Bankability and Structuring of EPC Contracts

The suitability of each of the contractual structures depend on the nature of the project, the parties involved and commercial, practical and bankability considerations. PRANJAL BORA in this article focuses how careful risk analysis and attention to lender concerns can help contractors manage their EPC contract risks and preserve projects bankability.

More often than not large scale projects like power projects, port development projects, etc., are financed on what is commonly referred to project finance basis (limited recourse), which essentially means that the lenders are looking at the repayment of the loan from the revenues to be generated by the project itself rather than repayment of the loan from the sponsors. Therefore, it is of paramount importance that the project contracts are drawn in a manner so to make the project bankable or in other words the project should be sufficiently attractive in terms of returns and all risks typically associated with the project should be duly addressed. In case the lenders are not satisfied with the way the risks have been addressed then the equity exposure of the sponsors may be greater.

Setting up such large scale projects require substantially large sum of money and are usually long drawn affairs. Projects of such nature are usually fraught with several risks, whether perceived or real. The nature of such risks vary depending on which stage the project is at, for instance the risks during the construction period would be different from risks during the operating period. Each of these risks needs to be adequately addressed to ensure that a project is successfully constructed and operated. To a great extent these risks can be and are usually addressed through appropriately drafted project contracts. Perhaps the greatest exposure that a project has to risks is during the construction phase and thus the present discussions would be limited to risks arising during the construction phase of the project.

Since the risks associated with a project is perhaps the highest during the construction phase before venturing any further let's take a quick look at the factors which affects the bankability of the project especially during the construction phase. While banks would look to several factors certain issues which most lenders would always look for while financing a project are as under:

- A fixed completion date;
- A fixed completion price;
- Output/performance guarantees;
- No or limited technology risk;
- Liquidated damages for both delay and performance;
- Security/guarantees from the contractor and/or its parent company;
- Restrictions on the ability of the contractor to claim extensions of time and additional costs; and
- Single point responsibility.

In most cases the repayment for project financed loans commences after the completion of the construction project or the commercial operation of the project has commenced. Any delay under a particular contract could lead to delays under the other project contracts like the off take agreements and expose the project company to penalties there under apart from delaying the loan repayment process and also increase the interest during the construction period. In extreme cases, it may also lead to project cancellation. Hence it is necessary to ensure that there are no time overruns for any project.

Likewise any unaccounted for cost overruns may make the project unviable and thereby affecting the ability of the project company to service the debt.

Similarly if the project is to deliver a particular amount of output, let’s say the project upon completion is to deliver a minimum output of 500 MW at a particular station heat rate but fails to do so then what happens? Obviously in such a scenario not only the debt servicing ability of the project company would be affected but it may also affect the long term economic operability of the project. Therefore, such issues need to be addressed contractually for the project as a whole to address the lenders’ concerns and to ascertain the commercial viability of the project. Apart from the foregoing there are other separate factors like step-in and cure rights, privity of contract and direct agreements, guarantees being furnished, assignability of the project contracts, etc., which would also affect the bankability of the project. Customarily, EPC contracts provide for the mitigation of all such issues in one integrated package and as such the project company and the lenders do not have to look towards different contractors to complete and deliver the entire project as a whole.

The EPC contract is the primary tool for allocation of risks between the project company and the contractors and to a certain extent also provides a level of protection to the lenders by providing for overall coordination and single point responsibility. Thus, EPC contracts are generally favoured for large scale projects which are financed, however, that is not to say that other forms of contracts are not used for large scale projects although EPC contracts are one of the leading form of contracts. Some of the risks to a certain extent can be addressed through other forms of contracts as well. For instance, the entire works for the project can be broken down into several packages and accordingly contracted out to different contractors or the same contractor as well. However, in such an approach the biggest risk that arises is the possibility of the lack of coordination amongst the various contractors in executing the works for the project. While certain sections do contend that EPC contract are expensive propositions but then the price, at the end of the day, is perhaps nothing but a function of the risks being assumed by a party and it is only but natural for a party to keep a certain float in the quoted price to provide for contingencies.

While the scope of work to be performed by the EPC contractor does vary from project to project, most EPC contracts would need to provide for single point responsibility for the execution of the entire works and perform such works on lump sum fixed price basis within a pre-agreed time period. Thus, EPC contracts, as mentioned above, mitigate to a great extent the various risks associated with the project. Given below is an illustrative list of risks that are assuaged through an EPC contract -

(i) Completion risk – the
completion risk is undertaken by the EPC contractor as it remains liable to pay liquidated damages for delay in case of any time overruns. The liquidated damages payable by the contractor is usually a percentage of the contract price.

(ii) Price risk – the EPC contract would be a fixed price lump sum turnkey contract. Most EPC contracts have very limited scope for any change in the lump sum price.

(iii) Performance risk - the EPC contractor would guarantee that the technology used for the project would be capable of delivering the desired outputs failing which the EPC contractor would be liable for payment of liquidated damages for under-performance.

(iv) Securities / guarantees – most EPC contracts would require the EPC contractor furnish adequate securities / guarantees from reputable banks to ensure due performance by the contractor. At times, in addition to bank guarantees the EPC contractors are also required to provide guarantees from their parent entities.

(v) Extension of time / additional costs - the grounds on which the EPC contractor can ask for extension in the completion schedule and additional compensation are limited. Certain restricted events like force majeure, change in law, variations, etc., may give rise to occasions where the EPC contractor would be entitled to an extension in the completion schedule and/or additional cost. However, it is not necessary that because an event has arisen which requires an extension of time it would lead to additional costs also and vice versa.

(vi) Permits / approvals - large scale projects require several approvals from governmental authorities and regulatory bodies, including environmental clearances. The EPC contractor remains responsible for obtaining and maintaining a great part of all such required approvals. The EPC contractor would be required to obtain not only those permits in its own name but also those needed in the name of the project company. Of course, needless to mention, the project company would be required to provide adequate support to the EPC contractor in this regard.

(vii) Defects liability / latent defects liability – the EPC contract would provide that the EPC contractor would remain liable for any defects in the works for a certain period of time. Usually in India the defects liability period in India varies from 12 months to 24 months and under certain circumstances the defects liability period may be extended subject to an overall capped period. At times the EPC contractor also remains liable for latent defects, which usually are for a longer duration than the defects liability period. However, typically an EPC contractor would be liable for latent defects only if the EPC contractors has done the designing for the project itself.

(viii) Subcontracting risks – the EPC contractor remains liable for all acts and omissions of the subcontractors, including all payment responsibilities and performance related issues of the subcontractors.

As mentioned earlier, some of the issues highlighted above may also be addressed through other forms of the contracts and not necessarily through EPC contracts. Also, whether an EPC contract is entered into or not would also depend on the sector in which the project is being undertaken. For instance, EPC contracts are perhaps not the most usual form of contracts for executing the works for a refinery project in India. Given that the nature of risks associated with each projects would be different it is imperative to carefully examine and analyze each such risk and to properly allocate such risks. Such careful analysis would not only address the lenders’ concerns but also enable each party to manage their risks effectively and make the project a success.
Structuring of EPC contracts

At times EPC contractors act as a consortium and each contractor in the consortium remains responsible for different portion of the works. To ensure that the works are properly performed the members of the consortium must coordinate and integrate their respective works. The EPC contract must permit such cooperation and integration while at the same time keeping intact the principle of single point responsibility.

Since there could possibly be more than one contractor for a project and also different taxation regimes different contracting structures may need to be adopted to carry out the works effectively and at the same time make such EPC contracts cost and time effective.

EPC contracts can either be single consolidated EPC contracts or split structure EPC contracts. In a single consolidated EPC contract structure the entire works, i.e. all the supplies and services are performed under one contract. From a project company’s and lenders’ perspective perhaps a single consolidated EPC contract may be the most attractive in terms of single point responsibility and in terms of enforceability of the contract, however, the price payable for such consolidated contracts are likely to be significantly higher for various tax reasons. Therefore, at times people do prefer to go for split structure EPC contracts. The key driver for adopting a split EPC structure is the tax efficacy of such structures.

In a split EPC contract structure the entire works are divided into separate contracts. For instance, assuming there is an offshore component in the works then there could be an onshore supply and services contract and an offshore supply and services contract. This could be further split into onshore services contract, onshore supply contract, offshore services contract and offshore supply contract. The aforesaid is a fairly straightforward simple split structure and certain split structures could be quite complicated. Such complicated structures may need to be adopted depending upon the objectives sought to be achieved.

Split EPC structures however, dilutes the concept of single point responsibility of the contractor for performing the works for the project. For such large value contracts it is extremely critical from the project company’s and the lenders’ perspective that the single point responsibility principle is retained and that in case of any non-performance or under-performance the project company does not have to pursue different entities for delivering a fully completed and operational project and/or other remedies. Thus, usually in split structures another agreement which is sometimes referred to as a wrap agreement or as a guarantee and coordination agreement entered into between the contractor(s) and the project company. The primary function of the wrap agreement is to ensure that the single point responsibility of the contractor(s) is retained and for ensuring that the entire works for the project is coordinated and completed in a seamless manner. Ideally, such wrap agreement should survive till all the liabilities of the contractors are satisfied as per the underlying contracts.

However, having stated all of the foregoing, it is not necessary that each of the above mentioned issues would be same or relevant in all projects and each project would need to be analyzed on its own merit. Above all, while preparing any project contract it is important to not only address the typical issues faced by each project but to address effectively the exact commercial understanding of parties to the contract.

It is strongly recommended that prior to adopting any particular contracting structure for a particular project and prior to entering into any EPC contract or other project contracts expert legal and tax advice is sought.