Briefing

A-Z of issues in renewable energy projects: W-Z

In this series of articles, Burges Salmon's Energy team provides an "A-Z" of key legal and practical issues in renewable energy projects. This final instalment covers "W to Z" and sets out a number of issues that our construction, energy and project finance teams regularly encounter.

Warranties: are they construction contracts?

For most construction projects, collateral warranties are essential and renewable energy projects are no exception. A collateral warranty is a contract between (1) an entity that was involved in the design, management, construction, operation and/or maintenance of a project and (2) an entity that has an interest in the project but who does not have a direct contractual right of recourse, for example a purchaser or a funder.

In building, purchasing or funding any renewable project, it is vital that you consider securing direct rights of recourse against all relevant parties. Whether securing such rights are useful will require consideration of important factors such as financial standing, value of works/services being undertaken by the relevant party and any particular specialism/limited market concerns. This is particularly important given the current post-recession climate and the very real risk of parties becoming insolvent. A collateral warranty can give you that direct right of recourse and therefore provide peace of mind to a beneficiary.

However, will a collateral warranty amount to a construction contract for the purposes of the Housing Grants, Construction and Regeneration Act 1996 (the "Act") and, if so, what might the impact be on a project?

Parkwood v Laing O'Rourke

In the landmark decision in *Parkwood Leisure Ltd v Laing O'Rourke Wales and West Ltd [2013] EWHC 2665*, Akenhead J held that a collateral warranty can be a construction contract (as defined by section 104 of the Act).

Whilst the *Parkwood v Laing O'Rourke* decision dates from 2013, there has been no subsequent case law considering or applying the decision. Arguably, this is not surprising as the decision is only two years old and the Courts have only

very rarely considered the meaning of 'construction contract' under the Act since it came into force almost 20 years ago. Therefore, the principles arising from this decision are as pertinent as ever.

It should be noted that whilst there are exemptions from the application of the Act to energy projects, the extent of this is unclear where, for example, the works being delivered contain a mix of pure energy generation activities and traditional (e.g.

civils) construction activities. Whilst there is not enough time in this note to address whether the exemption might apply in those circumstances, it is worth taking a conservative view and ensuring that all possible interpretations and eventualities are covered off in your contractual relationship.

Consequences of this decision

All construction contracts (as defined in the Act) allow any party to that contract the statutory right to adjudicate and (in the absence of express alternative terms) the statutory adjudication scheme rules supporting the Act (the "Scheme") will apply. Therefore, *Parkwood v Laing O'Rourke* opened the door to potential adjudication claims to be brought under collateral warranties.

Adjudication is a quicker, often less costly alternative to other remedies available in case of a dispute, namely litigation and arbitration. Until this decision, litigation and arbitration were the only viable dispute resolution options for rights under a collateral warranty. However, adjudication is now a possible alternative.

However, it is not only the adjudication provisions that will apply to a collateral warranty if it can be considered a construction contract. The rest of the Act may also apply, which includes the statutory payment and suspension provisions under the Act and the Scheme.

Under the Act, for example, a party to a construction contract is entitled to periodic payment if the duration of the work is more than 45 days. In the absence of express agreement in relation to periodic payment, the regime under the Scheme will apply. It is almost certain that a collateral warranty will not contain provisions relating to periodic payment as a beneficiary under a warranty would not be expected to be liable for paying the contractor. However, the *Parkwood v Laing O'Rourke* decision has left the question of how such statutory payment and suspension provisions apply to a collateral warranty unanswered.

This decision has been welcomed by beneficiaries of collateral warranties who now have another (arguably more appealing) method of resolving any dispute arising under a warranty. However, the decision has not been received as favourably by entities that regularly provide collateral warranties, which include contractors, sub-contractors and consultants. Their reticence centres around the fact that:

- beneficiaries now have an easier, more readily available method of dispute resolution at their fingertips which may encourage more disputes to be pursued that would otherwise have been; and
- there is uncertainty surrounding the application of the statutory payment and suspension provisions under the Act.

For these reasons, it is important for contractors, sub-contractors and consultants to consider how to avoid any collateral warranty they might give being categorised as a construction contract.

Drafting pitfalls

The *Parkwood v Laing O'Rourke* decision reiterated the need for parties to use clear and unambiguous language in any contract or agreement, including a collateral warranty. Akenhead J made it clear in his judgment that not every collateral warranty will be a construction contract for the purposes of the Act. Instead, whether a collateral warranty will be considered a construction contract will depend on the wording of and the factual background to the warranty in question.

In the definition of 'construction contract', the Act refers to an agreement for the carrying out of construction operations, which casts the net of this definition very wide indeed. In considering the words used in the collateral warranty between the tenant and the contractor in *Parkwood v Laing O'Rourke*, Akenhead J had no doubt that the warranty fell into this wide definition.

The warranty in this case contained express wording that the underlying contract was *"for the design, carrying out and completion of the construction of a pool development"* and that the contractor *"warrants, acknowledges and undertakes"* under the collateral warranty. On the facts, the contractor warranted to continue to comply with the underlying construction contract and did so before completion of the works.

Akenhead J considered that the words *"warrants, acknowledges and undertakes"* are not synonymous, but rather all have different meanings: *"a warranty often relates to a state of affairs (past or future); ... An acknowledgement usually seeks to confirm something. An undertaking often involves an obligation to do something."*

On the facts, it was not just a simple warranty that had been given, but rather an undertaking that the contractor would carry out and complete the remaining works. Further, the warranty entitled the tenant to claim for damages for breach of contract or for non-completion (even though the warranty did expressly exclude liability for delay).

Akenhead J did give some clues about what might indicate whether a warranty is a construction contract or not, saying that:

"A very strong pointer to that end will be whether or not the relevant Contractor is undertaking to the beneficiary of the warranty to carry out such operations. A pointer against may be that all the works are completed and that the Contractor is simply warranting a past state of affairs as reaching a certain level, quality or standard."

Conclusion

Despite this judgment, collateral warranties show no signs of being phased out in favour of reliance on the statutory rights granted by the Contracts (Rights of Third Parties) Act 1999. It appears that parties still appreciate the certainty of a separate warranty which is signed and agreed by all parties, rather than using third party rights as an alternative providing a similar protection. However, following *Parkwood v Laing O'Rourke*, it is particularly important to pay close attention to the wording used in any collateral warranty to be entered into in relation to your renewable energy project.

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X-Factor: Securing Project Finance

Not all developers of renewable energy projects have the means or the desire to fund construction of such projects on a balance sheet or an all-equity basis. However, help is at hand in the form of limited recourse debt funding products provided by banks and other financial institutions. The project finance market has had its up and downs over recent years, moving from a period of buoyancy to becoming virtually closed during the height of the debt crisis. There is no doubt, however, that in the current climate competition amongst funders to lend to the best projects is as strong as ever.

The key to successfully securing debt funding is preparation and planning. Developers need to understand the importance of carrying out early-stage development work in the context of their financing strategy, asking themselves throughout the process, "is this solution bankable"?

Financing strategy: identifying funding partners

Developers should identify their preferred funding partners as early as possible in the process. Different funders have different requirements and it is far easier (and more cost effective) to build those requirements into project contracts at an early stage than it is to revisit them later. Whilst retaining a level of flexibility is a good thing, developers should at least identify whether funding from traditional project finance banks, infra funds, ECAs and multi-laterals is both desirable and viable. Some developers will appoint professional financial advisors to put together a debt funding strategy.

Engaging legal advisors

Too many projects lose momentum at the financing stage because development phase contracts were negotiated without bankability advice or because contracts were negotiated

separately rather than as a package. Developers should strongly consider the advantages of early engagement of a single law firm with sufficient breadth and experience to develop the project contracts, consents and land rights as a coherent whole. Advisors that have experience in project finance, and ideally in acting on the lender side, will be able to bring perspective as to funder requirements and that experience can then inform negotiations with contractors. The initial investment in early-stage legal advice is highly likely to generate significant cost and time savings later on in the process.

Project contract principles

Developers intending to project finance their project, or even wishing to retain that option, should be aware that funders are more risk-adverse than equity providers and require a more conservative approach to negotiations with contractors. This inevitably leads to tension between maximising equity returns and making the project bankable, but developers can leverage off the experience of their professional advisors to assist with this balancing act.

Passing down the sort of risks that funders will not take to contractors is absolutely essential to creating a bankable project. When thinking this through, developers should carefully consider clauses of contracts that allow for the costs of the project to increase beyond the budget, both in the construction and operational phases and in relation to construction, O&M, feedstock and services contracts. Funders like creditworthy counterparties and clear lines of responsibility, and are adverse to interface risk and contracts that don't properly compensate the project for contractor breach.

Refinancing

Whilst there is a strong market for construction financing, projects that reach operational phase open up new lines of credit amongst investors, such as pension funds and US Yieldcos that won't take construction risk. In maximising future flexibility it is important during the early development phase to limit any restrictions on future refinancing, both in the finance documents and also in the project contracts. PPAs, for example, have often in the past been subject to gearing tests or debt service cover ratios and developers should consider what potential these sorts of clauses have to restrict refinancing options. Experienced developers are mindful of the benefits of a portfolio approach to refinancing, where cross-collateralising a number of operating projects can reduce risk and, therefore, reduce the cost of funding.

If there are two key points for developers to take away in terms of maximising opportunities to attract debt finance, they are:

- thinking about the financing issues from the outset is absolutely vital; and
- early engagement of professional advisors can assist enormously in this process.

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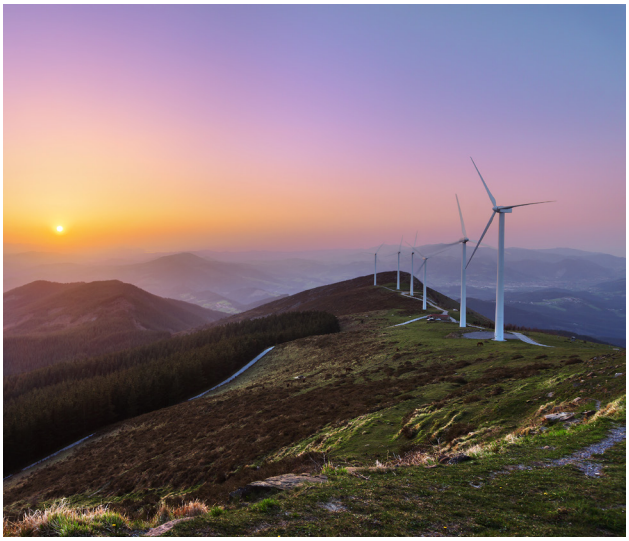
Year: highlights of our firm's last 12 months in renewable energy

2014/2015 has been another memorable year for UK renewable energy for a variety of reasons, **both good and bad**. Some of the key positive and negative developments that the UK renewables sector and Burges Salmon have seen in the past year are highlighted below:



- ➕ Acquisitions and disposals race ahead. This has been largely driven by solar and onshore portfolios and projects changing hands. In this last year, Burges Salmon has advised on over 59 such deals, putting us at the top of the European Legal Advisor tables.
- ➖ The Government's announcement of early Renewables Obligation closure to large scale solar (in April 2015) and onshore wind (in April 2016).
- ➕ The development of community ownership guidelines for the renewables sector and the insulating of community energy projects from many of the "brake" measures applied by Government to the wider sector.
- ➖ The rise of competition between renewable technologies. This has been partly driven by divergence in support mechanisms.
- ➕ The European Energy Union Strategy focussing on a variety of aims for the future, such as interconnectors, renewable heat and convergence of European support mechanisms.
- ➖ State Aid guidelines from Brussels for energy which caused, amongst other things, a rethink on the Contracts for Difference design and uncertainties on the potential redesign of the UK's Feed-in-Tariff.

The £51.3m financial close of the MeyGen Tidal Stream Project providing a huge boost to the marine sector. (A project on which Burges Salmon advised.)

? Uncertainties over the pace of technology development and deployment for wave energy, with the demise of Pelamis and painful Scottish grid constraints. However, in the same year there was good news for deployment at Wave Hub and a reconfirmation of strong political support in Scotland.

The removal of the renewables exemption for the Climate Change Levy announced in the first Conservative budget post-election.

The re-emergence of tidal range (lagoons and fences) and the consenting of the Swansea Lagoon.

Constraints on the EPC contractors available to construct new biomass projects in time for the Renewables Obligation deadlines. There was no shortage of projects but the supply chain resource was drained by the rush.

? The first Contracts for Difference allocation round illustrating to all that the renewables sector can drive down costs but that the Levy Control Framework amounts to encourage new development are wholly inadequate.

The National Grid – Future Energy Scenarios report which identifies a "Gone Green" scenario as the only scenario which enables the UK to meet all its renewable and carbon targets on time and avoid being a new importer of electricity.

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Z Clauses (NEC) – Provisions for renewable energy projects

The third edition of the New Engineering Contract ("NEC3") adopts a flexible "pick 'n' mix" approach to developing the terms for an individual project and accommodates all procurement strategies (e.g. cost reimbursable, fixed price and target cost). It contains nine core clauses, intended to apply to all contracts, and various optional clauses that may be used if relevant. Any additional terms or amendments to the NEC3 clauses are addressed by "Z clauses", which refers to Secondary Option Z "Additional Conditions of Contract".

Use of NEC3 on renewable energy projects

The NEC3 is not often the contract of choice in the renewables sector for medium to large scale projects. Most onshore renewable energy schemes use other forms of contract, such as the FIDIC Yellow Book or bespoke forms of contract developed by key technology vendors. However, the NEC3 is being used on some Round 3 offshore wind schemes and is generally growing in popularity, which may result in an increase in its adoption in the wider renewable energy sector.

The NEC3 is very popular in the nuclear sector, where it is used almost exclusively for decommissioning schemes and is also used for the development of new plants in conjunction with other forms of contract. The NEC3 is also being used on other major infrastructure projects such as Crossrail, is commonly used by Utilities and is the contract of choice for the public sector. Procurement and commercial executives are therefore becoming increasingly familiar with the NEC3 and some are becoming strong advocates of its benefits over other more traditional forms of contract.

Unlike other engineering and construction contracts, the NEC3 uses plain English, is written in the present tense and avoids cross-referencing, which makes it more appealing to non-lawyers and encourages its use as a management tool. The NEC3 also places great emphasis on the early identification of risks and swift resolution of the cost and time effects of employer risk events through the use of its 'early warning' procedure, risk reduction meetings and register, 'compensation event' regime and rigorous programming obligations.

However, the NEC3 does have its drawbacks too. The NEC3 has not been used extensively outside the UK and is therefore relatively unknown; this may well cause concern to some members of the international supply chain, not least because it 'looks and feels' substantially different to traditional engineering contracts such as the FIDIC suite of contracts. The judiciary and some leading barristers have criticised the drafting of the NEC3 which, they say, is more difficult to interpret than more traditionally drafted forms of engineering contract and lacks a significant body of binding case precedent to aid interpretation.

Using Z clauses

Z Clauses typically fall into one of three categories: common modifications to existing terms, common additional terms, and project specific terms. It can be helpful to divide Z clauses into two separate sections for ease of reference (i.e. (1) amendments to the NEC3 terms and (2) additional terms).

The NEC3 terms do not deal with some important issues as comprehensively as other contracts. For example, there is no design warranty, no obligation to comply with laws or applicable consents, no "tests after completion" regime, no assignment clause and the clause on intellectual property rights is sketchy. These gaps should be filled using appropriate Z clauses.

When drafting Z Clauses, it is important to use the defined terms carefully to avoid ambiguity (there are two types of defined terms in the NEC3) and to ensure any consequential amendments are made. Some Z clauses may require further project specific data, in which case the relevant entry should be included as an amendment to the Contract Data.

However, your Z Clauses should be used with great care and should not be so extensive as to undermine the key principles of the NEC3 described above.

As Rekha Thawrani, general manager for NEC, noted:

"the issue all users can face is that if a Z clause is wrongly inserted, it can make the contract ambiguous. As a result, good project management can be hampered and the project is likely to cost more, or take longer to complete."[1]

That said, the NEC3, like any other standard form, does not deal with all eventualities that could apply to a particular project. It is therefore entirely legitimate to amend the contract to ensure that the commercial principles that have been agreed between the parties are unambiguously reflected in the contract and that other stakeholders are also satisfied with how those key principles are expressed (e.g. funders and prospective investors).

[1] https://www.neccontract.com/About-NEC/News-Media/Z-Clauses

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For futher information on Burges Salmon's renewables and wider experience please go to **http://www.burges-salmon.com/Sectors/energy_and_utilities/default.aspx**

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