South African Department of Energy issues LNG-to-Power Independent Power Producer Procurement Programme Information Memorandum – Part 1

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The South African Department of Energy has issued an Information Memorandum in connection with the previously announced LNG-to-Power Independent Power Producer Procurement Programme.

On 4 October 2016, the South African Department of Energy (DOE) issued a preliminary information memorandum (PIM) in connection with the previously announced 3,126 MW LNG-to-Power Independent Power Producer Procurement Programme. This was followed on 5 October 2016 by a more detailed information memorandum (IM).

Key aspects and certain related considerations are summarised below in context of a preliminary strawman legal and contractual structure.

Overview

Two-staged procurement process

While the DOE is still in the process of developing definitive procurement documentation for the LNG-to-Power Independent Power Producer Procurement Programme, a basic overview of the procurement process and related documents has been specified in the IM. The IM envisages a procurement process involving two successive stages – the first being a request for qualification (RFQ) stage and the second a request for proposal (RFP) stage.

Request for qualification (RFQ)

A separate RFQ will be issued for each Project. The RFQ will set out the qualification criteria that will need to be met by a bidder in order to be pre-qualified. The minimum qualification required of each bidder (and which may be demonstrated by individual participants in a bidder) are expected to include requirements in relation to:

- capability in the development and operation of gas-fired power plants
- capability in the supply of LNG

- capability in the development and operation of an FSRU (or equivalent technology)
- capability in raising corporate or project finance and financial standing of the equity provider or corporate finance provider

A bidder may participate and pre-qualify under one or both RFQs and bid for both Projects. However, key equity participants (those equity participants on whom a bidder will rely to fulfil the first three capabilities above) may only be an equity participant within one bidder for each Project. RFQ responses will be evaluated on a pass or fail basis. Only bidders who have passed the RFQ stage ("Pre-Qualified Bidders") will be eligible to submit responses to the RFP.

Request for proposal (RFP)

As indicated above, a separate RFP will be issued for each Project and only Pre-Qualified Bidders will be involved at this stage. The RFP will contain a suite of pro forma legal agreements (which are usually non-negotiable) – see the section on commercial agreements for more details. In this case, since the DOE expects significant engagement and consultation with Pre-Qualified Bidders in respect of site-enabling work and the RFP, as well as pro forma project agreements which will form part of the RFP. According to the IM, an initial RFP will be issued to Pre-Qualified Bidders for comment, following which a final RFP (which may or may not take into account results of the DOE's engagement and consultation with Pre-Qualified Bidders) will be issued.

Location and allocation

The original 18 August 2015 ministerial determination described a 3,126 MW gas-to-power procurement process. The PIM clarifies that the LNG-to-power programme will involve 3,000 MW allocated between two gas-fired power generation plants, one at each of following two ports:

Port	Allocation
Richards Bay KwaZulu-Natal	Up to 2000 MW will be allocated to Richards Bay
Coega (Ngqura) Eastern Cape	Up to 1000 MW will be allocated to Ngqura

The DOE has identified a site in each of the Ports for regasification facilities and close to each of the Ports for power generation facilities (studies and investigations are ongoing). Bidders can, but will not be obliged, to develop their power projects on sites identified by the DOE. The Bidders take site risk (including as to geological conditions and environmental matters) in either case.

Scope of each Project

According to the IM, each LNG-to-power project ("Project") is expected to be developed on an integrated basis and is expected to involve the following sub-components:

LNG procurement, receipt and related activities

- LNG procurement and delivery
- LNG storage and regasification facilities through an FSRU (or equivalent)
- Port facilities and infrastructure (including fixed maritime structures and dredging)
- Provision of third party access to regasification facilities

LNG and gas distribution and related activities

- Gas transmission pipelines from the FSRU to power generation facility
- Provision of a gas distribution hub for third party gas distribution
- Provision of a LNG distribution hub for third party distribution of LNG (road and/or rail)
- Provision for future handling of indigenous gas for supply to power plant
- Sale of gas (from LNG) to third parties

Generation facilities and related activities

- Provision of a gas-fired power plant using combinations of CCGT, OCGT or OCGE technology
- Alternative fuel storage facilities and back-up fuel supplies
- Connection of generating facility to electricity transmission grid (on a self-build basis)

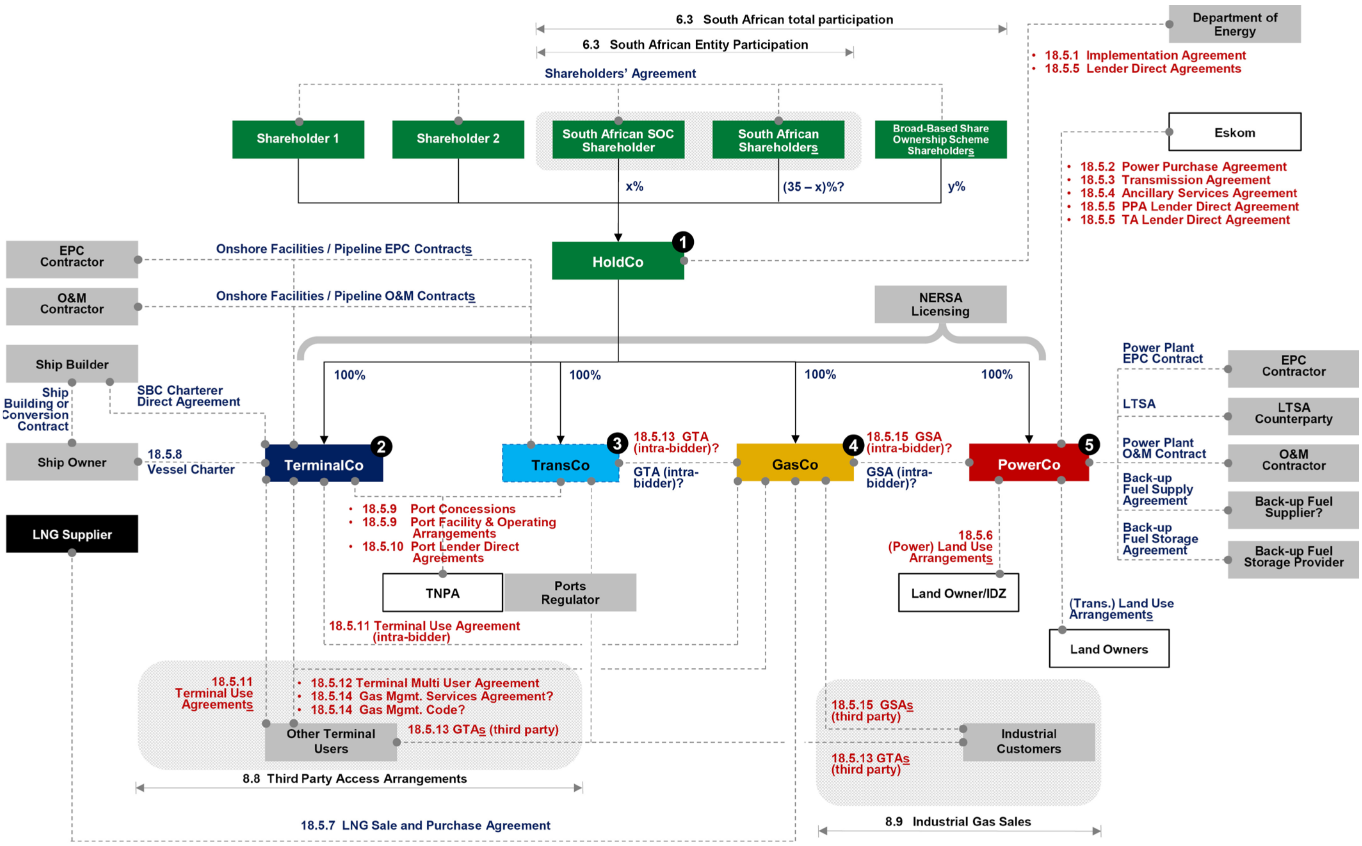
Although there is mention of power offtake for possible future desalination facilities, the IM clarifies that these are not part of the core features of the Projects.

Strawman structure

On the basis of the information contained in the IM and the components described above, White & Case has developed the following strawman structure. This strawman structure reflects structuring options which are generally consistent with the IM and also raises certain specific questions and structural suggestions which prospective bidders may find useful to consider in the context of the forthcoming RFQ, RFP and, ultimately, for the purposes of detailed engagement with the DOE and their eventual bid. The strawman structure derives elements, and lessons from models used successfully in different countries and is intended to form the basis of further discussion – it will evolve as additional information is released by the DOE and will, of course, vary to accommodate the requirements and viewpoint of each individual bidder.

Strawman structure

*Agreement numbers are cross references to paragraphs of the IM



LNG	Title in LNG transfers from the LNG Supplier to GasCo. TerminalCo and TransCo do not acquire title to LNG.	Risk in LNG transfers from LNG Supplier to TerminalCo. GasCo does not take risk in LNG.
Gas	Title in gas transfers from GasCo to PowerCo. TerminalCo and TransCo do not acquire title to LNG.	Risk in gas transfers from TerminalCo, to TransCo and finally to PowerCo. GasCo does not take risk in gas.
Power	Title in electricity transfers from PowerCo to Eskom .	Risk in electricity transfers from PowerCo to Eskom

Project vehicles

According to the IM, each Project is to be developed under one special purpose vehicle (SPV) and its wholly owned subsidiary vehicles. The IM is not prescriptive as to the number, role or scope of subsidiary vehicles but does however refer to a "terminal company" subsidiary, a "pipeline company" subsidiary and a gas manager. It is envisaged that the successful bidder for each Port will incorporate other entities to develop, supply and operate the other elements of the value chain, with an appropriate allocation of risks.

Tariff structure

All energy generated by the gas-fired power plants will be purchased by Eskom and the Project will receive revenues under a PPA with Eskom. The tariff structure proposed in the IM is Rand (ZAR) based and is expected to cover:

- **Fixed costs:** Including capital, development, financing, insurance costs and fixed elements of operations and maintenance through a capacity payment which will be payable regardless of dispatch
- **Variable costs:** Including fuel, variable operations and maintenance, consumables and chemicals through an energy charge. Fuel costs, based on agreed power plant performance parameters, are intended to be passed through to consumers through the PPA with Eskom. A mechanism which reduces electricity price volatility in the short-to-medium term and also reduces foreign currency exposure whilst ensuring bankability of the Projects will be proposed at a later stage by DOE in consultation with NERSA

Government support

Under the Implementation Agreement, the Government of South Africa will provide support if Eskom is unable to fulfil its payment obligations under the PPA.

Fuel flexibility

According to the IM, significant flexibility in relation to fuel arrangements will be required:

- **Industrial gas sales:** In order to stimulate the development of a gas industry, the successful bidder may be required to sell a percentage of the gas it acquires (anticipated to be up to 5 percent) to third party gas users by entering into gas sales agreements
- **Flexible dispatch:** A flexible dispatch regime is proposed for power plants which are expected to operate effectively as mid-merit order plants. It is acknowledged that a minimum volume of gas will have to be used to ensure viability of the gas value chain. To this end, the RFQ will outline a minimum annual dispatch level expressed as an annual average plant capacity factor and a maximum monthly dispatch factor
- **Back-up fuel:** Bidders must consider and put back-up fuel arrangements in place.

Third party access

The IM requires infrastructure capacity (LNG receiving, storage and regasification infrastructure and gas pipelines) to be oversized in relation to the expected requirements of the Projects. Though the successful bidder will have dedicated, committed and priority access to gas facilities for the gas volumes it requires to supply its power plant in a commercially workable and financeable manner, spare capacity must be made available to third parties who meet certain financial, commercial and operational conditions (for instance, large scale users) to facilitate such parties' importation of separate, additional amounts of LNG. Third party access will be regulated contractually through terminal use agreements, gas transportation agreements and multi-user terminal agreements, which will be included in the RFP as pro forma non-negotiable project agreements. Subject to the priority rights described above, as is customary, third party access will be subject to arm's-length and non-discriminatory principles.

Local participation; economic development

Consistent with past practice and government policy, the RFP will include requirements in relation to economic development, including:

- **Ownership and participation:** By black people and South African entities - each bidder must provide for South African entity participation of at least thirty five percent (35 percent) (inclusive of mandatory strategic participation by SOCs (to be identified) but exclusive of a proposed broad-based share ownership scheme)
- **Localised industrialisation:** Project structuring to ensure optimum local content spend on locally procured goods and services
- **Skills development:** This aspect will focus on the development of skills of black people
- **Enterprise and supplier development:** This focuses on subcontracting to empowered enterprises, black enterprises, qualifying small enterprises and exempted micro enterprises and enterprises owned by women
- **Socio-economic development:** Project structuring to achieve primary and secondary education, health care, social and welfare projects as well as housing and infrastructure

Contractual framework

Two types of commercial agreements are expected:

Type 1 - Non-negotiable project agreements	Type 2 - Negotiable, Project-specific agreements
Full form included in RFP	**Full form not included in RFP – certain key terms and provisions may be specified in the RFP**
Implementation Agreement	LNG Sale and Purchase Agreement*
Power Purchase Agreement	Vessel Charter*
Transmission Agreement	Power Plant Land Agreements (privately negotiated)*
Ancillary Services Agreement	Transmission Land Arrangements
Terminal Use Agreement	Power Plant EPC Contract*
Terminal Multi-User Agreement	Power Plant O&M Contract*
Gas Management Services Agreement	Power Plant LTSA*
Gas Sale Agreement	Back-up Fuel Supply Agreement
Gas Transmission Agreement	Back-up Fuel Supply Storage Agreement
Land Use Arrangements	Onshore Facilities EPC Contract*
Port Concession Agreement	Onshore Facilities O&M Contract*
Port Facility and Operating Agreement	Pipeline EPC Contract*
Direct Agreements (for certain of the above)	Pipeline O&M Contract* SBC – Charter Direct Agreement Shareholders' Agreement Direct Agreements (for certain of the above)

* Key terms may be provided for these agreements in the RFP.

Financing framework

In addition to the commercial agreements described above, financing of the Project will involve the usual suite of finance agreements. Depending on the final corporate structure and financing terms agreed, on-loan agreements and cross-guarantees by each of the four subsidiary SPVs described in the strawman structure may be required. Further detail will follow in (a financing-focussed) Part 2 of this Client Alert.

Access to information

The DOE is undertaking work that will enable Pre-Qualified Bidders to evaluate the port infrastructure facilities that will need to be developed at each Port. On payment of a specified fee, potential bidders will be granted access to a data room which is expected to contain technical and environmental information, including:

- **Ports:** Geotechnical, topographical, bathymetrical, meteorological and oceanographic conditions; pre-feasibility studies relating to layout development within ports, including dredging, navigation, downtime and structural option assessments
- **Servitudes:** For gas and power transport routes
- **Environmental:** Environmental impact studies to South African and international standards
- **Land:** Land access and/or use agreements
- **Others:** Preparatory studies for planning and permitting requirements

As at the date of this alert, the following fees are contemplated:

- **RFQ Access Fee:** ZAR 75,000
- **RFQ Data Room Access Fee:** ZAR 300,000
- **Access Fee:** ZAR 2,000,000

Expected milestone dates

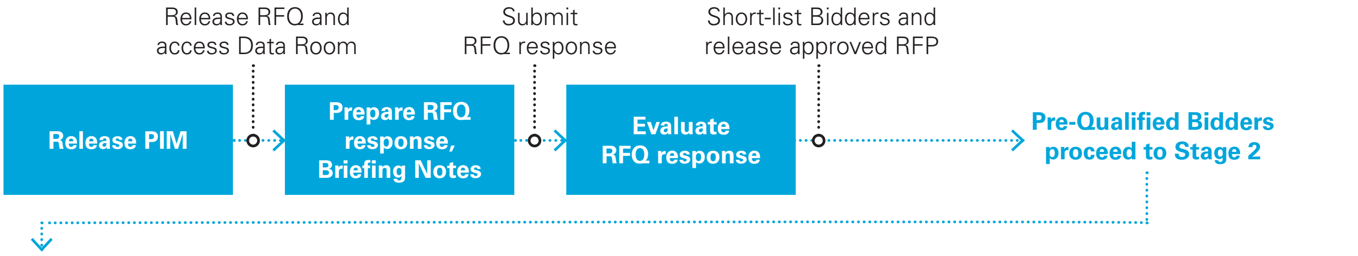
The following milestones will apply for both Projects:

	Milestone	Anticipated date
RFQ Stage All interested bidders	Issuance of RFQ	November 2016
	RFQ response submission date	February 2017
	Announcement of Pre-Qualified Bidders	April 2017
RFP Stage Pre-Qualified Bidders only	Issuance of initial RFP	April 2017
	DOE engagement with Pre-Qualified Bidders	May 2017
	Issuance of final RFP	August 2017

Sequence

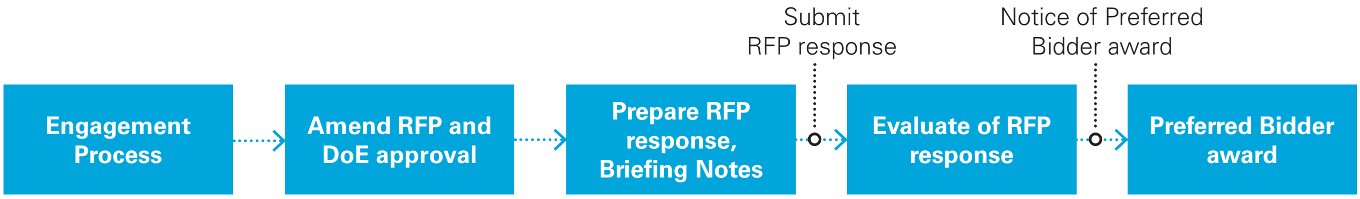
Stage 1

Pre-qualification phase



Stage 2

RFP phase



Adapted from IPP Office presentation dated 5 October 2016, South Africa Gas Options Conference

Additional details

The IM can be downloaded from https://gaslng.ipp-gas.co.za/Documentation. All communication and enquiries in respect of the IM must be addressed to the Project Officer at query@ipp-gas.co.za.

Key considerations

On Project vehicles

Our strawman structure proposes the following five distinct SPVs:

SPV vehicle	Role and observations
1. HoldCo	HoldCo is a single South African SPV holding company which owns 100 percent of the shares of each of the other SPVs described below. This is consistent with the approach of the IM and we expect that this vehicle will be South African to facilitate the involvement of South African shareholders. ▫ The strawman structure proposes that HoldCo will not hold any "hard assets". Instead, its assets and liabilities will be primarily contractual (under the Implementation Agreement and financing agreements) or in the nature of shares in the other SPVs.
2. TerminalCo	TerminalCo will charter or own regasification and storage assets, benefit from regasification and port-related rights, discharge certain port-related obligations as well as provide regasification, LNG distribution and gas send-out services to GasCo and third parties. ▫ The strawman structure assumes that TerminalCo will not own LNG or gas at any stage, although it will take risk in LNG and gas which is in its custody. ▫ Pending further clarity, we have not at this stage described ownership and operatorship of the LNG distribution facilities. This would likely fall within the scope of TerminalCo's activities, but it is also feasible to place the LNG distribution hub in a ring-fenced vehicle or in TransCo.
3. TransCo	TransCo will benefit from certain port-related rights, own and operate gas transportation infrastructure including the gas pipeline and gas distribution facility and provide related transportation and distribution services to GasCo and third parties. The strawman structure assumes that TransCo will not own LNG or gas at any stage, although it will take risk in gas which is in its custody.
4. GasCo	GasCo is not described in or expressly contemplated in the IM. Under our strawman structure, GasCo will act as the single commercial LNG and gas-related entity in the Project – it will enter into the LNG SPA, toll LNG through the regasification facility under a terminal use agreement and enter into gas sale agreements with PowerCo as well as industrial users. ▫ The strawman structure assumes that GasCo will own LNG and gas, although it will not take risk in LNG or gas (which will always be in the custody of one of the other SPVs or a third party). ▫ We recommend a GasCo to ring fence the business (and risks associated) with the sale of gas (even if only a small fraction of the overall quantities of LNG sourced) to third party industrial users. This also has the effect of ring-fencing (to a limited degree) the TerminalCo, TransCo and PowerCo (none of which are necessarily appropriate vehicles to purchase LNG and sell gas) from liabilities associated with the sale and purchase of LNG and gas. ▫ A robust contractual structure will insulate other SPVs from the impact of an insolvency or other similar event of GasCo – customarily, this has been achieved on other projects by entering into contractual direct agreements (for instance, between the LNG supplier and PowerCo or PowerCo and TerminalCo) which become effective automatically upon the occurrence of pre-defined events in relation to GasCo. ▫ Clearly, it is not essential for GasCo to exist and TerminalCo or even PowerCo could be the LNG purchaser; however, in this case, the business of the relevant entity would extend beyond their primary activity to also include third party gas sales.

SPV vehicle	Role and observations
5. PowerCo	PowerCo will act as the single commercial generation-related entity in the Project and own and operate the power plant. □ The structure assumes that PowerCo will enter into a gas sale agreement with GasCo to secure feedstock. PowerCo will also enter into multiple power-related agreements with Eskom and land-related agreements. □ The strawman structure assumes that PowerCo will take title and delivery of gas, however, PowerCo will not own LNG at any stage (unless the contractual direct agreements described above become effective).
6. Gas Manager	□ The IM notes that the RFP may also include a standard format Gas Management Services Agreement between the Successful Bidder and a gas manager (which may be a subsidiary of the Project Company (in the case of our strawman structure, HoldCo) and between each new user and the gas manager. This notwithstanding, we have not suggested incorporating a standalone gas manager at this stage. □ The IM states that the gas manager is expected to manage the scheduling of LNG supply, the management of LNG storage, the scheduling of regasification and gas delivery and the LNG lending and borrowing arrangements between all the users in accordance with a Gas Management Code. While having a separate entity discharge this role is certainly possible, at this stage, we have assumed that all of these functions can and will be discharged by TerminalCo (or a dedicated business unit within TerminalCo).

On the tariff structure

The IM states that it is intended that the tariff structure will be largely cost-reflective and will be able to support the funding of the Project. Clearly, the manner in which foreign currency costs are passed through under the PPA will be a key area of focus:

- **Pass-through of base project (fixed and variable) costs:** Our strawman structure assumes a seamless pass-through of all costs and expenses associated with TerminalCo, TransCo and GasCo's activities and operations to PowerCo and these, in turn, being passed through to Eskom under the PPA (this includes payments under the LNG SPA, in respect of the FSRU, etc.). Since there can be no guarantee that day-one "acceptable" third party users or industrial gas users will exist, the costs associated with sizing infrastructure and contracts to accommodate possible third party users or industrial gas users may need to be accommodated under the PPA in the first instance (unless sponsors are willing to bear this risk). Presumably, as third party users or industrial gas users come on-stream, to the extent that a portion of the costs of TerminalCo, TransCo and GasCo are borne by such new users, this will result in an appropriate abatement of costs and expenses being passed through to Eskom.
- **No exchange rate protection on debt or equity:** Power purchase agreements in the renewable and coal base load IPP procurement programs have not offered exchange rate protection on equity or debt (outside of limited protection in the post-bid, pre-award period). The IM suggests that this will continue to be the case for the LNG-to-Power programme. Potential bidders will need to consider this structure in light of the limited medium to long-term ZAR-USD hedging currently available and in the context of whether there is adequate domestic liquidity to be able to support expected capital expenditure, especially for the larger Project possible at Richards Bay.

On government support

- **Coverage under the Implementation Agreement:** At this stage, the description of the Implementation Agreement in the IM does not clarify whether the Government of South Africa will also provide support in respect of the obligations of SOCs other than Eskom which are involved or are required to be involved with the Project (whether as shareholders or as contracting entities (such as TNPA in respect of the port)). If the Implementation Agreement remains limited to Eskom, it will be important to fully evaluate the extent to which risks are passed through by various SPVs to PowerCo and through to Eskom.

- **Limitations on support:** The forms of implementation agreements used in previous procurement programmes have contained limitations on termination costs that are payable to entities such as PowerCo. For instance, the coal base load power purchase agreement caps payments to the fuel supplier on account of loss of profits at six months. Careful analysis will be required to ensure that potential liability of the SPVs to third parties is either adequately backstopped, or if not, the arrangements with the third parties themselves limit recovery to what is recoverable under the programme documentation.

On fuel flexibility

- **Sizing for flexible dispatch, industrial sales:** While and increasing degree of buyer flexibility is available to potential LNG buyers in the current "buyer's" market, unlimited and instantaneous flexibility is rarely on offer or possible under long-term LNG SPAs. Given the limited storage that an FSRU offers and the possibility of industrial sales and third party access, consideration will need to be given to how LNG is sourced and managed where the power plant experiences high plant load factors, especially on short notice.
- **Allocating LNG-related liability:** The IM states that the RFQ will outline a minimum annual dispatch level (expressed as an annual average plant capacity factor), a maximum monthly dispatch factor and these will be reflected in the PPAs. Analysing and structuring LNG arrangements will involve understanding how take-or-pay or failure to take cargo-related liability is allocated to (in our strawman structure) the GasCo and passed through by GasCo to other entities such as Eskom (especially where multiple failures of different parties cumulatively result in liabilities under the LNG SPA).
- **Planning for back-up fuel:** Structuring the Project to operate on back-up fuel and entering into related arrangements will have upfront and ongoing cost and efficiency implications. Given the emphasis in the IM on bidders' proposed solutions optimising the plant's specification at the least cost, prospective bidders will likely be keen to ensure that final RFP documentation is prescriptive as to the nature and extent of back-up facilities and arrangements – so all bidders are held to the same standard.

On third party access

At this stage, it is not clear whether the priority access described in the IM implies subordination of third party access rights if the power plant is dispatched in manner inconsistent with the usual load profile of a mid-merit facility or what is specified in the RFP.

On local participation; economic development

- **Basis of SOC involvement:** The IM clarifies that the rights of the shares held by SOCs will be on the same (or a similar) basis as the other shareholders. However, prospective bidders will want to understand the basis on which SOCs will participate in more detail, including whether SOCs will execute and be bound by shareholder agreements entered into by non-SOC shareholders, the relevant SOC's credit standing and consequences of a funding failure. Prospective bidders will also want substantive clarity on the reference in the PIM to the possibility of a requirement to "grow" South African equity participation over the term of the Project.
- **Interest in SPV project vehicles:** At this stage, the strawman structure assumes that South African equity participation (including by SOCs) and the broad-based share ownership scheme will apply at the level of HoldCo and flow through in the same proportion to each of the SPV project vehicles – this may change if the procurement documentation permits a more nuanced approach to be adopted such that South African equity participation is higher in, for instance, GasCo and TransCo, but potentially lower in TerminalCo and PowerCo.
- **Down-streaming EDO-related requirements:** A number of EDO-related requirements will need to be down-streamed through contracts entered into by the bidder with third parties, including EPC contracts and O&M agreements. Depending on the procurement documentation, it may also be necessary to downstream EDO-related requirements through other documents described in the strawman structure and entered into by each of the SPV project vehicles.

On the contractual framework

- **Changes in documentation:** The nature of the LNG-to-Power Procurement Programme and the broad range of stakeholders involved with the Project will likely necessitate changes to the customary form of documentation that has been used in previous procurement programmes. Specifically:

  (1) **Treatment of Unforeseeable Conduct:** Treatment of Unforeseeable Conduct has previously been limited to acts and omissions of Eskom or Governmental Authorities (not SOCs) that (among others) have an impact on fuel price or that apply to specific generators. This concept and related relief may need to extend to cover the entire LNG to power value chain and take into account the conduct of other SOCs as well.

  (2) **Change in law (not being Unforeseeable Conduct):** Whether relief offered in respect of additional capital expenditure or operational expenditure or in relation to consents will apply only in relation to the power plant, or the entire value chain, including LNG procurement, regasification, transportation and even distribution/third party access related matters.

  (3) **Compensation Events:** While PowerCo has previously been entitled to relief for material breach by Eskom of certain obligations under the PPA, bidders will look to understand whether PowerCo will also benefit from relief for breach by other SOCs of agreements entered into in connection with the Project.

  (4) **System Events:** While PowerCo has previously been entitled to relief and payments for System Events, bidders will want to confirm whether relief will extend beyond the Grid, potentially to port and gas transmission-related events as well.

- **LNG distribution-related arrangements:** While the IM refers to an LNG distribution hub, limited detail has been made available at this stage for LNG and, unlike gas, for which a standard form GSA is expected to be provided as part of the RFP, the IM does not at this stage contemplate the provision of standard form agreements in relation to LNG sale and/or distribution. Besides LNG sale agreements (and related codes and procedures), to rail transportation arrangements may need to be separately entered into.

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