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Shifting Sands in the Economy and International Procurement Market

By Nick Henchie[1]

Recent economic events around the world have caused the delay or cancelling of many major infrastructure projects which, in turn, has led to a marked change in the relative bargaining positions of contractors and employers.[2] This sea-change comes on the back of the most favourable suppliers' market for many years, during which time suppliers and contractors strongly influenced the manner in which major projects were procured, leading to contractors adopting very risk adverse positions and, inevitably, an increase in the premiums that employers had to pay for engineering and construction services.

Of course, as acknowledged in the author's article in ICLR,[3] contractors would argue that the favourable economic conditions prevalent in recent years resulted in no more than a correction in the construction market so that the relatively high levels of risk which contractors had traditionally accepted in order to serve a role in major projects had, in recent years, been replaced with a fairer and more appropriate balance of risk and reward.

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2 In the AWCS/MEED Gulf Construction Outlook Survey (the "Survey") it was reported that amongst construction companies surveyed in February 2009, 87% have had one or more contracts cancelled or postponed in the last 3 months and 35% have had five or more contracts cancelled or postponed.

3 Nick Henchie and Philip Loots, "*Worlds Apart: EPC and EPCM Contracts: Risk Issues and Allocation*" [2007] 1 CLR 252.

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The purpose of this article is not to argue whether or not any particular balance of risk is right or wrong, but to indicate what issues seem, in the author's experience, to be influenced heavily by the prevailing economic conditions when it comes to the procurement of a major infrastructure project, and how some of these issues are being addressed in the present market, or might be addressed in the future.

Procurement method

For many years now the so-called fixed price lump sum turnkey approach has been a favoured procurement route for employers and funders of projects. There are many reasons for this, notwithstanding that employers and funders, particularly where lending is on a non-recourse basis, have acknowledged that a hefty premium will usually be paid to obtain the benefit of the single point of responsibility. Throughout the 1990s, and early in this decade, fixed priced, lump sum turnkey was the most common approach to the procurement of a major infrastructure project. However, during the boom years in construction (2002-2008), and particularly so in the overheated Middle Eastern market, a traditional fixed price EPC contract had become increasingly difficult to obtain. During this period, some of the well known and biggest EPC contractors, scarred from huge loss making ventures and expensive arbitrations on high profile projects, made a dramatic move away from fixed price turnkey, and focussed on an engineering and project management based approach, where some or all of the construction risk was taken by others. The author explained at length in his article[4] how for many projects, particularly in the mining and petrochemical sectors, the EPC model had been largely replaced with the EPCM model and variants on that. This was far removed from the EPC model in that it did not give the employer a single point of responsibility or provide the certainty of a fixed price lump sum approach. In the author's experience, this was not because employers concluded that the EPCM approach was necessarily to be favoured over an EPC approach, but rather it was largely dictated by market conditions and the fact that, increasingly, the world's largest and best EPC contractors were no longer prepared to take, and given the plethora of available major projects did not need to take, the traditional risks associated with contracting on a fixed price, EPC basis.

However, since mid to late 2008, and in a climate of uncertain economic conditions, we have seen the return of fixed price lump sum EPC contracts. The first and most obvious impact of the worldwide credit crunch is that contractors, concerned by the stalling of major projects and with uncertain order books, have become increasingly concerned to preserve cash flows and win business to tide them over during the downturn.[5] In short, in many sectors and regions it can no longer be described as a supplier's market and procurers of the major projects that are proceeding are increasingly holding favour and,

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4 Nick Henchie and Philip Loots, "*Worlds Apart: EPC and EPCM Contracts: Risk Issues and Allocation*" [2007] 1 CLR 252.

5 In the Survey, it was reported that 44% of construction companies year on year forward order book had shrunk by more than 10%.

in many respects, can demand better terms.[6] The fall in the price of materials such as steel, cement and diesel fuel, coupled with an over capacity in the labour market has, within a matter of months, combined to create the most favourable buyer's market for many years. Consequently, there has been a shift away from EPCM and back to an EPC turnkey approach.[7] The change has been quick and marked.

This article considers those terms which have been materially influenced by market conditions.

Cash flow

Whilst many of the issues which are discussed in this article might be seen as ones which, in the present economic conditions, favour the employer's negotiating position, the reality is that more than ever, in an economic down turn, the contractor's cash flow position becomes paramount and often crucial to the potential success of the project.[8] Whilst this article does not analyse why projects go wrong when they do, it is clear is that when a contractor is hampered by negative cash flow, (for whatever reason) the risk of project failure increases markedly. In the current market, access to extended credit lines for even the largest contractors is uncertain and difficult. Consequently, some employers have recognised the need to properly plan and agree sensible cash positive positions with the contractor at the outset, if a truly competitive tender process is to be maintained. Inevitably, this may mean larger than usual advance payments for mobilisation of plant and personnel, in some cases up to 15%-20% of the contract price, rather than a more typical 5%-10%.

There will also inevitably be a retreat from milestone based payments which trigger negative cash flows for contractors waiting to be paid dependent upon achieved milestones, rather than to match actual progress and expenditure.

Employers are also likely to be encouraged to make further on-account payments to the contractor during the life of large projects, particularly when large items of plant and materials are required to be procured in advance of incorporation into the permanent works. The payment for off-site materials and plant is certainly a dilemma for employers who will need to consider whether, in addition to larger than usual advance payments, they are willing to part with large sums of money in respect of plant and materials not on the project site and not incorporated into the permanent works. If appropriate securities are obtained (such as a letters of credit and performance bonds - considered below) then this may be an acceptable and necessary step for employers to take on some projects. In such circumstances, consideration should also be given as

6 The author acknowledges that there are isolated regions and sectors that remain buoyant such as Saudi Arabia where more than $400 billion of projects are planned or underway.

7 According to the Survey, the cost of plant, labour and materials are expected to fall sharply in 2009 with most expected to fall by 10% or more.

8 Indeed, in the Survey, ensuring that clients pay on time is seen by 29% of companies as the key determinant of success in 2009.

to whether title in such materials and plant should pass at the time of payment, (with the risk of loss remaining with the contractor), or whether title will pass on delivery to the project site. In this regard, a clause in the FIDIC forms of contract[9] often struck through during recent years, namely, clause 14.5 (*Plant and material intended for the Works*) is being increasingly utilised. Clause 14.5 provides that relevant plant and materials shall be paid for once they have been sent to the site for incorporation into the permanent works, rather than being paid for as part of the estimated contract value of the works, once the permanent works have been executed.

Of course, if a contractor is to be paid by progress and not milestones, it will be important for the employer to properly vet and interrogate the contractor's plan of work at the outset, during the tender period or shortly thereafter, in order to be certain that the cash curve or cash flow planned for the project is acceptable and realistic. Usually, this is achieved by interrogation of the cost loaded programme provided by the contractor with its tender which will demonstrate its plan of work and how it intends to allocate its resources and costs during the project, against the output required by the employer.

With the mechanisms of advanced payments for mobilisation, advance payments for plant and materials, payment for off-site plant and materials, a reduction in milestone payments, and a properly interrogated cost loaded programme, where required, it is possible for a contractor and employer to reach a sound position which properly addresses the risk of project failure due to negative cash flow. Against this, contractors will have to expect to provide adequate financial security for advance payments, albeit the employer may ultimately bear such cost through the contract price.

Security documents - increased risk of ratings downgrade

As the preceding section of this article demonstrates, one consequence of procuring a major project during difficult economic conditions, is increased concern on the part of employers as to the financial standing of the contractor. This reinforces the need to ensure that the contractor's cash flow position does not negatively affect progress of the works and therefore heightens the need for employers to take adequate security against the risk of project failure due to contractor default. Of course, these are concerns in any project irrespective of market conditions, but a number of additional factors come into play in an uncertain financial environment.

In circumstances where larger than usual advance payments are being made and the payment profile of some projects may be positively changed to recognise the increased difficulties contractors face in bank-rolling major projects, it is clearly important that employers takes adequate security against contractor default. The usual tools will continue to be used, namely security instruments, usually in the form of irrevocable

9 See, for example, FIDIC Conditions of Contract for Plant and Design-Build, 1st Edition, 1999.

letters of credit and surety or performance bonds. Where such instruments are required, it is vital that the credit worthiness or standing of the financial institution providing the security is considered. Although it is not uncommon to find that the instrument which a contractor is required to provide to secure advance payments from the employer is from a specific institution named in the contract, the more common position is for the contractor to have a discretion as to which institution it may provide the security from, provided that institution falls within an acceptable class of financial institution, usually defined in the contract. For example, the contractor might be required to provide a security instrument from a financial institution with "a minimum long-term credit rating from S&P of AAA". Other ratings agencies such as Moody's and Fitch are also commonly cited in contracts.

A major dilemma that drafters of contracts will need to address in the current market is what happens in circumstances where the security instrument which is provided by the contractor at the outset of the contract is from an institution which falls within the definition in the contract, but, following a ratings downgrade by the agency in question (e.g. from AAA to AA), subsequently becomes non-compliant. In recent years, contracts have often simply required the instrument to have such a rating at the outset (i.e. at the time the instrument is provided) but remain silent (and usually ambiguous) as to who carries the risk of ratings downgrade during the progress of the contract. With the turmoil in the financial markets, and financial institutions long regarded as financially secure being bailed out by governments, becoming insolvent or otherwise in financial difficulties, and consequently many having had their ratings downgraded, this is now a feature which is being addressed clearly in the contract. The question is, who should carry the risk of a ratings downgrade? Clearly, the risk of any financial institution being downgraded is not one completely within the contractor's or employer's direct control.

It is important not to underplay the importance of the risk of a ratings downgrade and the fact that a valid instrument (which might provide security for advances of very substantial sums of money) provided at the outset by the contractor, may ultimately become worthless. In the larger projects, if a major advance payment for plant and materials has been made, it is essential that the employer has adequate security against contractor default in the repaying of the advanced payment during the progress of the works. The option of the employer drawing upon the letter of credit immediately upon a rating downgrade is clearly an attractive one for the employer and is increasingly common. But contractors argue that it is only fair that they be given a period of time to correct the default, and that a drawing by the employer in circumstances where there may be no underlying contractual default by the contractor (other than the rating downgrade) is an inappropriate solution to something which is largely out of the contractor's control.

Further, in the event an appropriate security instrument cannot be obtained with the required rating, the contract should address the remedies which the employer has.

To address these two eventualities, the contract might allow the contractor, instead of providing a single letter of credit from an acceptable financial institution, to provide multiple letters of credit of lower values which total the aggregate sum required under the contract. In this way, whilst a contractor may not be able to obtain an overall letter of credit from a financial institution with the required rating, smaller amounts from various institutions may be easier to procure with the required rating. Whilst this may be ultimately more expensive, and administerably more inconvenient for the employer, it is a possible compromise solution.

Other possibilities include the employer being entitled to deduct larger cash retention payments during a downgrading period (instead of making an immediate draw on the instrument), but with the contractor remaining under a best endeavours obligation to replace the security downgraded with a compliant one and to show evidence that it is attempting to do so. If, during the course of the contract, market conditions change so significantly that it is no longer possible for a contractor to obtain a security instrument from an institution at the rating required at the outset of the contract, then it is also possible that the employer's obligation to make the advance payment required by the contract, which might be dependent on the prior provision of the security instrument from the contractor, would cease to apply. Again, whilst this provides the employer with an adequate remedy against the fact that the required security has not been provided, it is a solution which does not help the contractor's cash flow position which was negotiated at the outset in different market conditions. Provisions will be included in contracts to address such an issue and to make sure that the project is not jeopardised merely by a requirement for a financial instrument of a certain rating which may have reflected market conditions at the time, but which is no longer appropriate or commercially attainable.

In addition to on demand forms of security, surety bonds (particularly in the North American market) have been an alternative source of performance security for the employer. A performance security in the form of a surety bond does not weigh on the contractor's balance sheet and is usually provided by an insurance institution rather than a bank. The surety company usually sits above the contract and monitors performance, and in the event the contractor defaults, will step in and complete the contract or provide for the completion of the contract by others.[10] This form of security is not without its risks for employers. In the current economic conditions, the ability of contractors to obtain surety bonds for the full 100% value of a major project has become increasingly difficult or even impossible.

It will be interesting to see how the surety market responds to the current economic crisis and whether there will be increased use of surety bonds, as opposed to bank letters of credit, outside of the North American market. It has also become increasingly difficult for contractors to provide bank letters of credit since the letter of credit will

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10 See for example the AIA 312 Forms which are standard in the North American market.

be a contingent liability on the contractor's balance sheet, also effecting its cash flow or access to credit. Increasingly risk averse banks need to have absolute confidence that, in the event of a call on the instrument, recompense from the contractor can be achieved. In contrast, surety bonds follow an assessment by the insurance company of the company's financial strength and experience but do not sit on the balance sheet. A surety bond should not circumscribe the contractor's borrowing capability, and for this reason are often favoured by contractors.

Whilst a traditional bank letter of credit is an on demand instrument which will allow the employer to claim on first written demand from the bank up to the sum of the letter of credit, a surety is a very different instrument which relies on contractor default which will be investigated by the surety at the time. If surety bonds became more prevalent in this market, employers will need to brush up on the plethora of defences that surety companies may run when a call is made as many such defences are not available to a bank when a call is made against an on demand instrument such as a letter of credit. It is important to note that in many jurisdictions there is the great body of surety law and an employer needs to be careful in order not to allow the surety a potential defence to its obligation to step in and complete the works where there is contractor default.[11] One feature of the FIDIC suite of 1999 which parties should bear in mind when contracting with a surety is that FIDIC provides for the termination of the contract, rather than the termination of the contractor's employment under the contract.[12] This could have risks, particularly in the North American market, where termination of the underlying contract by the employer could jeopardise the validity of the surety bond and provide a possible defence to a surety on the basis that the surety's existence and obligations are dependent on the contract itself surviving, which is usually incorporated into the surety agreement. In this respect, it is of note that FIDIC chose to change the language of the termination clause from the previous editions, albeit it is accepted that FIDIC is rarely used in the North American market.[13]

Limitation of liability

It is of course dangerous to be overly general in writing about typical limitations of liability and how they may change according to prevailing market conditions. There is no doubt that, notwithstanding the downturn, some of the larger EPC contractors and engineering houses have yet to recognise that their approach in recent years to limitation of liability may need to change in this market, if they are to remain competitive. By the same token, in some niche markets and regions, changes in risk profile may be less marked - for example, it is considered unlikely that one of the major turbine suppliers would drastically change its policy on limitations of liability simply

11 The surety usually also has the option to pay the penal sum of the bond rather than stepping in to complete the works.
12 See Clause 15.2 (*Termination by Employer*).
13 Replacing the wording, for example, of the Conditions of Contract for Design-Build and Turnkey (First Edition 1995) where in a termination situation it was "*The contractor's employment under the contract*" which was terminated, and not the contract itself, as is the case in the 1999 suite of FIDIC Contracts.

because of an economic down turn and as mentioned earlier in this article, some regions such as Saudi Arabia arguably remain a suppliers market. Obviously, practices vary markedly throughout the different sectors and depending on the type of procurement method. That said, in overall terms, whilst it was not unusual, in, say, 2001, for EPC contracts to have a limitation of liability of 100% of the contract price, over recent years, as projects have become bigger and market conditions more favourable to contractors, overall levels of limitation of liability have reduced markedly. In general terms, over the last 7-8 years, typical limitations of liability have been in the region of 20%-50% depending on the size and complexity of the project. It has been relatively unusual to see anything much higher than 50% during these times for the larger projects using the established EPC players, whether on an EPC or EPCM basis.

To be considered in close conjunction with the overall limit of liability which is found in almost every major EPC or EPCM contract are the typical carve-outs (or exceptions) to the limit. As overall limits have reduced, so employers have sought to carve more out of the cap. A carve-out which could be considered routine in almost every EPC or EPCM contract would be the one for gross negligence, wilful misconduct and/or fraud or deliberate default. As exemplified in the FIDIC forms, for example, it would also be usual and reasonably standard for one or more of the indemnity obligations of the contractor to be excluded from the overall cap, particularly with regard to infringements of intellectual property rights and damage to third party property and persons. In a buyer's market, in response to increasing overall limits of liability, it is certain that Contractor's will negotiate hard for reduced carve-outs. Where overall limits do not increase, employers, in contrast, will demand greater carve-outs.

Equally, it has been common in recent years, with the reducing number of EPC contracts being procured in favour of multiple contractual arrangements, such as EPCM, for the employer's ability to recover for contractor default under each of the contracts to be severely circumscribed. For example, it has been common to let the front-end engineering design (FEED) on a cost reimbursable basis with the consultants carrying out the FEED taking virtually no risk. The leading consultants have often been able to negotiate a position whereby their liability is limited to the rework of any defective engineering, successfully shutting off any liability for consequential losses in relation to defects in the FEED which manifest themselves subsequently during the detailed engineering, often performed by others under a separate arrangement.

Whereas, for example, in a UK construction project, one would expect a consultant designer to take responsibility at least up to the level of his professional indemnity insurance (which for any major consultant would be at least in the region of £10 million) on international projects, where consultants often do not carry PI insurance, this has been unusual. Market conditions and the lack of good engineering houses available with capacity to carry out the large FEED studies required on the major projects that have been prevalent, means that design houses have made large recoveries on a fully reimbursable basis, with a project fee to cover profits and overheads, but without taking much, if any, risk.

These conditions have changed, with the lack of projects available meaning under-utilised personnel in design houses, and the need to take additional risks and responsibility for the engineering that is provided, including in relation to liability for errors in the FEED which may manifest themselves some time later, when another party or contractor is carrying out detailed engineering of the project.

Liquidated damages

It is common in any major EPC contract for there to be provisions for agreed damages in circumstances of delay or under-performance by the contractor. During a downturn in the construction market the overall levels of liquidated damages increase. Of course, in most jurisdictions liquidated damages must represent at least a genuine pre-estimate of the loss which will be suffered on the occasion of the default in question. However, whilst during a suppliers market, contractors have successfully negotiated reduced periods, for example, during which liquidated damages are paid for delay, in some cases on major projects to as little as 8 or 10 weeks of delay related damages (which are often expressed as the sole remedy to the employer for delay), these periods increase in an environment where employers can demand improved terms.

Overall caps on liquidated damages are standard. For example, on an EPC contract for an industrial plant with an output, one might normally expect to see performance damages and delay damages of anything between 5%-10% for each, possibly with an overall cap on all liquidated damages of 10%-15%. Those percentages may well increase in forthcoming projects to as much as 25% of the overall liability. One major battleground in negotiations will be the extent to which the liability for liquidated damages is to be considered as part of the overall cap on liability or to be carved out of it.

Design responsibility

Earlier in this article the central issue in all EPC contracts of design responsibility was touched upon. In the author's article[14] he explained how, with a shift in recent years towards the EPCM approach, potential problems concerning responsibility for design have arisen because of the multiple contracting arrangements and the lack of a single point of responsibility for all design and construction matters under a typical EPCM arrangement. In recent years, one of the major areas of risk which contractors had retreated from accepting was the responsibility for the FEED or basic engineering where it was performed by others. With contracts commonly being split between the FEED study and the subsequent EPC package or process design packages, unless it was the same contractor responsible for both the FEED and the detailed engineering, employers increasingly assumed the risk of design errors in the FEED and consequent interface problems.

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14 Nick Henchie and Philip Loots, "*Worlds Apart: EPC and EPCM Contracts: Risk Issues and Allocation*" [2007] 1 CLR 252.

Under an EPC contract, the contractor usually has responsibility to produce detailed design and meet the performance output requirements of the specification, but when latent errors are found in the pre-tender FEED studies during the course of that detailed design, claims are invariably made by contractors as a result. There are essentially three ways of dealing with this risk in the contract. Firstly, and most commonly, during the contractor's market of recent years, provisions were regularly entered into many contracts to ensure that latent errors in the FEED studies or basic engineering provided with the tender documents, which subsequently manifested themselves during the course of the EPC contract, would be the employer's responsibility. This led to many claims for variations and extensions of time by contractors. Contractors were usually not willing to take the risk of errors in a third party's design unless there was adequate provision during the tender period to investigate and interrogate that design and, even in such circumstances, were extremely reluctant to do so. This was rarely the case with fast-track projects in the Middle East particularly, which often did not allow contractors sufficient time to interrogate the specialist basic engineering. Secondly, exemplified by FIDIC's Silver Book, FIDIC attempted to capture the position prevalent on many projects during and around the time of its issue (1999), that where the banks were involved in funding a major project, the employer and lenders needed a single point of responsibility for the whole project including all of the design. Clause 5.1 of FIDIC's Silver Book[15] whilst being, on the face of it, controversial and vehemently objected to by contractor bodies,[16] merely reflected the position common on project finance deals at that time, that the contractor would take responsibility for errors or omissions in the employer's requirements (which usually included the FEED/basic engineering). A third way in which this issue was sometimes dealt with (or to be more accurate, not dealt with) was for the contract to remain silent. This left the possibility of claims being made on the basis of information that was defective, balanced against arguments by employers that the contractor had responsibility for design which included designing out any errors in the basic engineering provided at the outset; an uncertain and hence unsatisfactory position and one that might be treated differently depending on the governing law of the contract.

There have been many disputes, controversies and arbitrations in the last 10 years which had at their heart the responsibility for design provided in the employer's requirements at the outset. It has now become a major negotiating battleground and it has been fascinating to see how, as market conditions have changed, so the emphasis on design responsibility in EPC contracts has shifted one way and then the other. In the current market, there is no doubt that more contractors will be prepared to take on the risk of design error in the employer's requirements, particularly where they have adequate time to tender for a project and to interrogate the basic engineering.

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15 See Conditions of Contract for EPC/Turnkey Projects, 1st Edition 1999.

16 For example, European International Contractors (EIC) took great umbrage at the apportionment of risk in the Silver Book.

Fluctuations

One of the features of a supplier's market was not only the move in favour of EPCM contracts, but also the fact that where a project was procured on an "EPC lump sum basis" there were a number of features of the EPC contract which meant that it was not truly a lump sum contract. Typically, there would be provisions for escalation in the cost of materials and escalation in the cost of labour, particularly on longer term contracts. Further, the boom in the construction market meant that contractors could negotiate very favourable fluctuation clauses as well as providing hefty risk premiums in a lump sum price against the rise in cost of materials and labour. The shortages of materials (typically cement, iron ore and steel) and skilled labour, meant rocketing prices and potential delays. The consequences for an employer not willing to allow such fluctuation clauses were huge contingencies built into the contractor's lump sum prices, or an uncompetitive tender process due to a lack of bidders. Rather than the lump sum price being seen as the maximum price which the employer would pay for the works, it was really the minimum price and was likely to rise by a significant amount during the course of the contract, as contractors sought to maximise returns.

As with responsibility for errors in the design, contractors were also able to negotiate positions which meant that they did not take the full risk of quantities growth during detailed design. Thus, whilst contractors were in some instances prepared to bid on the basis of conceptual design information which had been developed to a stage which enabled lump sum bids to be provided, their negotiating position meant that in many instances they did not have to accept the risk of quantities growth during detailed design. Various mechanisms were seen in EPC contracts providing that, where quantities grew during detailed design beyond that anticipated at tender stage, the contractor could be reimbursed on a quasi-remeasurement basis, often subject to a cap on quantities growth. Indeed, some major projects, such as the Channel Tunnel Rail Link for example, were even procured on a largely cost reimbursable basis at the high point of the contractors market.

Cost reimbursable contracts and favourable mechanisms for uplifting lump sum prices will be gradually eroded during the current market as a return to truly "lump sum" prices will be obtained.

Flexibility of approach for employers

In any trading conditions, it is important for employers that they have a flexibility of approach so that, if circumstances change, an employer has the ability to abort, delay or postpone, or reschedule a project, preferably without suffering major financial penalties. In a contractors' market such flexibility was difficult to obtain, other than for a significant premium. Contractors would charge for the opportunities (profit) that would be lost by having to commit resources to a particular project.[17]

17 In the Survey it was reported that amongst construction companies surveyed, 87% have had one or more contracts cancelled or postponed in the last 3 months and 35% have had five or more contracts cancelled or postponed.

Clearly, if the contract only provides for termination or suspension in the event of contractor default, an employer would expect to pay a hefty premium or to be involved in a major dispute should it wish to stall or abort a project halfway through, for its convenience. Consequently, it is usual, and the standard contract forms mostly provide, that the employer has a termination for convenience mechanism, albeit one which usually provides that the employer must compensate the contractor for his costs as a result of the termination or suspension, usually with an element of the contractor's lost profit being compensated for in such circumstances. In recent times, many major projects have been halted for employer convenience, rather than default, as the financing and/or viability of projects has been called into question.

Increasingly, contracts will provide that the employer has a flexibility of approach by allowing it to, for minimal compensation, phase or reschedule projects into sections allowing it to develop a project to suit prevailing economic conditions and demand.[18] Increasingly complex structures are being found in EPC contracts allowing the employer such flexibility of approach beyond just straightforward rights of suspension or termination. Within certain boundaries, contractors are now taking on projects which allow flexibility to the employer, without the attendant premium to compensate lost profit and overheads where projects are delayed or suspended, thus recognising the declining status of a contractors' forward order books. Employers are also pushing for terms which allow repayment of all monies expended where there is a contractor default event, after which the employer decides not to complete the project. This might be seen to be opportunistic but it does reflect what some employers will seek to obtain in a favourable and uncertain market.

Excusable delay

The mechanisms in a construction contract which allow a contractor to claim relief from liquidated damages and entitlement to extensions of time have long been one of the most heavily negotiated issues. Usually there are two provisions which deal with excusable delay, namely, the extension of time mechanism itself, and the force majeure provisions.

With regard to the extension of time mechanism, it is usual for a construction contract to set out the grounds which entitle the contractor to an extension of time. In recent years the grounds have become reasonably extensive on major projects. As well as almost always including provisions for extensions of time in circumstances where the employer has initiated variations, or where the employer has caused a delay or impediment to completion, contracts have also often included provisions relating to climatic conditions, and also unforeseeable shortages in the availability of personnel or plant and materials.[19]

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18 Indeed, one advantage to the employer of an EPCM approach over EPC is the inherent flexibility it provides and this is one reason why, notwithstanding the shift towards EPC, EPCM will remain a commonly used procurement route.

19 See, for example, Clause 8.4 of the Conditions of Contract for Plant and Design-Build, 1st Edition 1999.

Closely related to this, is the issue of unforeseeable ground conditions. With contractors increasingly being pressured to accept more risk, the risk of problems in the ground which were unforeseeable at the time of tender will be keenly negotiated. Where such conditions do materialise, then claims for extensions of time may not be allowed by the contract as routinely as hitherto.

Similarly, an event of force majeure will usually release the contractor from liability for delay and its obligations during the period of force majeure. Definitions of what constitutes force majeure vary widely from contract to contract and between jurisdictions. It is usually good practice to define the meaning of force majeure within the contract, sometimes including a list of what does constitute force majeure and/or what does not constitute for force majeure.[20] During the contractors' market it was not unusual to find force majeure clauses extended to include shortages of materials and goods and, indeed, on occasion shortages of labour, even though, no-one would really regard these as exceptional and unforeseeable events. There will be a retreat from these widened definitions of force majeure during the downturn.

Dispute resolution and choice of law

Along with the limitation of liability clause, for many of the major contractors and equipment suppliers the choice of dispute resolution forum and/or the choice of the governing law of the contract represent one of the potential deal breakers in a major project. The reality is that even if a contractor can successfully limit its potential exposure under the contract by virtue of well-drafted limitation of liability clauses and by negotiating an acceptable risk allocation, if the governing law of the contract does not uphold, support or recognise the validity of such clauses or risk allocation, or the forum for dispute resolution is not considered sufficiently neutral to allow for the prospect of a fair and independent hearing of any disputes, then many contractors will either not accept the risk or will have to do so in the knowledge that the clauses they have negotiated may not be upheld.

The issue of dispute resolution forum and choice of law is often considered jointly because contractors are often prepared to make concessions in relation to the choice of governing law, if they have confidence that any disputes will be resolved in a neutral venue and before an impartial and international Tribunal. In the present market, contractors will increasingly be willing to accept local governing laws (including the middle eastern civil codes) in exchange for dispute resolution in a neutral venue under institutional rules, for example ICC or LCIA Arbitration. The rationale is straightforward. Although there will often be the risk of the unknown in contracting under a local law, that risk can largely be mitigated if any disputes will be heard before an international and impartial Tribunal in a neutral venue, which is more than likely to apply international legal principles and standards and uphold the contract, rather than allow one party's carefully negotiated

20 See for example Clause 19 of the FIDIC Yellow and Silver Books in this regard.

contractual position to be undermined by peculiarities of local law never truly intended to apply or contemplated by the parties at the outset. Whilst a foreign contractor will always be interested to ensure that, particularly, its limitation of liability clause is valid and would be upheld under local laws, and particularly, in this context, contractors will always be interested to see how local law treats or interprets the concepts of gross negligence and wilful misconduct, for example, the overriding objective will be to obtain dispute resolution in a neutral venue. A further protection against overly wide interpretations of gross negligence and wilful misconduct by local laws is to define such terms, since they are, of course, meant to refer to rather exceptional circumstances usually falling just short of fraud.[21] Indeed, under English law the position as regards the meaning of gross negligence and wilful misconduct is particularly unsatisfactory since there is a dearth of relevant precedent concerning the meaning of such terms, which are far more routinely used in the Civil Codes.

It is considered that, even with the increased pressures to take on work on more onerous conditions than has been the case in recent years, for major infrastructure projects, it is unlikely that the major international contractors will accept local laws as well as (unless there is good reason and a good track record of success) dispute resolution in the local courts.

Conclusions

The months ahead will set challenges for those negotiating major EPC and EPCM contracts and positions on risk allocation hitherto will need to adapt to market conditions. A flexibility of approach will be required and new solutions and contractual mechanisms will no doubt be created and implemented. The market has moved so quickly in the last few months that those negotiating contracts will need to keep abreast and take cognisance of this. There is a role for innovation and creative thinking when it comes to risk allocation.

The irony is that although the market has moved in favour of those procuring projects, contract conditions will still need to reflect the difficult trading conditions which contractors find themselves in. This will particularly be so in relation to the cash profiles of projects and the need to consider if contractors should have access to cash earlier in the project to ensure that projects do not fail for this reason. Increased attention will be paid to ways of securing projects and to the credit worthiness of the financial institutions and insurance companies providing instruments to guarantee performance. The allocation of risk has, and will undoubtedly continue to, move in favour of employers, particularly with regard to limitations of liability and responsibility for design. The return of the truly fixed price lump sum contract, rather than some of the hybrid variants that have been seen in recent years, is inevitable.

21 Since the concepts of gross negligence and wilful misconduct are usually exceptions to the limitation of liability cap, the meaning of such concepts under local law is of extreme importance to contractors.

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