Who should assume the risk?

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Engineering, procurement, and construction contracts, or EPC contracts, are a type of construction contract between parties where the contractor is responsible for the engineering, procurement, and construction activities to deliver a completed project to the owner within a predefined time and cost.

Here at SCS Engineers, we've seen an increase in demand for EPC delivery on our largest projects, most notably in the renewable natural gas sector. The RNG market is exploding due to the generous subsidies aimed at addressing emissions linked to climate change.

This drive to take advantage of the lucrative incentives is steering developers and owners to the EPC model to "fast track" project execution and get to production in the shortest time possible. In our current environment, where supply chain issues and labor shortages are commonplace, the ability to procure major equipment and begin site development prior to final design completion can result in material time savings.

As an owner, selecting EPC as the contract delivery method can be a straightforward decision. But negotiations with the contractor may be challenging, and this is often the longest and most arduous phase of the project. Allocating and monetizing risk is usually what bogs down contract negotiations. But if owners and contractors take more of a team (versus adversarial) approach to identifying and allocating risks, the process will go much smoother.

Experienced owners and contractors can alleviate the stress involved when negotiating risk terms, because they have the ability to identify possible risks at early stages of project development. However, simply identifying potential risks is only part of the process. Allocating them is another. Owners may try to shift the bulk of the risk to the contractor, as long as they can afford the associated fee increase.

But speaking as a contractor, I feel that accepting risk that is out of our control can lead to mistrust. It is in the interest of both parties to critically review risks and allocate them to the party most capable of controlling them. Some owners believe that if the risk is allocated to another party, the risk simply goes away – but that is not the case.

Here at SCS, we see this risk allocation balancing act most notably in regards to the project schedule. Our RNG clients are eager to begin producing RNG as soon as possible in order to realize return on their investment. Our contracts may contain fairly significant liquidated damages, which are often an owner's best recourse for mitigating the risk of project delays.

While most contractors understand there are real costs for not meeting project schedules, it is important to acknowledge that there are always owner responsibilities that can have an impact on the schedule. Land use and environmental permitting, which typically begin well in advance of EPC contract negotiations are some of the more typical owner responsibilities. This is an example of where well-defined contract allowances for time extensions due to delays outside of the contractors control can help establish a contractor/owner relationship centered on teamwork, trust, and transparency, which will benefit the project.

Dr. Patricia Galloway summarizes this point very well in a paper titled "The Art of Allocating Risk in an EPC Contract to Minimize Disputes."

"Every risk has an associated price, whether that be visible or hidden," Galloway writes. "Visible risk cost shows up as project contingency or insurance costs and can be compared. It is the onerous contract clauses that promote hidden costs. How risk is allocated will have a significant determination on how a project is financed. Owners can certainly transfer risk to the contractor but need to recognize that in doing so, there is a cost to that risk premium. Allocating risk to the party most able to control and manage it is always a good starting point. Innovative risk sharing arrangements have become the best method of allocating risk and reducing the total contract price. Carefully thought out contract clauses relative to risk allocation and risk exposure limitation that do not grossly and inequitably allocate all the risk to the contractor positively impacts overall project performance and the owner-contractor working relationship."

The next time you negotiate contract terms, remember to allocate risk to the party in the best position to control the risk. Then do not be afraid to get creative about clearly defining baseline conditions with fair incentives and penalties that encourage both parties to do the right thing.

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