



Does your project risk “flow”?

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Very often the topic of risk allocation in project finance transactions is treated superficially e.g. it is common to see a broad generalization such as “Construction risks are allocated to the EPC Contractor, Operating Risks to O&M Contractor...” and so on. A discussion of the liquidated damages regime then follows this generalization and that is where the discussion usually ends. In our **Project Finance Foundations Online Course**, we like to teach risk allocation using the analogy of “flow”.

Let’s look at a typical Power Purchase Agreement type structure. By choosing not to build the power plant itself and contracting with the Project Company to deliver an agreed quantity of generation capacity and / or energy at a fixed price, the Off-taker has essentially transferred through the risks of construction (e.g. cost overruns, delays etc.) and operations to the Project Company. To create a viable project financing, the Project Company must let the risk it has accepted from the Off-taker, “flow through” to third parties “**undisturbed**” through various contracts.

What do we mean by undisturbed? Under a typical project financing, the project company enters the following contractual arrangements:

- **EPC Contract:** Usually a fixed price, date certain contract with specified performance parameters that is backed by an obligation on the EPC Contractor to pay liquidated damages for non-performance.
- **O&M Contract:** Usually a fixed price contract with the O&M Contractor with clear performance benchmarks and an ability to claim compensation for losses through an abatement regime.
- **Fuel Supply Contract:** A fixed price or indexed price contract with the fuel supplier with clear contractual requirements regarding volume, fuel quality and delivery schedules backed by a liquidated damages regime.
- **Insurance Contracts:** These usually transfer Force Majeure risks to the insurance provider.
- **Political Risk Insurance:** This transfers Political risks to the PRI Insurer.

- **Currency & Interest Rates:** These risks flow through to the hedge providers or in some cases the Off-taker.

However, the risk transfer has not flowed through undisturbed if some key clauses in the various contracts e.g. EPC and O&M do not exactly mirror what is in the Off-take Agreement.

For example, if the EPC Contractor has the right to make a claim for increased costs arising from a Change of Law, is the Project Company protected if it also has a Change of Law clause in the Off-take Agreement?

It is only protected if the clauses in the Off-take Agreement and the EPC Contract are identical in defining what constitutes a “Change of Law” and the compensation claimed by the EPC Contractor matches the compensation the Off-taker is liable to pay. If the Off-taker challenges the claim and the dispute resolution processes under the EPC Contract and the Off-take Agreement are different, the Project Company has not really mitigated this risk. Moreover, a mismatch in when and how the compensation is payable under the two contracts could still leave the Project Company with a funding shortfall.

Risk has not flown through “undisturbed” in these scenarios. Looking at risk as a flow highlights the interconnectedness of the contractual structure and the need for consistency between the contracts if the Project Company is to genuinely limit its risks.

At the end of the risk allocation process, whatever risk has not flowed through to third parties resides with the Project Company. Residual risk can arise because:

- Third parties do not fully accept the risk in the form it has been transferred to the project company “undisturbed” (e.g. carve out of specific risks such as delay caused by extreme weather events, differences in definitions of Force Majeure);
- Third parties accept the risk transfer but cap their liability at a level that may not fully compensate the project company. For example, if the EPC Contractor insists on a sole remedy clause (i.e. where liquidated damages are the sole remedy available to the Project Company), then once the cap is



reached, there is no further recourse back to the EPC Contractor even though the loss incurred by the Project Company may be significantly higher.

- In addition, there are certain risks that lie where they fall (e.g. uninsurable Force Majeure such as a national strike that causes delay in completion)

These risks then need to be controlled (e.g. allowing extra time in the schedule) or absorbed (e.g. with a sufficient cash buffer) to achieve a risk allocation acceptable to financiers.

To find out more check out our “Project Finance Foundations” Course @ www.learnprojectfinance.com