

Liquidated damages – Delay and performance



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Introduction

The standard form international contracts designed for use on infrastructure projects (for example, ENAA and FIDIC) differentiate between liability for delay and liability for underperformance of a plant or facility.

This paper explains why, from a legal and practical perspective, it is necessary to differentiate between liability for delay liquidated damages and performance liquidated damages as well as different types of performance liquidated damages.

Delay liquidated damages

The purpose of liquidated damages for delay is to compensate the Project Company for loss and damage suffered as a result of late completion of the plant or facility. In order to be enforceable, delay liquidated damages must be a genuine pre-estimate of the loss or damage that the Project Company will suffer if the plant or facility is not completed by the target completion date. The genuine pre-estimate is determined at the time of entering into the contract.

Delay liquidated damages are usually expressed as a rate per day which represents the estimated extra costs incurred (such as extra insurance, supervision fees and financing charges) and losses suffered (revenue forgone) for each day of delay.

Performance liquidated damages

The purpose of liquidated damages for underperformance is to compensate the Project Company for loss and damage suffered as a result of underperformance of the plant or facility. In order to be enforceable, performance liquidated damages must be a genuine pre-estimate of the loss and damage that the Project Company will suffer over the life of the project if the plant or facility does not achieve the specified performance guarantees. As with delay liquidated damages, the genuine pre-estimate is determined at the time of entering into the contract.

The nature of performance liquidated damages means that the measure of liquidated damages will depend on the relevant performance guarantee, for example efficiency, output or availability. Performance liquidated damages are usually a net present value (NPV) calculation of the revenue forgone over the design life of the project. For example, in the case of a power station, if the output of the plant is 5 MW less than the specification the performance liquidated damages are designed to compensate the Project Company for the revenue forgone over the life of the project by being unable to sell that 5 MW.

Differentiation between delay and performance liquidated damages

The law relating to penalties and uncertainty of liquidated damages regimes is clear. If the amount of liquidated damages is held to constitute a penalty or if the liquidated damages regime is uncertain, it will be held by a court to be invalid.

We have seen contracts where delay and performance liquidated damages are combined. This is not recommended as there is a very real risk of a combined liquidated damages regime being struck down as a penalty as it will necessarily include many of the features of performance liquidated damages.

This means, from a legal perspective, if there is a combination of delay and performance liquidated damages, the liquidated damages rate must include more of the characteristics of delay liquidated damages if they are to remain a genuine pre-estimate of the Project Company's losses. If a combined liquidated damages amount includes an NPV or performance element the Contractor will be able to argue that the liquidated damages are not a genuine pre-estimate of loss when liquidated damages are levied for late completion only. The reason for this is if the plant or facility is finished late but performs exactly as required the liquidated damages can only legally compensate the Project Company on an extra costs/revenue forgone basis not an NPV basis.

However, if the combined liquidated damages calculation takes on more of the characteristics of delay liquidated damages it means the Project Company would not be properly compensated if there is permanent underperformance of the plant or facility.

From a practical perspective, the best way of demonstrating why it is necessary to differentiate between delay liquidated damages and performance liquidated damages is to examine situations at both margins, that is, when the plant or facility is 99 percent complete and when it is 95 percent (or less) complete. The examples below assume that the project is being project financed and the Project Company and, more importantly, the Lenders will accept the plant or facility operating at least 95 percent of guaranteed output in preference to terminating the contract and commencing litigation to recover losses.

If the plant or facility is 99 percent complete at the date for commercial operation issues of acceptance will arise as the financing agreements will require 100 percent compliance. In order to accept the plant or facility and thereby commence commercial operation and service the debt (which under the financing agreements will take place after commercial operation) the Project Company will have to waive full compliance with the requirements under the contract. The Lenders are likely to approve the waiver because the defective performance will not impact on the project's ability to service the debt. However, if a single combined liquidated damages calculation is used (which takes on more of the characteristics of delay liquidated damages as described above) it will impact on the return earned by the Sponsors/equity participants. This situation would not arise if there was a differentiation between delay liquidated damages and performance liquidated damages because the project company would be able to accept the plant or facility and recover the NPV of the lost revenue from the Contractor.

If the example at the other margin (when it is 95 per cent or less complete) is examined the risks to the Project Company are even greater. If performance of the plant or facility is at only 95 percent and there is no prospect, in the foreseeable future, of increasing that performance the Project Company has relatively few options if a combined liquidated damages calculation is used (which takes on more of the characteristics of delay liquidated damages as described above). Obviously, the Project Company can wait for the performance to be rectified and receive liquidated damages. However, because they are presumably inadequate to fully compensate the Project Company for underperformance, it is likely that the Project Company will default under the financing arrangements which, at a minimum, will trigger additional equity contributions from the Sponsors. It may even lead to the Lenders taking over the project. A better option for the Project Company is to be able to accept the plant and commence operation and recover at least a portion of the forgone revenue as performance liquidated damages. The other alternative is to terminate the contract and sue to recover losses. However, that will be time consuming and expensive and it will not solve the problems under the financing agreements.

Differentiation between types of performance liquidated damages

The same arguments arise in relation to differentiating between types of performance liquidated damages as apply to differentiating between delay and performance liquidated damages.

It is important to differentiate between the different types of performance liquidated damages to protect the Project Company against arguments by the Contractor that the performance liquidated damages constitute a penalty. For example, if a single performance liquidated damages rate is only focused on output and not efficiency, problems and uncertainties will arise if the output guarantee is met but one or more of the efficiency guarantees are not. In these circumstances, the Contractor will argue that the liquidated damages constitute a penalty because the loss the Project Company suffers if the efficiency guarantees are not met are smaller than if the output guarantees are not met.

Conclusion

The prime goal of a Project Company is to receive a plant or facility on time and on budget that operates to specification. The contract should be aimed at achieving that outcome, however the contract should also protect the Project Company when the ideal outcome in relation to performance is not achieved, even where the technology is standard.

A contract which differentiates between delay liquidated damages and performance liquidated damages as well as different types of performance liquidated damages achieves an optimal mix between the two outcomes described above, is industry practice and is bankable.

Although a single combined liquidated damages calculation may appear simpler, it is legally flawed and will cause significant practical and commercial difficulties. The parties cannot have a single liquidated damages amount which takes into account all the potential permutations and combinations of delay and underperformance as it would not represent a genuine pre-estimate of loss and would be struck down by the courts as a penalty. In addition, a single combined liquidated damages regime is also likely to be held invalid for reasons of uncertainty.

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