



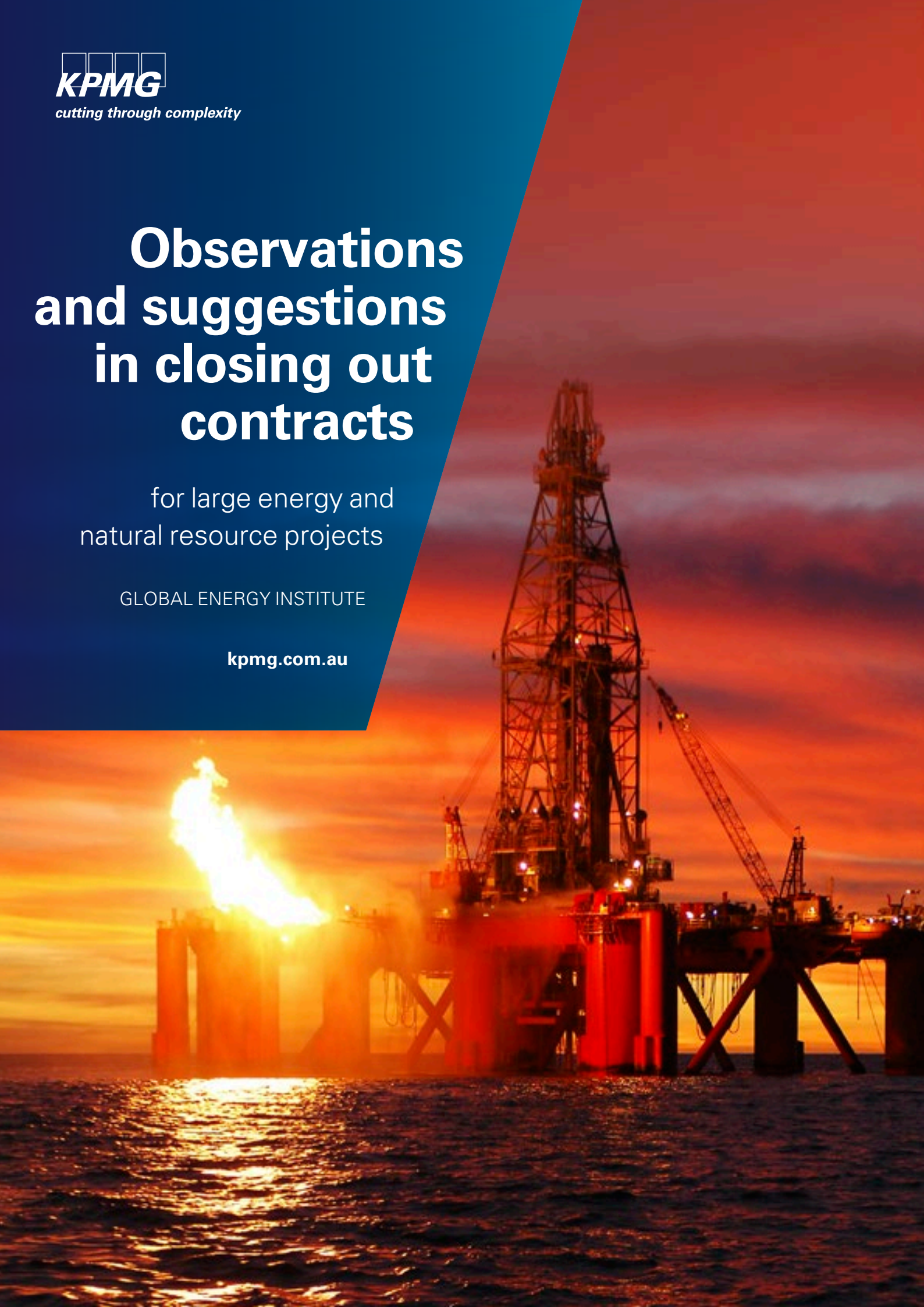
cutting through complexity

Observations and suggestions in closing out contracts

for large energy and
natural resource projects

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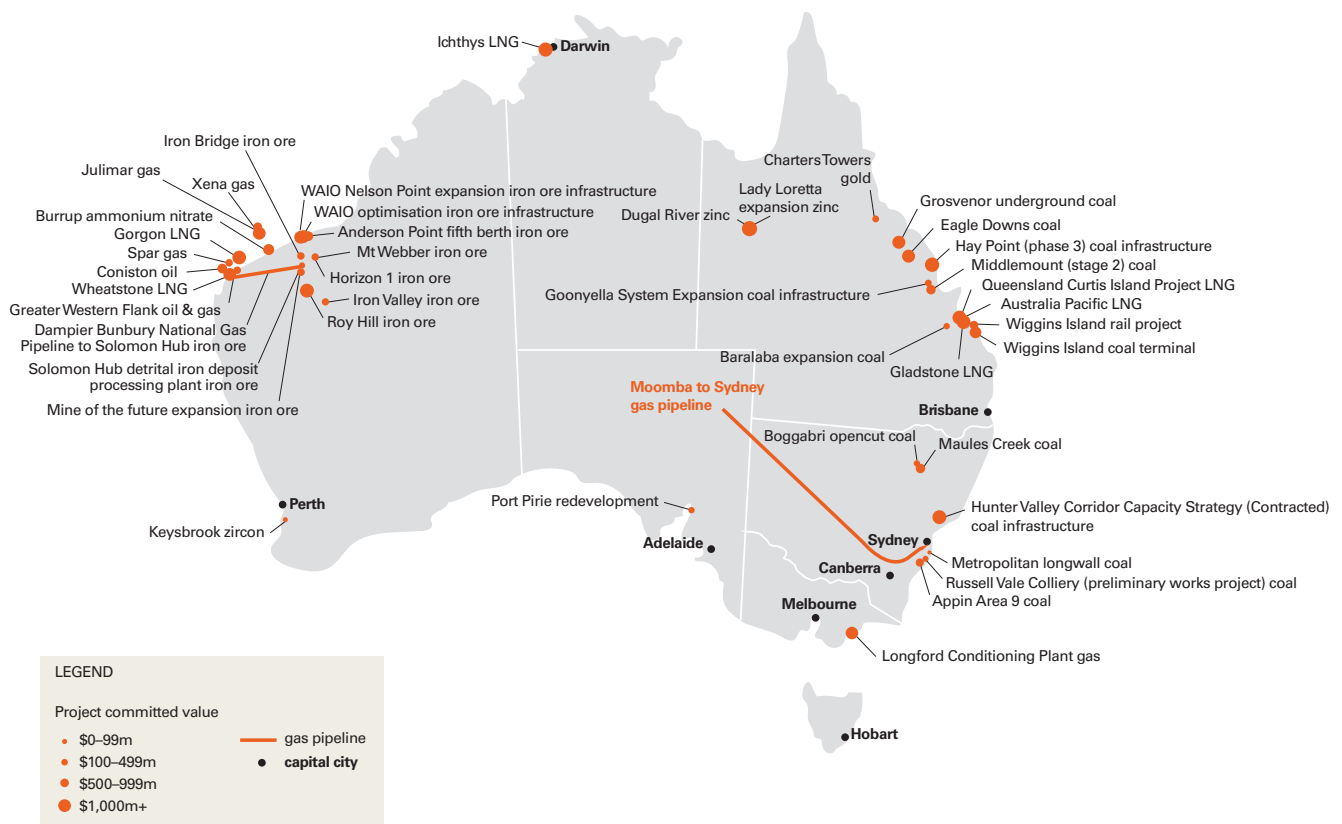
The downturn in global energy markets has led to a situation where affected parties – joint venture partners, service providers, employees and all those affected by contract disputes – need to protect their reputations, retain margins and, in several instances, recover costs where projects are challenged economically.

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Executive summary: Closing contracts in a changed market

Over the next 2 years, nearly \$70 billion worth of contracts will be closed out on major capital infrastructure projects across Australia, a large portion of which is centred around the large LNG projects in central Queensland and on the North West Shelf in Western Australia.



Source: Resources and Energy Major Projects October 2014

The majority of these contracts were executed in a different economic paradigm, when commodity prices were at historic highs and the outlook for the industry was positive. With tight project development timelines and a limited pool of specialised resources, project owners were forced into commercial arrangements with contractors (EPCMs, principle contractors, subcontractors and service providers) in a supplier constrained market. The focus of most project owners was on project schedule and the cost of completing these projects rapidly escalated as contractors and project owners sourced supplies in already constrained global and local supply chains.

The completion of these projects and contracts is occurring in a vastly different economic environment. Commodity prices have slumped, and in particular global oil and gas prices have plummeted. Project owners have been forced to engage in aggressive cost-containment programs, including amending their operating model to operate sustainably into the future. Project managers, now dealing with competing priorities of cost and schedule, are faced with increased tension to contain costs without compromising on quality and the timely commencement of operations.

The downturn in global energy markets has led to a situation where affected parties – joint venture partners, contractors, employees and all those

affected by contract disputes – need to protect their reputations, retain margins and, in several instances, recover costs where projects are challenged economically.

This is creating significant challenges for boards, senior executives and their legal advisers – and is being closely watched by shareholders, regulators and other stakeholders not only in Australia, but around the world. The nature of the contracts themselves, the way in which they were drafted and their numerous ambiguities are increasingly being put under the microscope as the affected parties strive for the best commercial and reputational outcomes.

This paper discusses a number of factors that have influenced the difficulties now being experienced in closing out contracts. It also provides suggestions for affected parties to consider going forward, not only in closing out contracts, but also in establishing and managing them into the future, including suggestions around:

- Embracing risk management in prioritising contracts
- Conducting detailed data analysis
- Engage the right people across the organisation
- Consider requirements for sustaining operations
- Conducting lessons learnt.

Issues observed that have impacted the closing out of contracts

There are a myriad of reasons why large contracts in the oil and gas sector are open to dispute or likely to become contentious, despite the fact they may have been drafted by an army of in-house and external lawyers. The speed and complexity of contracting activities, the complexity of the project, the volatile combination of collapsing energy prices and changing priorities, complex ownership arrangements heightened by ingrained behaviours of respective parties; have all influenced the circumstances that many parties now find themselves in.

Weaknesses in the contract establishment process

At the time when many contracts were signed, the focus was getting activity on the ground moving as quickly possible, maximising first mover advantage and ultimately extracting the resource as quickly as possible. As a result activities, especially in the non-conventional arena such as digging wells and accessing land, were performed in many instances without comprehensive and well-defined contracts. The priority was to reach an agreement that said: 'We'll do this and achieve this'. Often a loose structure

was put in place, often through memorandums of understanding or draft contracts, with the assumption that all parties would profit from first-mover advantage and any issues would be taken care of at some later date, including refined scope definition and contract particulars.

In the haste to drive project schedules and secure contractor resources (a number of which were scarce at the time), some contracts were ambiguous and subject to a large amount of interpretation. As such, a 'grey area' has arisen where precedence has been set by prior contract behaviour, rather than the activities stipulated by the contract itself.

There have been instances where contracts were haphazardly thrown together without considering the risks involved, and the quantum of such. As a result, the contracts were vague about scope, key contractual requirements, costs and performance indicators, all this despite the amounts being invested often running into the hundreds of millions of dollars.

However, when circumstances significantly change (i.e. collapsing commodity price that challenges the business case for a particular project) all parties want to maximise their return but unclear and ambiguous contract provisions are causing further difficulties in disputes with contractors.

In addition, owners were often hamstrung due to 'right to audit clauses' and other assurance arrangements were not stipulated into contractual terms. While this in itself did not prevent assurance and audit



activities occurring, it often created delays and behaviours that were not conducive to a cohesive working arrangement. Further, assurance work often undertaken focused on substantive and transactional measures rather than considering the overriding governance and control environment of the party in question, leaving systemic issues untouched.

Variable understanding and articulation of reimbursable costs

One of the frequent ambiguities being dealt with when closing cost reimbursable contracts, and in approving monthly progress claims, is understanding what is a reimbursable cost and then more implicitly, the delineation between reimbursable costs and costs recovered through corporate overhead or margin. These terms are frequently seen in contracts and frequently there is insufficient detail within the commercial framework to define what is included within these terms.

In our experience, we often see tension between parties around the recoverability of the following areas:

- Corporate recharges
- Labour on-costs and redundancy charges (and the build-up of such)
- Plant rates and plant utilisation (and the build-up of such)
- On-site and off-site labour
- Mobilisation and demobilisation costs
- Tax credits (fuel, R&D etc.)
- Travel and accommodation costs (including arrangements for fly-in and fly-out workers)
- Supplier discounts and/or refunds.

This ambiguity has the potential to be resolved during the contract establishment process. However, due to time constraints and other pressures we have increasingly seen limited up front engagement on these matters.

Further complicating this understanding of cost, is when a contract transitions from a fixed-price contract to a cost-reimbursable contract, or variant thereof. Across recent projects in Australia this has been a frequent occurrence, creating risks and opportunities for all parties concerned. While there are sound commercial reasons for these changes, the transition and back-end close out process is notoriously difficult to manage.

Loss of corporate memory

The rapid downsizing of workforces due to the cancellation, completion of projects or new market conditions has led to a high turnover of personnel, especially those with contract establishment, contract management and administration expertise.

The people responsible for negotiating, drafting and signing project contracts, variations and amendments, who had implicit knowledge of the intent of certain terms and conditions, are often no longer at their respective organisations. This means those attempting to resolve disputes in contract close-outs have to decipher what the original intent of the contract or variation was, and what was actually agreed to or stipulated. Adding to the issue is that these points are rarely documented outside of the contract itself.

In the haste to drive project schedules and secure contractor resources (a number of which were scarce at the time), some contracts were quite ambiguous and subject to a large amount of interpretation. As such, a 'grey area' has arisen where precedence has been set by prior contract behaviour, rather than by what should have been stipulated by the contract itself.

In rare cases, contracts or formal agreements are unable to be found. We have seen instances where owners and contractors are not aware of the existence of contracts and/or who has responsibility for the contract within the organisation.

Lack of clarity over key project management roles

Having the right personnel is essential for good contract governance and project-wide standardised risk management processes. However, many contracts were drafted without a strong contractual agreement, limited understanding of roles between the owner's team and the contractor's team or variable understanding of where tasks would be performed (e.g. on-site versus off-site, on-shore versus off-shore). This failure to clearly define roles, responsibilities and accountabilities resulted in operational gaps and role overlap between the owner and contractor due to the lack of clarity.

Roles, accountabilities and responsibilities of owner's representatives and the contractor should be clearly defined within the contract and associated documentation, such as the organisational chart, project management plan and resourcing plan. Furthermore, the division of tasks performed by off-site versus on-site and on-shore versus off-shore labour should be clearly defined and agreed.

Weaknesses in project governance and contract management processes

Large-scale complex projects require clear governance structures (policies, systems and frameworks established and operating effectively), to provide the necessary transparency, accountability and oversight over all aspects of the project through its lifecycle.

In many instances contracts were executed and being delivered while the project governance arrangements (both internal and external, including policies, systems and frameworks), were still being developed, agreed to (by consortium partners) or being implemented. As such, systems and data to provide the necessary oversight over the performance of critical contracts, especially over areas of cost, schedule, quality and change (variations), were not as robust as desired resulting in potential performance and non-compliance issues not being identified or being identified too late.

Complicating the governance picture was often the unclear relationship and arrangement between owners, contractors' and their subcontractors. Too often owners relied upon the principal contractor's governance and project control systems, without undertaking sufficient checks to satisfy themselves these were fit for purpose to manage and execute contracts and packages of work of a relevant size and complexity. This often created a false sense of calm, with issues often crystallising when contracts were starting to be closed out.

At the heart of a number of issues was the management of contract variations, where the processes to manage variations in many instances were either not complied with or were not sustainable given the size, speed and complexity of the projects themselves. This is evident by the large number of funds withheld by various owners working through a backlog of variation claims and disputes, where work was been completed long ago. Quite often the speed at which activities were occurring, the number of people involved in completing various programs of work, the process itself to raise, analyse, cost and approve a variation, and document management requirements, created a number of weak points in the process.

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Suggestions when closing out a contract

The closing out of a contract is a critical activity that in simple terms reflects that all parties have fulfilled their obligations under the contract. However, given the large sums of money involved, reputation concerns and the need for an owner to operate an economically viable ongoing asset; the contract close-out process was often complicated.

It is therefore appropriate to work through an informed process that embraces risk management, considers all available data, engages with all relevant people across the organisation and ultimately considers strategic and operational requirements relevant for an operating asset. And finally, conducts a lessons learnt exercise to enhance the contract process next time.

Embrace risk management in prioritising contracts and in closing them out

As noted previously, large oil and gas projects often have hundreds of contracts in place and it is therefore prudent to apply a risk lens over these contracts to ensure the right organisational effort and attention is applied relevant to the potential risk.

While most organisations will have their own detailed risk and contract management systems, we believe it is worthwhile for the organisation to identify and consider those contracts that:

- Are of a material financial impact
- Are viewed as being contentious and potentially litigious
- Include cost reimbursable elements
- Were vague in initial scope or subject to a large quantum of variations
- Relate to areas of intellectual property important to the ongoing utilisation and management of the asset

- Relate to matters necessary to the ongoing utilisation and management of the asset i.e. maintenance activities
- Link to third party compliance obligations i.e. environmental matters.

We believe these contracts require a higher level of scrutiny than those contracts going through an organisations normal contract close process. This scrutiny may require an organisation's general counsel or legal adviser to be engaged to lead the close-out efforts to manage any litigation risk. Contracts associated with technical designs and drawings may require checks undertaken to confirm all contracted documentation has been provided and appropriately certified.

Understanding these risks and developing an appropriate close-out strategy is an important first step, but the following activities are still required to validate the proposed strategy.



Consider all available data

To make informed decisions it is vital that all parties go through a process to identify and collect all necessary information relevant to the development and conduct of the contract. Typically this information would be contained in a document management system, however, as noted earlier, the use and effectiveness of such systems often are not as effective as planned.

Information to be sought would include change requests, variation approvals, claim information, monthly performance / status reports, site logs, decision logs, etc. However, increasingly we are seeing a more sophisticated use of data analytics to provide greater insights around cost, productivity and schedule performance. Often this information is being obtained and presented in more litigious environments, but its prevalence is being seen more widely in progress claims monitoring.

It is important to note that to get the most benefit out of project data analytics, that the data management strategy for the project needs to be considered at the beginning of the project lifecycle and that it is aligned with the core project control components of cost, schedule, quality and change. Establishing this early

provides significant capability to both the owner and contractor to gain oversight over project performance.

Where a particular contract lands on the risk assessment will influence the level of data analysis undertaken. It is important that this data is used to inform and ultimately support the on-going contract management and the close-out strategy. It is also important that this analysis, and the broader close-out strategy is shared and discussed with all relevant stakeholders given the impacts of these material contracts are normally felt across an organisation.

Engage with all relevant stakeholders across the organisation

Given the complexity of some of the contracts and the other matters mentioned earlier in this paper, it is critical that affected parties adopt an enterprise-wide approach when closing out high risk and material contracts.

This ensures the right people in the organisation are engaged, all data relevant to the contract is sourced, and potential scenarios and options are appropriately considered and challenged. The final decisions should then be well documented and approved by the people with the correct authority.

We have observed instances where at times legal, tax, finance and operational managers have been unaware of decisions being made in closing out material contracts. In these instances the organisation has suffered or not achieved as optimal a result as possible.

More importantly though, the ongoing sustainable operation is often more critical than a contractual dispute about cost or other matter. Thus it is important to understand those contracts and contractors that directly impact the operating asset in perpetuity.

Ongoing operations

Through design and construction activities, contractors often gain a deep knowledge of the asset being developed. It is often beneficial to the owners to retain this knowledge, usually through keeping a relationship of sorts with critical suppliers and contractors.

It is therefore critical that these relationships are identified and considered prior to the closing out of any contracts, and that this has been adequately reflected in the close-out strategy and socialised across the organisation.

Case study: LNG Project Upstream construction work process review

KPMG was engaged by an LNG company to help improve a construction project's processes and controls associated with its claim preparation and submission process. KPMG conducted a detailed process review and held workshops with the owner's team and engineering, procurement and construction management (EPC) representatives to arrive at a mutually agreed-upon resolution of controls and process issues.

KPMG analysed data to detect anomalies and potential areas of contract non-compliance. Testing covered all direct costs claims, including those for salaried staff, contracted labour, subcontractor labour, plant and equipment, materials and other project-related costs such as goods and services.

In undertaking the review of monthly payment claims we identified issues in, and assisted with the implementation of changes to, key systems and processes, including claim preparation, personnel approval controls, personnel rate changes, labour escalation rates, procurement and overhead recharges.

Lessons learnt

Conducting lessons learnt exercises periodically during the lifecycle of the project enables the owner and contractor to improve future performance either on this project or future projects. Lessons learnt exercises conducted during the project lifecycle also increase the likelihood that issues are either mitigated or eliminated prior to project completion.

Results of these lessons learnt exercises should be clearly documented and the results used in both the close-out of other contracts and in the establishment of future contracts. Critical to the success of lessons learnt exercises is that the results are shared beyond the immediate project team, and provided to the wider organisation to leverage experiences.

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