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EnergySource

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ashurst

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T: +44 (0)20 7859 1209
E: geoffrey.picton-turbervill@ashurst.com

Given the high level of risk associated with upstream oil and gas projects, the effective and cost efficient allocation of certain risks is key to the success of such projects. Accordingly, in this edition of EnergySource, we consider the manner in which **upstream risk** can be **contractually allocated in the oil and gas sector**.

European LNG regasification capacity is expected to grow significantly over the coming years in response to increasing LNG imports to Europe. In this issue of EnergySource we report on recent developments in the **LNG regasification sector** and assess the prospects for the future.

The Spanish legal regime has been successful in creating a favourable regulatory framework for the development of **renewable energy generation in Spain**.

In this edition of EnergySource, we consider some of the key revisions to that regime as introduced by the recent enactment of a Royal Decree on renewable electricity generation.

Finally, many companies, either in their capacity as project sponsors, or in the course of their normal business dealings, routinely issue parent company **guarantees**. In this issue of EnergySource, we examine the recently decided case of *Van der Merwe*, which potentially could have harsh consequences for guarantors and look at how these consequences may be mitigated.

I hope that you enjoy reading this edition of EnergySource.

Geoffrey Picton-Turbervill
Head of Ashurst's global energy team

Ashurst worldwide

Brussels

Avenue Louise 489, 1050 Brussels, Belgium
T: +32 (0)2 626 1900 F: +32 (0)2 626 1901

Dubai

Level 5, Gate Precinct Building 3
Dubai International Financial Centre
PO Box 119974, Dubai, United Arab Emirates
T: +971 (0)4 365 2000 F: +971 (0)4 365 2050

Frankfurt

Oberlindau 54-56
60323 Frankfurt am Main, Germany
T: +49 (0)69 97 11 26 F: +49 (0)69 97 20 52 20

London

Broadwalk House, 5 Appold Street
London EC2A 2HA, UK
T: +44 (0)20 7638 1111 F: +44 (0)20 7638 1112

Madrid

Alcalá, 44, 28014 Madrid, Spain
T: +34 91 364 9800 F: +34 91 364 9801/02

Milan

Via Sant'Orsola, 3, 20123 Milan, Italy
T: +39 02 85 42 31 F: +39 02 85 42 34 44

Munich

Prinzregentenstraße 18, 80538 Munich, Germany
T: +49 (0)89 24 44 21 100 F: +49 (0)89 24 44 21 101

New Delhi Liaison Office

6 Aurangzeb Road, D-1, New Delhi 110011, India
T: +91 11 2301 4054 F: +91 11 2301 4089

New York

156 West 56th Street, New York, NY 10019, USA
T: +1 212 245 4540 F: +1 212 245 4335

Paris

18, square Edouard VII, 75009 Paris, France
T: +33 (0)1 53 53 53 53 F: +33 (0)1 53 53 53 54

Singapore

55 Market Street, #07-01, Singapore 04894
T: +65 6221 2214 F: +65 6221 5484

Stockholm

Birger Jarlsgatan 6B, Box 55564
102 04 Stockholm, Sweden
T: +46 (0)8 407 24 00 F: +46 (0)8 407 24 40

Tokyo

Shiroyama Trust Tower, 30th Floor
4-3-1 Toranomon, Minato-Ku
Tokyo 105-6030, Japan
T: +81 3 5405 6200 F: +81 3 5405 6222

www.ashurst.com

Contractual allocation of risk in upstream oil and gas projects



T: +81 3 5405 6200
E: sharon.wilson@ashurst.com

Sharon Wilson, a senior associate at Ashurst Tokyo, considers the ways in which risk in the upstream oil and gas sector can be effectively allocated in project contracts.

Participation in the upstream oil and gas sector, while requiring significant capital contribution, brings with it a high degree of risk, both in terms of risk of property damage and loss of life. The contractual allocation of upstream risk is critical to the efficient implementation of exploration, development and production activities.

Sophisticated liability models have been developed in the oil and gas industry as a result of the unique operating environment and the potentially serious consequences that result from comparatively minor acts or omissions. This article considers the manner in which risk is contractually allocated in the upstream oil and gas sector.

Risk allocation

The premise of risk allocation is to allocate risk to a party best able to control that risk, since such a party is generally best placed to reduce the likelihood of the risk eventuating

and/or to control the consequences of that risk.

In the upstream contract context, risk is allocated by using a combination of exclusion and limitation of liability clauses and indemnity clauses. These clauses will cover liability for negligence, breach of statutory duty and breach of contract for:

- death and personal injury;
- property loss or damage;
- loss or damage to third parties (property or death/personal injury); and
- environmental liability.

The operator of an upstream project is required to engage in a skilful juggling act to ensure that project risks, both between the operator and the upstream participants, and between the upstream participants and contractors, are effectively allocated in the relevant upstream works or services contracts.

Operator and upstream participants

An important, but often overlooked, aspect of risk allocation in upstream project contracts is risk allocation between the operator and the upstream participants, as provided in the Joint Operating Agreement ("JOA").

"The operator must ensure that the risks are allocated or shared ... by way of a cohesive liability regime such that a working chain of contractual indemnities exists as between all persons involved in the project."



Usually, the JOA will contain provisions by which the operator excludes liability to the upstream participants for any loss suffered by the operator while performing its duties under the JOA. That exclusion of liability is supported by an indemnity such that the upstream participants indemnify the operator against losses incurred by the operator in the execution of its duties under the JOA.

One of the keenly contested points in a JOA negotiation is the extent of any carve-outs or qualifications to the operator's liability regime. While the operator typically is reluctant to bear any liability as a result of its activities, the upstream participants may seek to use qualifications to ensure that the operator complies with its duties under the JOA or to cover against events where insurance is prohibitively priced or unavailable. Qualifications to the operator's liability regime may include exclusions of liability for:

- **Gross negligence and wilful misconduct.** The operator may be liable to the upstream participants where loss is incurred as a result of the operator's gross negligence or wilful misconduct, or the gross negligence or wilful misconduct of the operator's senior supervisory personnel. The former is contemplated as an option in the model JOA prepared by the Association of International Petroleum Negotiators ("AIPN"). When drafting a gross negligence or wilful misconduct qualification, it is best to specifically define gross negligence or wilful misconduct, as the meaning of these terms is unclear under English common law. Industry standard definitions are available in the AIPN model form JOA.
- **Unauthorised, negligent or unlawful acts.** The indemnity for the benefit of the operator will not normally extend to cover liability for the operator's

unauthorised acts, but depending on the wording of the indemnity, it may cover the liability for the operator's negligence. With respect to unlawful acts, as a general principle, it is unlikely that an operator will be able to enforce any indemnity to its benefit. However, this will depend upon the nature of the unlawful act and the effect of any applicable legislation.

- **Consequential loss.** In most situations, the operator will also seek to exclude liability for consequential loss or indirect loss. In the upstream context, difficulties frequently arise in relation to claims for loss of, or delay in, production. At the time of negotiation it is often impossible to predict whether a delay in production in a particular circumstance will be considered a direct or indirect loss. The preferable approach is to consider all possible losses (such as deferral of production) and, if the intention is to exclude it, expressly

define consequential loss as including "deferral of production".

In addition, where the operator is liable for specific events (i.e. losses arising from the operator's gross negligence) the operator's liability may also be subject to a monetary cap (on either a per event or cumulative basis).

Third party contractors

It is the operator's role to enter into contracts for a variety of services during the different phases of an upstream project. The operator must ensure that the risks are allocated or shared (between itself, the upstream participants and contractors) by way of a cohesive liability regime, such that a working chain of contractual indemnities exists as between all the parties involved in the project.

This article touches on two aspects of third party liability:

- whether the upstream participants are liable to third party contractors for contracts entered into by the operator; and
- the extent of the third party contractor's liability.

Liability of upstream participants

Whether the operator or the upstream participants are liable under third party contracts will depend on whether the operator has contracted with the third party as a "principal" or as an "agent" of the upstream participants. If the operator contracts as agent for and on behalf of the upstream participants, the upstream participants will be liable according to their percentage interest share under the JOA. As a result, the upstream participants can sue or be sued on the contract.¹ Alternatively, if the operator contracts as a principal or independent contractor, liability rests with

¹ Subject to the application of the Contracts (Rights of Third Parties) Act 1999.

the operator and the upstream participants cannot sue or be sued on that contract.

Whether the operator is appointed as the agent or independent contractor will involve a careful review of the JOA and the nature of the relationship between the upstream participants and the operator. It is clear that if the operator is contracting on this basis, it should ensure that it has adequate indemnities from the upstream participants under the JOA.

Extent of contractor's liability

Third party contractor liability can be allocated either on a fault (or "the guilty party pays") basis or on a "knock-for-knock" (or "mutual hold harmless") basis, which is unique to the oil and gas industry.

The key difference between the knock-for-knock model and the fault-based model is that the knock-for-knock model has the effect that each party is responsible for loss or damage to its own personnel and property, while under the fault-based model, a party is only liable to the extent that it contributed to or caused the loss.

Most commonly, in upstream contracts:

- injury to a party's own personnel and damage to a party's own property is allocated on a knock-for-knock basis;
- loss suffered by third parties as a result of the operator's or contractor's conduct is allocated on a fault basis;
- usually, each party's own consequential loss is allocated on a knock-for-knock basis; and
- each party's liability is supported by a contractual indemnity.

It is also common to extend the benefit of a liability and indemnity clause to the members of a defined "group". In the case of the contractor, the defined "Contractor Group" will usually extend to the contractor's subcontractors, affiliates of the contractor and its subcontractors and their respective officers and employees. In the case of the operator acting on behalf of the joint venture, this is achieved through the term "Company Group" which is defined in a similar manner to the Contractor Group, but will also include upstream participants. Both terms exclude those parties which are already captured in the other group. The operator and the contractor will then ensure that back-to-back indemnities are included in each of their subcontracts. An example

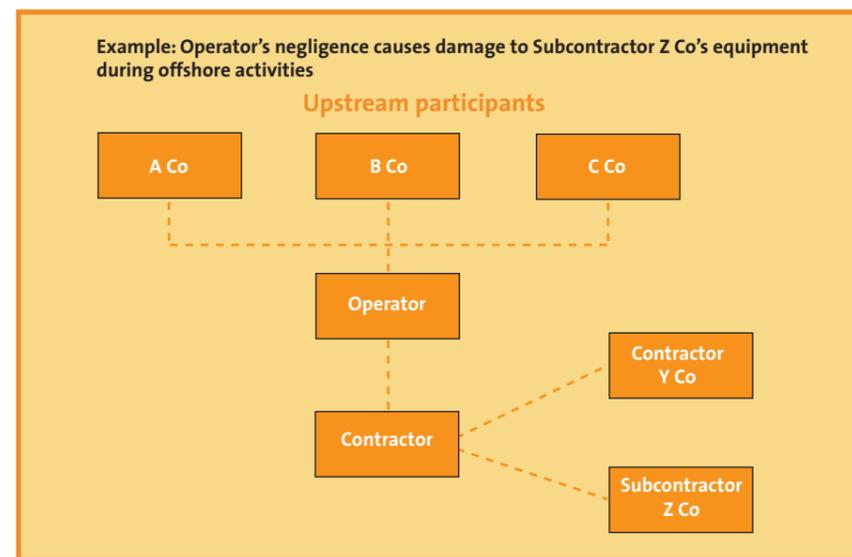
of this approach can be found in the LOGIC² General Conditions of Contract for Offshore Services:

"The [Contractor] shall be responsible for and shall ... indemnify ... the [Company Group] from ...:

- (a) loss of or damage to property of the [Contractor Group]... arising from...the performance of the contract;
- (b) personal injury... to any person employed by the [Contractor Group] arising from... the performance of the contract;
- (c) ... personal injury ... or loss of or damage to the property of any third party to the extent that such injury, loss or damage is caused by the negligence or breach of duty (whether statutory or otherwise) of the [Contractor Group]. "third party" shall mean any party which is not a member of the Company Group or Contractor Group."

The LOGIC standard form contains a reciprocal liability and indemnity provision in respect of Company liability.

By way of example, the operator ensures a working contractual chain of indemnities (as shown in the diagram below), which gives effect to the intended knock-for-knock risk allocation.



If Subcontractor Z Co sues the Operator to recover its loss, the contractual chain of indemnities operates as follows:

- the operator is responsible for and will indemnify the contractor against any claims related to or arising from pollution or contamination emanating from any other source.

Step 1: Z Co recovers against Operator in negligence.

Step 2: Operator claims against Contractor on the basis that under the OSA, Z Co is a member of the Contractor's group. Under a knock-for-knock model, the Contractor is liable for and indemnifies the Operator for damage to Z Co's equipment.

Step 3: Contractor claims against Z Co on the basis that under the back-to-back OSA, the Operator is a member of the Contractor's group. Under a knock-for-knock model, Z Co is liable for and indemnifies the Contractor for the claim by Operator in respect of the damage to Z Co's equipment.

The net result is that Z Co bears its own loss, consistent with the knock-for-knock regime.

Pollution liability is separately dealt with in upstream agreements. While contractors must comply with an agreed form of environmental standards when performing the services or the works, liability for a pollution event is borne based on the origin of the pollution, as follows:

- the contractor is responsible for and will indemnify the operator against all claims arising out of pollution which emanates from the contractor's equipment or vessels while the contractor is under control of the equipment; and

Again, this allocation of liability is consistent with the approach adopted in the LOGIC General Conditions of Contract for Offshore Services.

Variations may be negotiated to the model outlined above due to the nature of the services under the agreement. Offshore drilling services agreements ("ODSAs") and well services agreements ("WSAs") often contain variations to the standard model due to the unique intrinsic risks associated with offshore drilling services and well services, and the demand for those services, based on rig demand and availability. For example, a high demand for rigs often produces a contractor-friendly ODSA, with the risk associated with the drilling services pushed back to the operator, regardless of who is best able to control that risk.

While the liability regime of ODSAs and WSAs is a topic which deserves separate consideration, it is worth noting that an ODSA or WSA will apportion liability for matters such as:

- (a) wreck removal;
- (b) loss of equipment "down hole" (in the well bore or inside casing or in the riser below the rotary table);
- (c) abnormal damage to surface equipment resulting from corrosion, erosion or abrasion caused by the nature of well effluent;
- (d) loss of or damage to the well or the hole;
- (e) reservoir damage;
- (f) cost and losses associated with fire, blowout, explosion, cratering or uncontrolled well condition (including well control costs and removal of debris); and
- (g) radioactive materials.

Conclusion

While standard allocation of liability models exist in the upstream oil and gas sector and these models can be found in standard form contracts such as the AIPN and LOGIC model forms, it is advisable to consider, on each occasion, the particular circumstances and relevant activities in question when negotiating upstream contracts. It may be that these standard forms do not effectively allocate the particular risks associated with the service on a basis that is consistent with insurance requirements or in a cost efficient manner.

Developments in the European LNG regasification sector



T: +44 (0)20 7859 1243
E: philip.thomson@ashurst.com

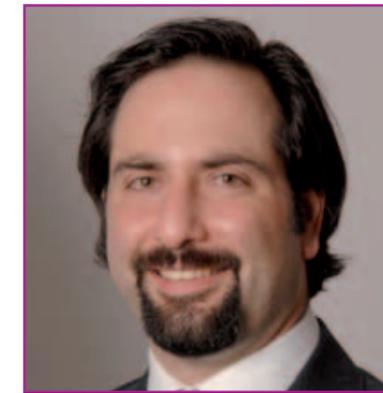
Philip Thomson, partner, and Alexi Dimitriou, associate, at Ashurst London, consider recent developments in the LNG regasification sector and assess the prospects for the future.

There is currently approximately 75 billion cubic metres per annum of operational regasification capacity in Europe. This is expected to grow significantly over the coming years in response to increased LNG imports into Europe. Imports of LNG are, in turn, expected to increase in response to the need to:

- replace depleting domestic sources of energy;
- avoid over-reliance on Russia and the CIS states for energy supply; and
- meet the demand for gas as a cleaner fuel than oil and coal.

In addition, and as explained below, a number of regasification projects are being developed in order to provide access to the European gas markets for upstream liquefaction projects which are scheduled to come onstream in the coming years.

This anticipated growth is reflected in projects at different stages of development



T: +44 (0)20 7859 1191
E: alexi.dimitriou@ashurst.com

or construction in Spain, France, the United Kingdom, the Republic of Ireland, Italy, the Netherlands, Germany, Croatia, Poland and a number of other countries, as well as expansion of existing terminals.

Investors

Given the different objectives set out above, the sector attracts a range of different types of investors, some of whom are not currently active in the upstream segments of the LNG chain.

Downstream gas suppliers

Traditionally, LNG regasification terminals have been developed by gas suppliers in the relevant downstream gas markets or network operators.

For gas suppliers, regasification infrastructure has been a means of accessing LNG to meet their downstream customers' demand for natural gas or the demands of gas-fired power stations. This is the business model applicable to DEPA's regasification terminal at Revithoussa, the terminals developed by GDF in France and the investments made by Unión Fenosa and Iberdrola in the Sagunto and Ferrol regasification terminals in Spain.

Network operators

In other cases, the investor has been the transmission system operator (or

equivalent) in the host country. For example, Enagas of Spain owns regasification terminals at Barcelona, Cartagena and Huelva, and is building a further terminal at Gijón. The Isle of Grain terminal in the United Kingdom is ultimately owned by National Grid plc, which owns the UK's electricity and gas networks. Gasunie, the Dutch system operator, is developing the GATE LNG project in Rotterdam. In these cases, the regasification capacity has been contracted to third parties.

LNG producers

More recently, national or international oil companies have invested in the regasification sector as a means of delivering equity LNG to the European gas markets. In some cases, the LNG is intended to come from a specific liquefaction project. For example, the South Hook project being developed by ExxonMobil and Qatar Petroleum in the United Kingdom will process LNG from Qatargas II. In other cases, sponsors intend to regasify LNG sourced from a portfolio of liquefaction projects. This is the case at South Hook's neighbour, the Dragon LNG project, which is sponsored by BG Group, Petronas and Petroplus.

In some cases (and again Qatar Petroleum and BG Group are good examples), regasification capacity in Europe is part of a portfolio giving the holders, subject to any contractual restrictions on destination flexibility in their LNG supply arrangements and assuming adequate flexibility in their shipping resources, the ability to divert cargoes between the different markets in Asia, the United States and Europe, to take advantage of relative price differences in different markets.

Others

As the LNG industry has grown, a number of companies with complementary skills are seeking to focus on the LNG regasification and, in some cases, shipping segments to the exclusion of the upstream production and downstream marketing segments. Such companies include: Golar (traditionally an LNG shipping company which is diversifying into floating regasification and storage projects);

² Leading Oil and Gas Industry Competitiveness (formerly known as the Crine Network): www.logic_oil.com

Accelerate Energy (which is pioneering on-board regasification technology); 4Gas which is backed by two private equity houses Carlyle and Riverstone and which is developing a number of regasification terminals; and Royal Vopak, whose core business is the operation of tank terminals and Golar whose core business is LNG shipping.

Financiers

In many cases, regasification projects have been financed on a corporate basis by their sponsors.

However, in response to the arrival of new entrants in the regasification sector and the increase in construction costs (see below), a number of projects have been, or are being, project financed. An LNG regasification project, if robustly structured, is an asset that lends itself well to project financing techniques.

To date, financing has come from the commercial bank market (e.g. the South Hook project in the United Kingdom, the Sines terminal in Portugal and the Cartagena project in Spain). There is no reason why regasification projects should not be financed in the capital markets in due course.

In addition, the European Investment Bank (“EIB”) has indicated its support to projects which contribute to energy diversification and security at European Union level, such as LNG regasification projects. This policy is within the framework of EIB’s support for the EU’s policy objective of securing sustainable, competitive and secure sources of energy. To date, EIB has lent to the Zeebrugge terminal, and is reported to be looking at other opportunities in the sector.

Issues

Set out below is a summary of some of the issues currently affecting the LNG regasification sector. Some of these issues are generic to other sectors of the energy industry; others are specific to the LNG regasification sector.

LNG supply

The development of regasification capacity in Europe is inevitably affected by a number of conditions in the global market for LNG supply. First, while there are a number of liquefaction projects scheduled to come onstream in the coming years, global demand for LNG is significantly outstripping

supply. Further, recent developments in shipping technology (including, in particular, on-board reliquefaction technology and the development of Q-Flex and Q-Max ships) and higher gas prices in the downstream markets have made LNG competitive over longer distances. As a result, European gas markets have to compete for LNG supply on both long and short-term bases with gas markets in North America and Asia-Pacific, which are priced using different indices.

The global shortage of LNG is constraining the development of LNG regasification projects which are not integrated into upstream projects or portfolios of liquefaction capacity and/or supply contracts. However, given that LNG supplied into European, North American and Asian-Pacific markets are all priced using different indices, access to European regasification capacity is an important asset for LNG sellers who wish to be exposed to European gas prices.

Access to LNG terminals, gas customers and EU legislation

As mentioned above, regasification capacity gives access to the relevant downstream gas market. However, this is subject to securing transportation capacity on the necessary downstream pipe network and being able to sell regasified LNG in the downstream market.

Europe’s gas markets were historically vertically integrated. In those conditions, it was difficult for an LNG importer, other than the incumbent gas supplier, to market the regasified LNG. The European Commission therefore developed legislation (discussed below) to help reduce these barriers and to encourage effective competition in the LNG sector.

In the context of its review of the competitiveness of the European gas and electricity sectors, the European Commission has indicated its support for LNG imports into Europe, emphasising that LNG imports are important to both the security of energy supply and to increase competition between different upstream suppliers. The principal areas of the Commission’s energy policy relevant to the LNG regasification sector are third party access and unbundling.

Third party access

EU member states must in principle ensure that regulated, non-discriminatory third party access is provided to the liquefaction and regasification terminals, as well as

transmission and distribution systems. The third party access rules applicable to regasification facilities include granting access to the provision of ancillary services and temporary storage necessary for the regasification process and subsequent delivery to the transmission system. The Second Gas Directive also provides for non-discriminatory third party access to stand-alone gas storage facilities.

An exemption from the third party access regime is available to major new gas infrastructure, including LNG terminals, provided that certain conditions are met. The criteria for exemptions aim to strike a balance between incentivising investment and facilitating competition. The majority of the regasification terminals currently being developed have obtained exemptions from the third party access regime. In some cases (for example the Dragon, South Hook and Isle of Grain regasification terminals in the United Kingdom), the exemptions have

been for all of the regasification capacity. In other cases, such as the various Italian terminals, the model is for 80 per cent of the regasification capacity to be reserved for the sponsors with the remaining 20 per cent being offered to third party customers. None of the Spanish regasification terminals have exemptions from the third party access regime (although Spanish law does provide for exemptions from the third party access regime in special circumstances and on a case-by-case basis).

Unbundling

The Second Gas Directive imposes a range of obligations requiring the legal and functional unbundling or separation between transmission/distribution networks and production/supply activities. In April 2006, the European Commission began infringement proceedings against various member states where legal and/or functional unbundling is incomplete.

Certain member states, however, such as Greece, Latvia and Lithuania, have been able to derogate from the unbundling and certain third party access obligations of the Second Gas Directive.

The European Commission’s sector inquiry into competition in gas and electricity markets published its final report in January 2007. The report found that the current provisions relating to unbundling are not proving to be effective and the current limited level of unbundling is having an adverse effect on the effective functioning of both gas and electricity markets and on incentives to invest in networks.

In response, the European Commission adopted a third package of energy liberalisation proposals in September 2007. One of the key elements of these proposals is that member states would be required either:

- to implement complete ownership unbundling or separation between the transmission system operator/ the transmission system on the one hand and production/supply activities on the other – this is the European Commission’s preferred option; or
- to ensure that the transmission network itself is managed by a separate independent system operator which will be subject to regulation and monitoring in order to safeguard its independence.

Given the importance of LNG and investments in LNG terminals, the Commission also proposes that there should be legally binding guidelines relating to how third party access to LNG terminals should operate where this applies. These proposals have not yet had their first official reading before the European Parliament.

Structural implications of third party access and unbundling

As a result of the European Commission’s policies on third party access and unbundling, many of the regasification terminals developed in the European Union have been structured on a tolling basis, where the rights to regasification and storage capacity are separate from the ownership of the infrastructure. On this structure, the regasification terminal provides regasification and storage services under terminal use or throughput agreements to customers who are

responsible for delivering the LNG to the regasification terminal and for marketing the regasified LNG. These agreements may also provide that if reserved capacity is not used, it may be accessed by third parties. Our experience is that regulators look kindly on provisions of this type as they facilitate third party access to regasification facilities. In simple terms, the alternative would be to structure the regasification terminal to buy LNG, regasify it and sell regasified LNG into the downstream gas market.

Site selection

The number of suitable sites for LNG regasification projects in Europe are limited by:

- environmental constraints;
- planning/zoning laws (including local political pressure against the construction of large-scale infrastructure); and
- the need to minimise downstream transportation costs (including the capital costs relating to the construction of any dedicated pipelines required to deliver regasified LNG from the terminal to the existing grid) by locating a regasification terminal close to centres of demand for regasified LNG.

These factors have driven interest in alternative regasification solutions such as floating storage and regasification technology (e.g. the Offshore Livorno OLT Project offshore Italy) and on-board regasification technology such as that used by Accelerate at the Teesside Gasport in the United Kingdom. Projects of this type can often be developed more quickly than land-based projects.

Conclusion

In response to both increasing European demand for LNG and the growth of the LNG industry worldwide, the LNG regasification sector is expected to grow significantly in the coming years. This growth is expected to involve further diversification of the business model away from the “traditional” model led by energy utilities and system operators active in the downstream market. There remain a number of issues which will affect the growth of the sector. However, these factors are likely to influence how the sector develops, rather than prevent it from doing so.



A new legal regime for renewable energy in Spain



T: +34 91 364 9800
E: mariano.lopez@ashurst.com

Mariano López, a senior associate at Ashurst Madrid, considers some of the key changes introduced by the recent enactment of a Royal Decree on renewable electricity generation which came into force on 1 June 2007.

The Spanish legal regime for renewable energy in Spain was updated when Royal Decree 661/2007 dated 25 May 2007, on electrical power generation under special regime (the “**Renewable Energy Decree**”), replaced its predecessor, Royal Decree 436/2004 dated 12 March 2004.

The Renewable Energy Decree came into force on 1 June 2007.

The Renewable Energy Decree does not radically change the previous regulatory regime, but seeks to build on previous regulations in creating a favourable platform for the development of renewable energy in Spain. This is in line with the Spanish Government’s goal of meeting 20 per cent of the country’s total energy demand from renewable energy sources by 2020. It is also consistent with the recently announced EU policy for tackling climate change.

Remuneration regime

The regime for the remuneration of renewable generators in Spain is based on two alternative reward structures from which renewable generators can choose. These are: remuneration based on a regulated tariff; or one based on a market price supplemented with a “premium”.

Prior to the enactment of the Renewable Energy Decree, regulated tariffs were set out in Royal Decree 436/2004 and took into account the investment costs of each renewable generator. Premiums were set at a level which sought to ensure that the two alternative payment structures produced broadly similar remuneration for renewable generators. For the purpose of its calculation, the market price assumed by the Spanish Government was €36/MW.

However, during 2005/2006 electricity prices rose sharply to between €50-60/MW. Consequently, all renewable energy generators chose the market price option, as this produced a significantly higher revenue than under the regulated tariff option, due to the unexpectedly high market price for electricity during that period.

Accordingly, the Renewable Energy Decree purports to address the disproportionate (and unanticipated) profits made by renewable generators (particularly wind energy) due to these circumstances over recent years. In particular, the new regime it introduces provides the following:

- An increase in the level of the regulated tariffs set out in Royal Decree 436/2004 as follows:
 - 12% for wind energy;
 - 13% for hydraulic energy;
 - 17% for thermoelectric solar energy;
 - 82% for photovoltaic solar power higher than 100 Kw¹;
 - 56% - 113% for biomass; and
 - 16% - 40% for biogas.
- Adjustments to the market price option; these adjustments comprise a cap and floor price mechanism

¹ Photovoltaic solar power of less than 100 Kw maintains the same regulated tariff.



for the premium payments payable during the first 15/20/25 years of the relevant renewable facility’s life so that renewable generators can make more accurate estimates in relation to the future premium which they receive in view of the current market prices.

To smooth over the switch to the new regime, the Renewable Energy Decree provides transitional arrangements for existing renewable generators by allowing them to choose between the “old” and the “new” regime. In particular, under the

Renewable Energy Decree, renewable facilities which commenced operations before 1 January 2008 are required to choose by 1 January 2009 one of the following remuneration options:²

- The regulated tariff set out in Royal Decree 436/2004 for the remaining life cycle of the relevant facilities;

² Those options are available to wind power generators. Solar power either thermo or photovoltaic will be subject to the new legal regime.

- The new regulated tariff set out by the Renewable Energy Decree; or
- The market price fixed on the electricity wholesale market in which case, renewables generators can benefit from the premium and incentives set out in Royal Decree 436/2004 until 31 December 2012.

Another main change brought about under the Renewable Energy Decree is the indexation of remuneration payments. Payments are now to be linked to the Spanish retail market price (“**IPC**”) minus 25

basis points (“**bp**”) until 2012 or minus 50 bp from 2012 onwards.

A review of the remuneration regime will be carried out every four years by the Spanish government starting in 2010.

The renewable generators remuneration regime will, therefore, no longer be linked to the average electricity tariff (the so called “tarifa media de referencia” or “**TMR**”) set out by the government on a yearly basis.

Certainty of tariffs once the installed capacity goal is reached

The Spanish Energy Commission (the energy regulator known as “CNE”) is required to supervise and control the development of the different renewable energy technologies against capacity goals prescribed in the Renewable Energy Decree. It is also required to publish on its website information about the growth of each renewable technology against these targets.

Under the Renewable Energy Decree, when 85 per cent of the capacity goal prescribed for the relevant renewable energy technology is achieved, the General Secretary of Energy within the Spanish Ministry of Industry, Tourism and Commerce (the “Ministry”) is required to publish a resolution stating that such limit has been reached. The Ministry is also required to prescribe a period not shorter than 12 months which entitles generators who register on the official registry during this period (or who have already registered prior to the commencement of that period) to continue to receive the regulated tariff at the existing level for the life cycle of their projects.

In the case of photovoltaic solar energy, the Renewable Energy Decree prescribes 371 MW as the capacity goal for maintaining the regulated tariff at the current level. The relevant resolution stating that 85 per cent of this capacity goal has been reached, was published on 29 September 2007. Therefore, 29 September 2008 is the deadline for all photovoltaic solar generators that wish to benefit from current tariff levels to commence operations and be registered on the official registry. Unsurprisingly, this is pushing many sponsors to start exploiting their projects on or before this deadline. Those who are already registered and have commenced operations need not worry as they are already entitled to receive the regulated tariff at existing levels for the life of their projects.

The level of the regulated tariff for photovoltaic solar power after the 29 September 2008 deadline is not known at this stage, but is expected to be lower than the current amount.

The rapid satisfaction of the prescribed capacity goal demonstrates the dramatic growth of Spanish photovoltaic solar projects during 2007. This growth has led to market saturation and some sponsors are now turning to alternative investments in less mature projects, such as: thermoelectric solar power, biomass and/or biogas projects.



Interconnection of renewable facilities into the electricity network

The Renewable Energy Decree addresses technical and management matters for the correct interconnection of the renewable facilities into the overall Spanish electricity system, including the following:

- Setting out guidelines for a new procedure between generators and network operators for sharing the costs and investments required to increase the capacity of the existing electricity network so as to support renewable power. This is intended to address the previous uncertainty experienced by many renewable facilities under construction (particularly wind farms), as to their ability to obtain adequate physical connection to the system and/or incur disproportionately high costs for network upgrades to facilitate such a connection.

- Requiring renewable generators to provide performance bonds in respect of access to both the transmission and distribution networks at the amount of €20 per Kw.³ These performance bonds are enforceable in the event that the facility owner voluntarily decides to abandon the administrative process for obtaining the necessary permits, or does not satisfy any additional information requests from the competent authorities within three months from the request being made. Essentially they are intended to ensure that the developers in question are committed to the development of their project.
- Introducing new IT procedures among the central, regional and local governments for the co-ordination of their actions in the permitting process.

Conclusion

The Renewable Energy Decree does not completely depart from the previous legal regime, but continues to build on the previous regulations in order to incentivise renewable generation.

Broadly speaking, the new remuneration regime is positive because, on the one hand, it increases the regulated tariff for the majority of renewable projects and, on the other hand, it sets out the necessary adjustments to the premium payments, taking into account variations in electricity prices on the market. However, there is some uncertainty about the level of remuneration once the Ministry confirms that the 85 per cent limit of capacity is reached for each specific renewable technology, as has happened in the case of photovoltaic solar power projects.

The Renewable Energy Decree also includes other novelties, such as detailed regulation of the interconnection of the renewable facilities into the Spanish electricity system and the regulation of hybrid renewable projects.

This revised regime will no doubt continue to encourage the further development of the renewables sector in Spain, particularly in view of the recent EU announcement of its strategy for tackling climate change.

³ Photovoltaic solar power generators are required to deposit a higher amount (€500 per Kw).

The blurring of guarantees and performance bonds: a recent case



T: +44 (0)20 7859 1265
E: gabrielle.samuels@ashurst.com

Gabrielle Samuels, director of professional development (international finance) at Ashurst London, examines the recently decided Van der Merwe case in which the High Court held that a guarantee may, in certain circumstances, become a demand guarantee payable against a first demand, without reference to any defences which may otherwise be available to the guarantor.

This ruling may have potentially harsh consequences for guarantors and will be of interest to project sponsors and other companies which issue parent company guarantees in the course of their business dealings.

What is the difference between guarantees and performance bonds? That has long been a somewhat tricky question to answer. The theory is straightforward – a performance bond (also known as a “demand guarantee” or “demand bond”) is a direct undertaking to pay a specific amount to the beneficiary. It is payable against

the presentation of certain stipulated document(s) – typically a written demand or notice of default of the underlying debtor, the presentation of which triggers the payment to the beneficiary. The payment must be made regardless of any defences which may exist in the underlying documentation. In contrast, a guarantee is a promise to see that a contract is performed or to perform the contract following the default of the principal. If the principal has defences to liability, then those defences may equally be argued by the guarantor (unless the guarantor has agreed to their exclusion).

So far, straightforward. The practical problem is that guarantees are now rarely simple contracts of surety, that is, secondary obligations under which the guarantor will perform, if and when the principal has defaulted. Almost all modern contracts of guarantee now also include a direct contractual undertaking from the “guarantor” to indemnify the beneficiary against any loss suffered in relation to the principal contract. Additionally, almost all contracts of guarantee are expressed as being payable on demand and express the liability of the guarantor as being one of “principal debtor” – this is where the lines have become blurred.

This article does not go into all of the classic indicators of what distinguishes a performance bond from a true guarantee. It suggests however, that in the case of **Van der Merwe -v- IIG Capital LLC**,¹ the courts have drawn the wrong conclusion. It is a surprising case since the weight of guarantee law over the years strongly favours guarantors; indeed guarantors are known as “the darlings of the courts”. Guarantees are to be construed strictly so that no liability is imposed which is not clearly covered by the instrument. In cases of ambiguity, they are to be construed in favour of the guarantor. This case is hard to reconcile with those principles.

The facts

In 2006, IIG Capital LLC (“IIG”) entered into a loan agreement under which it provided finance to Hurst Parnell Import & Export Limited (“HPIE”). The loan was secured by a debenture and also guaranteed by Mr and Mrs Van Der Merwe, who were directors of HPIE. On 12 January 2007, IIG demanded US\$30,303,576 from HPIE said to be due; HPIE did not pay and so, on 16 January 2007 IIG wrote to Mr and Mrs Van Der Merwe reciting HPIE’s failure to pay, certifying the amount due under the guarantees and demanding payment within two days.

Mr and Mrs Van Der Merwe resisted payment on the basis that they were entitled to raise defences available to HPIE. The basic point to be decided was whether the guarantees were payable on presentation of a demand for payment of a certified amount – in which case no defences could be raised – or whether they were true contracts of guarantee, which would permit the guarantors to raise the defences open to the principal (to the extent that those defences had not been effectively excluded).

The key terms of the guarantees were as follows:

- The guarantees were expressed to be for “all monies ... due, owing, payable or expressed to be due, owing or payable”.
- Each guarantee was expressed to be given “as principal obligor and not merely as surety”.
- The guarantees included a clause stating “if ... any of the Guaranteed Monies are not paid in full on their due date, [the Guarantor] will immediately upon demand unconditionally pay to the Lender the Guaranteed Monies ...”.
- There was additional indemnity language - “As an original and independent obligation ... the Guarantor shall indemnify ... the Lender against any loss ... incurred by the Lender ...”.
- There was included a provision stating that “A certificate of the Lender stating

¹ [2007] EWHC 2631 (Ch).



the amount at any time due and payable by the Guarantor ... shall, save for manifest error, be conclusive and binding on the Guarantor”.

- There was a typical preservation of guarantee clause (specifying no discharge following amendments to the principal contract etc).

All of the above terms are either entirely standard or, at least, not uncommon in a typical guarantee and we would not (prior to this case) have interpreted the above features as giving rise to interpretation as a “demand guarantee”; that is, an instrument payable against presentation of documents only (presentation of demand).

The Judgment (Mr Justice Lewison)

The question which the judge considered apt was: what rights and obligations have the parties created by the words of the instrument, construed in its factual and commercial context?

The key case cited was **Marubeni Hong Kong and South China Ltd -v- The Mongolian Government**.² In *Marubeni*, Carnath LJ held that, outside a banking context (this should mean so long as the guarantor is not a bank/financial institution), there is a strong presumption against giving the words “on demand” the

² [2005] EWCA Civ 395.

effect of creating an independent primary obligation. The question then becomes whether there are sufficient indications in the wording of the instrument to displace that presumption. Lewison J was satisfied that the *Marubeni* presumption had arisen. He then considered the relevant factors which might displace the presumption:

- The instrument is described as a “guarantee” and not a “demand guarantee” or “performance bond”. This factor, which potentially supported the presumption, was given no weight. It is hard to argue with this in view of the generally misleading/inconsistent names commonly given to instruments.

- The definition of Guaranteed Monies includes not only monies which HPIE actually owes to IIG but also monies “expressed to be due, owing or payable”. Lewison J ascribed weight to this in terms of displacing the *Marubeni* presumption. These words do go further than the common language found in traditional guarantees, but it is still very arguable that the intention is to displace the problems associated with the secondary obligation of guarantees and, in that sense, to create a primary obligation – but not one payable on presentation of a certificate only.
- The instrument included the specific wording “it will immediately upon demand unconditionally pay to the Lender ... the Guaranteed Monies”. Lewison J confirmed that the obligation to pay on demand is not enough on its own to displace the *Marubeni* presumption, but it did carry weight. Lewison J went on to say “The usual

“Many guarantees will now be open to the interpretation that they are payable on first demand, irrespective of the true liability of the principal debtor.”

- beyond the obligation to pay monies due. It also fails to distinguish between a primary obligation which retains the benefit of defences (to the extent that they have not been waived) and a primary obligation to pay on demand (which almost always is expressed as payable against presentation of a certificate of default of the principal).
- The promise to pay is “as principal obligor and not merely as surety”. Lewison J acknowledged that this is not enough on its own to displace

Comment

This is a harsh case on guarantors and out of step with their typical treatment by the courts. It is especially surprising in view of the guarantors being private individuals, when the vast majority of performance bonds are issued by banks. The guarantee contained comprehensive waivers of defences (as is standard) and the *Van Der Merwes* may well have found that no defences were left open to them. In our view, they should have been able to argue such defences as they had left. In any case, the practical impact is that many guarantees will now be open to the interpretation that they are payable on first demand, irrespective of the true liability of the principal debtor. Arguably, this will not make a huge amount of difference to many guarantors, given the typically comprehensive waiver of defences. Nevertheless, given that guarantors do regularly raise defences, one would think



contract of suretyship is a promise that the principal debtor will perform his contract, whereas in the present case the promise is a promise to pay the Guaranteed Monies”. We would disagree with that statement in the context of a guarantee of a loan agreement.

- The promise is limited to the payment of Guaranteed Monies. It does not extend to the performance by HPIE of any of its other obligations under the loan agreement. Lewison J considered this to be consistent with an obligation to pay as a primary obligation. This ignored the fact that there were unlikely to be any obligations of significance under the loan agreement

the *Marubeni* presumption, but it did carry weight. Again, this is standard guarantee language – aiming to mitigate the harsh effects of the secondary nature of the guarantee.

- The inclusion of a provision for conclusive certification of the amount due. Lewison J felt that this point clinched the argument for rebuttal of the presumption.

Ultimately, Lewison J was satisfied that the *Marubeni* presumption was rebutted. He declined to consider whether any of the points would have been sufficient on their own, since they were not on their own. The *Van Der Merwes* were obliged to make immediate payment under the guarantee.

that they would like their remaining rights to be preserved. Guarantors can, however, deal with the demand guarantee interpretation; rather than attempt to negotiate the removal of the cumulatively “problem” provisions identified above (which is unlikely to be a successful tactic in any case) we would recommend the inclusion of an express provision in the instrument along the lines of: “this instrument is not a demand guarantee or a performance bond and the guarantor shall be entitled to raise defences to its liability hereunder save for where those defences have been expressly excluded by the terms of this instrument”.

Stop press!

New partner in Ashurst Tokyo



We are delighted to announce that Matthias Schemuth has joined the firm as a partner and is to be based in our Tokyo office.

Matthias specialises in project finance, international banking transactions, export credit and trade finance and has substantial experience in advising commercial banks, multi-lateral lending agencies and export credit agencies in connection with major projects in the oil and gas, petrochemical and mining and metals sectors. Matthias is qualified as a solicitor in England and Wales and is a registered foreign lawyer in Hong Kong where he has been based since 2006.

Matthias has previously been seconded both to a Japanese and a German bank.

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Energy partners

Jonathan Angell (London)
T: +44 (0)20 7859 1364

Matthew Bubb (Singapore)
T: +65 6416 0272

Rupert Burrows (Tokyo)
T: +81 3 5405 6200

Paul de Cordova (Dubai)
T: + 971 (0)4 365 2010

Louise Eccleston (London)
T: +44 (0)20 7859 1976

Matthew Hughes (London)
T: +44 (0)20 7859 1904

John Inglis (London)
T: +44 (0)20 7638 1111

Gonzalo Jiménez-Blanco (Madrid)
T: +34 91 364 9800

Michael Johns (London)
T: +44 (0)20 7859 1254

Ronnie King (London)
T: +44 (0)20 7859 1565

Alan Kitchin (London)
T: +44 (0)20 7859 1978

Michel Lequien (Paris)
T: +33 (0)1 53 53 53 53

John McClenahan (Tokyo)
T: +81 3 5405 6200

Carl Meyntjens (Brussels)
T: +32 (0)2 626 1900

Richard Palmer (London)
T: +44 (0)20 7859 1289

Geoffrey Picton-Turbervill (London)
T: +44 (0)20 7859 1209

Tim Reid (London)
T: +44 (0)20 7859 1548

Michael Robins (London)
T: +44 (0)20 7859 1473

Jan Sanders (London)
T: +44 (0)20 7859 1246

Matthias Schemuth (Tokyo)
T: +81 3 5405 6200

Hermann Schlindwein (Frankfurt)
T: +49 (0)69 97 11 27 95

Cameron Smith (London)
T: +44 (0)20 7859 1246

Huw Thomas (London)
T: +44 (0)20 7859 1125

Philip Thomson (London)
T: +44 (0)20 7859 1243

Alexandre Vandencastele (Brussels)
T: +32 (0)2 626 1900

Franco Vigliano (Milan)
T: +39 02 85 42 34 51

David Wadham (Dubai)
T: +971 (0)4 365 2015

Nick Williamson (London)
T: +44 (0)20 7859 1894

Ashley Wright (Singapore)
T: +65 6416 0298

email: firstname.surname@ashurst.com