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FOCUS

PROJECT FINANCING

December 2006

ALLIANCE CONTRACTING – IS IT BANKABLE?*

Fears of cost blow-outs and of prolonged and costly disputes have given rise to a new approach in some greenfields project financings. Alliance contracts involve a collaborative process which is meant to promote openness, trust and risk-sharing between principals and contractors. They have been embraced by government procurement and the oil and gas sectors. Partner Phillip Cornwell explores alliance contracts and their suitability as an alternative development structure for project financings.

What is alliance contracting and is it a viable basis for project financing?

* This is an abridged version of an article published in *Project Finance International* on 29 November 2006.

HOW DOES IT AFFECT YOU?

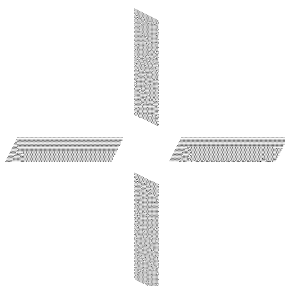
- Alliance contracts can diminish the threat of disputes through a more co-operative approach between principals and contractors.
- Most risks remain with the principal – the contractor is entitled to be reimbursed for all direct costs even in the case of delay, negligence, cost overruns or defective design;
- More contractors are likely to bid on projects because of lower liability exposures and a greater ability to pass through cost increases and delay risks.
- The design process should be more innovative and co-operative when unconstrained by liability apportionment issues.
- Despite the increased uncertainties of time and cost, with suitable precautions and the inclusion of appropriate contingent equity and cost overrun facilities, alliance contracts can provide a bankable project delivery method even for a project financing.

BACKGROUND

At one time, the completion risk in greenfields project financings was assumed by creditworthy sponsors. The banks also took security over the underlying construction and development contracts, but there was no head contractor wrapping the risk, just the sponsor guarantee.

By the early 1990s, the larger resources players had decided they could finance new developments more cheaply on balance sheet, leaving the project finance field to smaller, less creditworthy players.

At the same time, there was the growth of the head contractor, creditworthy construction companies, and developers which were prepared



to take a large, or sufficient, portion of the completion risk under EPC (Engineer, Procure, Construct) and turnkey contracts.

As with all cycles, there followed an unhappy period when it appeared that some contractors had taken on too much risk. Over the past decade, there have been quite a few problem projects, characterised by cost blow-outs, disputes and write-offs for most of the parties concerned. Well-publicised examples include BHP's HBI plant, the Murrin Murrin lateritic nickel plant, the BassGas project, the Wembley Stadium in the UK and the Spencer Street Station redevelopment.

Soaring fuel, steel and materials prices and skilled labour shortages have contributed to construction cost inflation of as much as 30 per cent over the past two years. This has severely eroded profit margins for head contractors and hard lessons have been learned.

These experiences, combined with consolidation in the contracting market and buoyant demand, have meant that in recent years invitations to tender using the EPC/turnkey model (where major risk is shifted to a head contractor) have met with disappointing, or even disastrous, responses as in the case of Australian Magnesium.

At the same time, seeking to move away from the traditional adversarial approach, alternative relationship-based contracting models have been trialled. Initially this took the form of 'partnering', but now the momentum is with 'alliance contracting', which has been embraced in the oil and gas sector (eg the Wandoo offshore petroleum project (WA) and a number of North Sea developments), and by governments (eg the Perth desalination project, various Department of Defence projects, Paradise Dam (Qld) and the National Portrait Gallery).

In September 2006, Origin Energy announced that the NZ$980 million Kupe offshore gas project would be developed under an alliance contract with Technip: 'We believe the alliance structure, incorporating shared objectives and risk/reward arrangements, will lead to more effective project execution in today's challenging oil and gas construction market'.

WHAT IS ALLIANCE CONTRACTING?

In this context, we are focusing on project-specific, rather than industry-wide, alliances. Alliance contracting is a co-operative model characterised by openness, trust and an alignment of interests. Some of the most striking features, and those likely to be of concern to a project financier, are as follows.

RISK-SHARING

Most risks remain with the principal – the contractor is entitled to be reimbursed for all direct costs even in the case of delay, negligence, cost overruns or defective design. There is usually a target contract cost and a target completion date, but these are used to drive painshare/gainshare.

The contractor is motivated by earning a greater or lesser profit margin depending on performance incentives and on their share in the overall cost performance of the development relative to the indicative budget. Transparency is the keynote.

Procurement/sub-contracting is done on a co-operative 'managing contractor' style basis (and may involve more conventional risk allocation to the subcontractor for the benefit of all alliance parties). Accordingly, there is no certainty of time or cost.

NO BLAME/NO DISPUTE

The principal and the contractor (and any other alliance parties) release each other from all liability except in the case of 'wilful default'. Disputes have to be amicably resolved, though sometimes (not in a 'pure' alliance contract) there is an ultimate deadlock breaker.

The philosophy is that rather than spending time and energy on apportioning blame, the better approach is for the parties to work co-operatively to overcome the problem on a cost-effective basis. Similarly the design process, unconstrained by liability apportionment issues, is intended to be more innovative, iterative and co-operative.

ALLIANCE BOARD

Project development is driven by a co-operative, but all powerful, board of management made up of representatives of both parties, with a mandate to deliver the project in accordance with agreed goals (the argot inevitably features

‘win/win’, ‘commitment to excellence’ and ‘open communication’) and alliance principles. Generally, all decisions must be unanimous. The absence of a deadlock breaker means there is a risk the agreement could be void for uncertainty (the courts don’t like agreements to agree).

WHAT DO THE AGREEMENTS LOOK LIKE?

They still tend to adopt the basic framework of a typical EPC contract, subject to incorporating the above features. The first few pages look very different, as they set out the alliance principles, good faith commitments, alliance board and no-dispute provisions.

There are no change order, extension of time, or liquidated damages provisions. If there is a major change of scope or direction, the alliance board may decide to adjust the target contract cost, which is the basis for gainsharing/painsharing.

There is still typically a parent guarantee for the contractor, and even bonding. But without firm time and cost obligations, and with liability limited to wilful default, these have considerably less work to do. The principal generally has a right of termination for convenience, and either party can terminate in the event of wilful default by, or the insolvency of, the other.

WHAT DOES IT MEAN FOR PROJECT FINANCE?

At first sight, the shortcomings of an alliance contract on traditional bankability issues such as certainty of time and cost, appear fatal. In fact, the increased risk aversion of head contractors means the EPC or turnkey contract has become an endangered species in many sectors.

Contractors are insisting on much lower liability limits (even on a repeat deal) and a greater ability to pass through cost increases and delay risks, and have sometimes refused to bid on these models at all.

Allens Arthur Robinson is currently working on at least three projects where the delivery method is an alliance contract and a project financing is planned. Two are at the term-sheet stage and have had preliminary sign-offs from banks.

HOW ARE BANKS GETTING COMFORTABLE?

- Enhanced due diligence: not just on technical and engineering issues (and especially on the interface issues, the subcontracting plan and the adequacy of time and cost contingency allowances) but also, and perhaps most importantly, on the alliance track record of the participants. Have they got the right background, people and systems, and a genuine commitment, to make it work? The project document due diligence will also need to check that any off-take or other key operating phase contracts can cope with a delay in start-up.
- Financing structure: will need to cater for reasonably foreseeable overruns by various means, including:
  - more equity, or contingent equity in the form of sponsor standby commitments triggered by delays or cost overruns, or even sponsor completion guarantees; and
  - cost overrun debt facilities, typically attracting a higher margin and repayable by a cash sweep.
  - The alliance contract itself will contain such mitigants as:
  - a gainshare/painshare mechanism which seeks to achieve an alignment of commercial interests;
  - a reasonably prescriptive process for subcontracting and direct procurement, with tough/traditional bonding and risk allocation and enhanced treatment of interface issues – also there should be savings through reduction or elimination of the head contractor margin (here the contractor is more like a managing contractor);
  - sometimes, a ‘reserved powers’ provision under which particular topics of concern (eg functional or output specifications, emergencies) are taken out of the jurisdiction of the alliance board and placed under the exclusive control of the principal; and
  - banks will generally prefer to see a deadlock breaker to cover a prolonged failure of the alliance board to agree any material issue (and the principal always has the right of termination for convenience).
- Insurance: professional indemnity insurance in particular, will need special wording to make it effective despite the exoneration of the contractor for negligence and defective design.

Banks are also asking, is this model really so radical? Drilling contracts are typically cost plus, and many oil and gas projects have used a 'managing contractor' approach, with discrete parts of the development separately contracted out by the operator.

A number of recent power projects have been transacted without the traditional head contractor, eg the Alinta cogeneration deals, Lake Bonney Windfarm and the Braemar Power Project, so there is no doubt the interface risk is manageable.

There is also a perception that the worst is over in terms of unexpected cost increases – the experience of the past few years means that more realistic costing, while hurting some projects, is de-risking those that proceed.

CONCLUSION

Projects with inflexible completion deadlines, such as most PPPs[1] or new or high-risk technologies, are unlikely to be suited to an alliance approach where a project financing is planned.

But in the vast majority of cases, it could be said that alliance contracts are just facing reality. They are a natural response to non-conforming tenders which seek head-contractor style profit margins while pushing back on risk transfer.

The traditional EPC/turnkey model, dogged by prolonged and costly disputes, is hardly perfect, and with the right financing structure, the right alliance partner and the right project, the alliance contract can be a viable basis for a project financing.

1. However, the UK Treasury's preferred model under consideration for future PFI projects has some obvious alliance elements. A 'development partner' is to be selected early, and each other role will be separately tendered: design, construction, FM services, debt and equity funding.

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