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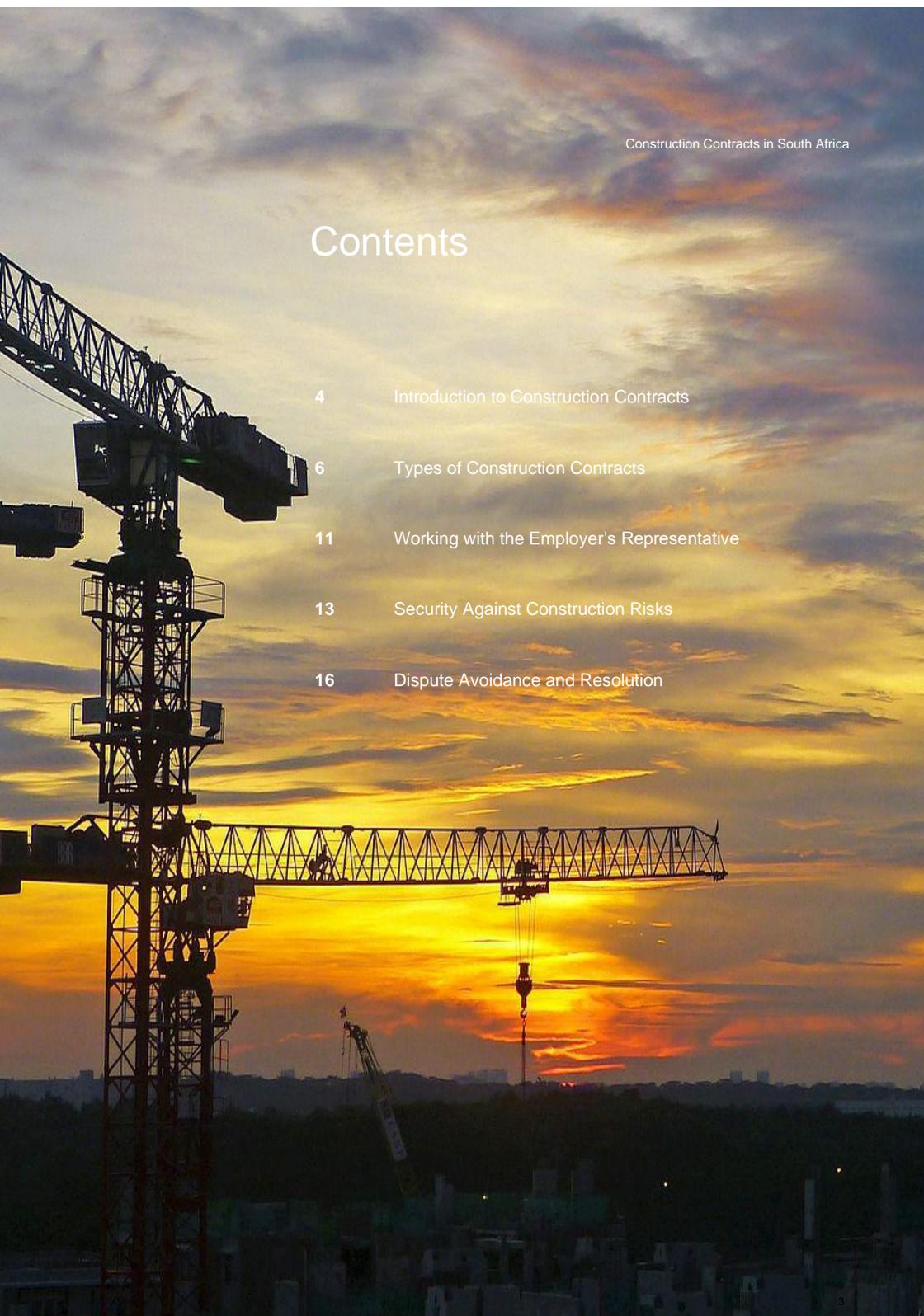


GUIDE – CONSTRUCTION CONTRACTS IN SOUTH AFRICA

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Contents

- 
- 4 Introduction to Construction Contracts
 - 6 Types of Construction Contracts
 - 11 Working with the Employer's Representative
 - 13 Security Against Construction Risks
 - 16 Dispute Avoidance and Resolution

Introduction to Construction Contracts

Construction plays a vital role in Africa's development, not only in respect of its physical infrastructure, but also in its broader economic and social development. This Guide provides some basic knowledge and understanding in relation to construction contracts, industry standard forms and typical approaches to risk allocation in construction projects.

WHAT IS A CONTRACT?

So, what is a construction contract? In basic terms, it is an agreement between an employer (sometimes referred to as the client) and a contractor to construct, repair, modify, renovate or even demolish something in an agreed time frame, for an agreed price and to agreed standards. It should describe:

- What will be done;
- How long it will take to complete;
- How much it will cost and the payment terms; and
- The consequences of failing to meet the requirements of the contract.

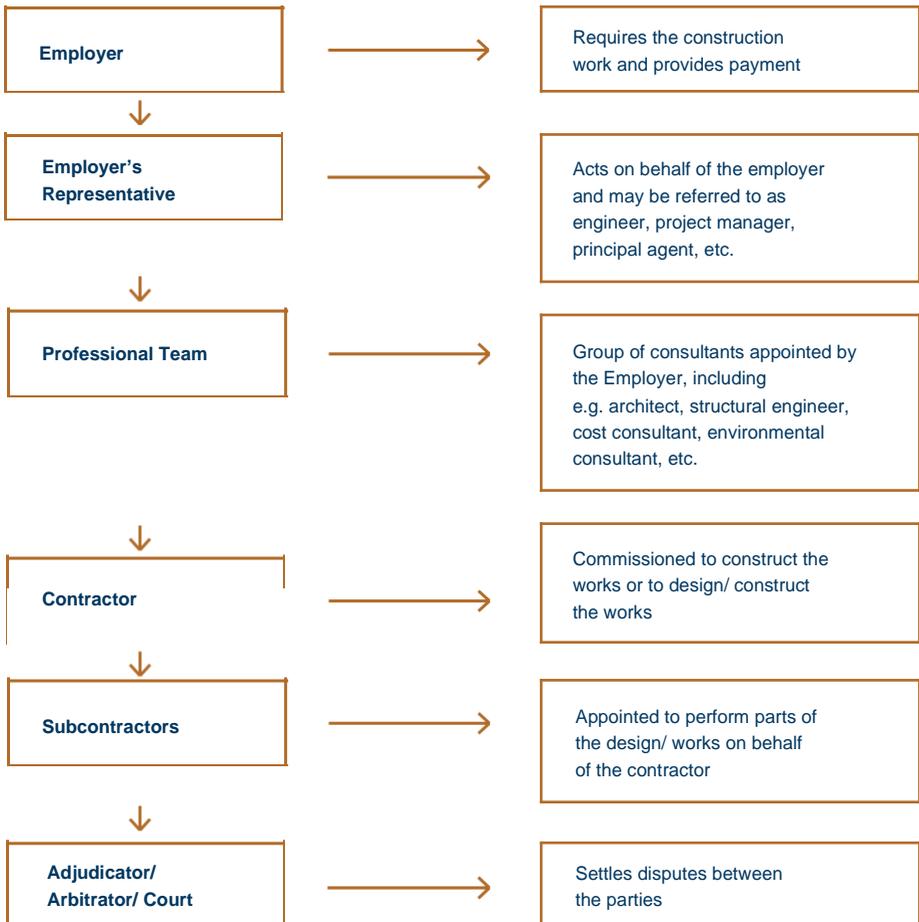
Once properly concluded, each party has a legal obligation to do the things which the construction contract specifies. Like any contract, if a breach occurs, the other party will have certain remedies, such as claiming for additional costs caused by the breach.

ROLE PLAYERS IN THE CONSTRUCTION PROCESS

Although the construction contract typically only has two parties,

(the employer and contractor), there are a number of other role players who contribute to the construction process.

The role players are set out below:



Types of Construction Contracts

The type of construction contract to be used for a project will depend on various factors such as: the nature of the works to be executed; whether design and construction are combined or separated; the split of responsibilities between the contractor and the professional team; the approach to risk allocation; financing terms; and market practice in a particular industry or region. This section of the Guide contains a summary of the various procurement strategies available for a construction project, taking account of these factors. It then considers some

of the most commonly used industry standard form contracts in Africa.

CHOICE OF PROCUREMENT METHOD

Every construction project is underpinned by a procurement strategy which determines the structure of the contractual arrangements, the roles and responsibilities among the various key players and the approach to the allocation and management of risk. There are generally considered to be three main procurement methods: (i) Traditional Procurement (ii) Design and Build (iii) Construction Management/ Management Contracting. Partnering and alliancing based procurement methods are also

available but are less commonly used, particularly in Africa.

Traditional Procurement

Traditional procurement (sometimes referred to as “general contracting” or “design-bid-build”) is regarded as the most commonly used method of procuring building works. The main distinguishing feature is that the design and construction processes are separate. The employer’s professional team will design the works and prepare the tender documents, including drawings, specifications and bill of quantities. Contractors are then invited to submit tenders for the construction of the project on a competitive basis. The employer carries design risk, although in some projects the contractor is responsible for certain discrete elements of the design. The employer will typically appoint a member of his professional team to administer the contract.

Various pricing mechanisms are used in traditional procurement but the main options are: (i) lump sum, (ii) re-measurement and (iii) cost plus (sometimes referred to as “cost reimbursement”).

Lump sum: A single “lump sum” price for the project is determined before the works commence. This is an appropriate option where the works are well defined at the time of tender and there is a low likelihood that the employer’s requirements will change. Although the price may alter during the carrying out of the works

(e.g. due to variations, provisional sums, the occurrence of certain “relevant events”, etc.), this pricing option tends to give the employer a reasonable amount of price certainty at the outset of the project.

Re-measurement: The price for the works is not determined when the contract is entered into. It is calculated based on the “re-measurement” of the actual work carried out. The re-measurement calculation is undertaken using agreed rates/ unit prices which the contractor originally tendered on the basis of the drawings and bill of quantities provided by the professional team. As the total cost of the works is not determined at the outset, employers tend to carry greater risk under a re-measurement contract. It is therefore suitable where there is a lack of certainty as to the volume of work required, even though the design, specification and quality requirements can be reasonably well defined at tender stage.

Cost-plus: The contractor is reimbursed the actual costs incurred in carrying out the works (i.e. labour, plant, materials, sub-contractors, etc), plus an additional fee to cover overheads and profit. This option is appropriate where the scope of the work cannot be well defined at the outset but the employer nevertheless requires an early start on site. As the contract is typically entered into on the basis of an estimate of the costs only, cost-plus contracts are generally high risk for employers. As a means of incentivising efficiency and cost control, a “target cost” mechanism is sometimes used, whereby the contractor and the employer share the risk of cost overruns/ savings on a pre-agreed basis.

Design and Build

The key feature of design and build procurement is that the contractor carries responsibility for both the design and the construction of the works, to the employer’s requirements. The approach to the preparation of the design will differ from project to project, depending on the degree of influence the employer wishes to have over the design development process. For example, on some projects the employer will

appoint a design team to prepare an initial, concept design. The contractor will then be required to complete the design and undertake the works. The contractor may use his own in-house designers or appoint external design consultants or take over the employer's design team.

A design and build contract will usually be based on a lump sum price (with no bill of quantities). The employer has greater price certainty than under traditional procurement because the contractor is required to design and build the works for an agreed price and within an agreed time for completion. While adjustments to the price and programme may still arise due to e.g. variations and the occurrence of certain "relevant events", there is generally less opportunity for contractor's claims under design and build contracts. This means greater risk for the contractor and therefore a higher price.

Engineering, Procurement and Construction (EPC) contracts are similar to design and build contracts in that the employer appoints the contractor to carry out both design and construction but the employer will have less influence over

design and the contractor will generally carry a greater level of risk in terms of time, cost, quality and performance. For this reason, EPC contracts are often referred to as "turn-key" contracts. They are typically used for engineering and infrastructure projects where performance and cost certainty are the most critical factors for the employer. EPC is also common where a limited recourse financing structure is used to fund a project.

Construction Management/ Management Contracting

Under the Construction Management (CM) model, contracts for the various packages of work are entered into by the employer but the management and supervision of those work packages, as well as the coordination of the design, is undertaken by the construction manager. The construction manager is appointed under a form of professional services agreement, with authority to act on behalf of the employer in relation to the management of the project. While the employer takes the risk in the performance of the various package contractors, the construction manager

is liable for bad management, planning and coordination. The construction manager is typically paid on the basis of reimbursable costs plus a management fee, covering both pre-construction and construction phase activities. Under the Management Contracting (MC) model, by comparison, contracts for the various packages of work are entered into by the management contractor directly rather than by the employer.

Engineering, Procurement and Construction Management (EPCM) contracts can be regarded as a variant of CM and MC models. The main differentiating feature is that an EPCM contractor will undertake design and other engineering activities as part of his scope of services. The level of risk assumed by an EPCM contractor in relation to the works will be driven by project specific factors but typically, the employer will seek to include incentive mechanisms in the EPCM contract to ensure the EPCM contractor has a degree of responsibility in relation to the project programme and budget. EPCM models are most often used in the mining, petrochemical and power sectors.



BESPOKE OR STANDARD FORM CONTRACT?

One of the key decisions to be made by the employer, when designing the procurement strategy for a project, is whether a bespoke or industry standard form contract should be adopted.

Over the years, industry norms in relation to risk allocation across the most common types of construction and engineering projects have emerged. This has led to the development of a number of international standard form contracts. The most commonly used standard forms in Africa are FIDIC, NEC and (in Sub-Saharan Africa) JBCC. Often employers will elect to use

a standard form contract rather than preparing a bespoke contract because using an industry recognised set of terms makes the procurement process more efficient and competitive.

International standard forms such as FIDIC and NEC have been around for decades. However, they have recently been updated in response to industry feedback.

The long awaited new FIDIC “Rainbow Suite” was launched in December 2017. The changes to the Red, Yellow and Silver Books are primarily designed to make the contracts more balanced, comprehensive and prescriptive. They also place greater emphasis on dispute avoidance rather than dispute resolution.

The new NEC4 suite of contracts was launched in June 2017. The changes bring more clarity, simplicity and flexibility to the standard terms. New measures, like value engineering and early contractor involvement were also introduced to enhance collaboration between employer and contractor. Like the 2017 FIDIC, there is also more emphasis on dispute avoidance.

Working with the Employer's Representative

Employers usually elect to work through a representative who may be an architect, an engineer, a project manager, a quantity surveyor or any other qualified third party. The employer gives his or her representative the authority to act on his or her behalf in the execution of certain provisions of the contract.

The representative's role is to oversee and administer the contract and the project itself. It is important for the Contractor to develop a good working relationship with the employer and/ or the employer's representative, as the parties will benefit from a relationship based on trust and co-operation.

Importantly, the employer's representative is usually the person to whom all notices, invoices and claims must be submitted and is the person who determines the amounts due to the contractor.

There are some important steps a contractor can take to develop this relationship such as:

- Report all problems to the employer, through the appointed representative, as quickly as possible. This is very important if the problems could cause cost increases or delay completion.
- Handover in good time all notices, advices, time delay claims, bad weather reports, certificates for payment, invoices, lists of workers, plant on-site, etc.
- Make sure claims are submitted in strict compliance with the applicable contractual provisions, in writing within the period stated in the contract. If a claim cannot be prepared within the required period, extensions should be sought prior to the expiry of the period. If no extension is granted or communicated prior to the expiry of the time periods, the claim (even if not fully complete) and all documents available at that time should be submitted (explaining

if possible why the claim cannot be completed and submitted on time), with any further documents and information required to be provided thereafter.

- Only make reasonable claims for additional payment. Inflated or frivolous claims will be rejected.
- Carry out all written instructions. If the instructions are difficult or impossible to execute, talk to the representative who issued the instructions as soon as possible to see if it can be done in a different way – do not delay.

If the contractor disagrees with any decision taken by the employer's representative, the contractor should, as soon as possible, give notice of a dispute in terms of the contract to the employer's representative. In some contracts time bars are also in place for when a dispute should be disclosed and submitted to an adjudicator or arbitrator. The contract should always be studied to see if such time bars apply, and to ensure that they are followed.

It is important for the contractor to develop a good working relationship with the employer and/or the employer's representative, as the parties will benefit from a relationship based on trust and co-operation.

Security Against Construction Risks

The management and mitigation of risk is a core feature of any construction project. The contract itself will allocate the various risks between the parties, based on the general principle that the party best able to control or manage a risk should carry responsibility for it. However, there are parties external to the contract who are also likely to play a role in providing security against these risks, including, for example, the parent company of

the contractor, major sub-contractors, insurance companies, banks and other financial institutions.

In general terms, there are three main types of security against construction risks: (i) contractual forms of security such as delay liquidated damages, performance liquidated damages, retentions, etc; (ii) insurance policies; and (iii) security instruments issued by third parties such as guarantees, bonds and letters of credit. In most cases, all three of these types of security will be adopted as part of the risk management strategy for a project but the level and value of the security will vary depending on the nature and complexity of the project, the financial standing of the parties, pricing/ commercial considerations and market practice.

Liquidated damages

Liquidated damages provide an employer with a contractual remedy against the risk of delay and performance failure. The essential characteristic of liquidated damages is that the parties agree, in advance, a predetermined sum (or means of calculating that sum) payable by the contractor to the employer if a particular breach occurs. In common law jurisdictions, there are rules which limit the scope of liquidated damages.

In such instance, an employer would not be required to prove its damages as with a normal damages claim, but simply that the breach occurred. In order to be enforceable, they must be designed to fairly compensate the employer for the breach and not act as a penalty against the contractor. In addition, they must be a reasonably foreseeable consequence of the breach.

Liquidated damages are most commonly associated with delays to the completion of the works. They are usually calculated daily or weekly and will be capped to a percentage of the overall value of the works. Most contracts will specify that the liquidated damages are the

sole remedy for delay, save that the employer's rights to terminate the contract will be preserved.

In projects involving an output based specification, such as those in the energy, water, waste/ wastewater sectors, there may also be liquidated damages payable by the contractor where the required performance levels specified in the employer's requirements are not achieved. These types of regimes are designed to recognise that while the contractor has delivered a functioning plant/ facility, the employer should still be compensated for the loss of expected output.

Insurance

Many of the major risks involved in construction projects, in terms of loss, damage and liability, can be insured against. The main types of insurance policies likely to be required include: construction all risks insurance; public liability insurance; employer's liability insurance; professional indemnity insurance; political risk insurance; environmental insurance; delay in start up or advance loss of profit insurance. The

contract will set out who is responsible for taking out and maintaining each of the required insurances and at what minimum levels of indemnity. It will also specify which of the project participants, with an interest in the works, should be named insured on the policies. Given the criticality of the insurances as a risk mitigation tool and the expense involved in purchasing cover from reputable insurance companies, it is advisable to take specialist advice from an insurance broker with good knowledge of the local and, in some cases, international insurance markets.

Security instruments

Depending on the financial standing of the contractor, the employer may require a parent company guarantee to be provided as a means of backing up the contractor's obligations, both in terms of performance and payment. Parent company guarantees are considered particularly useful as a means of securing the contractor's obligation to pay compensation following the early termination of the contract, where the sums involved are likely to be substantial.

In addition, employers may seek a guarantee or bond from a bank or other financial institution to secure the fulfilment of the contractor's obligations. These instruments can be on-demand or conditional in nature and will secure an employer against certain non-performances by the contractor under the contract. It is important to remember that the substance of the instrument will determine its nature and scope, i.e. what it says on the tin is not necessarily what the tin contains. Although organisations such as FIDIC and the ICC (responsible for the Uniform Rules for Demand Guarantees) have attempted to standardise the terms

of such instruments, it is still the case that these documents are often heavily negotiated and that there is, in some jurisdictions, a lack of uniform practice in this area. It is therefore essential that both employers and contractors take specialist legal advice in relation to these documents, particularly where guarantees are being given by a local bank in respect of a foreign contractor, in which case a counter-guarantee will be given in favour of the local bank by the contractor's relationship bank in another jurisdiction.

Given the criticality of the insurances as a risk mitigation tool and the expense involved in purchasing cover from reputable insurance companies, it is advisable to take specialist advice from an insurance broker with good knowledge of the local and, in some cases, international insurance markets.

Dispute Avoidance and Resolution

Most international standard form construction contracts provide for a dispute resolution mechanism, including the procedure to be followed when a dispute arises between the parties to the contract. If parties conclude a bespoke construction contract, it is recommended that the parties provide for a dispute resolution clause and agree to a dispute resolution mechanism that will be

best suited considering the nature of construction project and disputes that may arise between the parties.

Contractual Claims procedure

Each of the standard forms of construction contract provides for a specific procedure that the parties should follow if either one of the parties believes it is entitled to claim relief in terms of the contract. Generally the party that believes an event entitles it to relief under the contract will be required to deliver a notice to the opposing contract party. The notice usually has to provide details of the event, the effect or damage caused by the event, and the relief which the party seeks as a result of the event. Often, for the contractor, such

notice may have to be issued within a prescribed period of time, failing which, the contractor may forfeit any entitlement to relief under the contract. These types of time prescriptions often do not apply to an employer's claim, although recent developments in some of the international standard forms have paved the way for a more balanced claims procedure.

Where the contractor has issued a notice of claim, he will generally also be required to deliver details of the claim within a specific period of time after delivery of the notice. As with delivery of the notice of claim, the particulars of claim may also be subject to a time-bar provision where it is submitted out of time. The particulars of claim need to show supporting evidence for the claim, including details on the quantum of the claim and, often, a revised programme of works where the claim is one for extension of time.

The notice and particulars of claim are submitted to the employer's independent contracts manager (referred to mostly as "Engineer", "Project Manager" or "Principal Agent") for determination within a specified period of time.

Determination

The contracts manager will make a determination upon assessment of the particulars of claim, which determination will be implemented upon determination. A determination for money is, mostly, given effect to in the next payment certificate through inclusion of an additional sum due to either the contractor or the employer. A determination for additional time is, mostly, given effect to by extending the date for completion and by acceptance of a revised programme of works.

A claim for delay damages by the employer may be implemented as soon as the completion date has passed and the contractor has not yet completed the works. The contracts manager may deduct the delay damages from any amount due to the contractor in the next interim payment certificate.

The determination will include a finding on the merits of the claim and the relief sought by the claiming party.

Some contracts provide that the claim may be resolved by dispute resolution where the contracts manager does not determine same within a prescribed period. The claim may, likewise, be referred to dispute resolution where either party is dissatisfied with the determination, subject to notice obligations. Some contracts provide that such notice of dissatisfaction be given within a prescribed time period.

Dispute

Subject to the provisions of the contract, the parties may resolve a dispute by mediation, adjudication, arbitration, litigation or any other mechanism set out by the contract.

Certain contracts require the parties to first endeavour to reach amicable settlement of the disagreement within a specified period of time (usually between senior management representatives of the parties), failing which the parties may proceed with formal dispute resolution procedures. Mostly, a contract would provide for resolution of a dispute firstly by

adjudication (either by a single adjudicator or by a Dispute Adjudication Board), and thereafter arbitration.

Some contracts provide for an adjudicator or arbitrator to be agreed between the parties at the time the contract is entered into. If this is not done, the contract will provide a process for the parties to agree an adjudicator or arbitrator when a dispute arises. Failing agreement, an adjudicator or arbitrator will be appointed by a nominating body (which is agreed between the parties at the time of contract conclusion).

The party who wishes to commence with a formal dispute resolution process, will be required to make a referral to the adjudicator or arbitrator (once appointed). The contracts often provide a time period within which a referral to adjudication or arbitration should be made. The referral should set out the relevant background and detail of the claim and set out the claim(s) required to be resolved. An adjudicator or arbitrator may only make determinations on disputes referred by the parties.

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