Australian Constructors Association

Bonding Issues Faced by Construction Companies in Australia

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1 Introduction and Summary

Federal and State governments have ambitious plans for major infrastructure projects to stimulate the economy, relieve bottlenecks that hinder economic growth, and replace worn out existing infrastructure. Some private sector companies also have major expansion plans. However, limits on the availability of performance guarantees and bonds threaten these plans. Construction contractors have to supply these guarantees or bonds for major projects, but some banks have stopped providing them altogether, whilst others have cut back on their supply. The same problem applies to major projects promoted by the private sector. At the same time, both Government and private sector clients have become more risk averse and, in some cases, demand higher levels of performance guarantees or bonds.

In the light of these problems, the Australian Constructors Association (ACA) has engaged KPMG to undertake independent research on the current bonding issues facing the construction industry. This research has included:

- interviewing representative samples of:
  - ACA member firms on their experiences of the change in bonding requirements and costs;
  - PPP project developers and lenders on their requirements;
  - performance guarantee and bond providers (banks, insurance companies) on their terms; and
  - Government bodies with responsibility for major infrastructure projects (PPPs and others);
- undertaking desktop research on practices in other countries with similar legal systems, particularly the UK;
- reviewing our findings and developing alternative funding options; and
- preparing this report outlining our findings.

The Global Financial Crisis (GFC) has led banks, who are the main providers of performance guarantees, to restrict their supply and to increase their price. Banks have found it more difficult and expensive to raise the capital they need to back performance guarantees, which have been relatively unprofitable in their own right.

The credit rating downgrades that have hit many international banks have meant that the market has been restricted further. Banks having a credit rating of AA/Aa2 credit rating is now relatively rare, and clients need to consider accepting a lower rating of perhaps A/A2 or even lower from providers of performance guarantees.

However, the difficult economic climate means that clients are unwilling to relax their requirements for performance guarantees or bonds. For some more complex projects, clients require both a higher amount of the performance guarantee or bond as a proportion of the construction contract value and a longer period for which the contractor has to provide it.

Clients run a significant risk that construction contractors bidding for major infrastructure projects with onerous performance guarantee or bond requirements either will have to submit qualified bids, restricting the performance guarantee or bond, or will not bid at all. Therefore, clients should consider carefully their requirements for performance guarantees or bonds to ensure that they are not excessive.

For financially stronger contractors, there is a question whether the value of performance guarantees or bonds for clients is worth their cost. Some construction contractors have investment grade credit ratings, and hence are very creditworthy in their own right, diminishing the value of a performance guarantee or bond, the provider of which may not have much better a credit rating. Therefore, clients could just rely on their recourse under the construction contract.

For PPP projects, there is a question whether Conditions Precedent and construction bonds provided directly to the Government are appropriate, given the strong financial incentives already faced by the Project Company to satisfy its obligations through it being fully at risk for its future revenues from the project.

Although most clients have clear criteria for acceptable providers of performance guarantees or bonds, they often also give considerable discretion to project managers, particularly about the replacement of guarantee or bond providers. Often managers exercise this discretion to restrict further contractors' ability to provide guarantees or bonds.

In particular, surety bonds can be worded to be unconditional and on demand, and hence to be equivalent to bank guarantees, and their providers often have a better credit rating than many banks. However, some clients or project managers are unwilling to accept them, further restricting the market. A wider acceptance of surety bonds is important to enable construction contractors to be able to meet their bonding obligations on future projects.

A further problem is that clients sometimes delay the cancellation or release of performance guarantees or bonds following completion of construction and the end of the defects liability period. This delay may not be caused by any concern over the contractor's performance, but be purely the result of administrative processes. However, even a small delay can still have a material impact on a contractor's ability to provide performance guarantees or bonds for new projects. Clients therefore need to cancel or release promptly, and perhaps construction contracts could contain damages provisions if there is an excessive delay in cancellation or release.

2 Purpose of Performance Guarantees and Bonds

Fixed price, Design and Build (D&B) construction contracts have become very common in Australia, particularly for major projects. Both public sector and private sector clients see them as transferring much construction risk to the parties best able to manage them, namely the construction contractor. Research[1] has estimated that 30-40% of private sector construction projects and 20-30% of public sector construction projects use D&B contracts across most construction sectors. Clients particularly use them for large, complex projects, including Public-Private Partnership (PPP) projects, for the key construction sub-contract.

Clients for major infrastructure projects include:

- State and Federal Governments, for conventionally procured projects;
- developers of and lenders to PPP projects and, in some cases, Governments procuring PPP projects; and
- in some cases, head contractors in respect of major sub-contracts.

Although D&B contracts are fixed-price, they normally provide for payments of regular instalments of the contract price based on a certified or assessed value of work completed, to avoid construction contractors having to finance their costs over the full construction period. Hence, the client will have paid out most of the contract value before completion of construction and successful commissioning. Construction contractors still have a contractual obligation to complete construction and commissioning successfully, even if the client has paid out the full contract value. Further, construction contractors' reputations are important for winning future business, so they have a powerful incentive to ensure that they complete and commission their projects successfully and on time.

However, clients typically require payment by the construction contractor of liquidated damages if successful completion and commissioning is later than an agreed date. These damages cover the loss to the client of the project being late, and can be substantial. They can exceed 10% of the contract value at an annual rate. In addition, the contractor may also have to pay liquidated damages if the completed project does not meet required performance standards (particularly important for process plant). Construction contractors also normally have to fix (at their own cost) any problems that appear during the first year or two after completion (the defects liability period) and also are often liable for damages claims during a longer warranty period.

D&B contracts typically include a requirement to provide security for all these obligations in the form of a performance guarantee (provided by one or more banks) or bond (in the form of an insurance company surety bond), which also would cover the contractor becoming insolvent. Bank performance guarantees have a substantially larger market share than surety bonds. The guarantee or bond normally is for a lot less than the potential liability of the construction contractor: amounts of 5 or 10% of contract value have been typical.

[1] "Design-build becoming a revolution", HANSCOMB•Means Report, International Construction Intelligence, Vol. 16, No. 6, January/February 2004

Guarantees or bonds normally are irrevocable, unconditional and "on demand", such that the client does not have to prove any loss or default by the contractor before calling on the guarantee or bond. (However, if the client does demand payment under the guarantee or bond without due cause, the contractor would be able to claim damages against it.) The performance guarantee or bond specifies a maximum amount that the client can demand.

Some performance guarantees and bonds have a fixed expiry date (normally, the expected end of the defects liability period), but others are undated. Performance guarantee and bond providers will cancel them when the client returns them. Commonly, clients agree to return 50% of a performance guarantee or bond on practical completion of the project, returning the remainder at the end of the defects liability period.

A client demanding payment under a performance guarantee or bond has serious implications for a construction contractor. Contractors' reputations depend on meeting their obligations, so a client calling on a guarantee or bond means that it has failed to do so. In addition, the contractor has to reimburse the provider of the guarantee or bond, and the contractor may have problems obtaining performance guarantees or bonds in the future. As a result, in reality, clients rarely demand payment under performance guarantees and bonds. ACA member firms' experience is that such payments have occurred only on small projects, only after a lengthy dispute about whether the contractor has fulfilled its obligations and, in the words of one interviewee, "when the client has got fed up" with the continuation of the dispute.

Clients also use bank guarantees widely as security for any payment obligations of the contractor. Such obligations include a potential liability for liquidated damages, as mentioned above, but may also cover:

- a contractor's investment of equity in a PPP project company, where the timing of the actual investment may be delayed to the end of the construction period (which is normally more financially efficient that an up-front investment); and

- payments due from the contractor to the client for assets that it contributes to the project, such as land or existing facilities (more common in PPP projects).

Developers of and lenders to PPP projects sometimes require significant equity investments from their construction contractors as a condition of their involvement in the project. They see such equity as aligning the contractor's interests more closely with those of the project company, and hence reducing the potential for damaging disputes. Construction contractors have limited resources to make substantial investments that would substantially exceed any profit they might make from the construction contract. Both Government sponsors of PPP projects and lenders to them generally require initial project equity to remain in place at least until the end of construction and often for one or two years afterwards (and sometimes more), significantly tying up contractors' financial resources.

The National PPP Guidelines' Commercial Principles provide for the possibility of Government requiring to benefit directly from:

- a Conditions Precedent bond as security against the Project Company failing to satisfy Conditions Precedent under the PPP project agreement by the target date; and

- a construction bond as security for the Project Company's performance of its design, construction and commissioning obligations, though generally the Guidelines regard a requirement for the Project Company to obtain a construction bond from its contractor as sufficient.

In each case, the need for such bonds is questionable, as the Project Company already has a strong financial incentive to perform:

- the costs of bidding for PPP projects are substantial, and are irrecoverable if the project doesn't become effective because of a failure to satisfy Conditions Precedent; and

- generally, the Project Company won't receive any income until it commissions the project successfully.

Governments also generally require a performance guarantee or bond as security for a PPP Project Company's handback obligations at the expiry of a PPP project. As the alternative is an equivalent retention from service payments, which may be substantial, this requirement is more reasonable.

3 The Problem

In recent months, as a result of the GFC, construction companies in Australia face two major problems:

- the availability of bank performance guarantees (which have a substantially larger market share than surety bonds) has reduced and their price has increased; and
- clients have become more risk averse and, in some cases, demand higher levels of performance guarantees or bonds.

3.1 Availability of bank performance guarantees

Through the first half of 2008, banks faced substantial increases in their own costs of raising both equity and debt, as the equity and wholesale money markets became more and more concerned about the credit losses banks faced.

This situation worsened considerably in the third quarter of 2008, following events such as the bankruptcy of Lehman Brothers, the American Government's $85 billion bailout of American International Group (AIG), the sale of Merrill Lynch to Bank of America, and the nationalisation and government bailout of various European banks. Most banks' share prices collapsed, and many weaker banks were unable to fund themselves at wholesale money market reference rates. The stronger banks could still fund themselves for tenors of up to 6 months without paying a premium, but were having to pay a premium over short-term rates for funding in the wholesale money market over longer periods.

The provision by the Commonwealth Government of a guarantee of Australian banks' liabilities in October 2008 improved their ability to fund themselves in the capital markets, though there is a fee for this guarantee (0.70 % p.a. for the Big Four and other AA-rated banks) and tenors covered by the guarantee are limited to 5 years. In recent months, banks' funding positions have generally improved, with many raising new equity and medium term debt, and in recent days some commentators have questioned the need for the Government guarantee to continue. However, the cost of this funding (even on a Government-guaranteed basis) remains high, and banks have passed it on to their customers through higher pricing.

Some international banks have withdrawn from the Australian market, or severely limited the volume of business they do, in some cases where they have received support from their home Governments and had moral pressure put on them to focus their activities on their domestic markets.

More generally, bank regulators, shareholders and credit ratings agencies have pressured banks to improve the quality of their balance sheets. In particular, banks have:

- tried to increase their capital base relative to the size of their loan portfolios, partly by restricting new business, particularly to new customers;
- tried to limit their total, aggregate exposure to any one customer to a prudent proportion of their capital base (that proportion depending on the customer's credit quality); and

- generally become more risk averse in providing credit facilities, tightening their requirements.

In some cases, banks have reduced the size of existing guarantee facilities when they have renewed them solely because of these factors, without any deterioration of the construction company's creditworthiness.

Banks see the provision of performance guarantees as not being particularly profitable. Historically, they have provided them for existing clients as part of a wider relationship strategy that includes providing more profitable products. Indeed, before the onset of the GFC, construction companies often required their banks to provide performance guarantees as a condition of doing other business. In the current market, where the balance of power has moved more towards the banks due to limits on the availability of their capital, banks are better able to restrict the availability of performance guarantee facilities unless profitably priced.

Consequently, some construction companies have found that their ability to provide bank performance guarantees to their clients has reduced, particularly where they have relied in the past on international banks that have reduced their presence in the Australian market, or where their bank has substantial aggregate existing credit exposure to them, as noted above. This reduced ability comes from a combination of:

- existing guarantees not being cancelled promptly enough to leave room for new business within existing guarantee facilities;

- banks not renewing existing guarantee facilities in full when they expire, limiting any capacity for new business;

- construction companies finding it more difficult to obtain new or increased guarantee facilities to accommodate growing business volumes; and

- contractor mergers, where guarantee facilities for the merged firm may be less than that of its constituent parts before the merger.

In addition, head contractors' requirements for performance guarantees or bonds from major sub-contractors has exacerbated the overall problem with market capacity, as clients generally do not accept assignments of guarantees or bonds of sub-contractors as meeting part of the head contractor's requirements, resulting in a partial doubling-up (in some jurisdictions, such assignments are illegal).

A further problem with availability of performance guarantees and bonds is that clients generally require their providers to have a minimum credit rating. This minimum can be as high as AA/Aa2, and generally is at least A/A2. The GFC has meant a sharp reduction in the number of banks and insurance companies that meet this criterion. Construction contracts frequently require the replacement of a performance guarantee or bond where its provider no longer meets this criterion. Such a replacement may not be possible, depending on the identities of the construction contractors existing relationship banks. In such event, the contractor may be in default of the construction contract, entitling the client to demand payment under the performance guarantee or bond. In this context, some relaxation by clients of minimum credit rating criteria would be helpful.

Some clients (one interviewee particularly cited bank lenders to PPP projects) also require the right to exercise complete discretion over the acceptability of a replacement guarantee provider, even where that provider satisfies the minimum ratings criteria, further limiting availability. Limiting such discretion also would be helpful.

3.2 Changing client requirements

Clients see performance guarantees and bonds as part of an overall package of security for the construction contractor's performance that also includes:

- caps on contract liability;
- the length of the defects liability period;
- whether there are any retentions of progress payments under the contract; and
- in the case of PPP projects, whether the contractor also has invested equity in the project.

3.2.1 Amount

The "standard" level of performance bonds or guarantees for major projects is 10% of the contract value, though there are frequent variations from this level. More sophisticated clients will look at the overall security package in determining the appropriate level of performance guarantee or bond. For example, they may offset a lower cap on the contractor's liability by a larger performance guarantee or bond.

Clients also look at the nature of the project. They are likely to require higher levels of guarantees or bonds (perhaps 15% of contract value) for more complex projects, particularly those for process plants with a substantial degree of commissioning risk. In contrast, they may accept lower levels (perhaps 5% of contract value) for relatively simple projects.

There is a major question over whether clients should require performance guarantees or bonds at all. Their role is as (partial) security for a contractor's obligations, which the contractor already has powerful legal and reputational incentives to meet. In addition, tenders for contracts often have an accreditation or pre-qualification stage in which the financial capacity of the contractor to undertake the contract is an important criterion. However, clients like the "on demand" nature of performance guarantees as an ultimate incentive and sanction should the project go badly wrong, even if the guaranteed amount may be well short of any potential loss.

3.2.2 International experience

Performance guarantees are less common in the American and European markets than in Australia. For example, in European PPP projects, some stronger contractors have not had to provide them. Some banks found that they were providing performance guarantees as the construction contractor's bank for their own benefit as lender to a PPP project and concluded that, as they were happy with the construction contractor's creditworthiness, they were willing not to require further security of performance.

Construction companies argue that, for large projects, requiring performance guarantees or bonds of the same percentage of contract value as for small projects is onerous. However, clients argue that their potential exposure increases at least proportionately to the project size.

3.2.3 Duration

For a few projects, clients have increased the length of the defects liability period from 12 months to 24 months, which has a material impact on a contractor's ability to provide performance guarantees or bonds for new projects. Unless there is an evident risk that some defects will only appear in the second year after completion, such an increase will have no value, only a cost, to clients. Some Government clients also require a low level of performance guarantees or bonds (perhaps 0.5 – 1.0% of contract value) for several (5 – 7) years after completion. Because of this long duration, even such a low level of guarantees or bonds can have a substantial cumulative impact.

3.2.4 Cancellation or release

A further problem is that clients sometimes delay the cancellation of performance guarantees following completion of construction and the end of the defects liability period. This delay may not be caused by any concern over the contractor's performance, but be purely the result of administrative processes. Even a small delay can still have a material impact on a contractor's ability to provide performance guarantees or bonds for new projects. It also has a cost impact on the contractor that they cannot recover within a fixed price contract.

3.2.5 Pricing

Finally, the cost of new or replacement performance guarantee facilities has increased substantially over the last two years. Pricing depends critically on banks' assessment of the creditworthiness of individual construction companies and the value of their relationships with these companies. However, the ACA estimates that the cost of bank performance guarantees has increased to between 2½% and 3½% per annum of the guaranteed amount, contrasted with rates of under 1% p.a. before the GFC.

This increase results directly from banks' own increased costs of the capital they need to back the provision of guarantees, although there may also be an element of banks seeking to improve the profitability of guarantees. In current market conditions, most banks have limits on the use of their capital, and all new business, including the renewal of existing facilities, competes for this capital.

Construction contractors generally can pass on the higher cost of guarantees for new contracts, but this generally is not possible where banks have increased the cost of guarantees for existing projects, severely hitting contractors' margins. This problem is exacerbated by banks putting expiry dates on guarantees (in the past, they frequently were undated), requiring the reissue of the guarantee if the contractor's obligation to provide a guarantee extends beyond the expiry date. If the pricing of the guarantee has increased, contractors generally cannot pass on the increase within a fixed-price construction contract. In some cases, performance guarantee facilities have annual or semi-annual repricing provisions, which exacerbate this problem.

4 Is there a solution?

The financial markets do now seem to be recovering slowly from the GFC. As noted above, in recent months, banks' funding positions have generally improved a little, with many raising new equity and medium term debt, but the cost of this funding remains high and banks remain capital-constrained. Bank providers of performance guarantees argue that, in view of the pressures they still face, there is limited or no scope in the near future for significant increases in the availability of performance guarantees.

One positive sign is that some international banks that had withdrawn from or reduced their activities in the Australian market are slowly becoming more active. Nevertheless, performance guarantee facilities will continue to compete for bank capital with other business, so pricing is unlikely to reduce in the near future and may even increase further, and international banks are unlikely to expand the availability of guarantees significantly.

Another consequence of the GFC and the current difficult economic climate is that developers of and bank lenders to PPP projects are, if anything, tightening their credit standards, as they see the risks of contractor default as having increased. Interviewees are aware of the difficulties that construction contractors face in obtaining performance bonds, but see no scope in the near future for a relaxation of requirements. Government clients, too, are aware of the same difficulties, but also are unwilling to relax standards.

Nonetheless, clients run a significant risk that construction contractors bidding for major infrastructure projects with onerous performance guarantee or bond requirements either will have to submit qualified bids, restricting the performance guarantee or bond, or will not bid at all. Therefore, clients should consider carefully their requirements for performance guarantees or bonds to ensure that they are not excessive.

For financially stronger contractors, there is a question whether the value of performance guarantees or bonds for clients is worth their cost. Some construction contractors have investment grade credit ratings, and hence are very creditworthy in their own right, diminishing the value of a performance guarantee or bond, the provider of which may not have much better a credit rating. Therefore, clients could just rely on their recourse under the construction contract.

4.1 Are surety bonds the answer?

The wording of insurance company surety bonds now can be very similar to that of bank guarantees, enabling clients to call them on demand, unconditionally. In principle, therefore, surety bonds should be a ready substitute for bank guarantees, but they are much less widely accepted.

In the past, surety bonds have been much more conditional than bank guarantees, with clients having to demonstrate default and consequent loss before being able to call on them. Such conditionality came from surety bonds' background as insurance against poor contractor performance, rather than as an overall financial guarantee. More recently, insurance companies have agreed to unconditional, on demand wording for surety bonds to enable them to compete directly with bank guarantees.

Before the GFC, unconditional, on demand surety bonds struggled to compete with bank guarantees on price terms. The basis of their pricing is completely different from that of bank guarantees. Banks price guarantee facilities largely on the financial creditworthiness of the construction contractor, whereas insurance companies historically have priced surety bonds largely on contractors' history of clients calling on their bonds (albeit insurance companies' ultimate recourse is similar to that of banks, in the form of an indemnity from the construction contractor). The change in wording to be equivalent to that of bank guarantees has increased the risk of clients calling on surety bonds, resulting in increased pricing that generally was higher than that of bank guarantees. However, recent increases in the pricing of bank guarantees have meant that surety bonds are now often price competitive.

Despite the legal equivalence of surety bonds and bank guarantees, clients sometimes do not accept the former sometimes as readily.

Clients regard bank guarantees as being equivalent to cash, and rely on them accordingly. The banks that provide them view them in the same way. Banks do not wish to be drawn into disputes arising from the performance or otherwise of the underlying contract. Their reputations depend on strict compliance of their obligations.

Some clients regard unconditional, on demand surety bonds as being weaker than bank guarantees, with insurance companies being more willing to dispute the validity of a claim. In a well-known case dating back to 1992, Cigna Insurance disputed the validity of a demand to pay under a bond that it had issued. Although Cigna was unsuccessful, the reputation of this case remains.

More sophisticated clients recognise that surety bonds and bank guarantees are in principle equivalent, and focus more on the credit rating of the provider and, to some extent, the regulatory regime under which it operates. (Clients generally prefer local regulation by APRA, but generally accept similarly strong regulation in other developed countries.) Clients also look at claim paying history.

Most State Governments and the Federal Government have a policy of accepting either bank guarantees or surety bonds conditional on their providers having an acceptable credit rating and being appropriately regulated. However, individual Government departments may be more restrictive, with individual contract managers often having wide discretion on the acceptability of guarantee or bond providers. In view of the problems faced by construction contractors in obtaining bank guarantees, it would be helpful for clients to limit such discretion.

The National PPP Guidelines state a "strong preference" for "bank bonds" in satisfaction of any bonding requirement, though they do provide for accepting insurance bonds "in limited circumstances", "subject to the creditworthiness of the insurance company and being satisfied with the enforceability of its rights under the bond and with the process for recovering funds in the event that it makes a demand." It would be helpful for these Guidelines to look on surety bonds more positively.

Relatively few insurance companies offer unconditional, on demand surety bonds, as these features stray away from "traditional" products insuring against specific risks. Hence, although there is market capacity for an increase supply of surety bonds, it is limited. In addition, both banks and insurance companies look at their customers overall financial liabilities. Hence, if they regard a customer as having reached a prudent level of liabilities, the provision of a new or increased facility by one bank or insurance company may lead that customer's other banks and insurers to restrict their own facilities.

4.2 Do Governments really need bonds for PPP projects?

There is a question whether Conditions Precedent and construction bonds provided directly to the Government are appropriate for PPP projects. Such projects already have strong financial incentives for the Project Company to satisfy its obligations, through it being fully at risk for its future revenues from the project.

4.3 Prompt cancellation or release

If there is no dispute about completion and commissioning being satisfactory, clients should cancel or release performance guarantees or bonds promptly. There may be a case for the client to pay damages to the contractor if there is an excessive delay. Even if there is a dispute about completion or commissioning, unless the sums involved are very large, clients could cancel or release some of the performance guarantee or bond, leaving in place only a guarantee or bond covering the amounts under dispute.