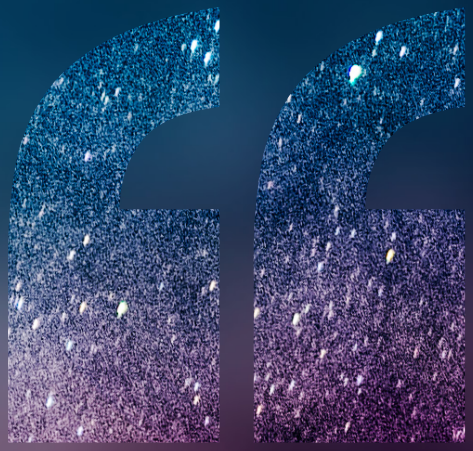
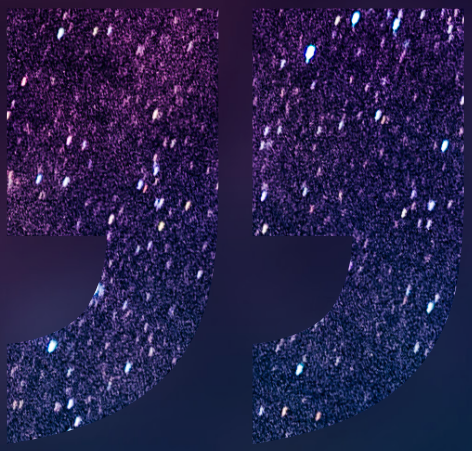
CLIFFORD
CHANCE



CONSTRUCTION PROCUREMENT TRENDS: AVOIDING PANACEA THINKING



— THOUGHT LEADERSHIP

APRIL 2020

CONSTRUCTION PROCUREMENT TRENDS: AVOIDING PANACEA THINKING

In these turbulent times it is hard to imagine the world after the Coronavirus (Covid-19) and to predict the long-term impact of the outbreak on our societies and economies. One thing is certain – the effects will continue to be felt for many months after the immediate crisis has passed.

When that time comes, the world may be left facing a global recession and governments will need to consider what measures are available to kickstart their economies. One such method is the tried-and-tested tactic of increasing spending on public infrastructure. Indeed, even before the Coronavirus outbreak, one of the rare issues uniting parties across the political spectrum was the need to increase investment in public infrastructure.

At the same time, however, a key model for the delivery of public infrastructure is under attack in the countries where it has arguably enjoyed its greatest success. Support for public-private partnerships (PPPs) has somewhat withered in recent years under relentless criticism by opposition camps about value for money and perceived excessive returns for equity investors. In the UK, this led to the government announcing in late 2018 that it would no longer use this delivery model for the procurement of public infrastructure projects.

Many are now looking for alternative financing and procurement structures which will enable projects to be delivered efficiently, and new revenue streams to be unlocked, so as to realise ambitious infrastructure plans.

Problems can arise, however, when clients (public or private) seek to rely on a single structure, contract form or philosophy to deliver infrastructure projects.

This paper considers some of the main options available for the procurement of major infrastructure projects globally, and highlights the importance of tailoring the structure to the particular asset and the capabilities of the project parties.

The fundamentals

Before launching any project, owners or developers need to make some fundamental decisions which will inform and, in some cases, limit their procurement strategy options.

The right approach can give the parties the leeway to deal with unexpected circumstances which may arise during the execution phase and even (counterintuitive though it is for us to say!) overcome deficiencies in the contract documentation. Choosing the wrong structure, however, can be costly or even impossible to reverse once the project has been launched.

Holyrood, the Scottish parliament building in Edinburgh, is often cited as an example of how not to procure a major construction project. The client on that project opted for a Construction Management model which was in vogue at the time and which can, if properly managed, deliver assets more quickly and more cheaply than under a D&B/EPC/traditional route.

What the client had underestimated, however, were the high demands this model places on the client team to manage the multiple trade packages (in Holyrood's case, over sixty) and to mitigate the construction and interface risk retained under this structure. Failings in this regard ultimately proved to be a major contributing factor to the Holyrood project being delivered three years late and significantly over budget.

Two-stage contracting is another structure that can appeal, due to the attraction of fast-track procurement and early contractor involvement in the

design, but which needs to be handled with care. Several UK real estate developments which initially adopted this model have had to be re-tendered in recent times (resulting in inevitable delays to the overall programme) due to the counterparties failing to reach agreement on a final lump sum price.

A similar story can be found in the downstream oil & gas sector where major infrastructure projects using the two-stage model have failed to achieve conversion to lump sum pricing, resulting in the client bearing the cost risk of all unforeseen circumstances up to and including commissioning and completion.

It is vitally important therefore that clients apply the right decision-making methodology when choosing between the various options for the procurement of infrastructure projects, rather than maintaining an allegiance to any particular structure or philosophy.

The Options

Before turning to the key factors that should be considered as part of the client's decision-making methodology, we summarise below some of the main procurement options, each of which has its own features and application.

Procurement option	Overview	Pricing	Points to note	When used?
D&B/EPC Design and Build/ Engineer Procure and Construct	Contractor wraps the design and the workmanship/materials risk (even where it did not prepare the basic design). Under an EPC contract the contractor often guarantees the performance of the completed asset.	Typically lump sum.	Recourse limited in practice by caps, waivers and balance sheet.	Commonly used in project financed deals and in certain sectors, e.g. gas-fired power.
CM/EPCM Construction Management/ Engineering, Procurement support and Construction Management	An enhanced contract for services with limited legal remedies. Owner bears significant construction risk, including interface risk.	Theoretically a cheaper procurement model compared with D&B/ EPC due to removal of the EPC risk premium, but owner bears cost risk of interface claims between the packages.	Works procured via multiple package contracts (which can number in the single digits or the thousands) usually signed by owner. Recourse limited by value of individual packages not by reference to overall project capex.	Potential 'fast-track' delivery method: multiple packages can be let simultaneously before design of the whole asset is complete.

Procurement option	Overview	Pricing	Points to note	When used?
Split BOP/MSA/TSA Split Balance of Plant/ Module Supply/Turbine Supply Agreements	Rarely features an 'EPC wrap' - no single party takes responsibility for the timely completion or performance of the asset. Greater interface risk compared with single stage EPC.	Minimises capex (and therefore facilitates the bidding of lower tariffs) via the removal of the EPC risk premium.	Interface risk can be mitigated via a co-ordination or umbrella agreement particularly in the PV solar sector (although difficult to obtain in practice from unaffiliated contractors). Recourse limited by value of individual packages not by reference to overall project capex.	A feature of the renewables sector.
Two-Stage Contracting	A single contractor is signed up under either: • a separate Pre-Construction Services Agreement; or • Stage 1 of an integrated convertible EPC/D&B contract. The PCSA/Stage 1 contract covers design development, some open book procurement, possibly some early construction activity and a conversion process.	Payment pre-conversion is on reimbursable basis. Post conversion pricing and risk allocation switch to lump sum D&B/EPC.	Conversion is designed to take place on defined triggers (such as a % of detailed design development). Incentives may be required to encourage conversion if agreement cannot be reached.	Potential 'fast-track' delivery method compared with single-stage EPC/D&B: no need for full detailed design at the tender stage, although delays can occur around conversion.
IPD/Alliancing Integrated Project Delivery	A single contract for the delivery of the project signed by all key stakeholders (owner, contractor, designers, suppliers, subcontractors). Project administered by a board composed of senior staff from each of the stakeholders. Decisions are made on a 'best for the project' basis.	Pricing mechanism varies but typically payment is on an open book reimbursable or remeasurable basis, subject to a Target Cost.	Parties share risks and rewards on a 'no blame, no claim' basis, except for liability arising out of fraud or wilful misconduct.	Upstream oil & gas/public sector procurement

Procurement option	Overview	Pricing	Points to note	When used?
GMP/TC Guaranteed Maximum Price/Target Cost	An alternative pricing model which can be applied to a EPC/D&B risk allocation.	Payment is on a reimbursable basis. GMP: Payment subject to a cap. Owner and contractor share any savings (gains) below GMP. TC: Payment subject to a target. Owner and contractor share any savings (gains) below TC. Pain of overruns in excess of TC is shared between owner and contractor.	Requires significant owner resources during the execution phase to monitor the expenditure of costs and avoid, for instance, 'double-dipping'. Gainshare mechanism needs to be carefully calibrated to incentivise completion of the works below the GMP/TC.	Potential 'fast-track' delivery method: can be signed when design is immature.

Decision-making methodology

Before settling on the structure, the client needs to take into account the following key factors.

Funding sources

If external debt finance is desired or required (particularly in the project finance sector where there is no valuable asset as part of the initial security package) this favours a procurement structure which maximises cost and schedule certainty in the construction contract(s), such as D&B/EPC. There are, of course, exceptions to this, including where market barriers prevent a single EPC solution (such as offshore wind), where construction risk is considered extremely low (e.g. some solar PV projects), or where the sponsors are willing to provide significant completion support.

An internally- or corporate-financed project, on the other hand, gives owners greater flexibility to choose a procurement model which prioritises other commercial factors, such as maximising upfront capex savings. Construction Management or EPCM contracting may be a viable option in such cases.

One funding model that is much discussed at the moment is the Regulated Asset Base (RAB) model. This is used widely across the world for regulated utilities and is increasingly being considered for greenfield infrastructure projects, including airports and nuclear power plants. Under a RAB structure, investors earn a return on the accumulated capital expenditure incurred during the construction period – a significant departure from the PPP model under which revenues only commence on completion of the asset. In a RAB structure, the private sector is typically incentivised to control construction costs (ultimately borne by the taxpayer) via Target Cost pricing in the construction contracts.

Internal resources

Clearly the level and quality of internal resources and experience that a public utility would typically be expected to have, compared with a one-off SPV developer, for example, can vary widely. The choice of procurement strategy needs to acknowledge any limitations within the owner team which may make more labour-intensive options (such as Construction Management/EPCM, Target Cost and some of the alliancing methods mentioned below) impractical, unless the owner is prepared to supplement its team via external project management resources.

Procurement philosophy

In the UK, since the publication of the Latham report in 1994, the construction industry has continued to face criticism for delivering poor value for money to its customers compared with other industries. This has led to government-endorsed bodies recommending the use of collaborative contracting techniques

and contract forms such as NEC, in place of traditional 'adversarial' forms of contract, with the aim of driving change in the industry and improving project predictability and outcomes.

The owner's procurement philosophy (i.e. whether to treat the supply chain as a partner or to adopt a more conventional approach to risk allocation) will be a key factor in choosing the appropriate procurement structure.

Collaborative contracting comes in many different guises. It can involve the adoption of an industry standard form, such as NEC, which contains express provisions establishing a partnering ethos (e.g. a duty on each party to act in a spirit of mutual trust and co-operation) coupled with non-fixed price pricing options.

Another option would be the use of an overarching framework agreement or partnering charter designed to incentivise and reward over-performance in a programme of capital works against measurable KPIs.

At the other extreme, collaborative contracting can involve a full alliancing or Integrated Project Delivery (IPD) model. This model, first used in the development of oilfields in the North Sea, involves all key stakeholders (owner, contractor, designers, suppliers etc) signing up to one integrated contract which allocates the project scope amongst the parties and shares risks and rewards on a 'no claim, no blame' basis.

Not all owners will have the requisite resources or appetite to embrace and manage these collaborative concepts. State-owned clients from certain jurisdictions, for example, may be subject to strict budgetary constraints and used to a more conventional 'stick-based' approach to risk allocation. Similarly, a contract structure which features heavy partnering or alliancing concepts would be a significant departure for project finance lenders who are used to running downside-focused risk analysis on their projects and may struggle with the additional risks and uncertainty presented by these concepts when compared against conventional EPC/D&B-based contracting.

In the event that an owner/developer does decide to embrace a more collaborative approach, the effective use of alliancing or partnering techniques will require buy-in at all levels of the owner and contractor organisations (from top management down to the contract/project management team) and a recognition that it is people, not contracts, that deliver projects.

This is equally true, of course, for conventional contracting models. Even where the parties commit to spend significant time at the pre-contract stage identifying and allocating responsibility for the risks that may occur on a complex infrastructure project, owners should not lose sight of the 'people clauses' (i.e. key personnel, value engineering and early warning mechanisms, and tiered dispute resolution procedures). These provisions can be just as effective in helping to manage issues arising during the execution phase of a project as the provisions which allocate risk if things go wrong.

Commercial priorities

The owner's position with respect to some of the fundamental issues discussed above will drive the viable structural options. Where some flexibility exists, the next step in the decision-making process involves the owner/developer assessing its commercial objectives for the project. This exercise requires the delicate balancing of often competing goals, such as price or time certainty, speed to market and minimising capex.

For the development of a major element of the sporting infrastructure connected with an event such as the Olympics or the World Cup, the existence of a hard deadline may justify the selection of a procurement model that prioritises schedule certainty and safety over other commercial objectives, such as cost.

A balance sheet or state-funded developer of a port project, on the other hand, may opt for a disaggregated procurement model, motivated by the twin aims of (i) eliminating the EPC risk premium and reducing capex, and (ii) letting multiple packages simultaneously and thereby accelerating the timetable for completion of the project as a whole.

There is no one-size-fits-all solution, either by geography or by sector. Market practice is constantly evolving as a result of the impact of a variety of factors including new players entering the market, projects becoming bigger (which in turn places additional demands on the need for external finance), commoditisation and/or shifts in the political landscape.

Getting it right requires an understanding of how the main structures work, and matching the project variables with the most suitable structure.

Conclusion

Procuring major infrastructure projects is rarely easy and there is no panacea. It is possible, however, to overcome all manner of potential hurdles with a procurement decision-making methodology that helps parties select the contracting and financing structures most suited to the project requirements, the available resources and the features of the underlying asset.

As infrastructure investors increasingly stretch the definition of 'infrastructure' to capture, for instance, housing and power generation assets, as well as more traditional infrastructure such as roads, rail or hospitals, it becomes even more important to have an informed methodology for choosing the right procurement approach for any particular project.

The market-leading Clifford Chance Construction Group has a wealth of experience advising across all infrastructure sectors and geographies. Through acting on all sides of these deals (for governments, developers, contractors, investors, lenders) we have a 360-degree view of the challenges involved and know how to structure projects in a way which balances the competing interests of the various stakeholders.

CONTACTS

Edward Bretherton
Partner
London
T: +44 20 7006 4856
E: edward.bretherton
@cliffordchance.com

Matthew Buchanan
Partner
Singapore
T: +65 6410 2206
E: matthew.buchanan
@cliffordchance.com

Liesbeth Buiter
Partner
Amsterdam
T: +31 20 711 9326
E: liesbeth.buiter
@cliffordchance.com

Sandy Hall
Partner
London
T: +44 20 7006 6806
E: sandy.hall
@cliffordchance.com

Nadia Kalic
Partner
Sydney
T: +61 2 8922 8095
E: nadia.kalic
@cliffordchance.com

Inaamul Laher
Head of Construction, MENA
Abu Dhabi
T: +971 2 613 2433
E: inaamul.laher
@cliffordchance.com

David Metzger
Partner
London
T: +44 20 7006 4240
E: david.metzger
@cliffordchance.com

Ella Omelchenko
Counsel
Moscow
T: +74 95 258 5054
E: ella.omelchenko
@cliffordchance.com

Tim Steadman
Abu Dhabi
T: +971 2 613 2327
E: tim.steadman
@cliffordchance.com

Marianne Toghill
Head of UK Real Estate Construction
London
T: +44 20 7006 4373
E: marianne.toghill
@cliffordchance.com

CLIFFORD

CHANCE

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

2004-000303