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Project Contracts in Uncertain Times

Introduction

The current economic downturn presents particular challenges to those involved in the development of natural resource projects. This economic landscape is defined by a collapse in mineral and metals prices (subject only to certain precious metals such as gold bucking the trend), leading to the moth-balling or termination of intended projects as mining companies seek to reduce capital expenditure. For those projects that remain on the route to development (and particularly those dependent on external project finance), sponsors face a series of challenges to keep their project cost model whole and sufficiently robust to verify the ability of the project to repay debt and provide shareholder returns.

A whole host of factors impact the financial model and those factors have become more acute with the current economic climate. Obviously, the target price of the mine's output (be it gold, copper, nickel, coal or iron ore) is key. Hedging the risk of the market off-take price will usually be part of the financing arrangements, along with some export credit financing and political risk insurance, perhaps underpinned by some degree of sponsor guarantee. But what of the cost of completing the development itself and how about assuring the time it takes to complete the project and ensuring the output meets the minimum range required by the financial model for the project? This is where the project contracts come into play.

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In the current uncertain economic times, setting the design and construction of a mining project on a proper footing is arguably all the more important. Consideration of the most beneficial procurement route together with ensuring flexibility in contracting arrangements could mean the difference between a project which can be brought to market and one that remains unexploited. In this article we take a look at some options available to the project sponsor at the outset of the project (and to be considered by those who may be providing finance) and then explore a number of factors which can provide a degree of flexibility in the way in which the parties operate during the construction phase.

Procurement

In recent times, debate regarding procurement has centred on EPC (Engineering, Procurement and Construction) versus EPCM (Engineering, Procurement and Construction Management) arrangements. The key differences between the two can be summarised as follows:

- EPC: the appointment of one contractor under a fixed price (lump sum) agreement where the key project risks (time, cost and quality) are generally transferred to the EPC contractor. Any equipment vendors or construction contractors are engaged directly by the EPC contractor but the EPC contractor is responsible for their deliveries. This creates a single point of responsibility from the EPC contractor to the project sponsor. If there is a cost or time overrun or the plant fails to achieve its designed output, all those events can jeopardise the financial model. However, allocating responsibility to a single EPC contractor with clear remedies and an ability to obtain redress is seen as an attractive option, both to project sponsors and those providing debt finance.
- EPCM: the contractor is responsible for elements of the engineering and procurement along with the management of the construction of the project. The construction itself (and any other engineering and procurement) is undertaken by separate contractors engaged directly by the project sponsor. The project sponsor has rights of recourse direct to those providing the works but it does not get a complete assurance 'wrap' from the EPCM contractor. The EPCM contractor is generally paid based on the number of hours it has properly expended in carrying out its services. Although it may remain responsible for any delays and associated costs that may be caused through its engineering or procurement activities, the EPCM contractor does not carry much risk.

With an overheated market, as we saw prior to the current economic downturn, it became increasingly difficult for project sponsors to find contractors willing to bid on an EPC basis and the procurement emphasis moved towards EPCM. It will be interesting to see whether, in light of the current economic conditions, there will be a swing back to EPC arrangements or the EPCM trend continues. Considering that a number of projects have now been successfully completed using EPCM contracting, has its worth been proven, or will sponsors now use the shift in market power to extract better terms from contractors? In our view, as between project sponsors and contractors, the balance of power has shifted; it is now a buyers' market.

In a climate where interest rates, inflation/deflation, the price of raw materials such as steel, oil and concrete and currency are in a state of flux, flexibility and cost control are likely to be key drivers for project sponsors in deciding the most appropriate procurement route.

Whilst in theoretical terms, EPC contracts might have achieved cost certainty in days gone by, in the current climate, could the flexibility of EPCM arrangements prove to be the more popular choice? For one thing, it seems that the contingency fee which an EPC contractor would seek to build into its price may mean the project sponsor could be paying above the odds for cost certainty at the outset. To avoid this, the project sponsor may seek to:

(a) re-allocate risks under an EPC arrangement such that these are carried (and managed) by the project sponsor; or

(b) appoint the contractor on a cost-plus fee basis, so as to reduce the risk premium otherwise payable.

Whilst these arrangements have the potential to lower the construction costs, true savings will only be realised where the project sponsor has available an experienced in-house project management team. For example, in the case of (a), this team will need to have the control and management systems in place to undertake those aspects of the development for which it retains responsibility for completing. For (b), the team will need to monitor the costs being claimed by the contractor.

In relation to the latter, it is also vital that the contract is clear from the outset as to the terms of payment such as: the categories of reimbursable cost (including agreed rates where applicable); the categories of cost deemed to be included in the management fee; the circumstances where costs will be disallowed; the cost controls that the contractor will be required to maintain; and the project sponsor's (and finance parties') rights of audit. Whether adopting the EPC or an EPCM procurement route, it may also be appropriate to incorporate some form of incentive arrangement, linked to outturn cost and time.[1] One approach is to establish a target whereby the contractor shares a proportion of the savings where the outturn cost or completion date is less or earlier than the target. The flipside of such arrangements entails the contractor sharing some of the pain where the outturn cost or time exceeds the target. This ensures that the contractor also has an interest in how the project is developed throughout the construction phase.

A WORD ON INCENTIVES

As alluded to above, if the contractor is engaged to undertake construction management services (as opposed to the actual construction) then it is unlikely to guarantee the total

1 Other metrics can also be used to incentivise required forms of behaviour such as health and safety (reduced number of accidents and man-days lost through injury) as well as for plant performance levels.

project outturn costs. It is therefore customary to provide for an incentive scheme in which the contractor is entitled to a bonus if the total construction outturn costs and time to completion are less than the budget construction costs. Again, this ensures that both the project sponsor and the contractor have similar goals in terms of the overall construction cost and schedule, together with some form of early warning system to assist management of the same.

However, there are different forms of incentive schemes; not all are configured around explicit targets. Some parties prefer reduced rates for the man hour costs, with a fixed fee for the profit element. In the event of cost or time overrun, the profit element remains fixed. In effect, this means that the EPCM contractor recovers its cost but earns no profit for the duration of the overrun. This can operate as a powerful incentive to make sure the project is completed on time. Given that delay postpones the commencement of revenue-earning operations, this is arguably a key metric for any incentive scheme.

Flexibility

In an economic downturn project sponsors are faced with a greater need to ensure flexibility in their contractual arrangements. For instance, there may be a need to vary, suspend or even stop either a specific contract or a number of contracts, particularly where contracts are let in advance of securing funding for the project. And even before a start is made, the choice of procurement route and whether to proceed on a limited basis or with a formal contract can have a big impact on ensuring overall project flexibility. We list below a number of factors which can influence that flexibility.

VARIATIONS

Most contracts will contain express provisions allowing the project sponsor to vary the scope of works of the contract. However, variation provisions can take a number of forms and in order to ensure maximum flexibility, consideration should be given to:

- including an appropriate mechanism to deal with requests for variations swiftly and with transparency as to cost and time implications;
- making sure the contractor does not have an unfettered right to object to variations whether in total or to variations over a certain value;
- making sure the contractor is obliged to carry out a variation which has been instructed notwithstanding that the cost or time implications of the variation remains to be agreed; and
- listing all of the events that may constitute a variation, including the postponement or re-sequencing of activities, supplementing or accelerating activities or omitting works altogether.

As noted, such express variation provisions may include the right to omit works. The question arises as to whether the project sponsor may, having omitted part of the works, give those works to another contractor (for a lower price, for example). The latter may expose the project sponsor to a claim for loss of profits from the original contractor unless the contract expressly allows omissions for such purposes and states that loss of profits are not recoverable. It should be noted that the FIDIC forms of contract (which are frequently encountered on mining projects) expressly state that "*a Variation shall not comprise the omission of any work which is to be carried out by others*". Project sponsors using the FIDIC forms may wish to consider removing this express prohibition and replace it with an express right.

SECTIONAL COMPLETION/PHASED WORKING

Where flexibility in terms of handover of part of the works is required, the contract may provide for completion of the works in sections with a separate start and completion date for each section. Further, the contract may include a mechanism whereby certain sections or phases are only to be undertaken at the option of the project sponsor. Whilst such provisions can be included in the contract, careful drafting is required to deal with issues such as interdependencies between the various sections, whether the contractor will be entitled to loss of profit if a particular section is not instructed, and how this impacts on any liquidated damages applicable to individual sections of the works.

FORCE MAJEURE

Force majeure is a civil law concept and has no decided meaning in common law jurisdictions such as England. It is therefore customary to define expressly what constitutes an event of "force majeure" in the contract.

In strained economic times, phrases such as "force majeure" are banded around with increased frequency in an attempt to excuse a party from its obligations under the contract. Force majeure is the occurrence of events outside the control of the parties and events of force majeure will relieve the affected party from its obligation to perform under the contract. However, is an unforeseen rise in raw material or equipment prices an event of force majeure? What about increased charges for skilled operatives or manpower labour shortages?

Generally speaking, an economic downturn or difficulty is not recognized as a force majeure event. There are many examples of cases in the Courts where parties have sought to invoke the protection of a force majeure clause because performance under a contract has become economically untenable due to a change in market forces, such as a marked increase in prices or a slowdown in demand. In such cases, the courts have consistently rejected invocation of force majeure, absent any contractual language including such economic circumstances.

SUSPENSION AND TERMINATION

Under English law, the project sponsor would not have a right to suspend progress of all or part of the work under a contract, unless the contract specifically provides for this.[2] Where such flexibility is required, it is important therefore to include in contracts

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2 The only exception would be a construction contract which is subject to the provisions of the Housing Grants, Construction and Regeneration Act 1996.

a right of the project sponsor to suspend progress of all or part of the work. However, careful consideration should be given before exercising such rights because the contractor is likely to be entitled to payment of costs associated with such suspension.

Moreover, contracts which include a right to suspend also customarily provide that if suspension lasts for a particular period then the contractor can request the employer to proceed and if it does not do so it can terminate the contract. Project sponsors should ensure the period is of sufficient length as not to have to make what could be a difficult commercial choice too soon.

In addition to the right to suspend, a project sponsor may look to terminate a particular contract. If the contractor is in default of its obligations, then the contract will invariably include a right of the project sponsor to terminate the contract. However, what is the position if the contractor is not in default and the project sponsor simply wishes to terminate the contract for its own convenience (or "at will")? Such clauses are commonplace in the United States and have become increasingly common in other jurisdictions. Under English law the project sponsor would not have the right to terminate the contract for convenience, unless the contract specifically provided for this. A suitable clause should therefore be included in the contract to allow for this increased flexibility. There is some judicial guidance in both the US and the UK on the parties' rights and obligations when it comes to termination for convenience. Similar to the position noted above with the right to omit works and give it to another contractor, express words would be required in the contract if the project sponsor is to terminate for convenience simply to give the works to another contractor. Similarly, absent an express right, the contractor would have a claim for damages for breach of contract which would include loss of profit on the omitted portion of the works. So whilst it is useful to include such a clause in the contract, care should be taken when operating the clause and commercial considerations (such as the degree of flexibility required by the project sponsor as against the risk allocated to the contractor) should be taken into account.

LETTERS OF INTENT

From a legal perspective, "letters of intent" or "limited notices to proceed" should generally be used as a last resort. A letter of intent can come in many forms but will, under English law, often constitute a binding, albeit short form, of contract if it specifies some basic obligations (to undertake certain works, in return for some remuneration and within a certain timeframe) and is not expressed as being subject to contract or otherwise conditional on some formal process. Notwithstanding this fact, it is recognised that often at the early stages of a mining development project where contract terms have not been fully articulated, letters of intent will be used in order to allow an early commencement of necessary activities, such as preliminary engineering or long lead procurement. It is ultimately a commercial decision to be taken by the project sponsor, weighing up the advantages and disadvantages of entering into such an arrangement.[3]

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3 For further details please read Jonathan Hosie's article 'Early planning in awarding project contracts'.

If a letter of intent is to be used, it should ideally reference expressly terms of the contract which have been agreed. This may be appropriate where the project sponsor is not in the position to commit to entering into the formal contract (e.g. for financial reasons) but wishes to start certain activities in order to maintain its anticipated programme. It could also be used when the project sponsor wishes the contractor to undertake a discrete part of the scope of the formal contract in advance of entering into the formal contract (e.g. to undertake initial design). Problems can occur, however, when a letter of intent is issued when the main commercial terms have not been agreed.

Concluding remarks

The market for international mining development projects has changed markedly over the course of the last 12 months. High commodity prices have largely collapsed and debt finance has become far more difficult to secure. This has led to a number of projects being moth-balled, down-sized or abandoned altogether. In turn, this has freed up the delivery resources (specialist contractors, equipment vendors, material suppliers and engineers) which is expected to have a deflating effect on development costs and to lead to a move away from the seller's market enjoyed by contractors and suppliers that was prevalent 12 months ago.

This changing economic landscape impacts each part of the project delivery process, be it the hedging strategies adopted to control exposure to falling prices for the off-take or the availability of political risk and other insurances. However, the centre of this process is the financial model, which is built on an assumption of the capital expenditure and time schedule for completion of the project. This leads to a more acute focus on the project contracts by which the sponsor develops its asset.

Flexibility is probably the key here; allowing the sponsor to move slower or faster, in a different sequence or to be able to moth-ball the project until the economics improve. However, with a number of financial analysts suggesting a surge in mineral and metals prices by Q3 of 2009, now may be a good time for ensuring your mining development is configured to take full advantage of the up-swing.

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