tasmania), the application of such legislation can be excluded by express contractual provision. However, in other jurisdictions, the parties cannot contract out of the relevant legislation (although, it may be acceptable, through careful drafting, to circumvent the effects of the legislation).

3 Construction contractor's security

3.1 Forms of construction contractor's security

One of the essential requirements for a successful project financing, is the provision of guarantees and undertakings from various parties (including the project company and the construction contractor) sufficient to secure the project's revenue stream. In addition to the usual forms of security provided by the project

company (such as fixed and floating charges), the financiers will require from the construction contractor:

- (a) a direct agreement with the construction contractor (that essentially provides the financiers with “cure” and “step-in” rights in the event of default by the project company under the construction contract, to ensure that the construction contractor continues to perform its obligations while the financiers decide what they wish to do with the project (including the right to sell the project as a going concern to a third party purchaser and repay themselves out of the sale proceeds));
- (b) retention money or bank undertakings to secure the performance of the contractor’s obligations under the construction contract (including defective work); and
- (c) guarantees from the construction contractor’s parent company (in particular, where the financiers have concerns over the credit risk of the construction contractor).

3.2 Construction contractor’s direct agreement

- (a) As mentioned above, the main purpose of a contractor’s direct agreement is to provide the financiers with “cure” or “step-in” rights in the event of default by the project company under the construction contract, to ensure the construction contract remains “on foot” and design and construction responsibility does not fall back on the project company, as a result of the construction contractor’s termination of the construction contract.
- (b) Under a “step-in” regime, the financiers will require the contractor’s rights of termination to be suspended for a limited period, until the financiers determine whether or not they intend to cure the project company’s default (which may include taking over the project themselves, appointing a receiver over the project company or selling the project).
- (c) Without such a regime, the risk is that the construction contractor will terminate the construction contract, resulting in delay to the project and the passing back of risks to the project company that it is not in a position to manage.
- (d) The contractor’s direct agreement will include the project company as a party. This is necessary to ensure that, in a “step-in” scenario, the project company will be bound by any assumption of the project company’s rights and obligations by a third party purchaser of the project (which is given effect to through a novation of the construction contract to the third party purchaser). The direct agreement will also include the construction contractor’s consent to the exercise of the financiers’ rights upon step-in, and to a potential novation of the construction contract to a third party purchaser.
- (e) Where the financiers step-in and take over the project themselves, or appoint a receiver or other entity controlled by the financiers (as opposed to selling the project), the direct agreement will normally provide that the financiers, the receiver or other controlled entity (as the case may be) will be responsible for the performance of the obligations of the project company during the step-in period. However, the project company will not be relieved of its obligations under the construction contract by reason of the step-in and, upon the financiers stepping-out or the step-in period

coming to an end (other than by the financiers electing to sell the project), the project and the remaining unperformed obligations will be passed back to the project company.

- (f) Given that by entering into a direct agreement the construction contractor is effectively being asked to weaken its position under the construction contract (which it has already negotiated with the project company), direct agreements do meet some resistance, particularly from construction contractors that are new to project and construction finance dealings. However, contractors are increasingly becoming aware of the benefits of having someone who may continue to comply with the obligations owed to them and who will look for ways in which to keep the project alive and contractors will use this leverage to their advantage to seek undertakings from financiers in respect of payment and other obligations of the project company in a step-in scenario. Contractors with experience in project and construction finance transactions also know that, without a direct agreement, financiers will not be prepared to lend to the project.

3.3 Retention money and undertakings from financial institutions

- (a) The project company and the financiers will require either cash security (normally retained as a certain percentage of each payment made to the construction contractor, and commonly known as "retention money") or a bond or undertaking from a third party financial institution (or sometimes a combination of both) to cover any losses suffered, or expenses incurred, by the project company in the event of the default or insolvency of the construction contractor.
- (b) The amount of such security is a matter of negotiation, however, it will often be shaped by the risk profile of the project. Generally, for projects involving civil engineering work, security in the range of 5% to 10% of the construction price will be required and, for projects involving mechanical or process engineering work, usually 15% to 25%.
- (c) The security is released, in part, (usually half) on completion of the construction work, with the balance released after the end of the defects liability period (which normally runs for 12 months after completion).
- (d) In respect of retention money, financiers will normally require this money to be kept separately in a bank account and charged to them as part of their security. However, most financiers prefer the contractor's security to be provided in the form of a bank guarantee or bond, which ensures that the full amount of the security is provided up front (as opposed to progressively retained during the construction phase). This form of security also suits most contractors, since they prefer to receive all progress payments as soon as possible, to ensure they can meet their cash flow requirements. However, some contractors will push for retention money as the preferred form of contractor security, particularly where the contractor is only able to obtain a bank guarantee or bond that is required to be supported by "cash at bank" (thus, negating the "cash flow" benefits of providing a bank guarantee or bond).
- (e) Financiers will pay close attention to the form of bank guarantees or bonds, and normally insist on the following requirements:
 - (1) The bank guarantee or bond must be unconditional. In other words, the non-performance of the construction contractor's obligation

should not be a precondition to the activation of such security, otherwise the issuing financial institution would have to enquire into the merits of the project company's claim that they are entitled to the money. The issuing financial institution's payment obligation is separate and distinct from the construction contractor's obligations under the construction contract and, therefore, should be triggered by simply presenting the document containing the undertaking. Financiers will also normally require the construction contract to provide for the ability of the project company to draw on such security without having to prove a default by the construction contractor, or the amount of the loss suffered by the project company. Financiers are moving away from insurance bonds as an acceptable form of security (notwithstanding that they may be unconditional in nature) on the basis that there is usually a delay in receiving payment (normally 3 days) from the time the bond is presented to the issuing financial institution for payment.

- (2) The bank guarantee or bond must be valid and irrevocable until it is returned in accordance with the construction contract. However, sometimes construction contractors will offer such security with an expiry date (usually on the basis that it is less costly than bank guarantees or bonds that remain valid for an indefinite period). This will normally be acceptable to financiers provided the contractor agrees to replace the security within a limited period prior to the expiry date (except of course where the security has already been returned to the contractor under the construction contract) and the project company is entitled to draw on the full value of the security (and hold the drawn funds as cash security) if the contractor does not comply with such replacement obligation .
 - (3) The bank guarantee or bond must be capable of assignment to the financiers in the event that it "steps-in" to the construction contract.
- (f) Financiers will also usually require the contractor to provide an "advance payment" bond where the contractor is paid an amount that exceeds the value of the work performed (normally in the initial stages of the construction contract, to assist the contractor to mobilise on site). The amount of the bond will be for the amount of the advance payment, and normally reduces progressively as the contractor "catches up". This bond will allow the project company to recover the amount it has overpaid to the contractor, in the event that the construction contract is terminated before the contractor has performed the work that is the subject of the advance payment.
- (g) Where the construction contract entitles the contractor to claim payment for unfixed plant and materials, financiers will require the contractor to provide, as a precondition to payment, a bank guarantee or bond (normally, for an amount equal to the value of the unfixed plant and material the subject of the payment claim) to guard against the risk of such plant being seized by the contractor's creditors, in the event of the contractor's insolvency. In such circumstances, the bank guarantee or bond can be used by the project company to either directly pay the creditor for the return of the seized unfixed plant and materials, or to reorder such plant and materials from an alternative source.

3.4 Parent company guarantees

- (a) Where the construction contractor is a subsidiary in a corporate group, financiers will normally insist on the provision of a guarantee from the construction contractor's parent company (in particular, where there is concern regarding the credit risk of the construction contractor, or where the expertise or technology to be utilised for the project is held by the parent company).
- (b) A parent company guarantee will include an undertaking by the construction contractor's parent company, in favour of the project company, to perform the obligations of the construction contractor under the construction contract.
- (c) However, a guarantee alone will not offer any protection for the financiers or the project company where, for whatever reason, the obligations of the contractor under the construction contract are unenforceable, illegal or invalid. For this reason, financiers and the project company will also require the parent company guarantee to include an indemnity from the parent company in respect of the contractor's non-performance of its obligations. This indemnity creates a primary obligation in favour of the project company and is independent of the underlying construction contract (which means that if there is a problem with the enforceability or validity of the construction contract, the project company would still be able to recover under the indemnity for the contractor's failure to perform).

4 Conclusion

- (a) A clear understanding of financiers' attitudes to construction phase risk is important for a project company when drafting and attempting to negotiate a "bankable" construction contract. As demonstrated in this paper, financiers will pay close attention to the construction contract given that the risk of completion of construction is paramount to the project's success, and financiers stand to lose substantial amounts of money if completion is not achieved.
- (b) This paper has explored some of the key issues of primary importance to financiers in the allocation of risks under the construction contract. It has also considered the types of guarantees and undertakings that financiers normally expect of the construction contractor to ensure a bankable project.
- (c) However, this paper, has also highlighted that "bankability" is not an exact science. Nonetheless, being cognisant of the key concerns for financiers is essential in delivering a project structure necessary to achieve bankability.