

Early planning in awarding project contracts for international mining projects

Completion risks

On mining projects whose development is funded through limited recourse finance, there is a focus by lending banks on the key project completion risks of:

- Time to Completion
- Cost of Completion
- Performance of completed works

The simple reason for this is that the nature of the project finance means that it is the project, rather than the project sponsor/borrower, which is the means of servicing and ultimately repaying the debt. This in turn leads to a focus on the key completion risks referred to above; each one will impact the ability of the project to repay the finance.

The same considerations should be of equal importance to the project sponsor. However, in the rush to meet aggressive project timetables, project sponsors frequently proceed with the letting of key project contracts without sufficient regard to the key completion risks. The inevitable result is that the project contracts require retro-fitting to suit the requirements of lending banks for the project financing stage. This is an expensive process, involving many hours in re-drafting and re-negotiating numerous project contracts. Also and by this stage, there is very little commercial leverage over the incumbent contractors. The good news is that this is a problem that can be avoided.

A checklist for compliant projects

In order properly to identify the factors likely to impact these completion risks, project sponsors should focus early in the development of the procurement and contracting strategies for the project. This involves identifying the likely causes of cost and time overruns as well as factors that may impair eventual plant performance and efficiency. Matters to consider include the extent and impact of local site and sub-soil conditions, responsibility for the integrity and reliability of site condition data provided to the contractor and the impact of local weather systems. Also of key importance is the cost reimbursement mechanism under the contract (e.g. fixed price, lump sum or remeasurable according to the quantity of works undertaken, measured against rates in Bills of Quantity?). Other matters to be considered include the liabilities that will be covered by insurance, what liabilities might be excluded and at what level will any liabilities be capped. Complications also arise where the insurance programme for the project (determining what insurances are required, at what levels and by whom) has not yet been finalised at the point of early contract award. Also of critical importance is the extent to which the design and extent of the works is known and accurately scoped and specified. This level of specificity will determine the extent to which the sponsor can predict the final outturn cost of the works.

At Mayer Brown, we have developed checklists against which to assess the “bankability” of project contracts on international mining projects. These checklists focus on the issues outlined above and enable our sponsor and lender clients to gain a good appreciation of the risk profile of each project.

Other “standard” project finance requirements

The early award of project contracts, without proper consideration of the ultimate financial requirements, also frequently requires retro-fitting terms to contracts to accommodate other “standard” project finance features. In particular, provisions need to be added to cover the following points (all of which are market practice and none of which should be too controversial provided they are raised early on when placing tenders in the contracting market):

1. Impose an obligation on the EPCM Contractor and other key Contractors to enter into a Direct Agreement with the bank.
2. Introduction of obligations on contractor to provide all necessary assistance to the sponsor in respect of financing documents.
3. Recognising the role of the bank’s engineer including providing access and audit rights.

- 4 Provide an obligation on the Contractor to perform its obligations so as not to cause or contribute to any breach by the sponsor of its obligations pursuant to other identified project contracts, backed up with an indemnity to cover for any such breach.
- 5 Remember to allow for any export finance requirements requiring the Contractor to consult with the sponsor before placing orders for any goods that have long lead procurement or delivery times and generally design, procure, transport, execute and complete the Works in accordance with the terms of any export finance requirements.

Benefits of pre-planning

Project sponsors (and their advisors) should do well to ensure that in preparing invitations to tender, the project contracts include provisions addressing the key completion risks as well as the standard project finance requirements referred to above.

This will help the project by assuring outturn in accordance with the financial model, so preserving the rate of return on investment required by the project sponsor (and helping to assure the ability of the project to service and repay debt to lending banks).

However, despite the importance of these commercial issues, it is our experience that more often than not, the necessary terms and conditions are not addressed in early award contracts. We encounter this where acting for the project sponsor as well as where acting for the lending banks. Whilst as sponsor's counsel (if involved early enough) we have the ability to influence the terms on which key project contracts are placed before the terms are finalised, we do not have the same degree of fore-warning when advising lending banks. One way to characterise our role is that of being the crash barrier at the top of the mine pit (when involved early enough) or the ambulance at the bottom, if involved later (with the necessary advice to stitch the project contracts back into a bankable and robust form). Clearly, it is better to prevent the accident rather than treat the victim.

Those project contracts that we find at the base of the pit tend to be characterised by project contracts which have been placed on terms.

- with inadequate definition of scope
- with inadequate control over key completion risks
- without regard for key project finance requirements including Direct Agreements with banks.

In these cases (in order to satisfy project finance requirements and for the good of the project) it is necessary to extensively amend existing contracts, and then seek to negotiate the revised terms with the incumbent contractors.

A few simple steps taken early can save a significant cost later. We would estimate the value ratio leverage is in the region of at least 1:5; spending US\$10,000 at the front end on good quality guidance can save US\$50,000 on avoiding the retro-fitting exercise referred to above.

Checklists are important, as is experience which informs judgment as to risk. However, early engagement with the project sponsor is key. This allows for informed development of the procurement and contracting strategy for the project. Such a process is an investment with a pay-back ratio that would interest most sponsors and assist in the streamlining of the subsequent project financing.

This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The following is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein.

© 2008. Mayer Brown LLP, Mayer Brown International LLP, and/or JSM. All rights reserved.

Mayer Brown is a global legal services organisation comprising legal practices that are separate entities ("Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP, a limited liability partnership established in the United States; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales; and JSM, a Hong Kong partnership, and its associated entities in Asia. The Mayer Brown Practices are known as Mayer Brown JSM in Asia.