The Contractor’s View

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Abstract

I would like to summarize five key areas of risk the government donor of the concession, financial institutions, or other types of project sponsors are exposed to and the contractors involved, which means the groups who are designing, delivering, and putting into operation those plants and installations for periods generally expected to be twenty, thirty, or thirty-five years. These five risk categories are: first, that the project has to be completed in time, within budget, and has to be kept in operation; second, that the project must generate the cash flow required for the debt service and the return on investment on the equity put in by the sponsors; third, the currency fluctuation; fourth, the erosion affecting the political environment; fifth, the general economic conditions that nobody really has control over.
THE CONTRACTOR’S VIEW

Dr. Martin Heubel*

Dr. Nagla Nassar has very nicely and carefully explained the government’s interest, and I share with her the approach that we are not talking about the European environment. I would like to share some views with you in order to explain the concerns of a sponsor or a contractor from experiences I have in getting projects off the ground involving waste incineration in Greece and Brazil and a coal-fired power station in Mexico. I would like to preface that with the notion that monopoly situations for a group of sponsors, a group of contractors, or one contractor and one operator are scarcer than is considered. There is always international competition for these famous build-own-operate (“BOO”) projects.

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- first, that the project has to be completed in time, within budgets, and has to be kept in operation,
- second, that the project must generate the cash flow required for the debt service and the return on investment on the equity put in by the sponsors,
- third, the currency fluctuation,
- fourth, the erosion affecting the political environment,
- fifth, the general economic conditions that nobody really has control over.

If you would compare what the analysts and experts told us about two years ago about the tiger states to what they would say now, they just have forgotten whatever they said.

Thus, sponsors and, specifically, contractors involved face a far more challenging task than what normally occurs when bidding for a major construction project on a turn-key lump sum

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price. Although behaving in a rather fragile environment, you must assure yourself and the financing groups that the quality of the product or the service remains stable. Also, the supply and the price of all commodities or utilities that are required need to be dependable. The cash to be generated out of the service fees—for example, the service fee to clean up, to treat one ton of waste, or to process one cubic meter of waste water—flows at planned levels for the total pay-back period. All this cost has to be reasonably preestimated for a period of normally three to five years of construction and then from the date when the plant starts to produce or delivers service, for a period of twenty-five years. The long-term dependability of all factors is essential. I can imagine that we have many participants in this symposium who are all in favor of deregulation and privatization. The real world very often favors a more stable environment, which is why we do not have too much competition. The existing regulations are dependable and accountable for the lifetime of a specific project because, otherwise, nobody will support the financial and economical viability of a project.

Considering some of the observations Dr. Nassar already made, I will just refresh your memory: normally a BOO project entails a series of contracts. The most important contract is the concession. Generally, the concession is issued to a group of sponsors wherein the suppliers of the plant participate. Certain mandatory topics need to be cleared with the concession agreement. You can reduce the important topics to the dependability of cash flow and operation of the plant continuously over the lifetime at the planned and budgeted performance levels. Both of these topics are embodied into a long-term monopoly in the region for the service desired.

The sponsors will establish a legal entity that will be the partner to the public agency or body extending such concession. They will sign shareholders' agreements and articles of associations. In the shareholders' agreements, they must be very careful about how voting rights are established and what the ground rules are. The most essential ground rule is to keep the increase of debt or additional equity on a strictly voluntary basis. The concessionee then signs two contracts: one contract with the

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1. The public unit is the concessionaire. The build-own-operate group is the concessionee.
supplier of the plant, such as the waste incineration plant or the power plant; the other contract with the unit or the partners out of the total sponsoring group who are operating that plant for a longer period of time.

Deregulation or privatization tends to jeopardize cash flow. When the donor of the concession decides to privatize a portion of that service, the concessionee is supposed to make it consistent with another unit in the same region. There emerges a competitor for waste. The offers for price, the service charge, and the competing privatized unit are all different. Consequently, the expectation of cash flow to be generated over the lifetime of that plant cannot be supported anymore.

The way one is normally done—and you were very right in outlining the conflicts—is that the sponsoring group, with support of the financial institutions, is to insist on what you would call a deliver-or-pay obligation. Given a “deliver waste” or “pay money” obligation, the concessionee can count on the constant stream of cash needed to service the debt under the financing arrangements. If a situation for technical day-to-day or political reasons is such that the concessionaire cannot supply or prevents the collection of waste or establishes another waste policy, then that whole project can no longer be financed. The consequence is that these sponsors resort to the ultimate remedy, which is to trigger a buyout event for default of the concessionaire. You can assume and imagine what lengthy discussions it takes to negotiate a buyout clause because you must determine estimates for the various situations where that buyout situation may occur.

Dr. Nassar addressed the interest of the government to maintain stable tariffs. Certainly that is an understandable approach for economical and political reasons. Also, the investor or the sponsoring group is interested in keeping tariffs stable because we often have a very difficult negotiating session when it comes to the issue of a government wanting to preserve the right to change the tariff. If political or economical problems exist, then they would like to decrease the tariff.

In some areas, it may even be difficult to collect the service fees from all the users because if waste disposal gets too expensive, then people throw it out in the woods or into the desert.

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2. You all know that we have a lot of competition in Germany and in Europe to get enough waste to fire all of our incineration plants.
Alternatively, if waste water gets too expensive, then people discharge waste water by other means than through the public draining and sewage system. So normally in a situation like this, it very often helps to insert certain contingencies into the cost estimate or to apply certain percentages to cover an increase and to limit the decrease of the tariffs. This result has to be accepted by the financing institutions and that is sometimes not easy.

To sum up my observations, I would like to advise this honorable academic community that the fear of governments in emerging countries that they will be abused by powerful sponsors and contractors is overemphasized for understandable negotiating reasons. In fact, we do have competition in this industry as evidenced by the fact that we have nine major competitors for our Brazilian projects. Thank you.