Opinion

Sean Pearson is the assistant vice president of Construction, Middle East and North Africa at Liberty Specialty Markets.

Infrastructure projects – who is taking the risks?

Evaluation of contract between the principal and contractor is critical when understanding why amendments are made to established contracts

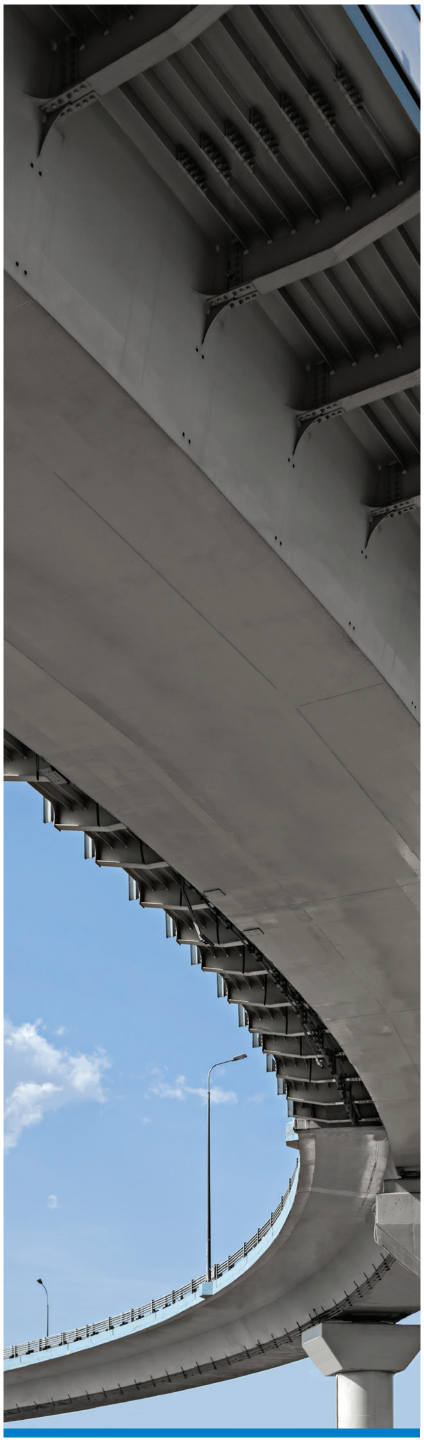
As a lead reinsurer in the Middle East and North Africa region, Liberty Specialty Markets provides underwriting capacity on a number of large, complex infrastructure projects.

In some respects, the MENA region lags behind Europe and the West in terms of the extent of its road and rail infrastructure. With the ever expanding sovereign wealth funds, there is sufficient liquidity to provide genuine solutions to inter-country travel to the region's citizens. As a result, we are seeing a surge in projects put out to tender by local ministries and organisations.

Many of these may never have procured a large-scale infrastructure project before, it typically being the domain of the international contractor. Dealing with these contractors is often therefore a new experience, presenting different challenges for organisations more used to working with local contractors, and the requirements for awarding construction contracts are different.

Unlike the procurement of a project that uses local contractors, the international contractor market is more familiar with construction contracts on the basis of internationally recognised standard contracts such as FIDIC or JCT. Increasingly, however, contracts are being awarded on amended versions of the standard contracts, which can introduce uncertainty. In many cases, we see these amendments ostensibly favouring the principal, such that a significant degree of the risk is transferred to the contractor.

The standard construction contracts, constructed by legal experts following years of practice and precedent, are modified by a series of amendments, normally undertaken by the principal's contracts team in an attempt to reduce risks that could affect the overall cost or schedule. While one can understand the reasons for doing this, as an insurer and a contractor, one should be aware of where the ultimate risk lies.



A common example is with respect to unforeseen ground conditions, a key risk for any underground rail project. Best practice suggests that this risk should usually be borne by the principal, and that a contingency be built in, in addition to a contractor's fixed price, for such an eventuality.

Where amendments have been made, we may see this risk as being put solely on the shoulders of the contractor. The situation is exacerbated when a contractor has been awarded the EPC contract on the basis of a lump sum turnkey. Where, under the framework of a FIDIC Yellow Book contract, there would be a sharing of the risk – normally by the provision of a GBR – the amended versions often seek to place all this risk with the contractor: "You bid for the works and were awarded the contract, now complete the project."

In this scenario, the contractor may have little flexibility in their price, having built in a fixed price at tender stage, and the principal would now have them held to rights. The impact we see as insurers is the potential for degradation in project quality. Rather than lose money on the project, there is a risk that the contractor may offset project quality to ensure profit margins are maintained, avoiding causing liquidated damages to be triggered.

From an insurer's perspective, it is critical that we evaluate this contractual relationship between the principal and contractor and seek to understand the reasons behind making any amendments to an established contract, particularly in respect of risk allocation. In some cases these amendments are borne out of practicalities, but often they are the result of naivety.

Where contract changes have been made for valid reasons, the implications of these changes need to be fully understood by all parties; otherwise, the original intention is lost. At a certain stage, we need to ask ourselves the question: At what point does a contract stop being an amended FIDIC contract and become something totally different?