

DEAL



DILEMMA

DEAL OR DILEMMA: CRITICAL ENABLERS FOR THE DELIVERY OF MIDSTREAM GAS PROJECTS

1.0. Introduction

In recent times and increasingly, Nigeria has been described as a gas bearing nation with pockets of oil. With reserves in the region of 203 trillion cubic feet ("tcf"), an upside of 600 tcf and the continued volatility in the prices of crude oil, it has become imperative for Nigeria to commit immutably to the commercialisation of its abundant gas reserves. Awakening to this reality, the Minister of Petroleum Resources for State declared 2020 – 2030 as the decade of gas ("Declaration"). The Nigerian National Petroleum Corporation ("NNPC") has also earmarked seven critical gas development projects (7CGDP) which are expected to deliver about 3.4 billion standard cubic feet of gas per day (bscf) to the domestic market and provide 15GW of power supply to the country.

In this thought leadership paper, we have highlighted the criticality of midstream gas infrastructure development to the actualisation of the Declaration. We have also considered critical enablers for the development of midstream infrastructure. Ranging from the development of gas processing and conditioning systems to evacuation and storage systems, the ability to achieve bankability and profitability is one that requires coordinated tact, effective risk management and diligence to move the project from conceptualisation to reality.

2.0. Deal or Dilemma- What are the Critical Enablers?

Whether the infrastructure unit is a gas processing unit, a transportation system, a floating liquefied natural gas facility or a simple tie-in spur line, the environment must be enabling. Five key enablers are discussed here:

- 2.1 **Feedstock Supply:** Without guaranteed supply of gas, a midstream gas infrastructure developer ("MID") might as well be building a sandcastle and putting the cart before the horse. The conversations on the availability of feedstock should never be deferred. Characteristically, a prudent lender to a midstream infrastructure project will review

the gas supply contract. In the lender's bankability assessment, the committed quantities; the take or pay scheme; deliver or pay clauses; the gas specification; the duration of the gas supply contract; pricing methodology and pricing re-openers; termination events and cure provisions will be carefully evaluated. A full appreciation of the regulatory landscape and market practice are crucial to this evaluation. For instance, if gas is being delivered in fulfilment of mandatory domestic supply obligations, the price re-opener may only be triggered by the pricing regulations. However, if gas is being delivered on a willing seller-willing buyer basis, the pricing and adjustment indices are

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different. The advisory team must appreciate these nuances.

Also, the feedstock supply risks that may be assumed by a central gas processing facility located in a gas supply hub may be significantly different from a gas processing facility with access to a remotely located gas supply source. To fully evaluate the supply risk in the latter and depending on the life cycle of the asset, additional requirements like the competent person's report ("CPR"), an approved field development schedule and reserve certification are deemed essential. In relation to brown fields which could have stale CPR, the operator's annual filings with the Department of Petroleum Resources, tracking the reserves and depletion rate may be relied upon to augment the information in the CPR. After wading through to commissioning and achieving the start date, the feedstock supply narrative assumes a different coloration. What if there is a prolonged failure to supply or prolonged force majeure leading to a termination? In a project site with no alternative supply source to ensure the continuity of the midstream operations, what is the real value of the gas processing plant or an immobile pipeline to the lender? Again, this justifies the case for robust risk analysis at the project structuring stage. The peculiarities of each project should be addressed.

For instance, a midstream infrastructure project that is reliant on a green non-associated gas field for its supply, may find that the feedstock supplier intentionally delays the development of its reserves until firm commitments have been procured from the midstream player either on a tolling or merchant basis. This inter conditionality may likely affect the estimated project timelines for the MID.

2.2. Reliable Design, Construction, Completion and Performance: The credibility and competence of the engineering, procurement and construction ("EPC") contractor are critical to project commissioning and operational integrity. If there are multiple infrastructure units to be integrated to achieve mechanical completion, the EPC contracting plan is encouraged to adopt a a turnkey model to eliminate, to the extent possible, interface risks. Whilst the EPC is usually highlighted as the main activity in the construction chain, we urge that

significant attention be paid to the scoping of the other activities leading to the EPC, such as the concept study, front end engineering design ("FEED") and the detailed design. These pre-EPC activities lay the foundation for the project as they shape the foundational parameters for the construction and operational phase. The pre- FEED and FEED studies provide a whole life view of the project, enabling the resolution of potential red flags early on.

Having scaled these hurdles, another concern that might agitate the MID is the risk of suboptimal performance, particularly for infrastructure units adopting process technologies. Thus, it is important that some level of rigor goes into the contractor selection process. Also, parties should carefully negotiate performance buy-down packages and determine the impact of such buy-down on the overall product output. If the contractor ("**DED contractor**") that produced the detailed engineering design is different from the EPC contractor, the contractual framework must be such that allocates design liabilities to the DED contractor, or one that allows the assumption of those liabilities by the EPC contractor at a negotiated price. This births a single point for liabilities and makes it easier to navigate the murky waters of latent design defect and remediation.

2.3. Foreign Exchange safeguards: This is perhaps a significant risk for an MID who purchases feedstock and procures debt capital in foreign currency but sells the processed products to the domestic market in Naira. Projections could easily move from profit to loss on the basis of exchange movements and currency conversion alone. As long as the mismatch between the currency of earnings and the currency of purchase of feedstock and the debt exist, the market is likely to witness more midstream tolling deals where the midstream is somewhat insulated from this risk, as there is more flexibility in setting the currency of tolling tariffs. The scarcity of foreign currency from the Central Bank of Nigeria (CBN), the gulf between the CBN conversion benchmark and the parallel market and the tendency for the upstream

supplier to insist on a currency conversion rate that tracks the parallel market do not strengthen the MID's position.

Some other project sponsors have employed hedging instruments to lock in an exchange rate. However, hedging instruments are expensive and would effectively increase the overall cost of the project.

2.4. Enabling Regulatory and Political Environment:

The oil and gas regulatory space has been in a state of flux for over a decade and there is still no finality with the provisions of the petroleum industry bill (“**PIB**”) and its passage. Although, the gas sector has witnessed bouts of regulatory developments in the form of policies, guidelines, codes and regulations, significant divergence still exists amongst stakeholders on fundamental matters that underpin and affect gas commercialisation such as gas pricing, mandatory domestic supply obligations and tariff setting. For instance, the aspiration of the National Gas Policy, 2017 (“**NGP**”) is to transition, within a short period, to market led wholesale gas pricing without price regulation except for monopoly infrastructure. This is at complete variance with the current draft of the PIB which seeks to regulate gas prices through price floors and caps for about 16 years. This type of inconsistency heightens the concerns for prospective market entrants. Another case in point is the Nigerian Gas Transportation Network Code (“**Code**”). Whilst the Code seeks to ensure open access to all midstream gas infrastructure networks, whether onshore or offshore, the inelegance of the provisions of the Code suggest that the Code was written primarily to regulate networks owned by the Nigerian Gas Company (“**NGC**”).

There is also the well-placed concern that a change of government could change the political posture towards projects of a certain nature, which may in turn have ripple effect on the feedstock supplier or offtaker, inevitably affecting the budding midstream sector. The concern around multiplicity of regulations and regulators also exists, with no central platform for the procurement of permits and licenses. It is therefore important that the MID is fully abreast of the regulatory landscape, the regulatory agency and the conditions for the

procurement and renewal of project licences and approvals, delay factors and the timing for the approval process. Thus, careful consideration is required in identifying licences and approvals that are critical to disbursement and the ones that can be deferred to the construction phase or pre-commissioning.

- 2.5. **Guaranteed Offtake:** After all is said and done, unmitigated market risk will expose the midstream company to cashflow squeeze and if left unaddressed, to insolvency. Therefore, It is critical that the midstream company secures the commitment of at least one creditworthy anchor offtaker before embarking on a long-term commitment to the upstream feedstock supply source. Market risk is hardly ever a permissible reason for adjusting the contracted quantities under the upstream feedstock supply contract. This risk is one that should be adequately mitigated. Also, where the offtaker commitments do not match the supply matrix, the MID must attempt to balance the disparity by negotiating an incremental or graduated offtake plan with its upstream feedstock supplier, which allows a ramp up as additional offtakers are onboarded. The MID may also consider a phased development which allows it scale up as the market develops. Market risk typically materialises where the MID fails to review the supply – offtake chain at the project conceptualisation stage, and hurriedly commits to quantities under the upstream feedstock engagement based only on the proposed capacity of its midstream infrastructure and a vague appreciation of the dynamism of the domestic gas market.



3.0. An Artificial Family- the IJV as a Critical Enabler

One of the ways sponsors have sought to mitigate these risks in recent times, has been to adopt strategic partnerships using Incorporated Joint Venture (“IJV”) structures. By integrating the various players across the value chain into the project as equity holders in the project company, the commitment to see the project succeed is strengthened. Constituted as a separate corporate legal entity with good governance framework, the IJV structure helps to shield these equity holders from liability and encourage private sector investment. Lenders also tend to favour such structures, as there is heightened confidence premised on the participation of critical stakeholders coupled with the commonality of purpose.

The risks and reward are shared proportionately amongst the stakeholders, potentially increasing the profitability and bankability of the project, whilst boosting the chances of a successful capital raise from the debt and capital markets.

Furthermore, the risk of creeping expropriation is mitigated when the government participates in equity through the NNPC or NGC or Nigerian Gas Marketing Company. Also, an EPC contractor who has equity in the project is incentivized to deliver the project on time and in accordance with the employer's requirements, thereby mitigating completion and performance risks. The risk of diversion of feedstock or sabotage becomes theoretical if the feedstock supplier has a stake in the project.

Nonetheless, the IJV has its weaknesses. The voluntary or involuntary exit of a participant may affect the commitment of the other equity holders particularly if their participation was influenced solely by the involvement of the exiting party.

4.0. Conclusion

There are several moving parts on the gas value chain and varying considerations that go into project structuring and bankability. Yet, if those parts can be curated within a controlled environment, the risks will be significantly minimized and properly allocated. In turn, the lending community will be incentivized to invest in Nigeria's gas sector. As Nigeria looks forward to the actualisation of the decade of gas commercialisation, midstream players are encouraged to carefully evaluate their project structures and the risk matrices before undertaking long term commitments across the contracting chains; the ultimate objective being the birthing of deals and not dilemmas.

