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Fitch Rtgs: Bondfield Default Highlights Project Completion Contractor Risk

Fitch Ratings-New York-11 February 2020: The default of a private project contractor for a number of large Design-Build Finance (DBF) social public-private partnership (P3s) projects in Canada highlights the need for robust risk assessment and efficient risk allocation, Fitch Ratings says. Bondfield Construction Company Limited defaulted on its payment obligations for a number of projects for which it served as contractor and filed for insolvency protection. The issues with Bondfield are the latest among a number of high profile construction challenges in the P3 sector, including the I-69 and Denver Great Hall projects, which underscore the importance of understanding and appropriately mitigating key completion risks.

Fitch recently published an [Exposure Draft: Completion Risk Rating Criteria](#), which focuses attention on contractor risk and allocating risk across multiple parties.

Work on the Bondfield projects, located in the province of Ontario, has been delayed from a few months to more than a year as the government sponsor, Infrastructure Ontario, the surety provider, Zurich Insurance Company Ltd, and bank lenders have been working to find a solution to the defaults. The projects employed standard DBF structures, with banks providing all of the financing through construction loans. There was no equity injection, nor was there a project company that actively managed the construction process.

Although relatively simple in scope, the DBF structure used in these projects provided very little liquid security. The lack of adequate liquidity to cover the short and medium-term incremental costs of contractor replacement, such as search and retendering costs, meant lenders were reliant on the sureties when the contractor defaulted. Although sureties typically guarantee completion, they do not guarantee timely completion because the adjudication of claims can take a long time. The Bondfield projects ran out of liquidity before the surety provider was asked to step in. Public information is limited as these projects are not rated.

Many years of successful delivery of social P3s in Canada led to a level of comfort with contractor/completion risk and an increase in competitiveness in the sector that resulted in a compression of construction margins. Underestimating completion risk can result in bids that are mispriced for the level of risk present and lead to cost overruns and delays. In a competitive environment, contractor replacement may also become a challenge because potential replacement contractors are unlikely to assume the contract if the risk is significantly mispriced and will require a significantly higher cost/premium to complete.

Fitch's completion analysis is heavily dependent on the opinions of technical experts, independent engineers (IEs). However, the processes and standards used in developing these opinions vary, and the influence of the issuer cannot be ignored. Fitch's Exposure Draft: Completion Risk Rating Criteria consequently identifies minimum levels of performance security required to cover replacement costs relative to the IEs' estimates based on contractor ratings.

These levels represent Fitch's experience and judgment, which is informed by discussions with a variety of market experts with considerable experience in construction projects that have experienced delays and cost increases following a contractor default. Fitch will review the IE's opinion and engage in discussions to ensure there is a complete understanding of the processes and standards used. The 'right-sizing' of performance security, both short-term liquid security and long-term performance security, to cover costs of replacing the contractor is vital to mitigate completion risk.

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