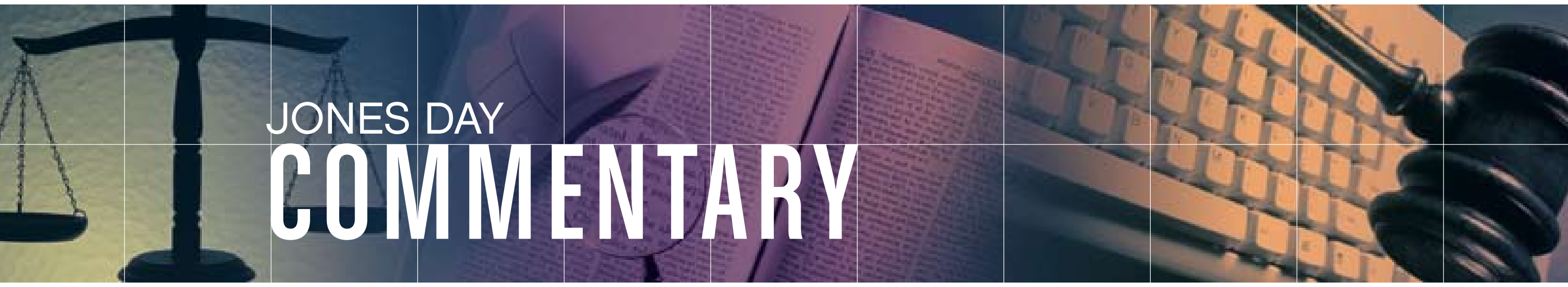
JULY 2006




# OLD RISKS, NEW CONTRACTS: CHANGES IN THE WAY CONSTRUCTION CONTRACTS ARE BEING PROCURED IN THE MIDDLE EAST

Project activity in the Gulf is booming and is showing few signs of slowing down. Estimates vary, but all agree that dollars invested in GCC projects over the next 10 years will be in the hundreds of millions. The independent power and water markets are buoyant; there is heightened interest in large LNG and GTL projects, refinery upgrades and new builds; new aluminum smelters are going ahead and production capacity at existing smelters is being substantially increased.

Until recently, market forces have, on the whole, favoured sponsors. There has been a large availability of engineering, procure, construct ("EPC") contractors; prices for labour, materials and equipment have been relatively stable and EPC contractors have traditionally signed up to lump-sum-turnkey ("LSTK") contracts (where the contractor undertakes to deliver the project substantially in accordance with an agreed schedule and for an agreed price).

LSTK contracts provide a level of certainty for the sponsors and their bankers with respect to delivery of the project, with the construction and completion risk being borne almost entirely by the contractor. Opportunities to claim additional time and/or money are very limited and in negotiating the LSTK price, the contractor will therefore incorporate a premium to reflect the assumed risks, and this will inevitably be influenced by market forces.

## CONVENTIONAL WISDOM?

Overall, EPC contractors have generally accepted the LSTK approach as being the norm, even if it has resulted in an unbalanced risk allocation, which has not always been compensated by an appropriate level of contingency and profit available to the contractor.

However the current boom is forcing a change to conventional LSTK contracting. Factors such as the number and size of projects, the general uncertainty as to material and equipment prices, the lack of suitably qualified and skilled resources and the increasingly challenging periods for bid preparation are causing sponsors and contractors to be more transparent with each other as to the costs they are likely to incur on a particular project.

This openness has increasingly lead to a re-think as to the best way to procure that contract. Sponsors can still get LSTK contracts (with a hefty mark up), or they can consider variations to LSTK contracts in order to achieve a lower price contract, and one with inherent flexibility as to how to deal with risks and contingencies.

## VARIATIONS TO LSTK CONTRACTING

There are myriad variations to conventional LSTK contracting which are aimed at establishing different models for allocating and managing the construction and completion risks (and their consequential costs) as between sponsors and contractors.

As an alternative to the rather opaque business of LSTK contracting, open book tendering is becoming more common. As its name would suggest, "open book" methods of procurement allow each party with a legitimate interest to have access to the project cost information. Open book techniques may be applied in situations where the front end engineering and design ("FEED") stage of a project is commenced ahead of the EPC stage so that a preliminary cost estimate can be established early on.

Where the sponsors are new to the Gulf or are lacking recent experience in it, they may engage the services of a Project Management Contractor ("PMC") to undertake the FEED and to prepare the preliminary cost estimate. If the economics are sound, the sponsors can proceed to the EPC stage and appoint an EPC contractor. The sponsors may choose to place the key orders themselves, subject to further value engineering, agreement of cost estimates and general terms and conditions. The sponsors may then novate these orders to the EPC contractor (if all the parties agree) in order to return to something more akin to a conventional LSTK contract (subject to agreeing on the EPC contractor's contingencies and profit).

Alternatively the sponsors may wish the EPC contractor to continue to operate on an open book basis with the continued involvement of the PMC. Overall this will reduce the bidding period and the open book approach provides far more transparency as to the agreement of the EPC contractor's contingencies, risk and profit than would be found with conventional LSTK contracting.

In addition, more sponsors are turning to target cost contracting (particularly in the form of a guaranteed maximum price or "GMP"). Under a GMP contract, the sponsors share in the upside cost risk (by sharing in cost savings where actual cost is less than the GMP) while passing downside cost risk to the contractor (in that the contractor will not be paid its actual cost to the extent the same is in excess of the GMP). The GMP is therefore effectively a lump sum price for a project where the amount of money that a client is contractually obliged to pay is the maximum price.

Target cost and GMP contracts can provide an answer in situations that are rapidly changing or difficult to quantify. They give the cost certainty desired by sponsors and their bankers. Contractors are willing to sign up to GMP contracts provided that they contain some financial incentives (usually by way of a mutually agreed shared savings scheme) if the work is completed for less than the GMP.

These kind of arrangements—where savings generated are shared between the sponsors and the contractor—are intended to encourage teamwork and to incentivise the contractor to fully utilise its value engineering and buildability skills to produce cost effective design solutions and best practice construction methods to make savings and reduce overall contract cost. However their ultimate success is reliant on an adequate definition of a target cost or GMP at the outset and the basis on which the target cost or GMP will change, as well as recognising the key role that the project management team will play after contract signature.

Another alternative is engineering, procure and construction management ("EPCM") contracting, which is commonly used as the preferred method of procurement for projects such as aluminum smelters in the Gulf.

As EPCM is a form of construction management, it significantly alters the risk profile because the project risks will largely be borne by the sponsors or owners and less by the contractor. The EPCM contractor will be responsible for engineering design, procurement, construction and management of the construction and in this sense the principles of LSTK contracting will remain. However the fundamental process design will remain as the owner's risk and process liability will be with the technology provider.

The EPCM approach will generally result in more efficient project pricing (and may include a GMP) but it will require the sponsors to have available, and to satisfy their bankers that they have, adequate financial reserves to meet project risk and contingencies. This is often the approach taken by large resource companies of significant scale and balance sheet strength.

Overall, the increasing scale and complexity of projects in the Gulf is causing sponsors and their advisors to push the boundaries of conventional LSTK procurement to search for more suitable forms of procurement. These need not be elaborate and may for example simply allow a traditional LSTK contractor to claim additional costs for rising costs of equipment, labour or materials or for specific elements of a project to be modelled on a GMP rather than the whole project being modelled on a GMP.

## THE BANKS

Banks have generally required LSTK contracts as a condition to providing finance. They are comfortable with the way that construction and completion risk is handled as well as the principle of single point responsibility and cost certainty. Furthermore, they are content that large international EPC contractors with healthy balance sheets are willing to sign up to cleverly drafted liquidated damages provisions for delays and shortfalls in performance (albeit subject to caps) and contracts that give little or no scope to claim for cost overruns.

This mindset will be difficult to overcome but banks can address a movement in project risk without necessarily raising their margins. For example, they may look for sponsor guarantees to deal with completion risk (often given in oil and gas projects where the sponsors are more likely to be cash rich and less likely to be given in the power and water sectors). Also, a bank active across the whole region may be willing to take more risk because it can spread that risk. Furthermore, banks can derive comfort from large, well known sponsors with inherent flexibility in their financial models and an EPC contractor with a proven track record for completing projects on time and to budget. The latter factor alone is a major one, as the Gulf generally has a good track record for completing projects on time and to budget—a testament to the quality of sponsors and contractors in the market.

## SEIZING THE OPPORTUNITIES

Some recent projects have been characterized by their disappointing turn out in terms of the number of bids received. The EPC price determines the viability of so many of these projects, so one has to question why the contractors have either been reluctant to throw their hat into the ring at all, or to throw it in on uncompetitive terms. The challenging time constraints for bid preparation is one factor, but so too is the requirement to enter into LSTK contracts with little or no in built flexibility to deal with likely risks.

The Gulf projects market represents huge opportunities for EPC contractors who are already in the region, as well as those with established track records elsewhere in the world that are looking to come to the region. However both categories are only likely to seize the opportunities if the transfer of risk is more evenly spread.

It is an established principle of contracting that "he who controls the risk should carry the risk". However this is often overstated with contractors that are expected to carry risks whether or not they control them. A better solution might be to share the risk if it becomes a reality. A project's financing structure will always influence the method of procurement; however this should not always mean that LSTK contracting is the only option, particularly if the margins no longer make it an attractive one.

## LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General e-mail messages may be sent using our “Contact Us” form, which can be found at www.jonesday.com.

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