MAKING THE CASE FOR INFRASTRUCTURE

INFRASTRUCTURE: AN INCREASINGLY RISKY BUSINESS

If the economy is to be stimulated through investment in infrastructure, it is vital that the risk profile of complex projects is reduced. **Todd Battley**, AECOM's Australia New Zealand Chief Executive, discusses key ways in which industry and state governments can drive positive commercial changes to risk allocation to deliver much-needed growth.

The scale of Australia's AU$100 billion, ten-year infrastructure pipeline and the complexity of the planned projects is both a cause for celebration and concern. More than two-thirds of the Australian infrastructure pipeline is transport related.

Unfortunately, the contracts underpinning many of these multi-billion-dollar projects have been established in such a way that much of the financial risk associated with delays or cost overruns resides with the delivery team (i.e. the contracting and engineering companies).

New roads, rail or metro lines and tunnels are far more complex to build than new social infrastructure such as new hospitals or schools and are therefore more likely to end in dispute.

This extra financial burden — combined with the increased cost of staff and materials which accompanies any construction boom — means that many of the larger contractors essential to the delivery of Australia's infrastructure pipeline are struggling to achieve a sustainable margin under the current contractual arrangements. →

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In the past 12 months alone, there have been multi-million-dollar write-downs announced by two of Australia's largest construction companies: Lend Lease and CIMIC (CPB Contractors' parent company). In a recent article the Australian Financial Review, Joe Barr, chief executive of one of Australia's largest contracting firms John Holland, said: "Tier 1 contractors in Australia are not making any money, and governments across Australia keep having successive project cost blowouts. We are in the midst of Australia's biggest infrastructure boom, but as an industry, we are teetering on the brink of collapse."[1]

Independent think tank Infrastructure Partnerships Australia (IPA) said in its Australian Infrastructure Investment Report that the risk allocation on complex projects combined with capacity constraint in the construction market is beginning "to impact the cost of infrastructure delivery."

The report also said that there is "increased onus on the government to do more upfront work to identify the risks, and by doing so reduce the overall delivery cost and associated insurance burden, before bringing projects to market. In doing so they are more likely to secure local and international bidding interest, better value for money and provide scope for innovative delivery."[2] →

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Hitting the headlines

The issue of inappropriate risk transfer, which has been simmering behind closed doors, has now boiled over and become far more visible as disputes have hit the headlines.

The construction of the Sydney Light Rail — a complex project that involved shutting down George Street in the heart of Sydney's busy retail and office precinct — is one high-profile project that has made the news.

The dispute between the New South Wales (NSW) government and the ACCIONA-led ALTRAC consortium arose from the additional costs incurred by the consortium for relocating utilities during the construction phase. In June 2018, following months of delays and no doubt significant legal fees for all parties, the state government paid ALTRAC AU$ 576 million (US$370 million) in an out-of-court settlement[3].

In another high-profile case, the stock market was shocked when Lend Lease announced an AU$350m write-down in 2019[4]. The most significant losses appear to have stemmed from several road projects in its engineering division, including the NorthConnex project, a nine-kilometre, 90-metre-deep tunnel, linking two motorways in Northern Sydney.

The size and unexpected nature of the write-down contributed to a significant hit to the company's market valuation, wiping off more than AU$2 billion. In the same year Lend Lease took a strategic decision to stop building tunnels, railroads and other large infrastructure by selling Lend Lease Engineering to ACCIONA for AU$180 million in December 2019.[5]

Finally, over 18 months after the Light Rail settlement in Sydney, a high-profile legal stand-off broke out in Melbourne between contractors, proponents of the AU$6.7 billion West Gate Tunnel toll road project, and the state government. Australia's two largest builders, CPB Contractors and John Holland, are refusing to foot the bill for the disposal of huge volumes of contaminated soil that will be produced if and when boring machines tunnel under the Western suburbs of Melbourne (currently they are sat idle).

The reality is that these disputes are just the tip of the iceberg with many more being played out behind closed doors between project owners, contractors, engineers and associated sub-contractors.

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Furthermore, as the industry grapples to respond to the current coronavirus pandemic and social distancing protocols, it is likely that there will be many new disputes arising as parties try to protect their commercial position.

Negative effects: a growing understanding

In the same month as the Light Rail project dispute was settled, the NSW Government's Construction Leadership Group (CLG) issued the NSW Government Action Plan: a ten point commitment to the construction sector guidance document to establish a more collaborative relationship with contractors. The first point states that government should "procure and manage projects in a more collaborative way" and "move away from a reliance on fixed-price, lump-sum procurement methods."[6]

Infrastructure NSW chief executive at the time, Jim Betts, acknowledged in an interview with the Financial Review, that there had been a "macho" view that governments should push the maximum level of commercial risk onto the private sector, even when they were unable to predict or manage the risks involved. →

He went on to say: "adopting more collaborative methods of contracting saves costs but it also enables us to acknowledge that some things are unpredictable and that we actually need to work together to reduce risks rather than simply arguing about how we allocate them between us."[7]

The Economic Benefits of Better Procurement[8], a Deloitte Access Economics report commissioned by Consult Australia, sheds further light. It found that firms often respond to onerous risk by either pricing it into their bid, or deciding not to bid on a particular project, which in turn drives up price by reducing competitive pressure. The report also estimated that savings of about 5.4 per cent could be made through better risk sharing and other improved practices. When translated to the current Victorian (AU$80bn) and New South Wales (AU$87bn) infrastructure pipelines over the couple of years, that could represent a potential saving of over AU$8bn through better procurement, that's enough to pay for another Sydney Metro Northwest.

According to Nicola Grayson, Consult Australia's Chief Executive, professional services have several common complaints when it comes to onerous risk allocation.

"Onerous contracting is more likely to lead to disputation, as well as lengthier negotiations in the initial phase," she says. "Should a risk be realised, and liability eventuate, an onerous contract means there will be less incentive for the parties to settle instead of pursuing costly litigation. Combine these adversarial contracts with the increasing size and complexity of the current pipeline of projects and you have a recipe for small delays or disputes to turn into multi-million-dollar legal battles."

Furthermore, research from legal firm Allens, in its Securing The Missing Benefits of Australia's Infrastructure Boom report, reveals an industry feeling the strain of project complexity. Prominent concerns raised in the survey and market research include:

/ 77% of senior industry leaders are more concerned with the risks facing the sector than they were five years ago

/ 90% of the future projects in the pipeline are in transport

/ Senior industry leaders say tunnels are nine times more likely than social infrastructure to cause delays or cost blowouts. →

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Melbourne city, Australia

The review from Allens looks at specific infrastructure project risks and proposes a range of measures to secure the future benefits of these projects. Partner David Donnelly, who is also the firm's Sector Leader of Infrastructure and Transport, explains how the industry is concerned that the benefits of the infrastructure boom may not be fully realised, calling into question the significant investments made by governments.

"The sector faces a conundrum: there is an infrastructure deficit but there are fundamental issues creating risk in supply chain and these underlying risks threaten the economic and social benefits of the projects," he says. WL

FURTHER SUGGESTIONS AND IMPROVEMENTS

Scott Langdon, Partner at Advisory and Investment firm KordaMentha, supports the concept of iterative tendering, a process that sees the contractor brought into the discussion early during the feasibility and design stage to identify the potential risks. Iterative tendering could comprise one-on-one meetings and a brief, allowing contractors to consider the brief and provide feedback on construction challenges, timeframes, risk allocation, authority interface and compliance. This could occur over many months and ensure all contractors understand what they are tendering for, while building camaraderie and ensuring the contractor understands the project better, which leads to more accurate pricing.

He believes the contractor pipeline also has an effect on pricing: "If you speak to contractors, when they price risk in, they can price the same project completely differently depending on how desperate they are for the piece of work.

"If they have a full book of work, they will price the risk tightly, whereas if future work is scarce, they are willing to take on more work and price the risk much more aggressively and that's not a good outcome for the project. The risk should be priced regardless of the appetite of the contractor."

If projects are priced more accurately, when the inevitable construction issues occur due to the inherent complexity, collaborative and prompt resolutions are far more likely. When risks are impossible to price effectively before contracts are signed, an alternative is to quarantine critical risk areas before approaching the market for a competitive price. Once a preferred proponent has been chosen, all parties can take a transparent and collaborative approach to agree how these critical risks are to be managed.

Another significant cost impost for infrastructure projects is the current approach to contracting, where the majority of projects seem to develop a unique contract, increasing legal fees and slowing down the procurement process. Adopting national contract models and standards would also save each state and project proponent significant legal costs, and in doing so reduce the overall cost of procurement for all parties. For example, the UK has a standard set of New Engineering Contracts or (NEC4) with a variety of options to tailor the contract to a specific project. Simple, concise and easy to understand, they are widely acknowledged to have reduced procurement delays and costs.

Prior to the coronavirus pandemic, the Australian construction industry employed approximately 1.2 million people or 9.2 percent of the total workforce. When we emerge from the current health crisis, there will be significant pressure on the government to stimulate economic growth by maintaining infrastructure investment while reducing the risk profile of project delivery through more collaborative contracting, in order to maximise the return on any stimulus investment.

Looking at the long-term, we must not let the significant investment in Australia's infrastructure be remembered for a decade of cost overruns, project delays and a pipeline of stalled projects.

Whatever methods are adopted moving forward, it is vital that we use this opportunity to drive positive commercial changes that will lead governments and contractors towards more collaborative and productive working relationships in our post-pandemic future.

With thanks to contributors: David Donnelly, Partner, Allens; Nicola Grayson, Chief Executive, Consult Australia; and Scott Langdon, Partner, KordaMentha.