

Investing in Infrastructure | International Best Legal Practice in Project and Construction Agreements | January 2016

Damian McNair | Partner, Legal | M: +61 421 899 231 | E: damian.mcnair@au.pwc.com

Splitting an EPC Contract



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The hidden dangers of split EPC Contracts

One innovation that is becoming more prevalent in infrastructure project financing in Asia involves an extension of the traditional project documentation structure whereby the works under an Engineering Construction and Procurement (EPC) Contract are divided or “split” into two or more separate contracts. The split structure offers reduced taxation obligations on the Contractor by allowing the Contractor to reduce local taxes on equipment and materials purchased from “offshore”. The savings result in a reduced project capital cost, which in turn may be passed onto the Project Company and its Lenders.

The concept of splitting EPC Contracts

Under the classic split, the EPC Contract is divided into two separate contracts, commonly referred to as the “onshore contract” and the “offshore contract”. The responsibilities of the offshore Contractor will usually be restricted to:

- the supply of design and engineering services
- the supply of plant, equipment and materials (equipment) sourced from outside the host country.

The responsibilities of the onshore Contractor will usually be restricted to:

- the installation of equipment sourced from outside the host country and procured under the offshore contract, once the equipment has reached its onshore destination
- the construction, testing, commissioning and other onsite activities (including some onshore design and engineering services) associated with the works
- the supply of equipment sourced from within the host country.

It will also be necessary to consider the splitting of obligations to provide training and supply spare parts.

To complete the split structure, an agreement is required to coordinate and wrap the obligations of the onshore and offshore Contractors to the Project Company. This way, any gaps that arise as a result of the split structure are appropriately covered and the Project Company’s recourse, in the event of a failure in the performance of either the onshore Contractor or the offshore Contractor, will only be to a single entity – The Guarantor (as would have been the case in the traditional EPC Contract form). In some structures the offshore Contractor will also be the Guarantor.

Why split EPC Contracts?

In a word: tax. The split structure is designed to avoid or reduce the profit element of any equipment supplied from outside the host country, or any design work performed outside the host country, becoming subject to local taxes. The classes of taxes, both direct and indirect, that an EPC Contractor and a Project Company may be exposed in the host country include value added taxes; withholding taxes; technology transfer taxes; import and stamp duties; local construction and property license fees and duties; and onshore income or profits tax.

Other commercial considerations may drive the split structure, such as avoidance of local “red tape” requirements and costs associated with obtaining permits, approvals and submitting designs to local government authorities in the host country.

Caveat on splitting EPC Contracts

Splitting EPC Contracts will not be appropriate for every project. Appropriate local taxation advice and legal advice should always be sought before deciding whether to split the EPC Contract into two or more contracts to take advantage of taxation savings and other commercial benefits. Different legal and tax jurisdictions will have their own specific requirements which will impact on the structure. For example, in some jurisdictions a mere reference in the onshore contract to the offshore contract (or vice-versa) may defeat the tax advantages that the split structure is intended to achieve.

The legal issues associated with splitting EPC Contracts

Specifications: Where two separate specifications are prepared, the Project Company should thoroughly review the specifications to ensure that there are no inconsistencies and that when combined, they cover the entire works. Any “gaps” produced as a result in splitting the specification should be covered in the umbrella agreement. If one specification is adopted to cover the whole of the works, then it should be made clear that the offshore Contractor’s scope of work includes all activities associated with the supply of design and engineering services and the supply of equipment sourced from outside the host country. The onshore Contractor’s scope of work will include all remaining activities necessary for the proper completion of the works.

Timing and performance issues: Where the split structure results in split liquidated damages and extension of time regimes, the Project Company will need to scrutinise the regimes in each contract to ensure they are consistent and interact logically and correctly.

Quality issues: The Project Company should ensure that the overall design obligations are assumed by one Contractor, usually the onshore Contractor which has established a presence in the host country. The Guarantor under the umbrella agreement should then provide a guarantee for the Contractors’ design obligations.

Coordination issues: The onshore contract should provide that the onshore Contractor is responsible for all equipment sourced from offshore from the moment the offshore Contractor ceases to be responsible for that same equipment and in the same way that the offshore Contractor is responsible under the offshore contract for the equipment.

Residual legal issues: The Project Company should also address the following issues with a split structure:

- caps on liability and liquidated damages
- termination and suspension
- variations/change orders
- confidentiality issues
- governing law
- *Force majeure*

The umbrella agreement

In terms of providing the necessary legal protection to the Project Company, the most important document is the umbrella agreement (also known as a “wrap around guarantee agreement”, “coordination and administration agreement”, “supplemental agreement” or “guarantee agreement”). The umbrella agreement will, if properly drafted, provide the Project Company with a single point of responsibility and more importantly, prevent the various Contractors from relying on each other’s defaults to avoid performing their contractual obligations – a tactic known as a “horizontal defence”. The umbrella agreement should also prevent a Contractor from relying on the Project Company’s default where the Project Company’s only default was a result, either directly or indirectly, of the non-performance, inadequate performance or delay in performance of any of the other Contractors under their respective contract. In addition to horizontal defences, the umbrella agreement should deal with the following matters:

- guarantees and indemnities
- liquidated damages
- the performance bond by the Guarantor’s parent
- liability (and limitation of liability) of the Guarantor
- duration of the umbrella agreement
- dispute resolution – it should be identical to the project documents and allow the Project Company to consolidate claims.

Conclusion

The splitting of works between two or more contracts is usually driven by tax and other commercial considerations. Provided appropriate taxation and legal advice is sought and received, and it should be in every case, and provided all associated legal issues are adequately addressed in the split contracts and co-ordinated and “wrapped” in the umbrella agreement, the taxation and other commercial benefits offered under the split structure should flow through to the Project Company and its Lenders.

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