

## PROJECT AGREEMENTS

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## INTRODUCTION

In Australia, over the last ten years, there has been a marked increase in co-operation between governments and private sector for the development, financing and operation of an array of infrastructure ranging from tollroads, water and sewerage treatment plants, sewerage outfall tunnels, power stations, hospitals, schools and prisons to defence-related equipment. These Public-Private Partnership (PPP) projects are being primarily driven by governments wanting to implement projects without recourse to public funding, and to improve the quality and efficiency of delivering these infrastructure facilities and on-going services to the public.

In Australia, PPP projects to date have been largely based on the Build-Operate-Transfer (BOT) model and project financed by the private sector. They are also commonly referred to as private financing initiatives or (due to the enduring Australian obsession with the three letter acronym) PFIs, PPPs or PFPs

This paper will focus on how concession companies are managing project risks 'downstream' with their construction and operator subcontractors.

## KEY PRINCIPLES OF PROJECT FINANCED PPP PROJECTS

A PFI/PPP deal generally involves:

a) a concession agreement between the government and the private concessionaire, with the concessionaire (usually a special purpose vehicle (SPV) formed solely for that purpose by the sponsors and having no substantive staff or physical assets) undertaking responsibility for the design, construction, operation and

maintenance of the relevant infrastructure

b) the concessionaire subcontracting its design and construction obligations to a contractor under a design and construct contract for the project, and its operation and maintenance obligations to an operator under a medium to long term operating and maintenance agreement, and

c) funding arrangements comprising both debt financing and equity.

The essential element of the project financing is that the project financier's recourse is limited in the main to the project's assets and revenue stream (often described as limited recourse financing).

Three overriding considerations when designing the risk allocation structure for a PFI/PPP are:

i) the cost of the project in its entirety - whilst the government wants to transfer most of the risks to the private sector, and the private sector wants to reduce its risk exposure, the main consideration is the efficiency gains and costs for the project in its entirety

ii) identification and allocation of all substantial project risks and the management of those risks by a combination of financial resources and firm contractual commitments, and

iii) to ensure that the risk allocation structure is sufficiently sound (or sensible) to cope with a combination of worst-case scenarios for the project.

Generally, the concession company can manage risks by:

a) retaining and managing the risk (rare, given their usually 'bare boner' SPV structure)

- b) transferring the relevant risk to another party (such as the contractor or operator), and
- c) using external risk management measures such as insurance.

The nature and extent of a project, and the circumstances and risk appetite of the government entity, individual sponsors and their project financiers will affect how each project risk will be managed and priced. Accordingly, it is difficult to generalise about the risks applicable to any specific project.

Most government entities will require a significant degree of risk transfer to the concession company to ensure off balance sheet treatment and to come within the 'value of money' framework.

Project financiers normally insist the concession companies retain very few risks and expect most risks to be transferred 'downstream' to the construction contractors and operators.

The most common approach for PFI/ PPPs is for project owners to enter into fixed time/fixed price 'turnkey' contracts for the delivery of the project so that the risks of cost overruns and delays, and technology risks (depending on the technology used in the project), are passed on to the contractor. The concession company would normally effect insurance for those risks which the downstream parties are unwilling to assume.

In addition, each concession company will need to ensure that it has appropriate and sufficient remedies against the construction contractor and operator in the underlying project documents.

The transfer of risks to other parties inevitably leads to increases in project costs,

because contractors naturally seek a higher return on investment for assuming a higher level of risk under the contracts, or because of increased insurance premiums. The project financiers are likely to require the concession company's sponsors to increase the equity in the project where a specific risk is not fully passed on.

## FLOW DOWN OR STEP DOWN OF RISKS AND OBLIGATIONS

### Concession agreements

The concession (or project) agreement sets the stage for risk allocation for the underlying project agreements. It will set out the government's overall requirements for the delivery of the project.

It is important for the concession company and the construction contractor and the operator to identify and appropriately deal with any risk or obligation set out in the concession agreement.

Although the construction contractor and the operator are not parties to the concession agreement, the final form of concession agreement shall reflect the design and construction risks and the operational risks that are accepted by the construction contractor and the operator will 'flow down' or 'step down' into the underlying project agreements.

During the bid preparation and contract negotiations phase, it is crucial that there is a co-ordinated approach towards finalising the project documents from the concession agreement down to the construction contract and operation and maintenance agreement.

Any mismatch in risk allocation is most likely to result in adverse

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contractual (and monetary) consequences for those parties who have not adequately priced in or managed those risks.

#### Indemnities and 'catch-all' provisions

A concession agreement usually contains indemnities in favour of the government entity for the concession company's breach and negligence.

These indemnities are generally made 'back-to-back' with the construction contractor and operator in the underlying project documents to the extent that any damages suffered by the government for which the concession company must compensate have been caused by either or both of them.

Usually, the underlying construction contract and operation and maintenance contract will contain a 'catch-all' clause under which each contractor/operator is required to perform the concession company's corresponding construction or operation and maintenance obligations.

#### Security and payment issues

##### a) Provision of security/ bank guarantees

Increasingly, concession companies are required by the government to provide security for performance of their construction, operating and handover obligations.

In the bidding process, a concession company will seek to minimise its bid costs. For example, it might require the construction contractor and operator in a bidding consortium to provide the security (in addition to any additional security that financiers may require) which the concession company is obliged to provide to the government entity.

A common contentious issue is what happens if the government calls on the construction bonds for non-construction matters. The resolution will depend on the risk management strategies of the project parties.

One solution might be that construction bonds provided by the construction contractor may only be called by the government or concession company for a construction contractor related default. Alternatively, the concession company might indemnify the construction contractor if the construction bond is called for non-construction contractor defaults.

##### b) Security of payment provisions

To keep the concession company whole, construction contracts and operating contracts often provide that the concession company's liability to pay monies only arises if and when the concession company receives monies from the government entity under the concession agreement for the corresponding obligation. In addition, the obligation is often limited to the relevant portion of what the concession company recovers from the government entity.

These type of provisions (better known as 'pay if paid'/'pay when paid' provisions) are void and unenforceable under security of payment legislation, now in force in New South Wales and Victoria<sup>1</sup> (and which will shortly be coming into force in Queensland Western Australia).<sup>2</sup> The legislation also provides that contracting out (or attempts to contract out) of these type of provisions is void. Attempts to circumvent these legislative restrictions (such as restricting rights of recovery or through other devices such as structuring payments as loans, etc) have to date not been tested before the courts. The NSW

security of payment legislation is presently the subject of a government review; it may be appropriate for governments to specifically exempt construction contracts in PFI/ PPPs from these prohibitions due to the special nature of these projects and the project funding structures.

### Completion issues

#### a) Completion obligations and extensions of time

Concession companies are increasingly obliged to meet completion deadlines under the concession agreements with limited extension of time entitlements.

The construction contractor is expected to adhere to these completion deadlines and accept similar limited extension of time entitlements (with compensation often only for breach solely caused by the concession company).

Generally, the construction contractor will only be entitled to an extension of time if the concession company is granted an extension of time under the concession agreement. Where a breach is solely caused by the concession company and the concession company is not entitled to an extension of time under the concession agreement, the concession company and the construction contractor will need to agree to alternative forms of compensation. These might include additional money to cover acceleration costs, and relief from liquidated damages in lieu of an extension of time (as the concession company will not be able to extend the completion deadlines under the construction contract beyond the completion deadlines under the concession agreement).

#### b) Damages for late completion

In some recent PPP transactions, concession companies have been required to accept the obligation to pay the government entities general damages for late completion (as compared to liquidated damages provisions commonly adopted in construction contracts). This is principally due to the fact that a government entity's losses are generally difficult to quantify and, for a liquidated damages regime to be enforceable, the liquidated damages need to be a genuine pre-estimate of the losses that that entity is likely to suffer.

Liquidated damages are generally preferred by construction contractors as a means to quantify and limit the risk and the damages that they face for late completion. In PFI PPP transactions, it is generally accepted that there is a two tier damages regime, namely:

- i) an indemnity from the construction contractor to cover any general damages that the concession company is liable to pay the government entity, and
- ii) liquidated damages covering any losses that the concession company separately suffers such as financing costs, loss of revenue and the like. This separate component of liquidated damages is usually capped.

#### c) Compensation for delay and breach

Most concession agreements provide that if the government entity delays the concession company in the delivery of the project, the concession company is entitled to be compensated for that delay. In most cases, the concession company will be compensated by extending the concession term, increasing the tolls or charges that the

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concession company can collect, direct monetary compensation or a combination of any of the above. The monetary compensation may thus flow significantly later than the time at which the delay is actually suffered.

The construction contractor or operator in the underlying project agreements will also expect to be compensated for those events. The concession company may therefore need additional financing to cover the more immediate monetary payouts that the construction contractors and operators, due to their more limited project involvement, will demand.

There is a potential mismatch between what the concession company is likely to get from the government entity under the concession agreement, what it is able to procure from the project financiers and its liability to the construction contractors and operators under the various underlying project agreements. The concession company should always attempt to ensure that there is no 'gap' between what it receives and what it pays out.

#### Land issues - access and condition

The concession company is generally expected to take the full risk of the condition of the project land and land requirements, unless it can demonstrate to the government entity that 'carving out' a specific risk would be a 'value for money' proposition for the government entity.

The construction contractor will generally be given access to the land that the concession company is given by the government entity under the concession agreement, and take the risk of that land (unless any specific risks are expressly carved out

and dealt with under a separate risk regime). The construction contractor will generally take the risk of acquiring (and the condition of) any additional land that has not been previously identified and is required by the construction contractor after the project commences.

It is important, therefore, for the parties to accurately identify the land requirements for the project and to carry out proper due diligence regarding the ownership (including any easements, restrictive covenants and the like), geological condition, contamination, native title, artefacts, planning approvals, endangered species present, etc as the government entity will not take responsibility (unless there are any carve outs agreed by the concession company and the government entity) for the land once the concession agreement is executed.

The construction contractor will therefore need to carefully investigate any potential risks and constraints to the delivery of the project and manage those risks either by having the appropriate carve outs in the construction contract (which will then be attempted to be mirrored 'upstream' in the concession agreement) or by pricing those risks accordingly.

#### Output performance

The concession company will generally be required to meet specified performance requirements. Payments to the concession company will usually be linked to the quality, amount and frequency of the services, and the availability of the infrastructure facility. Performance measurement may be linked to key performance indicators or an agreed set of performance standards.

If the concession company fails to meet the performance requirements, then its revenue stream (eg the tolls it is able to collect from the tollroad users, or the output or availability charges for use of a facility (such as hospitals, prisons, schools)) will be reduced accordingly to the level of achieved output performance.

Output performance requirements may be impacted by the quality of the completed project and by the quality of its operation and maintenance.

The construction contractor and the operator must therefore carefully review the output specifications issued by the government entity during the bid phase to ensure that they are clear and unambiguous, and that the criteria and methods for assessing performance are objective and measurable. Another area of concern which must be addressed is the allocation of responsibility for failure to meet the KPIs or performance standards and calculation of service credits. The failure could be due to defective construction works, failure to properly operate and maintain the infrastructure facility or to third party caused events (such as accidents).

Some important interface issues are discussed below in the next section.

### Design, construction and operation issues

Concession agreements contain design, construction, operation and maintenance related obligations. It is therefore important to a concession company that those obligations are passed down to the construction contractors and operators, ideally by being closely mirrored in the underlying project agreements. Care needs to be

taken to ensure there is clarity as to where responsibility lies for matters relevant to both design and construction, and operation and maintenance.

#### a) Fitness for purpose warranty

Concession companies are usually obliged to provide a fitness for purpose warranty to the government entity for performance of the infrastructure facility.

However, whilst the construction contractor is responsible for the 'initial' state of the infrastructure facility that it has designed and constructed, the facility must be appropriately maintained and where necessary upgraded to ensure that it continues to be fit for its intended purpose throughout the often decades long concession period. If the construction contractor is not itself responsible for the maintenance and any capital upgrades, it will not give a 'blanket' fitness for purpose warranty of lengthy or unspecified duration. The concession company will need to carefully manage the maintenance issues to ensure that the fitness for purpose warranty given by the construction contractor is not compromised.

#### b) Design, construction, operation and maintenance interface issues

It is also important for the concession company to manage interface issues between its construction contractor and operator. Some key interface issues include:

##### (i) defects

Under a concession agreement, the concession company would be responsible for correcting all defects arising from the design and construction work and be required to operate and maintain the infrastructure facility

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consistent with industry best practice. If there is a problem with the infrastructure facility during the operational phase, it may be difficult for the concession company to clearly allocate responsibility to any one party, as the problem could be due to defective construction work or poor operation and maintenance of the facility, or both.

It is therefore important for the concession company to manage the allocation of responsibility for any defective work or poor operational/ maintenance tasks so that it can discharge its obligations under the concession agreement.

To address this issue, the concession company may allocate the task of correcting any urgent problem that may impact safety or revenue to the party best able to fix the problem and then allocate ultimate responsibility after the source of the problem has been identified. The underlying construction contract and the operation and maintenance contract will need to contain provisions under which relevant parties agree to participate in a joint issues resolution process and to be bound by the final determination.

ii) co-ordination of design and operator's whole of life requirements

As the concession is normally for a lengthy term, the concession company is often required to ensure that the design of the infrastructure facility incorporates the operator's whole of life recommendations. The operator will also strive to ensure it receives a delivered facility which has been built to a high standard (so as to minimise operational and maintenance costs). This presents a potential conflict of interest (the concession company

would want to limit the higher standard for the facility and the operator wants these enhanced). It is therefore imperative for the concession company to carefully manage the design and operation interfaces.

iii) co-ordination of the construction and operational requirements to achieve completion

Completion under the concession agreement, which will invariably be a pre-condition to the obligation of government entity and/or the users of the facility) to commence payment, will depend on certain specified requirements being satisfied. These requirements might extend to the preparation of operation and maintenance manuals and management plans, testing to ensure that the facility functions properly, handover and opening of the facility, provision of spare parts, etc. These interface issues need to be carefully managed and co-ordinated to enable the concession company to discharge its completion obligations.

A useful discipline is to ensure underlying project documents contain an obligation allocation matrix which clearly allocates responsibility for each of the various obligations.

iv) quality of delivery facility and output specifications

As the operator is expected to meet output performance requirements in the operation and maintenance of the infrastructure facility, it will inevitably require the concession company to ensure that the delivered infrastructure facility satisfies the specified technical specifications. The concession company will in turn seek indemnities from the construction contractor in this regard.

v) access to operator prior to completion

The construction contractor is often required to complete various parts of the infrastructure facility before the completion deadlines, and hand over those facilities to the operator for training and pre-operation activities. Handover dates and co-ordination issues need to be carefully managed.

As the concession company will pass on the construction and operational risks to the construction contractor and operator as fully as possible, it is not uncommon for the construction contractor and operator to enter into separate bipartisan interface or co-ordination agreements. These type of agreements will set out the co-ordination roles and obligations that those parties have towards each other, and can be used to manage any risk interface gaps (including recovery of moneys if there is a breach).

c) Intellectual property

Intellectual property issues to be considered include:

i) ownership of intellectual property and licences to use

ii) keeping source codes in escrow, and

iii) attribution of contributors and waiver of moral rights.

Depending on the type of infrastructure to be constructed, the government entity may require ownership of, or an irrevocable, perpetual non-exclusive royalty-free licence to use, the intellectual property associated with the infrastructure (including any associated equipment). The concession company must obtain the appropriate rights to the intellectual property so it can meet its obligations under the concession agreement.

For high-tech equipment (such as telecommunications equipment, electronic tolling equipment and the like), the originating supplier is unlikely to give the project parties access to the source code except in limited circumstances, and then only after payment of appropriate compensation. In these cases, all interested parties may be required to enter into escrow agreements under which the source code supplier deposits the source code with an escrow agent, who will release that source code only in very limited circumstances, such as insolvency of the supplier or termination of the supply contract.

It is also prudent for the concession company to ensure that its underlying project documents allow it to do necessary things which would otherwise infringe an author's moral rights (since enshrined in the provisions of the Copyright Act 1968 (Cth)) in works produced for the project.

d) Independent certifiers, verifiers and other technical consultants

Most concession agreements contain a mechanism under which the government entity and the concession company appoint independent technical advisers (with names such as independent verifier, independent certifier, etc) to monitor the project on government and to carry out valuation and certification roles (including for extensions of time, variations, and the like). The decisions of those independent technical advisers are generally agreed to be final and binding with limited dispute rights.

It is therefore important that the underlying project documents

require the construction contractor and operator to adhere to the decisions of the independent technical advisers.

Concession companies may also want to limit the rights of the construction contractors and operators to require the concession companies to dispute these decisions (unless they are of a material technical or legal nature).

As the construction contractors and operators are not parties to the appointment agreements for the independent technical advisers, they often seek the right to require the concession company to take action against the independent technical advisers if the advisers breach their obligations under their appointment agreements.

#### **Material Adverse Effect (MAE) or Key Risk Events**

A concession agreement may include provisions for dealing with material adverse effects or key risk events. These provisions typically allow the parties to negotiate appropriate compensation to the concession company where a potential revenue shortfall, or a concession or a concession company's inability to repay project debt and equity, is caused by certain 'high risk' events (such as uninsurable force majeure events or a discriminatory change in law) or other specific risk events for which the company is not prepared to take the risk (such as native title challenges).

Usually, the compensation is only payable if a materiality threshold (such as the minimum rate of return for the concession company) has been triggered.

It is therefore important that the underlying project documents require the construction contractor and operator to adhere to the decisions of the independent technical advisers.



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The compensation may be in the form of an increased concession term, right to increase the toll or user charges or in monetary form, or a combination of those forms.

In the underlying project documents, the construction contractor or operator may not be prepared to accept any of these risks and may require compensation if they arise.

If the deal is to allow the construction contractors or operators to recover compensation, then the underlying project agreements will need to be drafted carefully to limit the compensation payable to an appropriate portion of what the concession company receives from the government entity. This may give rise to security of payment issues (discussed above).

It is common for construction contractors to accept the initial threshold risks (that is, the risks assumed by the concession company before the material threshold is exceeded) during the construction periods.

### Insurance

Under the concession agreement, the concession company is generally obliged to effect and maintain a whole range of insurances (including contract works insurance, public and product liability insurance, professional indemnity insurance, workers compensation insurance, director's liability insurance and business interruption insurance). Insurance costs are a major bid cost item. In some projects, the concession company (subject to the government entity's and the project financiers' agreement) requires the construction contractor to effect some of those insurances to avoid duplication.

However, the concession company needs to assess carefully the risk exposure that the construction contractor may have on its other projects if utilising the construction contractor's global insurance policies. It is imperative that there is sufficient coverage for the relevant project at all times.

### Compliance with obligations in ancillary project documents

Normally, the concession company also has obligations under a number of other project agreements, such as leases, licences, and interface agreements with other parties eg adjoining property and utility and infrastructure owners, etc. It is important that the underlying construction contract and operation and maintenance contract adequately identify which of these other obligations are to be assumed by the concession company, the construction contractor or the operator.

A similar analysis also needs to be carried out for any legislation (in particular, planning and environmental-related legislation) with which the concession company must comply under the concession agreement.

### Dispute resolution

In major projects involving many parties at various levels, it is important that disputes are managed in a co-ordinated manner. The concession agreement will contain the top-tier dispute resolution process between the government entity and the concession company. Disputes at the concession agreement level may be concerned with matters which arise under the underlying project documents (and vice versa). In other words, a dispute

between the government and the concession company may also result in or involve, a dispute between the concession company and the construction contractor (or all four of them).

When a dispute involving the same subject matter arises under the various project documents, the most common approach is for the dispute resolution in the concession agreement to have priority, the dispute resolution process in the underlying documents to be suspended, and for all the parties to be bound by the resolution under the concession agreement. The construction contractor and operator will, however, be given all relevant documents, and an opportunity to attend and make submissions and to participate in the upper tier dispute resolution process.

### Termination

The underlying project agreements will need to allow the concession company to terminate those agreements if the concession agreement is terminated for any reason. Different remedy mechanisms and consequences will apply depending on the cause of the termination, such as termination of the concession agreement due to breach by the Government entity, or by the concession company (including a breach which arises because of a default by the construction contractor or operator under their respective contracts), termination for breach by some other contracting parties, termination for convenience, etc.

### REFERENCES

1. Building and Construction Industry Security of Payment Act 1999 (NSW)

Building and Construction Industry Security of Payment Act 2002 (Vic)

2. Building and Construction Industry Payments Act 2004 (Qld), Construction Contracts Act 2004 (WA)

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