OVERCOMING MEGA PROJECT CHALLENGES

BY JAMES ALTMAN

Not many years ago it was highly unusual to see contracts in excess of $100 million. Costs have since escalated. Owners are packaging more into a single contract because they do not have the internal resources to manage multiple projects. The large public/private partnership projects, which usually involve large infrastructure improvements, have become more common. As a result, the industry has seen a greater frequency of projects in this "mega project" range.

Mega projects refer to those contracts with a value between $250 million and $500 million or more. Usually these projects involve joint ventures, require four to five years or longer to complete, and involve substantial risks to contractors and their sureties.

Mega projects present unique challenges to contractors because the analysis and assessment of the risk is more complicated. Therefore, contractors need to consider several aspects of a mega project in order to help ensure successful completion.

By their nature, these projects are big and long-term. They contain high levels of risk, and, as such, a prudent contractor will look to spread that risk through joint ventures or similar structures. When looking at a partner or partners to share the risk, a contractor needs to consider the following issues.

Make sure a potential partner is reliable for the long term. The close partnership lasts for many years, in good times and bad, until the job is completed and accepted. The philosophy, risk appetite and cultures of both partners should be compatible. The financial platforms of the joint ventures should be secure and stable. A partner should bring appropriate technical and other capabilities (i.e. labor, systems, engineering) to the partnership, depending on the needs of the joint venture.

Understanding the owner is important, and the same factors should be at work when choosing an owner. Be comfortable that the owner is a stable, sophisticated and experienced partner in the process and that the owner will be cooperative for many years. Contractors should consider the following:

- Does the owner have a good reputation?
- Is the owner a sophisticated buyer who understands the construction process?
- Are the terms of the contract between the contractor and owner fair and equitable ?
- Are those who act on the owner's behalf—their attorneys, managers and others—reasonable?
- Does the owner have the money needed to complete the project?

A bad owner can have as great an impact on the bottom line as a job that has not been executed well by the contractor. Choosing the right owner is as important as choosing the right job.

Contractors also should evaluate surety capacity. The amount of surety capacity available on a mega project depends on the completion time and size of the project, the size of the contractor's balance sheets in support of the project, the related experiences of the joint venture partners and each partner's surety company. The surety will want to understand how the joint venture addresses the contract risks, the commodity risks, the financing risk and the quality of the joint venture partners.

These specific contract risk exposures are reviewed carefully by the surety and discussed in depth with potential bidders. Normally the surety would like to see acceptable force majeure clauses in which the owner bears the risk of broadly defined force majeure events. The surety usually objects to consequential and actual damages, and damages with no cap. The surety also may want to evaluate financing exposures, unbonded subcontractor risks, long-term warranties or long-term operations contracts and exposure to commodity inflation.

All of these factors influence the approval process by the surety. If the surety brought into the process early enough, it will work collaboratively with the joint venture to resolve contract issues. Once the surety is comfortable with the contract, capabilities and capital available, it will decide to provide capacity to a project.

When a contractor is choosing joint venture partners, it needs to evaluate the joint venture's overall surety capacity. An analysis of the surety capacity can be complicated. The contractor's surety producer and surety should be able to assist early in the process.

All sureties have limits as to how much capacity they can provide on a single project. In some cases this can be as much as $250 million or more per surety per project. Some sureties will not co-surety (which essentially means joint venture) with other surety companies due to credit concerns or internal limitations. Because of reinsurance constraints, some sureties will not write bonds on projects that last

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Project	Owner	Contract Price	P&P Bonds
Manhattan Water Tunnel No. 3 New York (Nov. 2004)	New York City Dept. of Environmental Protection	$668,532,680	$668,532,680
US 17/Cooper River Bridge Charleston, S.C. (July 2001)	South Carolina Dept. of Transportation	$531,276,000	$531,276,000
Newtown Creek W.W.T.P. New York (June 2003)	New York City Dept. of Environmental Protection	$493,000,000	$493,000,000

more than four to five years. In the case of mega projects with several joint venture partners and several co-surety relationships, a surety may have exposure on each contractor partner that could exceed its single-job comfort level.

A potential joint venture should be evaluated every time a mega project is under consideration as surety markets may change, appetite for risk may change, and the co-surety relationships and the splits between sureties on individual accounts may change. Again, looking at the surety picture early is important to avoid surprises later.

Traditionally, owners determine what levels of bonding are required on projects. Because the size of projects has grown tremendously, obtaining 100 percent bonds—and the sense of comfort that goes with this—may not be possible. The table lists several recent bonds in the mega-project range.

As these examples demonstrate, in today's market, 100 percent bonding of a job up to the level of $500 million to $600 million is possible. If the contract value exceeds $500 million to $600 million, and the owner wants the security that a higher bond penalty can bring or a 100 percent bond is required by statute, it may be possible to arrange up to $250 million of excess surety over the primary bonds to reach a capacity of $750 million to $850 million. The excess surety product will respond to claims once the primary bond has been exhausted. Excess surety is an option only if the primary bond is $500 million or more and the primary bond is at least 40 percent of the contract amount.

Each mega project is unique and presents issues to the contractor, the owner and the surety that are not common in "normal-sized" contracts. Problems can be overcome by anticipating the issues and dealing with them early. With a good owner, a fair contract and the right joint venture and surety team, mega projects can be profitable and successful for all parties involved.

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