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ENERGY **ALERT**

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Dissecting direct agreements in power generation projects

Granting contractual step-in rights to lenders is common practice in project finance structures in South Africa and globally.

Direct agreements are project agreements that are often viewed with suspicion by power project offtakers but they provide critical protection to lenders by allowing them to protect themselves against the loss of their investment if the project company defaults under any of the major contracts it has entered into. This article examines how lenders can "*step-in*" to the project company's position in a project agreement, with the purpose of curing a default by the project company and securing their investment in the project.

Granting contractual step-in rights to lenders is common practice in project finance structures in South Africa and globally. Lenders will typically request step-in rights under key project agreements and in respect of certain rights and claims that the project company may have against third-party contractors or the offtaker (Counterparty). A lender will want to exercise its step-in rights in order to cure a default which may otherwise result in the termination of the relevant project agreement. Ordinarily, step-in rights will be contained in direct agreements which can be concluded in respect of, *inter alia*, a power purchase agreement, implementation agreement or similar government support agreement, engineering, procurement and construction agreement, operation and maintenance agreement, lease agreements, management services agreement, grid connection agreements, transmission or distribution connection agreements, and any other agreement concluded by the project company with a Counterparty. The parties to a direct agreement will ordinarily be the lender(s) (or their agent in syndicated lending structures), the project company (as borrower) and the Counterparty in respect of the project agreement.

The baseline position is that a step-in right will grant the lender the right to remedy any project company default and prevent the termination of the relevant project agreement. However, the lenders may also be entitled to take broader control of the project and direct the affairs of the project company. Generally, the step-in rights contained in a particular direct agreement may include the following types of rights:

- **cure rights:** rights to remedy the default committed by the project company under a particular project agreement within a particular period;
- **step-in rights:** rights to take control of the project and direct the affairs of the project company through an appointed representative for a particular period until the occurrence of a "*step-out*" date (i.e. the date on which the lender gives notice to the Counterparty that the appointment of the appointed representative shall be terminated). The duration of the step-in period will typically be determined by how long it takes to cure a default in relation to a particular project agreement, however, it may be determined by the lender, at its discretion, or it may be a predetermined period that is agreed in writing in the direct agreement. During the step-in period, the project company will typically be jointly and severally liable for all

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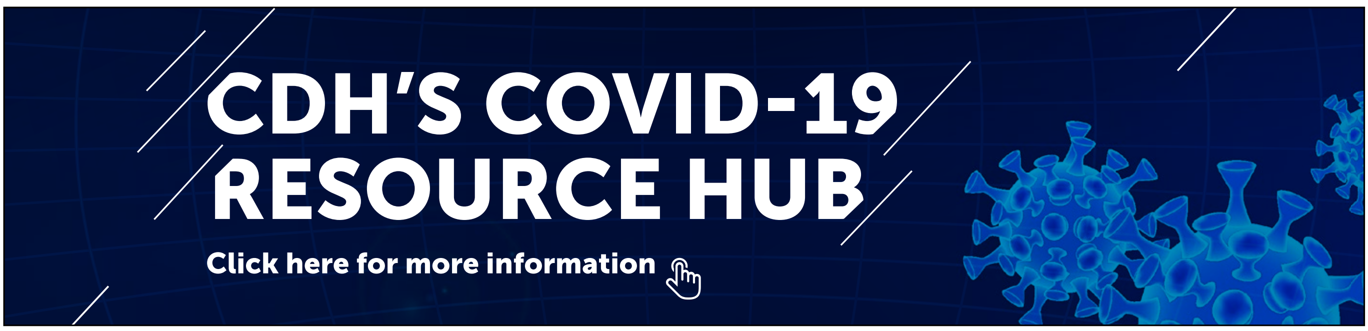
of the actions or omissions of the appointed representative, as if these actions and omissions were those of the project company. Upon the expiry of the step-in period, the appointed representative will be released from all of its obligations and liabilities under the particular project agreement, however, the project company will not be released from any of its obligations and liabilities under the project agreement; or

- **rights of substitution:** the lender will have the right to appoint a substitute project company (Substitute Project Company) that has the legal capacity, power and authority to assume all of the project company's rights and obligations under the particular project agreement, upon the occurrence of certain default events, by way of cession and delegation or transfer of the particular project agreement to the Substitute Project Company. Given that the lender is novating the whole project to another project company which is more capable of fulfilling the project, it will have to obtain the prior consent of certain project participants (including the parties to the power purchase agreement and implementation agreement) to appoint a Substitute Project Company and any other approvals from a relevant authority for the selection and appointment of the Substitute Project Company. In order to facilitate the appointment of the Substitute Project Company, it would be beneficial to include a provision in the direct agreement stating that all of the parties thereto shall, at the expense of the Substitute Project Company, take whatever action the lender may require to give effect to any cession, delegation or transfer of the underlying project agreement. Upon the cession and delegation or transfer to the Substitute Project Company becoming effective, the Substitute Project Company will become liable for all of the obligations under the project agreement and the project company will remain liable for any obligations arising under the project agreement, which arose prior to the date of such cession and delegation or transfer.

Counterparties also need to be given adequate assurances that if they give up or defer their termination rights, a lender will take appropriate steps to remedy the default under a project agreement. Direct agreements must be structured to include



Dissecting direct agreements in power generation projects*...continued*

There are important considerations to be borne in mind and certain key provisions that ought to be included in a direct agreement in order to ensure that it is mutually beneficial to all of the parties concerned and ultimately ensure the success of the power generation project.

provisions that give equal comfort to the lender and the Counterparty regarding the ability of the step-in rights to remedy the default. These include:

- if the lender has appointed a representative to take control of the project, the appointed representative could be obliged, within a certain number of days of being appointed, to implement a detailed remedial programme in respect of the defaults committed under the project agreement;
- a suspension period whereby the Counterparty is required, for a certain period, to suspend any right it has to terminate the project agreement (Suspension Period). During the Suspension Period, the lender would have the right to cure the default in accordance with its step-in rights contained in the direct agreement;
- the parties to the direct agreement should agree to a maximum liability that the lender will incur when exercising its step-in rights, whether this is in respect of project company costs that the lender pays out of its own pocket (on behalf of the project company) due to a lack of reserves in the project company, or costs which the lender incurs as a result of exercising its step-in rights (for example, administrative or operational costs incurred by the lender to deploy resources to operate the project for the duration of the step-in period).

  In relation to project company costs, the lender's liability can be limited to existing obligations payable as at the date of the step-in and any obligations which fall due during the step-in period; and
- the direct agreement should clearly set out how the Counterparty's rights to terminate the project agreement and/or pursue any and all claims it may have against the project company are revived at the termination of the Suspension Period.

Direct agreements form part of the suite of security documents in favour of the lender(s), as is typical to a project finance transaction. Direct agreements are particularly critical because of the rights they grant lenders to directly access control of the project company and its resources in order to maintain the project, avoid or cure project company defaults and preserve project value, whether it is to protect their ability to recoup their outstanding debt investment or to ensure delivery of the project as a commitment to broader socio-economic goals. As discussed in this article, however, there are important considerations to be borne in mind and certain key provisions that ought to be included in a direct agreement in order to ensure that it is mutually beneficial to all of the parties concerned and ultimately ensure the success of the power generation project.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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