PROJECT FINANCE IN IRELAND

FRAGMENTED EPC PROCUREMENT

1 Executive Summary – the Irish market.

1.1 The last four years have seen significant growth in the number large scale engineering and infrastructure projects in Ireland.

1.2 The principle drivers behind this increase in construction activity have been (i) an increase in energy demand due to the generally improved economic outlook; (ii) a combined public sector and private sector response to EU targets for increased generation capacity for renewables; (iii) increased need for investment in transport and utilities infrastructure in response to a deficit in investment in the preceding years (iv) and the increased willingness of banks to finance large scale construction projects.

1.3 Given the nature of the large scale projects currently under construction or in the planning stage (Dublin's "Metro North" project, the significant expansion of the "Luas" light rail tram network in Dublin, as well as unprecedented investment in modernising Ireland's water infrastructure, the development of a reverse flow natural gas interconnector between Ireland and Scotland and the continuing addition of new renewable generation capacity to the Irish grid) it is an interesting time in which to consider the status of EPC procuring and contracting in the Irish market.

1.4 Construction and engineering projects procured on an EPC basis traditionally provide for (i) single point responsibility; (ii) a fixed programme with a set date for delivery; (iii) a fixed price; and (iv) a guaranteed performance and reliability levels set against a developer's stated output criteria.

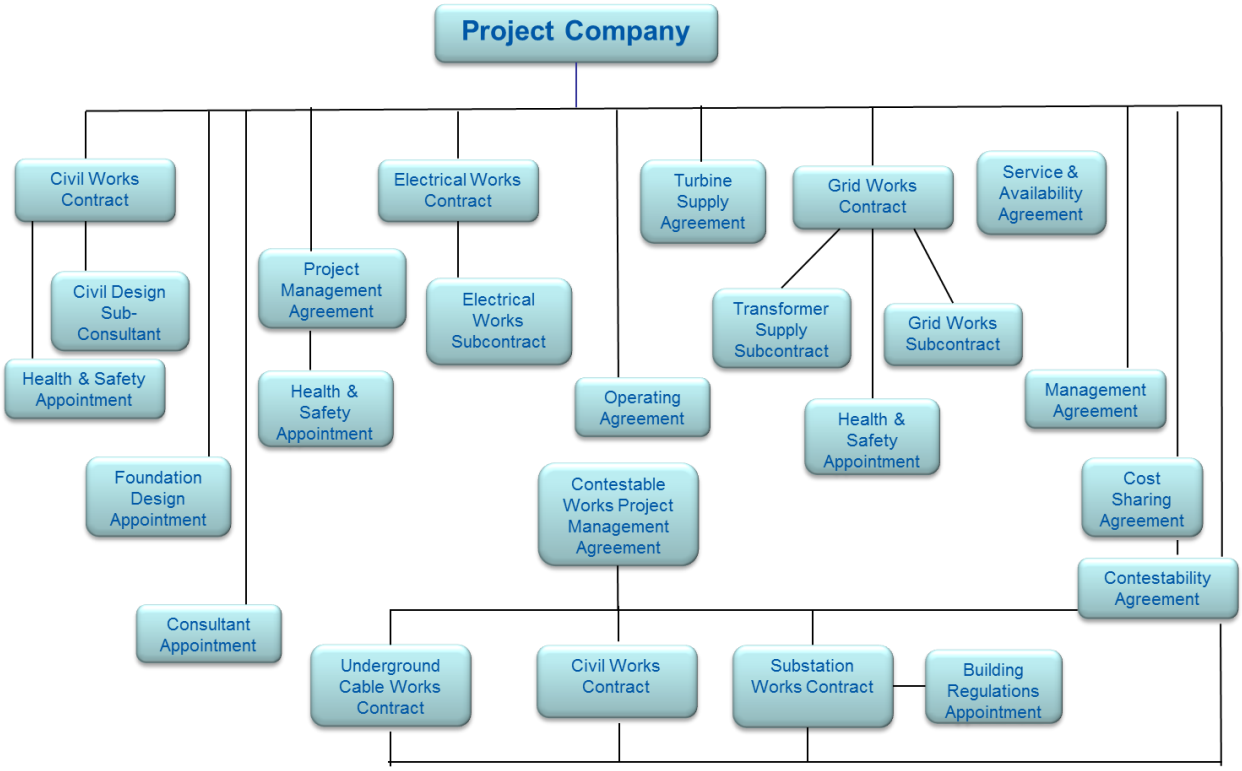
1.5 While the above remains the case in many bank-financed engineering projects in Ireland, it is the market norm, in part due to the relatively small number of large EPC contractors in the Irish market with the technical capacity to deliver a large project under a standard EPC structure, to proceed on the basis of a fractured EPC, or 'multi-contracting' structure, with two or more contractors being responsible for different works packages. This fragmented structure provides certain advantages in the Irish legal context (particularly given the concurrent wrongdoer provisions of the Irish Civil Liability Act 1961 – discussed in detail below) though it can increase the risk profile of a project from a funder's perspective.

1.6 Of potentially greater concern from a funder's perspective is the apparent willingness on the part of some developers to move away from traditional, robust risk transfer based contracts such as FIDIC to a more flexible, cooperative approach that is not based on the '*fit for purpose*' standard of care long associated with bank funded EPC procurement to a more cooperative based form of contracting such as the NEC 3 contract. This new approach has caused a re-think among both funders and their legal advisors as to how this increased risk is bankable in the first instance and, if so, where it can be offset or mitigated.

2 MULTI-CONTRACTOR PROCUREMENT IN IRELAND

2.1 Project financing in Ireland typically takes the form what can be described as a "multi-contract" structure. Very few contractors operating in the Irish market are willing to accept full EPC risk. The relevant project company will therefore usually need to engage a number of different specialist contractors to construct, operate and manage the project.

This is illustrated by the organogram below (which is based on a typical large scale on-shore wind farm project in Ireland).



2.2 A typical wind farm project will require a turbine supply agreement, a number of balance of plant contracts for civil, electrical and grid connection works, professional appointments for design and engineering services and a project management agreement for the construction phase. Consultants or contractors with responsibility for certain statutory functions under health and safety legislation and building control regulations will also need to be appointed either under the construction works contracts or pursuant to standalone professional appointments. Collateral warranties and step-in agreements will be put in place between the project company and all second tier sub-contractors and design sub-consultants.

2.3 Grid connection infrastructure in Ireland can be constructed on a “contestable” basis. This means that the project company has the option of building the grid connection infrastructure at its own cost rather than paying the system operator to do so. This will typically arise where a developer can build the grid infrastructure more cost effectively or in a shorter time frame than the system operator. This can often lead to an additional layer of contracts that further dilutes the single point of responsibility aspect of traditional EPC procurement.

2.4 The project company will also enter into a full suite of direct agreements with the funder (or its security agent) and the main contractors. This will form part of the funder’s security package along with collateral warranties from all tier-two sub-contractors and design sub-consultants.

2.5 Where contestable works are being executed for and on behalf of the project company pursuant to a contestability agreement, a direct agreement will be put in place between the funder (or its security agent), the project company and the lead developer in respect of the lead developer’s obligations under the contestability agreement. The funder (or its

security agent) will also enter into collateral warranties the contractors appointed by the lead developer to execute the contestable works.

3 FIDIC, NEC 3 AND RISK ALLOCATION IN IRISH PROJECT FINANCING

3.1 The standard form of contract internationally for bank funded EPC projects is the FIDIC Conditions of Contract for Design, Build and Operate Projects (the "**Silver Book**"). The FIDIC Conditions of Contract for Plant and Design-Build (the "**Yellow Book**") is also often used in Irish projects. Both the Silver Book and the Yellow Book (which are similar in terms of risk transfer to the contractor) have been considered as the international standard for bankable large scale engineering projects, primarily due to the robust risk transfer provisions (under FIDIC Yellow or Silver Book, the contractor bears the responsibility for reasonably foreseeable ground conditions and the design of the Works) and the tight controls on contractor claims.

3.2 The NEC 3 form of contract which has been widely used in the UK was, until recently, a relatively untested form of contract for large engineering projects in Ireland. However, what appears to be the first large scale engineering project based on the NEC 3 form of contract achieved financial close late last year. NEC 3 involves a very different approach to contracting. NEC 3 adopts a different philosophy which involves a partnering / co-operative approach. The contract is, due to this language, one of good faith. Contracts in English and Irish law outside of insurance do not normally involve good faith obligations. The difference is that in the absence of the good faith obligation a party can act exclusively in its own interests and does not have duties to warn / advise the other party.

3.3 It is generally considered that the NEC 3 form of EPC contract is currently only bankable in the Irish market where the risk transfer and claims provisions are significantly amended.

3.4 Clause 4.1 of the Silver Book states:

> "*The Contractor shall design, execute and complete the Works and provide the Operation Service in accordance with the Contract and shall remedy any defects in the Works. When completed, the Works shall be fit for the purposes for which the Works are intended as defined in the Contract, and the Contractor shall be responsible for ensuring that the Works remain fit for such purposes during the Operation Service Period*".

3.5 Clause 4.1 o the Yellow Book states:

> "*The Contractor shall design, execute and complete the Works in accordance with the Contract, and shall remedy any defects in the Works. When completed, the Works shall be fit for the purposes for which the Works are intended as defined in the Contract.*"

3.6 Where a contractor provides a fit for purpose warranty, a developer or funder will not be required to establish any negligence on the part of the contractor in order to recover under the contract. Instead, the claim will be proven where the plaintiff can establish that the works when completed do not conform to the developers requirements, which will typically be set out in detail in the Employer's Requirements.

3.7 The position under NEC 3 is very different to the FIDIC position. The contractor is simply required to provide the works in accordance with the Works Information (clause 20.1) and to design the parts of the Works which the Works Information requires him to design (clause 21.1). After that, the contractor submits his design to the Project Manager for acceptance. Unlike most design build contracts, there is no fitness for purpose obligation

stated here, nor is there any clarification as to whether the Project Manager's acceptance of the design constitutes an acceptance that the design complies with the contract requirements. Crucially, Clause 80.1 lists matters which are the Employer's risks and that list includes Employer design fault.

3.8 The claim provisions also serve to make FIDIC a more attractive and risk adverse form of contract than the NEC 3 for funders.

3.9 While the FIDIC terms are generally perceived to be equitable within the construction industry, the payment provisions provide protection to the employer in the context of costs as the contractor is required to notify claims for additional payment within 28 days, otherwise their entitlements under the contract are time barred. There is also a detailed requirement for contemporaneous reporting of claims, programme events and likely cost escalation issues which are designed to provide real time information on the project. These are all useful provisions in adding to cost certainty from a funder's perspective.

3.10 The relief and compensation events under the NEC 3 contract are much more extensive than under other standard forms of contract. Clause 60.1 contains a lengthy list of events which are deemed to be Compensation Events, and allow an adjustment to time for completion and prices. This adds to the NEC 3 being viewed as a less bankable form of agreement than FIDIC.

3.11 The risk in relation to specifying contract output requirements and the role of the contract administrator also amount to material differences between the more employer friendly FIDIC conditions and the NEC 3 form of contract.

3.12 Under a FIDIC form of contract, the Engineer undertakes the role of contract administrator. The Engineer is the Employer's agent, which is optimum in a sophisticated construction contract. The Engineer is appointed by the Employer under a prior and separate contract to assist it and to act on its behalf in connection with the works to be constructed. Clause 3.5 requires the Engineer to make "fair determinations" in respect of claims and the engineer at clause 3.1, the Engineer's acts or omissions are stated to be that of the Employer. The Engineer does not owe duties to the Contractor other than where expressly provided. This is a structure that most project financers are familiar with and the risk profile is considered to be low provided the Engineer has the necessary expertise.

3.13 The role of contract administrator under the NEC 3 form of contract is performed by the Project Manager. The Project Manager has a pivotal role and his functions include issuing numerous early warning notices (Clause 16.1), instructions to commence work, instructions which change the Works Information and Key Dates (Clause 14.3), assessment of compensation events (Clause 64). It is important the Project Manager has the competence and resources to fulfil the role. This project management role drives the contract relationship. This adds to cost and changes the risk profile. In one of the few reported English decisions on NEC, *Costain v Bechtel (2005)* the High Court was of the view that the Project Manager was under a general duty to act fairly and impartially as between the employer and the contractor.

3.14 One of the central aspects to EPC contracting is the need to clearly state the employer's output requirements in the contract documents. The FIDIC "Employer's Requirements" outline in detail the technical requirements for the project. At clause 5.1 of the Yellow Book, the contractor must notify the Engineer of any error, fault or defect in the Employer's Requirements. The Engineer then decides whether to issue a variation. The contractor is entitled to extension of time and adjustment of the Contract Price, unless the error was one which an experienced contractor would have discovered before submitting his Tender, had he used reasonable skill and care. This is generally considered to be a reasonable provision from a funder's perspective and the risk will

typically be mitigated through extensive site investigation studies prior to the contract award stage.

3.15 Under the NEC 3 form of contract, the transfer of risk for issues relating to scope differ significantly to other standard forms. The scope is contained in the Works Information. The Works Information must include all appropriate information and should be undertaken by someone appropriately knowledgeable as to how NEC 3 works. It is critical that the Works Information is complete and accurate as, oddly, the contract does not address how inadequacies in the Works Information are dealt with. This adds to the risk profile.

3.16 The experience of practitioners in Ireland with the NEC 3 is that it requires significant amendments with respect to the standard of care, contractor claims, warranties and other key funder considerations for it to be considered bankable for large scale projects. This has led in the past to protracted contract negotiations and funder due diligence resulting in increased expensive for users than the market tested FIDIC form of contract. It is also open to question whether the benefits of the NEC 3 form of agreement in terms of its collaborative approach can be retained in circumstances where a number of key provisions are amended to reflect a position closer to FIDIC.

4 INTERFACE RISK AND THE CIVIL LIABILITY ACT

4.1 As is evident from the diagram in section 2.1 above, a feature of large scale engineering and infrastructural projects in Ireland is the complex interfacing obligations between contractors to be managed by the developer and its funder.

4.2 The interface risk in Irish projects is mitigated to a significant extent by the concurrent wrongdoer provisions of the Civil Liability Act 1961 (the “Act”). Pursuant to Section 11(1) of the Act, two or more persons are concurrent wrongdoers when both or all are wrongdoers and are responsible to a third person for the same damage, whether or not judgment has been recovered against some or all of them.

4.3 In determining whether parties are to be regarded as concurrent wrongdoers for the purposes of Section 11, the Court will primarily focus on the damage caused and not on the specific role played by each of the defendants, provided each contributed to causing the damage suffered. The key feature in defining concurrent wrongdoers is that the wrong of each must lead to the one injury to the plaintiff.

4.4 The manner in which the Courts apply Section 11(1) was demonstrated in the High Court case of *Lynch v Beale (1974)* where an employer sought to sue his architect, main contractor and nominated sub-contractor for loss sustained as a result of alleged negligence and breach of contract of the three defendants in the construction of hotel premises. The defendant submitted that there were two separate and distinct causes for the structural defects that occurred and that the defendants were not concurrent wrongdoers. In rejecting this argument, the Court stated:

> "*The damage claimed in this case against all the defendants is the same damage, viz.: the loss sustained by him as a result of the internal collapse of the hotel and the subsidence thereof and the court is satisfied that the defendants are 'concurrent wrongdoers' as defined in the Civil Liability Act 1961.*"

4.5 The above approach has been followed in subsequent cases and remains the position of the law in Ireland.

4.6 Section 12(1) of the Act establishing that each concurrent wrongdoer is liable for all of the damage suffered by the plaintiff that results from the act to which they are a concurrent wrongdoer.

4.7 As such, where a plaintiff suffers damage as a result of the actions of two or more concurrent wrongdoers, if the action is successful, he/she shall be able to recover 100% of the damages from any one of the defendants, regardless of the fact that particular defendant's portion of the fault, provided that it results in the same damage suffered. This is particularly important for plaintiffs in a situation where one or more of the concurrent wrongdoers has the financial capacity to meet the damages awarded by the Court and one or more of the other concurrent wrongdoers does not.

4.8 Section 14 of the Act provides for the Court to grant judgment against the concurrent wrongdoers together or in separately. One important benefit this provides to a plaintiff is that he/she is entitled to obtain a separate judgment against each concurrent wrongdoer for the entire amount of damages suffered. However, recovery will only be permitted up to the amount awarded (i.e. where a plaintiff who has suffered damages in the amount of €100,000 due to the acts of concurrent wrongdoers obtains separate judgments against each of the concurrent wrongdoers for €100,000, the plaintiff shall only be able to recover €100,000).

4.9 The constitutionality of Sections 12 & 14 of the Act was upheld in the case of ***Iarnrod Eireann/Irish Rail v Ireland and the Attorney General***. In that case, Irish Rail was one of three defendants who had been sued in a personal injury action arising out of a derailment of a train after a collision with a herd of cattle. The other two defendants were the cattle owner and the person herding the cattle on the day of the accident. The High Court found Irish Rail 30 per cent liable and the cattle owner 70 per cent liable. As the cattle owner was without means, Irish Rail effectively had to compensate the injured passengers entirely.

4.10 Both the High Court and the Supreme Court found Section 12 and Section 14 of the Act to be constitutional. O'Flaherty J, giving the unanimous judgment of the Supreme Court, stated that the fact that Irish Rail would not be in a position to obtain any meaningful contribution from the cattle owner by virtue of the cattle owner's inability to pay such significant contribution simply meant that Irish Rail would be in no worse a position than anybody else who had a claim against a wrongdoer who could not pay compensation because of lack of means. He said that the alternative would be that an injured plaintiff would be partially or wholly without remedy depending upon the means of the respective concurrent wrongdoers.

4.11 O' Flaherty J stated:

> "*The legislation marked an amelioration and rationalisation of the liability of concurrent wrongdoers inter se from what had been there before. The possibility that one of a number of defendants may be insolvent and unable to meet his or her liability is an unfortunate aspect of litigation; that the risk should fall on the other solvent defendants who are concurrent wrongdoers whether because they are independent or otherwise rather than upon the plaintiff seems to the court to be a solution that is in harmony with the core principles underlying civil liability*".

4.12 The Court stated that, in essence, the wrong done to the plaintiff is regarded as indivisible. As between defendants, it is provided that there can be an apportionment of blame but if a deficiency has to be made up, in the payment of damages, it is better that

it should be made up by someone in default than that a totally innocent party should suffer anew.

4.13 Under Section 34 of the Act, where the injured person is found to have been guilty of contributory negligence, the court will reduce the damages awarded in accordance with the plaintiff's portion of blame. For example, where a plaintiff who has suffered damages amounting to €100,000 due to the negligence of concurrent wrongdoers was 30% responsible itself for the damage sustained, the Court will limit the damages that the plaintiff may recover to €70,000 due to its own contributory negligence.

4.14 The provisions of the Civil Liability Act have assisted funders to get comfortable with the multi-contractor approach in EPC projects in Ireland. In order to obtain the maximum benefit from the Civil Liability Act, a developer will typically retain the right to commence courts proceedings against a contractor notwithstanding that the EPC contract will typically provide for disputes to be resolved through arbitration. This will permit the developer or funder to draw additional parties into any claim before the courts, increasing the likelihood of recovery where a favourable judgment is obtained.

5 CONCLUSION

5.1 Due to a number of jurisdictional specific factors (including the relative lack of large scale EPC contractors, a tradition of multi-contractor procurement and the concurrent wrongdoer provisions of the Civil Liability Act) it appears that the multi-contractor approach will remain the most common form of procuring the completion of complex engineering projects in the coming years.

5.2 While the FIDIC Yellow Book and Silver Book offer the most straight forward form of contract for procuring such works, it remains to be seen to what extent the NEC 3 form of contract, modified to reflect the realities of the Irish market, can become an alternative form of bankable EPC agreement in Ireland.