

Sources of Delay and Cancellation Risks in Latin America

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Introduction

Large and complex infrastructure projects are prone to many sources of risk that could cause construction delays or cost-overruns, thus severely impacting a project's profitability. A prominent source of delay risk in the Latin American construction market in recent years has been the widespread corruption scandals involving some of the region's largest contractors that have consequently stalled projects as contractors attempt to manage the financial and legal consequences of the investigations. Another recent source of risk in Latin America involves the presidential and legislative elections of 2018 which brought new governments to the region that, in some cases, have begun to lay out infrastructure agendas that are distinct from their predecessors. While some of the newly elected governments claim to be champions of foreign investment and robust national infrastructure plans, others are sending mixed signals and are spending much time scrutinizing the results of government tenders from prior administrations. Political risks can increase the uncertainty surrounding contract enforcement, leading to potential project delays or project cancellation, particularly when projects are tendered close to election years. Although it is impossible to eliminate the risks inherent in developing large infrastructure projects, there are various risk mitigation strategies that can be implemented to minimize the impacts these risks may have on the execution of the project.

Delayed Construction Works and the Impact on Existing Insurance Programs

While project delays are common in the construction industry, it is important to consider that the consequences of these delays may be further exacerbated once construction of the project has commenced. Project delays not only add additional costs to the overall project and give rise to disputes amongst contractors and owners, but they can also impact a project's insurance coverage if not managed properly. One of the most common insurance issues owners or contractors may experience in delayed or stalled construction projects is that the insurer or insurers may be reluctant to approve an extension of the policy period if the initial date of construction completion is extended beyond what was originally anticipated at insurance inception.

According to the Brazilian newspaper, O Estado de São Paulo, more than 14,000 government funded projects had been stalled by the end of 2018, equivalent to about USD 39 billion of property under construction. Of these 14,000 projects, about 20% were infrastructure related and represented more than 90% of the USD 39 billion.

The main reasons why construction projects are either substantially delayed or postponed include:

- a) **Changes in government** – Large projects are prone to political risks, at a state or federal level depending on the country, which can create uncertainty during the procurement process. In cases where projects have been awarded, this can increase uncertainty surrounding the contract enforcement.
- b) **Lack of financial resources** - Complex infrastructure projects usually require extensive financing, and financing agents may impose many stringent requirements in order to secure the repayment of debt.
- c) **Technical problems** – Project discrepancies or errors that are not identified in the early stages of the project may arise in later stages of the construction phase.
- d) **Regulatory and legal issues** – Legal procedures may take months to years to reach a settlement which can severely impact the progress of construction projects.
- e) **Environmental licenses and violations** – Environmental licenses, usually the responsibility of the project owner, may be quite complex and difficult to obtain.

Impact on the Project's Construction Erection All Risk Insurance Program

Many large infrastructure projects are characterized by a long-term construction work period which can span several years. Therefore, it is crucial to have a best in-class insurance program that meets the needs of highly sophisticated project owners and lenders during the full lifecycle of the project to help provide protection against the various risks to which the parties are exposed to during the execution of the project. This section will focus specifically on one of the most important insurance coverages for a construction project - the Construction Erection All Risks (CEAR) insurance, which provides indemnification for any physical loss or material damage during the period of insurance due to any cause not specifically excluded.

As mentioned earlier, construction delays can severely impact a project in many ways, including insurance. In cases where the expected construction completion date needs to be amended, it is necessary to submit a request for an extension of the policy period to the insurer or insurers that contemplates the new scheduled completion date. However, serious issues may arise if the panel of insurers, which in the case of large construction projects can comprise dozens of insurers, decide to deny or partially deny the request. It is important to consider that once construction work has commenced, it is extremely difficult to replace any panel of insurers that have placed a CEAR insurance policy, and it becomes even more difficult to achieve once a project nears construction completion.

Some of the reasons why insurers may not accept policy period extension requests:

Construction Project Values

It is necessary to periodically update the insured property values, and thus policy limits, considering any advances in the construction of the project. In some cases, an insurer may not be able to increase its participation in the risk because it may have already deployed its entire capacity.

Loss of Interest in the Risk

In other cases, the insurer or insurers may refuse to extend the policy period if the insured's financial position has deteriorated since policy inception or has difficulties in proceeding with the project. This has become common within the last few years in Latin America amid corruption scandals that have halted large-scale construction projects and have severely affected the balance sheet of many prominent contractors. Additionally, insurers will occasionally lose appetite for a project if it has experienced severe losses on the project, while in other circumstances an insurer may lose appetite simply as a result of internal company changes to its risk portfolio.

High Cost of Extension Endorsement or Restriction of Coverage

An owner or contractor's limited ability to receive coverage from new insurers once the construction of a project has advanced jeopardizes their bargaining power to negotiate costs and conditions and could result in limited coverage during the extended policy period.

To prevent any lack of coverage in a CEAR policy arising out of construction delays, the following are recommended:

Keep the Insurers Apprised of the Progress of the Works

On large and complex infrastructure projects, contractors usually create monthly project status reports which detail the advances in the construction of the project. These reports can be submitted to the insurers, allowing them to monitor the progress of the construction work and thus enabling them to evaluate the need to extend the insurance policy period.

Start Negotiations for the Extension in Advance

Not only is it critical to keep the insurers informed on the overall project status, but it is also important to begin dialogue with insurers early. In projects that have long-term construction phases over one year, it is recommended to commence these discussions with insurers at least 4 months in advance of the initial date of construction completion to determine whether an extension to the policy period will be required.

Negotiation of Automatic Extension Clauses

Depending on the insurers and the type of project, it may be possible to include an automatic extension clause to the CEAR insurance policy which essentially extends the policy period without having to negotiate with the insurers. For large projects, it is common to see this extension for three additional months beyond the initial construction completion date.

It is important to note that any failure to extend insurance coverage up to the new scheduled completion date can result in non-recoverable exposure to losses due to a lack of insurance cover. Additionally, financing agents and manufacturers may impose penalties for non-compliance with contractual requirements. As such, infrastructure market participants are advised to engage an adviser with extensive local knowledge and experience in the nuances of complex infrastructure projects to help achieve an appropriate risk transfer plan to minimize risk exposures.

Contacts

If you have any questions about your specific coverage, or are interested in obtaining coverage, please contact your Aon broker. For general questions about CEAR, please contact:

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