



OPINION&ANALYSIS

REIPPPP

Multicontracting the cheapest way to skin a cat?

Electricity prices tendered in the first three rounds of South Africa's Renewable Energy Independent Power Producer Procurement Programme (REIPPPP) have fallen dramatically as the competitive auction process takes effect. Experience garnered from the first round ensured that, in subsequent rounds, the capacity made available by the Department of Energy was sufficient to generate market interest but not large enough to remove competition. At the same time, experience and streamlining in bid compilation, project development and the process to financial close meant that prices could also be more competitive. In the second round, wind and solar photovoltaic electricity prices fell on average by 20% and 40% respectively. In the latest (third) round, the market has seen the entry of developers capable of financing projects off-balance-sheet rather than through a debt-equity mix, which has seen prices being driven down even further.

The consequence of this market shift is that developers are searching for ways to reduce the capital costs of projects to increase competitiveness and maintain equity returns. One possibility is to move away from the engineering, procurement and construction (EPC) 'turnkey' procurement strategy – which has been the predominant choice for REIPPPP projects thus far – in favour of either split EPC or multicontracting procurement strategies.

EPC Contracting

An EPC contractor assumes the full responsibility of completing the works with a guaranteed date for delivery, at a guaranteed price.

As most of the projects in the REIPPPP are financed by way of nonrecourse project finance, the certainty offered by an EPC turnkey solution is attractive but it comes at a price.

That turnkey premium may be acceptable where the underlying profitability of the project is large enough to fund it but, as we see competition driving down electricity prices and margins, we need to look to leaner procurement alternatives and consider their bankability in the eyes of the lenders.

Split EPC Contracting

Splitting an EPC contract typically refers to the division of the complete EPC scope of works into two separate scopes to be provided by two affiliated companies (although they need not be affiliated) under an onshore contract with a local company and an offshore contract with a foreign company. In doing so, a developer may be able to save on the payment of onshore taxes, limit exposure to inflation or volatile local currencies and potentially avoid the cost of local licensing regulations being applied to works carried out offshore.

Importantly, the way in which an EPC contract can be split (and the methods used by the developer to protect its position in respect of risks described below) will be determined by the requirements of the particular onshore jurisdiction, and tax advice must be sought to ensure that the right contractual structure is adopted.

Splitting an EPC contract derogates from the EPC principle of a single point of responsibility. Developers and lenders will want to ensure that no obligations fall between the cracks and that neither contractor can claim against the developer for an extension of time or costs owing to the default of the other contractor. These issues are sometimes addressed in a wrap agreement between all parties to try to retain the advantages of a single contract without losing the benefits of splitting it. Care must be taken, however, to ensure that the drafting of the wrap agreement does not scupper the tax efficiencies being sought.

Multicontracting

Multicontracting involves the division of the complete scope of works into separate contractual packages. The number of packages ultimately depends on the complexity of construction and other commercial considerations. Project management then falls at the feet of the developer, who, with the involvement of lenders, will need to consider whether a separate consultant is required to manage the interface between the contractors on site. Multicontracting has been the trend in respect of onshore wind farm procurement in Europe and North America since the early 2000s, with typically



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two or three contractual packages, often without the need for a separate project manager.

Under this approach, no single contractor is required to accept the turnkey risk and, as a result, developers can avoid the

associated turnkey premium. It also allows the developer to choose from a variety of contractors and to have greater flexibility and control over project management. It may be less attractive to lenders, however, who foresee completion risks in the interface between the different contractors: knock-on delays from one contractor to another and the allocation of liability for defects found in the works. In wind farm procurement, the programming requirements for each of the turbine supplier and the balance of plant contractors are relatively sequential. Therefore, with clear and unambiguous scheduling, the chances of interface issues can be minimised. An interface protocol (or, if necessary, a separate agreement) allocating responsibilities between the contractors will help to mitigate these risks and limit contingencies required by lenders to cover the threat of cost overruns.

Conclusion

What works for one project will not necessarily work for another. There are different formulations of hybrid and other novel approaches that can be devised to fit the objectives of the particular project and parties involved.

While the splitting of contractual packages can bring with it complexities, there are ways, as the international market has shown, in which they can be addressed to make renewable-energy projects procured on such a basis bankable to lenders in South Africa. We are still in the early stages of the REIPPPP. Projects procured in the first round are only just being completed and nervousness around project delivery and operational performance understandably still remain.

However, the financing landscape is changing as the need to increase competitiveness and reduce overall project costs forces developers to look for cheaper alternatives.

Developers and lenders should consider whether the envelope can now be pushed to accommodate these alternative procurement strategies to achieve those goals.

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