TWO-STAGE CONTRACTS

These informal notes on two-stage contracts are intended to stimulate discussion and may not be relied upon as legal advice.

RATIONALE

The recent (but now rapidly reversing) surge in demand in the major project construction market revived interest in two-stage contract structures. They have been in growing use or contemplation in various sectors, notably oil and gas, petrochemicals and energy. Such structures have also been commonplace for some time in the UK real estate development market, albeit in simplified form.

In times of high demand, the usual reasons for embracing two-stage contracting are:

- speed to market (especially the ability to mobilise the procurement process despite the immaturity of the design at the date of signing);
- enhanced transparency for the owner in relation to pricing and key procurement decisions; and
- a perceived "de-risking" of projects aimed at enhancing bidder interest and/or optimising risk pricing.

Even in a slowing market, advantages may still arise from a two-stage approach. For example:

- an opportunity for contractors to price risk more accurately may make the difference between their survival and failure in challenging trading conditions.
- enhanced "buildability" and collaboration are always beneficial;
- pricing transparency can be as useful to owners in capturing reductions as in mitigating increases in price;
- step-in rights with major subcontractors are more readily available to owners in a two-stage context, affording a useful hedge against contractor failure.

Basic Structure

Two-stage contracting involves an initial pre-construction stage in which basic design is prepared or further developed (if not already existing), some procurement may be undertaken and open-book pricing is further developed. Other open issues may also need to be progressed during this period, for example consenting, site investigations, the evolution of programme and performance guarantees and the agreement of any contract terms for the construction phase which have not been agreed upfront.

Contractors often seek payment during the pre-construction phase on a reimbursable basis, though some degree of fixing or capping may be attainable, for example in relation to the margin or defined elements of the services. Incentivisation arrangements are sometimes also included at this stage, though their efficacy can sometimes be questionable (depending largely on the maturity of project definition at initial signing).

A distinction is sometimes made between "value added" activities (such as design development) for which payment is made by the owner during the initial phase and bid preparation activities (such as programme development or procurement) whose costs are initially borne by the Contractor and then rolled up into the eventual contract price after conversion.

A key issue for the owner is whether FEED/basic design should be carried out by the Contractor as part of his first phase activities or separately procured by the owner before letting the two-stage contract, and then simply further developed by the Contractor. The first approach enables the contract to be awarded at an earlier stage and may improve the degree of integration between the design phases and between design and related workstreams. However, owners may elect to pursue the second course despite these advantages, on the basis that a FEED/basic design provider who is appointed by and answerable to the owner is more likely to produce a cost effective design.

Tender Process

The bidding contractor generally quotes at the outset a percentage fee for risk, profit and head office overheads which is added to the open-book construction prime costs, as part of the process of developing the lump sum contract price which is intended to apply to the main works during the second phase.

An initially estimated outturn cost may sometimes be stated at the outset, but no definitive contract price is set at that time. Even the agreement of an estimate (for example as an incentivisation benchmark) will only be meaningful if a FEED or equivalent has already been prepared. Such estimates are in any event always heavily loaded with contingencies and may exert an unhelpful upward influence on the ensuing open-book pricing process.

The initial documents will state the nature of the pricing arrangements envisaged for phase 2, e.g. whether lump sum, GMP or target cost. Lump sum is the normal choice where limited recourse financing is the ultimate objective and such arrangements are sometimes known as "CLSTK" or "convertible lump sum turnkey" contracts.

Bidders are generally also required to agree to the full conditions of contract which are to apply to the second stage works. These are then annexed to the contract at the outset.

Other initially tendered data may include lump sum amounts for preliminaries and other items.

Phase 1

Having chosen a bidder on the basis of the tender data mentioned above, the owner then embarks on the first phase process with his chosen contractor.

The initial price estimate (if any) is progressively refined during phase 1 by reference to design development and open-book procurement undertaken during that phase, until the agreed trigger point for the conversion mechanism is reached (see below). Any issues other than price not resolved during phase 1 (for example scope or other technical issues) are also submitted to the conversion mechanism.

The approach to time varies from case to case. In some contracts the target completion date for the whole works is agreed at the outset and adjusted on the usual time extension grounds for events occurring in phase 1 (including scope changes but excluding design development, assuming that distinction can be captured in words). In other cases, e.g. where a basic FEED is not available upfront, the completion date is left to be agreed/determined as part of the conversion process.

Conversion Trigger

The ingredients for the conversion trigger are typically:

- progression of design development to an agreed level of detail; and/or
- the placing of orders (or fixing of price by other means) for work whose price is equal to or greater than a pre-agreed percentage of the overall cost estimate (typically in excess of 50%); and
- a longstop date.

Conversion Mechanism

The conversion mechanism usually consists of two stages.

The first stage is a structured and time limited process for delivery of a comprehensive proposal by the contractor and its negotiation by both parties, perhaps involving designated senior representatives.

If the first stage fails to produce an agreement, it may be supplemented by a second stage of mandatory dispute resolution (e.g. expert determination) to close the remaining gaps. Such a process may in practice not always be easy to enforce without contractor cooperation. For example, the dispute resolving person or tribunal may decline or be unable to exercise jurisdiction if the gap is too wide and/or if the amount of objective supporting data is insufficient. Mandatory processes (at least for items such as price) also tend to deter bidders.

It is therefore customary to support any attempted mandatory conversion with:

- commercial incentives, such as gain-share in relation to savings against the cost estimate achieved during the pre-construction stage and/or the deferral of payment of margin on pre-construction services; and
- shareholder relationships where appropriate.

As an alternative to a fully mandatory process, the agreement may provide either for a fully consensual process, or for a hybrid whereby matters which are analogous to normal contract variations (e.g. matters of scope or specification) are resolved by determination, whereas commercial risk items (e.g. price, LD rates or liability caps) are left for consensual resolution.

Fallbacks

The owner must consider the possibility that conversion may not always occur, or fully occur, and consider his fallback options in the absence of complete conversion.

One fallback always adopted in two-stage contracts consists of terminating the engagement of the original contractor and assuming ownership of all work product and related intellectual property rights. Any subcontracts or purchase orders already awarded by the initial contractor may also be taken over by novation/assignment. The owner then either rebids the second-stage contract or abandons the project.

A further option which owners should consider (save in cases of loss of confidence in the contractor) is to continue with the initial contractor even without full conversion. For example, the owner may decide to continue to enjoy the benefit of any already agreed or determined EPC terms as to time and quality while accepting ongoing reimbursable pricing for all or some part of the price, perhaps at a lower pre-agreed margin that the one agreed for full lump sum conversion.

Interim Funding

It is very unlikely that limited recourse lenders will be prepared to disburse funds before they have attained the certainty of a fully converted EPC contract. The owner and its shareholders will therefore be called upon to finance or guarantee costs incurred during the initial stage (in addition to their own development costs). These will include:

the fees payable to the contractor for pre-construction services such as design development;

payments for any early physical works authorised by the owner prior to conversion, such as site investigation or clearance; and

the cancellation or down-payment charges which are likely to be required by suppliers/subcontractors with whom orders are placed during the initial stage for certain major items of equipment and materials, especially those in short supply (e.g. in recent times, steel pipes and vessels).

These exposures can be substantially refinanced from the main facility if conversion occurs.

Documentation

The documentation for a two-stage contract can take one of two main forms:

- Integrated

  In some cases the initial signed document consists of a single set of conditions covering both stages and resembles a full EPC contract, save that it includes additional clauses or annexes which detail the initial stage activities of design finalisation, open-book procurement, price development and conversion. There will also be provisions which defer the full activation of certain clauses specific to the construction stage, such as the owner's obligation to start the "all risks" construction insurance.

- Non-Integrated

  The majority of two-stage contracts involve two distinct documents, namely:

(i) a pre-construction services agreement which governs the initial stage's services and the conversion process only; and

(ii) wholly or substantially agreed full EPC conditions which are annexed to the initial stage agreement and partially activated in that stage (for example, in relation to standard clauses such as copyright and dispute resolution provisions) but which come into full force and effect as an EPC contract only upon conversion.

This format is likely to be more immediately attractive to contractors in that it more clearly reflects the two-stage nature of the procurement.

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