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Equivalent Project Relief in the Gulf

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It's been 3 weeks since I relocated from Bracewell's London office to Dubai and I've been wearing down my shoe leather in the DIFC and beyond meeting old acquaintances and new contacts. Most of the time, discussions invariably focus on project pipeline, market trends and regional challenges. However, I've been constantly gratified by people's willingness to talk about my own specialism: construction. As my colleagues often tell me, construction isn't seen as the most glamorous area of law (although it should be). But a construction contract is where a project's capex is spent, so it's certainly worth some thought.

Pricing pressure is a running theme, both at sponsor and contractor level. How to ensure plurality of participation in the regional power IPPs is another popular talking point. However, clients have also raised a number of more contractual issues including, perhaps surprisingly, equivalent project relief (or "EPR"). Three developer clients have expressed a concern that EPR serves to pass too much risk to construction and O&M contractors, potentially attracting a price premium which then adversely affects the developer's ability to provide the lowest possible price at bid stage. The question is: can we live without EPR?

What is EPR?

It's probably helpful to recap the key features of EPR. An EPR provision is a tool used in a concession-based project to effect the maximum possible pass down of risk from the special purpose vehicle to the construction and O&M contractors. It is included in construction, O&M and other similar contracts and is generally drafted in broad terms to include (amongst other things) a general obligation to carry out relevant obligations in the concession document (a "Project Agreement") and an agreement that the contractor's contractual entitlement to additional time and money is limited to what the SPV can secure under the Project Agreement. The intention is to ensure that the Project Agreement and construction/ O&M contracts are 'back-to-back' in terms of obligations and liabilities, with minimal risk sitting with the thinly capitalized SPV.

Where did EPR come from?

I first came across EPR clauses fairly early on in my career when working on PFI/ PPP projects in the U.K. I have an example from those days on my shelf which is five pages long and contemplates every possible pass down scenario. It's bullet-proof, from a developer perspective. However, it wasn't especially contentious during negotiations with the contractors. There are a few reasons for that.

Firstly, the U.K. is one of the most mature PPP markets in the world. The U.K. Government introduced the 'Private Finance Initiative' in 1992 with a view to reducing the public sector borrowing requirement. Project participants in the U.K. market have had a long time to develop and refine the principles of EPR.

Secondly, a Project Agreement in the U.K. has consistently been a finely-crafted instrument, with clear, detailed provisions covering every conceivable project risk, and which is drafted with specific construction and operation phase sections designed to be passed down into the relevant contract. It has therefore been fairly straightforward for contractors to establish, through their own due diligence, the extent of the risk which they are expected to assume in their respective contracts.

Finally, and significantly, the equity participants in the SPV and the construction and O&M contractors are often from the same group of companies. The contractors effectively have a seat at the negotiating table for the Project Agreement and are able to exert meaningful influence on the positions agreed between the authority and the SPV. They know and understand the risks which they will be required to take on.

EPR in the Gulf

By contrast, EPR is a relatively recent feature of Middle Eastern project finance deals. Almost all of my colleagues in Dubai can remember a time when contracts didn't include EPR provisions. The concept was imported from abroad – possibly from the U.K. or from the South African REIPPP – and we see it in almost all EPC and O&M contracts which cross our desks. So what are the reasons for the murmurings of dissent in the market?

An important feature of concession-based projects in the region is that many of the active contractors are engaged by the SPV on a genuine, arm's length basis and do not have any equity interest in the project. For that reason, they generally don't have significant input into the risk allocation negotiations at Project Agreement level. In spite of this, the effect of EPR is often to pass down the entirety of project risk, many elements of which would perhaps be better assumed by the SPV (who can expect to make a healthy return if the project is a success).

An aggravating factor is that some Project Agreements (or at least certain parts of them) are occasionally not as comprehensive or as detailed or as clear in terms of risk transfer as those in more mature project finance markets. Clauses can often be ambiguous and the parties may not have certainty about how risks are allocated, if they have been allocated at all. EPR therefore runs the risk of being used as a blunt instrument to impose unclear or unknown project risks on the contractor, rather than to protect against small potential gaps in risk transfer. However, the margins for contractors in the current market are historically low, meaning that they cannot afford to adjust their prices to account for this uncertainty.

EPR and bankability

So if sponsors have reservations about EPR, and contractors don't want to accept EPR, the question is whether construction and O&M contracts can still be bankable without an EPR clause. In some respects, this isn't the right starting point. The market remains extremely competitive for contractors and there are many in the market who will offer EPR with no

apparent impact on price. This is especially true for new market entrants who are seeking to win their first contracts or for experienced players who are comfortable with the risks of working in a particular jurisdiction. So many sponsors will expect to see an EPR clause in the EPC and O&M contracts, regardless of the lender view.

Having said that, our office view is that EPR is not a bankability point if the lawyers and the technical advisors have carried out a thorough review of the Project Agreement and effected a comprehensive pass down of the relevant risks. A couple of years ago, I sat down with a client to consider residual claims which might arise outside of the key pass down areas (force majeure, change in law, authority delay, technical specifications, testing regimes and a small number of others). We couldn't think of anything which wasn't highly theoretical and the lenders were similarly persuaded: we proceeded with a very narrowly defined concept of EPR. This helped the contractor to offer a reasonable price and the project was delivered successfully. Based on what we're hearing, we expect this to become an increasingly popular trend.