



## STANFORD LAW SCHOOL *PROGRAM IN INTERNATIONAL LAW BUSINESS, AND POLICY*

SLS PILBP Case No. 001-99

### The Meizhouwan Power Project

#### Introduction

After eight years of planning, development and construction, the Meizhouwan power project ("Meizhouwan" or "the Project"), a coal-fired power plant located in Putian County, Fujian Province, People's Republic of China ("PRC" or "China"), was scheduled to begin producing electric power for Fujian Province by the end of the year 2000.

In some ways, Meizhouwan was a typical power project; its generating capacity would be ordinary and the technology it would rely upon to produce power had been previously employed in many other facilities. What distinguished Meizhouwan from previous power projects was the context in which it was developed: the context of China in the 1990's. This was a China that had never previously permitted a wholly-foreign owned corporation to build a similar facility. This was a China that was changing in many ways, politically, economically, and legally. The contextual environment of change mandated the use of new strategies for navigating the complex process of project development and for identifying and allocating risk among various project' participants and the host government.

#### Project Participants and Overview.

Taking a large power project such as Meizhouwan from concept to reality requires the assembly of a large cast of dependable, experienced participants. Assembling this cast is the responsibility of the project "sponsors," the primary proponents of a project. The sponsors must hire a company or companies to design and build the project. They must obtain all necessary approvals from government agencies. They must locate and secure an adequate supply of fuel for the plant. They must ensure that they will have purchasers for the power the plant will

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Revised 12/99

eventually produce. They must finance the project by locating parties interested in either purchasing equity shares in the project or in making loans to the project. If necessary, they must hire a company to operate the project once it has been completed.

### Key Project Participants

The key Meizhouwan participants were as follows:

<u>Participants</u>	<u>Role</u>
Bechtel Power Corporation and Affiliates	Contractors
Fujian Provincial Electric Power Bureau	Power Purchaser/Operator
Fujian Pacific Electric Company Limited	Project Company
InterGen	Sponsor
Lippo China Resources Limited	Sponsor
Asian Development Bank	Equity Investor and Lender
Spanish and French Export Credit Agencies	Loan Guarantors for plant equipment purchased from Spanish and French suppliers
Various Commercial Banks	Lenders

### Sponsors

Lippo China Resources Limited, an affiliate of the Lippo Group, held its interest, through another entity, China Pacific Electric Limited ("China Pacific"), in the project company, Fujian Pacific Electric Company Limited ("Fujian Pacific"). The Lippo Group was one of Asia's major business conglomerates, with focused expertise in five major areas

Of business: (a) property development and investment, (b) commercial, retail and investment banking, (c) retailing, (d) industrial and infrastructure investment and (e) insurance. Lippo Group was founded, and was controlled, by Dr. Mochtar Riady and his family, whose ancestors moved from Fujian Province to Indonesia. Lippo Group was the original sponsor of the Project, bringing other sponsors on board in 1993.

InterGen was a global power enterprise that developed, financed, owned and operated state-of-the-art electric power plants and related fuel, transportation and transmission facilities in various partnership arrangements. Formed in early 1995, InterGen was owned jointly by Bechtel Enterprises, Inc. and Shell International Gas, Ltd. Bechtel Enterprises was the finance and development unit of the Bechtel Group. Bechtel Enterprises and its affiliates had developed, owned and operated infrastructure facilities whose aggregate installed costs were more than \$17 billion.

1 Not an original sponsor of the project, InterGen in 1995 took over the sponsor interest initially held by Bechtel Power.

InterGen had principal offices in Boston, Hong Kong, London and Miami, as well as a dozen other satellite or project offices across Europe, Asia and Latin America. InterGen's project portfolio included five generation facilities totaling 2,865 megawatts ("MW")<sup>2</sup> under construction in Mexico, the Philippines, Colombia, China and the United Kingdom and a 700 kilometer gas pipeline facility under construction in Mexico. InterGen held its interests in the Project through a special purpose company, Meizhouwan Generating Company, Ltd.

The sponsors of Meizhouwan (hereinafter "Sponsors" or "Sponsors' consortium") held their interests in Fujian Pacific through Fujian Electric (Hong Kong) LDC, a limited duration company incorporated and existing under the laws of the Cayman Islands ("Holding Co. ").

### Contractor

The Meizhouwan contractor was responsible for designing and building the facility to specifications under price, performance and schedule guarantees. The primary contractor, Bechtel Power Corporation ("Bechtel Power"), was an affiliate of Bechtel Enterprises and was a leading engineering, procurement and construction company involved in power generation, transmission and distribution facilities throughout the world. Worldwide, Bechtel Power had provided engineering and construction services to 116 solid fuel-fired units totaling approximately 40,000 MW of capacity. Of these solid fuel-fired units, more than 20 pulverized coal units, each greater than 250 MW, entered commercial operation in the 1980s. In large-scale units, Bechtel Power had been very successful in combining the dependability of proven pulverized coal technology with the latest innovations in instrumentation, emission control, design and construction.

### Power Purchaser/Operator of Plant

Fujian Provincial Electric Power Bureau (the "Power Bureau") would be responsible for operating the facility and purchasing power from Fujian Pacific. The Power Bureau was established in 1983 as a state-owned independent legal entity responsible for its own management and profit and loss. The Power Bureau, which fell under the direct management and supervision of the PRC Ministry of Electric Power ("MOEP") and the Fujian Provincial Government, was responsible for the development and operation of the power network in Fujian Province and generated and distributed electricity as a commercial enterprise. During the period when the Meizhouwan project was being undertaken, the Power Bureau was undergoing a formal corporatization process which would result in the Power Bureau being

<sup>2</sup> A megawatt is one thousand kilowatts or one million watts. One megawatt is enough energy to power 1,000 average homes in the United States.

split into separate commercial and regulatory entities. Ownership of the commercial entity was to be jointly shared between the newly-formed State Power Corporation of China (successor to MOEP) and the Fujian Provincial Government.

The Power Bureau's service territory covered 64 cities and counties accounting for 93% of the population of Fujian Province. Most of the counties acted as wholesalers for redistribution of electricity, although electricity allocation in several economic development zones and counties was managed directly by the Power Bureau. As of year-end 1996, the Power Bureau directly owned and operated seven hydroelectric power plants and five thermal power plants with an aggregate capacity of 2,907 MW. In addition, the Power Bureau had direct interests in joint venture projects with an aggregate capacity of 1,041 MW. The Power Bureau purchased electricity from other independent producers with an aggregate capacity of 872 MW.

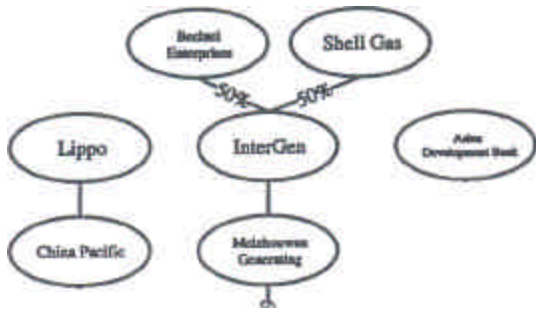
The Power Bureau had extensive experience in operating power plants. It operated four coal-fired power plants in Fujian Province: the 2 x 200 MW Zhangping Plant, the 350 MW Yongan Plant, the 50 MW Xiamen Plant, and the 2 x 300 MW Songyu Plant. In addition, the Power Bureau was directly involved in the staffing, training and startup of the Fuzhou thermal power plant, a 2 x 350 MW coal-fired facility built with imported equipment and owned by Huaneng Power International, Inc.

#### The Project Company

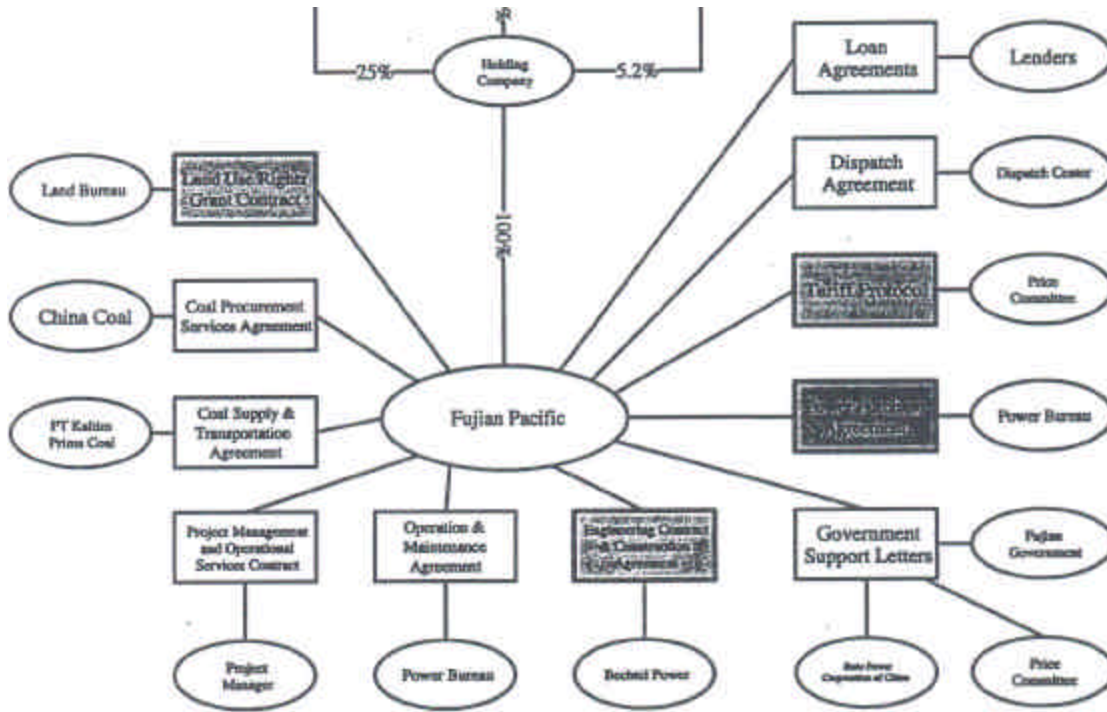
Fujian Pacific was a wholly foreign-owned special purpose company organized under the laws of the PRC to finance, build, own and operate the Project. Fujian Pacific held 100% of the ownership interests in the Project.

These entities (and many others) were eventually joined together in Meizhouwan by a web of relationships and contractual obligations, set forth in Figure 1 below. A glossary of project terms and parties is attached as Exhibit A to this case.

Figure 1: Project Agreements .



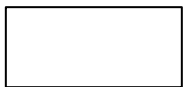
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KEY:



Entity



Documentation



Documentation Examined in this Case Study

-50%-

Ownership Percentage

## History

In 1992, when representatives of the Lippo Group signed a Memorandum of Understanding with the Fujian Provincial Government to build Meizhouwan on a marshy coastal site in Putian, they had little idea of the vast amounts of work that lay between that moment and the first sold kilowatt.

At the time, the Lippo Group had not yet been involved in the business of building or operating power plants; its expertise was in real estate and financial services. The Project was part of a larger vision held by Lippo's chairman, Dr. Riady. A native of the Meizhouwan area, Dr. Riady lived in China at an early age and had achieved business success in Indonesia. According to Joseph Chiang, one of Lippo's directors, Dr. Riady felt the desire to help the area develop economically - "when you are very well off," said Chiang, "you go back home trying to help them." When Lippo obtained the development rights to 40 square kilometers of land in 1992, it planned to build not only the power plant, but an industrial city and a golf resort. Dr. Riady's goal was to bring infrastructure, jobs and money to Putian.

As Lippo took the first steps toward building the power plant, it soon became clear that its lack of experience in the power sector was one of the smaller obstacles the venture would face. Lippo was able to solve this problem by bringing in other sponsors, specifically Bechtel Enterprises and Edison Mission Energy of California, both of which had extensive experience and success in constructing and operating power plants around the world. The Sponsors were determined to develop Meizhouwan as a wholly foreign-owned, Build-Own (Operate)- Transfer ("BOT") project. *See* Box 1. The Sponsors would construct the facility, supervise its operation and take profits for a 20-year period, and transfer ownership of the plant to the PRC government at the end of 20 years.

The biggest problems in developing the project resulted from its originality and the clash between two vastly different paradigms. In 1992, the Chinese had a well-established view of the way that power plants were supposed to be built - what Chiang calls "the rule book." This view was premised on the traditional Chinese notion of heavy central government involvement in every phase of a project, from design to approval to financing, construction and operation. Although the Chinese government was prepared to allow Meizhouwan to develop and operate differently, as a wholly foreign-owned enterprise, it was not sure exactly that meant. The Sponsors (and potential lenders) had their own "rule book" as well, written over the course of many years and dozens of power plants. The difficulties in completing Meizhouwan arose as the Sponsors and lenders attempted to use their established rules in a new setting while the Chinese simultaneously tried to force their established rules onto this new kind of project.

### Box 1: The Build-Own (Operate)- Transfer Model

The Build-Own (Operate)- Transfer ("BOT") model is a form of privatized project development in which a government grants a concession of defined and limited duration to private sector sponsors to build a project, hold an ownership position in it, arrange the balance of financing from third parties, and operate the project for the life of the concession. Usually, the concession life is significantly shorter than the facility's economic life (for a coal-fired power plant, typically 15-20 operating years for the concession vs. a plant life of 30-40 years.) Usually, the project ownership transfers to the government at no cost after the concession term.

In an effort to stimulate investment in the power sector to satisfy growing demand, on August 21, 1995 the former PRC State Planning Commission (now the State Development and Planning Commission), the former Ministry of Power Industry (now the Department of Power Industry under the State Economic and Trade Commission), and the Ministry of Communications jointly issued a document entitled *Several Issues Concerning the Examination, Approval and Administration of Experimental Foreign Concession Invested Projects Circular* (BOT Circular), formally introducing the BOT structure as an alternative means of investing in power projects in the PRC. This document was meant to clarify and streamline the procedures for BOT investment in infrastructure. Because the project was commenced prior to the issuance of this document, Meizhouwan was Dot considered as part of the experimental program described therein.

*Source: Project Finance in Developing Countries, International Finance Corporation, (1999),. BOT Projects, in Power in China, Sorab, ed., Asia Law and Practice Publishing, Ltd. (1998).*

The mismatch between new forms of investment and existing laws and institutions was not unique to Meizhouwan. In the evolving China, according to Barry Metzger, former general counsel to the Asian Development Bank ("ADB"), "almost every new project does not conform in some important way" with existing law.

#### Project Context

From 1992, when Lippo signed the Memorandum of Understanding with the Fujian Provincial Government, to 1997, when work actually began at the site, China was in a period of transition. The evolving law, politics and economics of the power sector in Fujian Province reflected the changes that were taking place throughout China.

The fundamental driver of change was economics. The economy of Fujian Province was growing at a rapid rate that exceeded the capacity of existing infrastructure. The average economic growth in the province during this period was about 20% annually. Remarkably, however, according to the ADB, "[t]his economic growth [was] being constrained by lack of power and other infrastructure. II The Power Bureau estimated that in order to meet the energy needs of the economic expansion, it would have to triple its ability to produce power between 1996 and 2005.

Fujian Province did not have the financial capacity to construct the power facilities necessary to supply this massive increase in generating capacity. It was unlikely that any help would come from the central government in Beijing. Beijing had long ignored the province. According to Xuecheng Zheng, Director of Development for InterGen, "the central government had restricted construction of infrastructure" from 1949 until the early 1980's. The reason, according to Zheng, was that "the area was right across the Taiwan Strait from Taiwan, and during that period, Beijing was afraid infrastructure might be bombed" by Taiwanese planes.

#### Box 2: The Transition to Market Economy in China's Electric Power Industry

China's electric power industry was developed under central planning. The central government managed the industry, provided all investment funds, and received all profits from its operation.

Reform of the electric power industry began in the 1980s. The first change was aimed at expanding sources of investment, especially from local governments, industrial sectors, and enterprises.

These reforms weakened the central government's monopoly of the electric power industry. New independent power plants were allowed to sell power to the grid competitively through established contracts. Existing state-owned enterprises were reorganized as companies or enterprises to operate commercially in a market environment.

The ownership in the electric power industry diversified as a result of the reform. Owners now included the state, joint state and local governments, stockholders, sole proprietors, and local and foreign enterprises. Sino-foreign joint ventures or cooperative ventures were created. Such enterprises operate independently and sell power to the grid. However, all projects are subject to approval by local and central planning commissions, and large projects- those costing over \$30 million- must be approved by the State Council.

The central government drafted an "Electric Power Industry Law" in 1995 and enacted it in April 1996. The law is regarded as the fundamental legal framework of the electric power industry. It ensures development of the industry in a market economy.

The Chinese government established the National Electric Power Corporation in 1997, a significant step in reforming the administrative system of the electric power industry.

The Ministry of Electric Power Industry was disbanded at the National People's Congress in March 1998. The National Electric Power Corporation was established by the State Council as a solely state owned entity and is authorized to manage national assets, make investments, operate State owned power grids, and manage transmission between grids. In the future, electric power enterprises will operate more independently from the government and the power market will be more open to investors.

*Source: China's Electric Power Options: An Analysis of Economic and Environmental Costs (Draft Final), Advanced International Studies Unit (June 1998).*

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In the early 1990's, Beijing offered the Power Bureau the opportunity to become independent, to step out from under the umbrella of the central power bureaucracy, the Ministry of Electric Power. Only a few other provinces, including Tibet, Guangdong and Hainan, had been granted independent status. Independence was not necessarily a good thing: it meant less federal money for new power projects. Concerned with its ability to raise capital for power, Fujian respectfully declined Beijing's offer.

It was clear though that independent or not, the province would need to look elsewhere for infrastructure investment. According to Zheng, Fujian became "very aggressive" in seeking foreign investment in all sectors.

The Power Bureau's freedom to operate in an entrepreneurial manner increased in 1995, when it became the only power utility in China selected by the central government under the Modern Enterprise Experiment Program. Under this program, 100 state--owned enterprises from all sectors were selected for restructuring into limited liability companies with a more Western-style management structure. The Power Bureau was reorganized into a commercial entity and was to be eventually renamed the Fujian Electric Power Company.

### Regulation of Foreign Investment in the Power Sector

Beginning in the late 1970s, China embarked on an effort to encourage foreign investment. The two most common foreign investment vehicles in China throughout the 1980s and 1990s were the joint venture (a foreign company partnered with a Chinese entity) and the wholly foreign-owned enterprise.

From the outset, the Sponsors of Meizhouwan wanted to develop the project as a wholly-foreign-owned enterprise. The primary advantage to this approach was that it generally allowed the Sponsors to develop the project using their own methods and toward their own goals. In a joint venture, the foreign investor must take into account the agenda of the Chinese partner. A wholly foreign-owned structure would allow the Sponsors complete managerial control over the development of the project. By relying on InterGen' s experience in this type of project, the Sponsors felt that they could maximize their chances of success by retaining control over development of the Project.

However, there was also some risk in utilizing the wholly foreign-owned form as opposed to a joint venture structure. Perhaps the most difficult aspect of developing a power project, or any large project, in China was obtaining the necessary government approvals along the way. There were two aspects to this problem.

A common complaint often heard from foreigners in the PRC is that the hardest part of doing business there is not getting the approvals one needs, but determining which approvals are necessary. This phenomenon is

especially true for power projects, since a wide variety and large number of governmental ministries, bureaus and commissions, as well as government related agencies, become involved at one stage or another.

Edward L. Turner, HI and Alan D. Seem, "The Approval Process and Strategies for Gaining Approval," 37, in *Power in China, supra*.

The involvement of a Chinese partner could serve to make both of these aspects of the approval process easier and less time-consuming. In the case of Meizhouwan, though, the Sponsors were convinced that the wholly foreign-owned BOT structure was the best option. The Sponsors believed that involvement of a Chinese governmental partner would slow the development of the Project. In addition, a joint venture with the most likely partner, the Power Bureau, would create a conflict of interest that might make financing more difficult to obtain. As a partial owner, the Power Bureau would seek to maximize profit; as power purchaser, it would seek to minimize cost.

The Wholly Foreign-Owned Enterprise Law, adopted in 1986, governed the *creation* of wholly foreign-owned enterprises in China. Implementing rules, promulgated in 1990, established the structure within which the wholly foreign-owned project would be *operated*. (Copies of the law and regulations are attached to this case as Exhibit B.) While these laws and regulations provided general guidance for establishing a wholly foreign-owned business enterprise in China (*see, e.g.*, Articles 6 through 10), there was much room for interpretation. A general lack of history in this area often left would be investors struggling to feel confident that they were in compliance with the law.

Several important laws and regulations relating to foreign investment in the power sector were adopted during Meizhouwan development. For example, in December of 1996, the Ministry of Electric Power issued the "Interim Provisions on the Application and Approval Procedures for Power Projects with Direct Foreign Investment." In March of 1997, the Ministry issued "Certain Provisions on Foreign, Investment Power Projects."

The adoption of new rules by the Chinese government in the midst of the Project added a new level of complexity to the development of the Project. As will be seen in greater detail in the case of the Land Use Rights Agreement, below, the Sponsors and their lawyers were faced with the question of which rules governed the project—those in place at the time the project began, or, the most recently enacted rules?

### **Negotiating Meizhouwan Agreements**

As counsel to the Sponsors, the lawyers of Los Angeles-based Milbank, Tweed, Hadley & McCloy ("Milbank") were part of the Sponsors' team responsible for negotiating the dozens of necessary agreements between Fujian Pacific and a wide variety of parties. (*See* Figure 1, above, and Figure 2, below.) This team consisted of Mil bank lawyers, and

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representatives of each of the project Sponsors, Lippo, and Intergen. In order for the project to be completed, Fujian Pacific would need agreements with, among others, contractors, lenders, coal suppliers, power purchasers, equity owners, and various local, provincial and central governmental entities.

This case study will focus on three of these agreements. The Power Purchase Agreement ("PPA") (and accompanying tariff protocol ("the Tariff Protocol")I), between Fujian Pacific and the Power Bureau, sets forth the amount of power that the Power Bureau is obligated to purchase from Fujian Pacific and at what rate it will buy this power. The Land Use Rights Agreement ("Land Agreement"), between Fujian Pacific and the Putian City Land Administration Bureau, establishes the terms under which Fujian Pacific will be able to use the land for the Project. The engineering/procurement/construction contract ("EPC contract"), between Fujian Pacific and Bechtel Power, governs the design and construction of the power plant itself.

Descriptions of the negotiation processes are provided to illustrate how the Milbank attorneys, and the other team members, worked in a hazy world of evolving law and complex bureaucracy, often under severe time constraints. Some of the parties with whom they negotiated, for example Bechtel Power, were represented by attorneys well-versed in the nuances of putting together large-scale international projects. Other parties, for example, the various local, provincial and central Chinese agencies, were represented by bureaucrats who had never before been involved in this type of wholly-foreign owned project.

Complicating negotiations, the parties involved in the project changed over time. (*See* Figure 2, below). For example, in the beginning, the Sponsors' consortium included

Lippo, Bechtel Enterprises, Edison Mission Energy of California, and Sembawang of Singapore. Bechtel Enterprises later transferred its equity share to its subsidiary, Intergen. In September of 1996, Edison Mission Energy and Sembawang withdrew from the project

The experiences of two Milbank attorneys, Alan Fenning and Desiree Woo, illustrate the difficulties in negotiating the allocation of risk in the Meizhouwan project. Fenning, of counsel to Milbank and counsel to the Meizhouwan Sponsors' consortium, was heavily involved in formalization of the Land Agreement. Fenning also helped negotiate the EPC contracts between Fujian Pacific and Bechtel Power. Woo, at the time a second-year associate at Milbank, helped negotiate the PPA and the related Tariff Protocol.

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Figure 2. Project Timeline

Activity	Date
Lippo signs Memorandum of Understanding with Fujian Province	1992
Lippo invites Bechtel Enterprises, Edison Mission Energy, and Sembawang to join as co-Sponsors	Summer 1993
Project approved by the State Planning Commission	September 1993
Power Purchase Agreement Negotiations begin between Sponsors and the Power Bureau	April 1994
Sponsors agree with Bechtel Power on terms of engineering and construction contracts	Summer 1994
Power Purchase Agreement initialed	January 1995
Sponsors begin effort to obtain Export Credit Agency involvement	November 1995
Fujian Pacific formed	January 1996
Sponsors sign memorandum of understanding with Asian Development Bank regarding its involvement as an equity owner and financier of the Project	January 1996
COFACE (Compagnie Francaise d' Assurance pour le Commerce Exteneur) and CESCE (Compania Espanola de Seguros de Credito a la Exportacion) chosen as Export Credit Agencies for Project	March 1996
New Chinese electricity law (Electric Power Industry Law) passed	Summer 1996
Sponsors and Fujian Province ask State Planning Commission for reapproval of higher Project cost	Summer 1996

Edison Mission Energy and Sembawang withdraw from the Project	September 1996
State Planning Commission reapproval obtained	November 1996
Land Rights Contract signed	March 1997
Sponsors begin seeking commercial financing	August 1997
Engineering, Procurement and Construction contracts signed	October 1997
Land Use Rights Granted	November 1997
COFACE/CESCE final approvals are obtained. All financing documents are executed	May 1998
Loan syndication is completed	Summer 1998

### The Iterations of Negotiation

In a project such as Meizhouwan, the negotiation of key project agreements takes place in two steps. First, sponsors and their counsel negotiate the contract with the relevant party. For example, the power purchase agreement would be negotiated between the sponsors and the power purchaser.

After the key agreements have been negotiated, the sponsors begin the search for private and multi-lateral banks willing to finance the project on a non-recourse basis. Banks may have interest in financing the project, but may harbor concerns about the extent to which certain risks are not mitigated under the negotiated agreements. Thus, interested banks often seek to reopen negotiations on previously negotiated agreements, bargaining for reductions in risk and exposure.

In a project such as Meizhou Wan, a main objective of the sponsors is to structure the project to be financeable on a non-recourse basis. Project financeability is not an absolute concept and is dependent upon a number of factors, including the quality of the sponsors, the contractual risk allocation, the creditworthiness of the offtaker, the project's cash flows and its resiliency, and the political risk of the host country. The contractual risk allocation aspect of a project's financeability is usually developed early in the development process, as key project agreements such as the power purchase agreement are negotiated between the sponsors and the power purchaser.

After the key agreements are substantively negotiated in a manner which can be described to lenders, the sponsors begin the search for private and multi-lateral banks to finance the project on a non-recourse basis. Banks may have an interest in financing the project; but may harbor concerns about the extent to which certain risks are not mitigated or clearly allocated in a satisfactory manner. In this situation, lenders will often request that the sponsors reopen negotiations to change certain provisions which will either reduce or clarify the project company's level of risk assumption. This negotiating dynamic often leads to a prolonged three-way negotiation between the lenders, sponsors and contract parties, as all parties seek to reallocate risks in a manner satisfactory to all. At the end of the process, the level of residual risk needs to be acceptable to the lenders given the overall project circumstances, with certain minor risks potentially covered by additional equity support, incremental insurance or higher loan pricing.

The appropriate time for the developer of a project to involve potential lenders in contract negotiations varies in each case. When a project is being developed in a country where few projects have previously been developed, it is important to involve the lenders at a relatively early stage. In such cases, sponsors will not be aware of lenders requirements in the economic and political context of that particular country. Likewise, in complicated or novel projects, sponsors should consult with lenders early on in the project. As a general rule, the more uncertainty surrounds a project, the more important it is to get lender input toward the beginning of project development.

The following sections of this case study examine the three key Meizhouwan agreements and their allocation of risk. In the case of the Land Use Rights Agreement, the actual negotiated document is presented in full form. Summaries of key provisions of the PP A and the EPC contract are provided. The reader should bear the following questions in mind in reading these documents:

1. Which provisions were probably most heavily re-negotiated by lenders in the second iteration of negotiations? .
2. If you were counsel to other lenders, which provisions would you seek to re-negotiate?
3. What types of language would you use to reduce your clients' exposure to risk?

#### Financing Issues in the Meizhouwan Project

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The Project agreements must be examined in the context of the financial structure of the Project because they not only established working relationships between parties, but they allocated financial risks between those parties. .

In some ways, Meizhouwan was a typical "nonrecourse project finance" project.

Nonrecourse project finance is an arrangement under which investors and creditors financing the project do not have direct recourse to the sponsors, as might be traditionally expected (for example, through loan guarantees). Although creditors' security will include the assets being financed, lenders rely on the operating cash flow generated from those assets for repayment. Before it can attract financing, then, the project must be carefully structured and provide comfort to its financiers that it is economically, technically and environmentally feasible, and that it is capable of servicing debt and generating financial returns commensurate with risk: profile.

International Finance Corporation, *Project Finance in Developing Countries*, p. 4 (1999).

There were, however, some unique financing aspects of Meizhouwan, according to Mark Takahashi, InterGen's Vice President, Finance. In general, banks considering making loans to developing country projects such as Meizhouwan look carefully at the political and legal context of the project. They look for legal certainty, the enforceability of contracts, and for transparency of legal processes. These were unclear, according to Takahashi, in the context of the evolving Chinese legal and regulatory framework.

The involvement of quasi-governmental entities in the project was also unique. Ordinarily, a project such as Meizhouwan will involve one or two multi-lateral investments banks or export credit agencies. Meizhouwan eventually had three—the Asian Development Bank, COF ACE and CESCE. The involvement of these three foreign, quasi-governmental entities added some stability and flexibility to the financing structure. The presence of the ADB, in particular, served to assure potential private lenders (as much as possible) that the Project would be insulated from political risks such as expropriation. The ADB had a high profile in Meizhouwan due to the fact that it held an equity interest (in addition to being a lender) in the Project. This was the first time the ADB had taken an equity interest in a private project in China.

Finally, while nonrecourse project finance became fairly common in China by the end of the 1990's, it was a relatively novel form of finance during the early 1990's, when Meizhouwan was being developed. A detailed summary of the financial structure of the Project is provided in Exhibit C to this case.

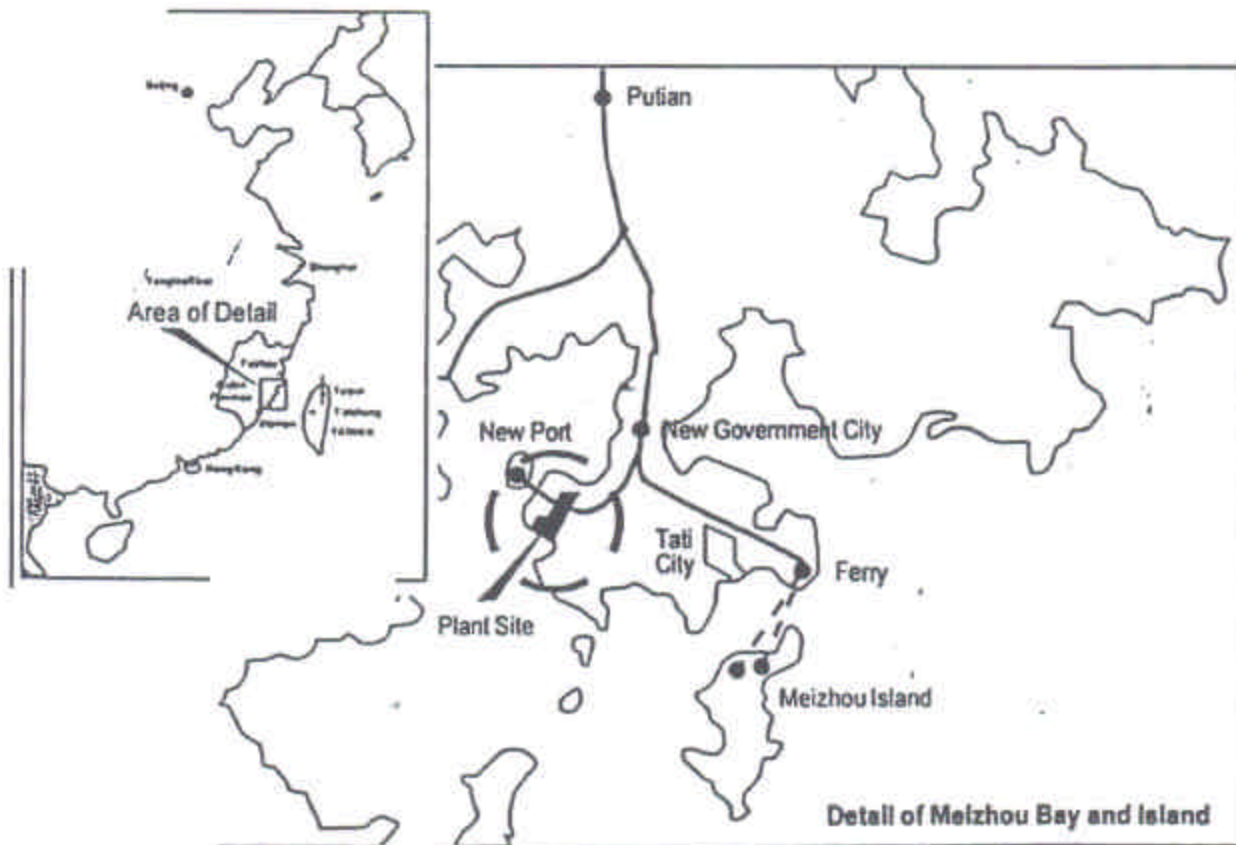
### Risks in the Project

A major component of each agreement, explicit or implicit, was the allocation of risk: between parties. While commercial or financial risk was the most obvious form of risk, there were many other types of risk involved. In an Information Memorandum presented to potential lenders to the Project in 1998, InterGen offered the a "Project Risk: Assessment." A copy of this assessment, which summarizes Project risks and mitigants, is attached to this case as Exhibit D.

## The Land Rights Agreement

In order to build a power plant, one needs land upon which to build it. There are also several less obvious reasons why land was needed to make Meizhouwan a reality. First, the operation would need land near the facility for depositing coal ash. A large power plant such as Meizhouwan produces a large amount of ash. In the developers' minds, the marshy areas near the facility would be ideal for ash deposition. The water would make the ash heavier, thus minimizing the potential for air quality concerns. In addition, the facility would need access to coastal waters: power plants require a great deal of water for cooling. Finally, and perhaps most important, the land would be part of the security package offered to lenders. The Sponsors' consortium was intent on financing Meizhouwan using non-recourse financing. One of the assets that would secure the loans to the project would be the land.

Figure 3: Map of the Project Area



Southern China

The Project is located near Talin Village on the southwest corner of Zhongmen Peninsula, near Putian City. Talin consists of three small villages, each located at the foot of a small hill at the three corners of a peninsula. Based on 1995 census' data, Talin had a population of 13,000. The three villages are separated by low, flat, sandy farmland in the middle of the peninsula. The plant will be located in the middle of this farmland. The land is not fertile, and agricultural production (mostly peanuts and sweet potatoes) is low. Traditionally, most villagers, on becoming adults, leave to seek employment elsewhere. There is no commercial or industrial

development in the area and the 1994 per capita income (Y2,228 [\$268]) was only about 40 percent of the gross national product per capita for Fujian Province (Y5,454[\$657]).

*Source: Asian Development Bank*

In the United States, the solution would be simple. The Sponsors would buy the land. In China, however, land is owned by the PRC. While the PRC will not sell the land to a private corporation, it will enter into what is called a "land use rights agreement," which gives the private party the right to use the land in specified ways for a certain period of time.

In addition to being of counsel to Milbank, Alan Fenning was general counsel to the Meizhouwan Sponsors' consortium. A 1975 graduate of Boalt Hall law school, Fenning had been involved in energy law for most of his career, working for Southern California Edison and its subsidiary, Edison Mission Energy. Edison Mission Energy was one of the largest non-utility power generators in the world.

At the outset of Meizhouwan, when Edison Mission Energy was one of the c0Sponsors of the project, Fenning was vice-president and general counsel of Mission. In late 1995, Fenning left Mission and joined Milbank. Milbank had previously been involved in the project as international counsel to the Sponsors. When Fenning joined Milbank, he took over the lead role as counsel to the Sponsors, along with another Milbank partner, Gary Wigmore, advising the executive committee on all legal matters and supervising the negotiation of the dozens of agreements necessary to the development of Meizhouwan.

In the fall of 1996, Fenning was drawn into the negotiation of the land rights agreement. The Milbank attorney primarily responsible for negotiating this agreement, Desiree Woo, was out on maternity leave. The matter had been semi-dormant for some time, when, according to Fenning, the Sponsors received "signals that some kind of [regulatory] change was about to occur in the land use regime. We decided that the agreement had to be finalized within a one or two month period," before those changes would take effect.

According to Fenning, it was important that the agreement contain "the highest tier of rights" available under Chinese law. Such rights would allow the Sponsors to grant a mortgage upon the rights to lenders as security for loans. The agreement also had to be for a satisfactory duration. Since it was contemplated that the project would be transferred to the Power Bureau after 20 years of operation, the land agreement had to last at least that long.

The land use rights were to be negotiated between Fujian Pacific and Land Administration Bureau of Putian City, Fujian Province ("the Land Bureau"). This negotiation was not extremely difficult: Because the project would bring jobs and money' to the area, the local government was a strong supporter of the project. In addition, officials in the Land Bureau were aware that the provincial government was also firmly behind the project. These officials did not want to be perceived or portrayed as putting up obstacles to development of the project.

Although the land officials were not interested in being inflexible or difficult regarding terms of the Land Agreement, they were not lawyers and they had never negotiated

anything resembling the type of agreement that the Sponsors sought. By tradition, written agreements in China tend to be extremely short and vague. The lawyers for Sponsors, on the other hand, needed a detailed agreement: potential lenders would not accept a vaguely worded document when there were hundreds of millions of dollars on the line.

Fenning recalls that it was a process of "educating the local officials about why we needed what we needed. Our job was to get them to understand the requirements of international financing." For example, there would have to be provisions in the agreement spelling out the circumstances under which the agreement could be terminated by land bureau. While the land bureau wanted simple terms providing that the agreement could simply be terminated for a "material breach," Fenning needed more specific language, setting forth a procedure by which Fujian Pacific could cure a breach before termination. (See Article 19 of the Contract for the Grant of State Land Use Right, attached to the case as Exhibit E.) Lenders would not feel secure with a mortgage on rights that could evaporate at any moment. Lenders also needed to feel that the plant would continue to operate, and generate cash flow, despite any minor unforeseeable occurrences; a default by Fujian Pacific in obligations under the Land Agreement could result in a shut-down of the plant.

The negotiations were further complicated by the fact that they were conducted with the use of translators. Woo was fluent enough in the local dialect so that she had been able to negotiate directly with land bureau officials. Fenning, however, did not speak any form of Chinese. The use of translators led to frequent misunderstandings. The lack of direct communication made it difficult to establish a rapport with the Chinese, for whom personal trust was a critical aspect of transacting business. All of these factors made the negotiation more strenuous and protracted than necessary.

In the context of other agreements, such dilatory factors might have been accepted calmly by the negotiators as part of doing business in China. In the case of the land agreement, though, such patience was in shorter supply: the Sponsors feared the whispers of upcoming regulatory changes.

After two months of intense negotiations, the parties reached accord on the terms of the land agreement. In March of 1997, in a late night ceremony at a small hotel in a village near the construction site, the land agreement was signed by representatives of the Land Bureau and Fujian Pacific.

According to Fenning, the agreement was signed "within one or two days" of when the rumored regulatory change was scheduled to take place. Fenning noted that China is not like the United States when it comes to forthcoming regulatory changes. "There is no notice in the Federal Register," he said. In the week following the execution of the agreement, the central government in Beijing placed a moratorium on the granting of new land use rights to private entities.

### Box 3: Environmental and Social Considerations

The "land" issues in Meizhouwan transcended the Land Agreement to include environmental and social concerns. Because the ADB was involved in the Project as an equity owner and lender, the Sponsors had to comply with ADB procedures for assessing social and environmental impacts of the Project. The ADB requires that social and environmental impact statements be prepared by project sponsors; these statements are meant to identify impacts and set forth various alternatives and/or mitigants.

Projects supported by the Bank are intended to have a positive effect, especially on the poor who have limited opportunities for earning incomes. However, certain projects (e.g., urban upgrading, watershed protection, power, road and railroad projects) may have adverse impact on some population groups. The adverse impact may derive from requirements for them to be resettled involuntarily, loss of livelihood, price changes which are caused by the project or program, or adverse change in their environment which would be caused by the project. It is necessary to identify vulnerable groups which may be adversely affected by a project and formulate measures in consultation with these groups to avoid, mitigate or compensate them for the adverse effect. Specific policies on this issue are being drafted for consideration by the Board of Directors. Until such time as these policies have been adopted, staff are advised to refer to World Bank's *Operational Directive 4.20: Indigenous People* and *Operational Directive 4.30: Involuntary Resettlement*.

In projects where it is not possible to design the project in a way which does not adversely affect a group, the groups that may be adversely affected should be identified. A socioeconomic profile should be prepared for each group which will be the basis for quantifying the adverse impact on the group. Meetings should be conducted with each group to obtain their views and priorities for measures which may avoid or mitigate the adverse impact, and about options for mitigating the adverse impact. It will be necessary to formulate and obtain the group's concurrence for provisions to compensate them for the adverse impact. It may be desirable for these analyses to be conducted or directed by persons who have professional skills in resolving conflicts. It is also recommended that notes be recorded at each step of the process for future reference.

*Source: Handbook for Incorporation of Social Dimensions in Projects, Asian Development Bank (1994).*

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The execution of the Land Agreement was merely the first step in a long process to secure land use rights. The agreement by itself was insufficient to obtain the "land rights certificates," which were required in order to record the mortgage on the land rights that was a necessary part of the anticipated non-recourse financing. Under applicable Chinese laws and regulations, such agreements were subject to approvals by various government agencies.

Depending on the amount of land involved, the agreement had to be approved by a chain of agencies, with the largest land agreements subject to approval by provincial and Beijing authorities. In the case of Meizhouwan, the Sponsors and their counsel determined that the highest level of necessary approval was by the Fujian provincial government.

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The big question, according to Fenning, was "would the moratorium apply to us?" Even though the agreement had been signed before the moratorium went into effect, the necessary approvals had not been obtained before that date. Although the Sponsors did not anticipate that the provincial government would *want* to reject the agreement, because it strongly supported the project and desperately wanted more power production, they became nervous that provincial officials would hesitate to sign off on the agreement in light of the moratorium. In China, says Fenning, there is "no case law or recorded administrative practice to guide you" as a lawyer.

The Sponsors submitted the agreement to the Fujian authorities for approval. Internally, the sponsors and their attorneys debated about whether they should go to Beijing and seek clearance for provincial sign-off. This became a moot point when the Fujian government approved the agreement and authorized the issuance of the land rights certificates.

Counsel were initially concerned about the long-term validity of these certificates, fearing that the central government might revoke them as improperly obtained in violation of the moratorium. However, their fears were eased slightly by informal communications with provincial officials, who indicated that they would not have given their approval unless Beijing "knew what was going on." In communicating with his clients, the Sponsors, about the situation, Fenning said he used language that he had learned from many years of practice in developing countries: "I will give you my best sense about what I think will happen, but it could be wrong."

Fenning and the other lawyers were aware that the issuance of the certificates was not the end of the land agreement ordeal. Although the Sponsors had to have all important agreements in place before looking for commercial financing, those lenders would certainly exercise their right to reopen negotiation of any Project agreement they saw as allocating too much risk to the Sponsors, and thus, the lenders.

Questions for consideration:

1. As counsel to the lenders, which specific provisions of the Land Agreement would you caution your clients to be concerned about?
2. Do you think the lenders were really concerned about their ability to mitigate losses by selling the land rights in the event of a default by Fujian Pacific? Or were there other reasons they were interested in a strong Land Agreement?
3. As counsel to the lenders, what changes to the Land Agreement would you recommend?

## The Power Purchase Agreement

The PP A is the central agreement in the development of any power project. Negotiated between the owners of the project and the eventual customers of the project prior to construction of the facility, the PP A establishes how much power the customers will buy from the finished plant and at what rate. Without such an agreement in hand, investors and financiers would in almost all cases be unwilling to layout the enormous amount of capital necessary to build a power plant

The overarching goals of the parties to a PP A are simple. The project wants certainty with regard to its future cash flow, which it will need to recover its costs, make a satisfactory return on equity and service its debt obligations. The project requires a firm commitment from the purchaser that it will buy power over the term of the agreement, regardless of need, at a price that will provide sufficient cash flow. The customer wants a reliable and predictable source of power at a reasonable rate.

Within these large goals are many objectives relating to the allocation of risk between the parties. For example, in what circumstances will the customer be able to take less power or take power at a lower rate? In what circumstances will the project be excused from producing promised energy? To the extent that its costs rise due to unforeseeable occurrences, will the project be able to raise its rates? Or will it simply have to absorb the economic losses?

Desiree Woo was one of the chief PP A negotiators representing the Sponsors and Fujian Pacific. A 1993 graduate of UCLA law school, Woo began working on the Meizhouwan PP A at the outset of negotiations in April of 1994, while based in Milbank's Los Angeles office. Born in Hong Kong, Woo could read Chinese, and could speak Mandarin and Cantonese. She explained that while she considered herself fluent in those dialects, it was still often difficult to communicate with people in Fujian province. Even within Fujian, many dialects of Fujianese are spoken. However, she was the best-suited among the Milbank attorneys to participate in the PP A negotiations and help draft the PP A, which had to be drawn up in both English and Chinese.

Perhaps even more important than her familiarity with the language, Woo understood Chinese thinking with regard to business matters. She knew, for example, not to expect "perfect" documentation to result from negotiations with the Chinese government. The long, detailed agreements that U.S. attorneys, businesses and lenders were used to seeing would be difficult to obtain from negotiations with the Chinese.

. After a period of time in which she was "flying back and forth a lot" between Los Angeles and China to work on the deal, Woo moved to Milbank's Hong Kong office. Woo recalled that, at the first meeting between officials from the Power Bureau and representatives of the Sponsors regarding the PP A, "we showed up with a fifty page

#### Box 4: Electric Power Pricing

" The central government formerly was the only investor in the electric power industry and it set prices to recover only the operational cost of generating power. Without sufficient income from the sale of electricity, China's electric power sector lacked funding to build new power plants and maintain old ones.

In 1985, realizing the need for reform, the Chinese government implemented a new policy for setting electricity tariffs on projects financed by local and foreign funds. The goal was to minimize expenditures from the central government and use market forces to encourage the development of power projects. The price of electric power from such projects was allowed to reflect the cost of financial sources.

In 1987, the Chinese government implemented a "fuel cost rider" policy. Under this policy, changes in fuel costs or fuel transportation costs could be passed through in power tariffs to keep overall profit levels constant. Before this reformation, the price of electric power was fixed once the power project went into operation.

In 1988, the Chinese government imposed a fee to collect funds for developing the power industry. The fee was RMB 0.02 Yuan per kilowatt-hour, which was imposed on industrial consumers' electricity bills. Starting in 1996, this fee was extended to residential electricity bills. To help defray costs of building the Three Gorges Dam, the government added a fee of RMB 0.003 Yuan per kilowatt hour in 1993 and raised the fee to 0.004 Yuan per kilowatt-hour in 1994 and then to RMB 0.007 Yuan per kilowatt-hour in 1996.

In 1997, the Chinese government intensified its effort to reform electricity tariffs. Authorities adjusted rates to compensate more for changing fuel and transportation costs, and to recover loans for new power plants. They also raised prices for residential users and industries with high capacity demand. The government also reduced fees unrelated to power consumption for funding local development, education, and even birth control programs.

China still uses two types of tariffs: the old "instruction" prices for state-owned power plants and "guidance" prices for new power plants that use funds from other sources, though the gap between the two types is decreasing. The government hopes to unify the price of electric power within grids soon, but many obstacles remain. The government still controls prices for some residential customers, large state-owned enterprises, and agricultural consumers. Subsidiaries to these sectors are decreasing but have not been completely abolished, particularly for irrigation.

*Source: China's Electric Power Options: An Analysis of Economic and Environmental Costs (Draft Final), Advanced International Studies Unit (June 1998).*

agreement" The Power Bureau countered with their own preferred form, which was "about five pages long." As with the land agreement, the PP A negotiating process involved convincing government officials that international financiers would require greater detail. Prior to Meizhouwan, the Power Bureau had negotiated such agreements with state-owned enterprises. They were accustomed to working by the "old role book" Joseph Chiang described.

One of the major risk allocation issues in the Meizhouwan PP A was the issue of *political force majeure*. (There is another type of *force majeure*: *natural force majeure* that encompasses events beyond the control of either party, such as floods, earthquakes and the like.) the purposes of the *political force majeure* clause are, first, to specify the events that constitute *political force majeure* events (e.g., policy changes, leadership changes, nationalization of private property, expropriation of foreign holdings, civil strife, currency inconvertibility, or war) and, second, to set forth how the obligations between the parties will

#### Box 5: Political Risk in PRC Power Projects

A project's success will depend on a supportive legal and regulatory environment. Such an environment should permit the project company to grant a meaningful security package to its financiers which cannot be retrospectively challenged or, ultimately, expropriated by state entities without cause or adequate compensation. It should also include a system which enables the project to obtain and maintain the consents and approvals it requires to operate the project, including permits to repatriate debt service to its banks and profits to its foreign shareholders. Finally, it should provide a reliable and meaningful means of redress and enforcement for breach of contract by other project participants.

Banks will increase the cost of their funding commensurate with their perception of the scope for arbitrary central or provincial government action in respect of the project. The risk of expropriation without compensation (covering at a minimum, the project's outstanding debt), or the imposition of, for example, a punitive tax regime which penalizes the project will obviously affect the project's viability; these are risks that are generally neither commercially insurable at acceptable rates nor can they be effectively passed off to other project participants. The cost of debt finance in respect of a politically high risk project could therefore be prohibitive, or commercial debt could be unobtainable.

Banks will also endeavour to ensure that the project contracts forming part of their security package, including the PP A, are governed by a legal system that is predictable and impartial, and will favour New York or English law in this regard. However, a PP A [in the PRC] must select PRC law as the governing law. As a practical matter, it would be difficult to obtain the agreement of the PRC party to submit to arbitration in a foreign jurisdiction. Furthermore, while the PRC is a party to the *New York Convention on the Enforcement of Foreign Arbitration Awards*, in practice it is difficult to enforce foreign judgments in the PRC. It is therefore usual for disputes to be subject to resolution by arbitration with the China International Economic and Trade Arbitration Commission ["CIETAC"] as the governing body.

Banks have historically looked to bolster their security package by obtaining project support from multilateral agencies in the form of direct project loans from institutions such as the Asian Development Bank or cover from international export credits agencies ("ECAs").

*Source:* Richard H. Lawrence, III and John Mitchell, *Project Screening: Avoiding the Pitfalls*, in *Power in China*, Sorab, ed., Asia Law and Practice Publishing, Ltd. (1998).

be modified if and when one of these events should occur.

With regard to the first part of the *political force majeure* issue, i.e., identification of

events that would be treated as political *force majeure* events, the Meizhouwan the Sponsors were particularly concerned about changes in law or regulations that might affect the

operation and/or profitability of the project.

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In general, in a contract between a host government and a private entity, the risk of such changes is allocated to the government. The idea is that because the government makes the laws and regulations, it can control the risk, and therefore should bear the responsibility for the effects of changing its roles. In Meizhouwan, the situation was not as clear. As part of the overall trend toward "market socialism" in China, the Power Bureau had, as noted above, been converted to a private company.

In the PP A negotiations, Power Bureau officials insisted that the Power Bureau was a private corporation, and thus had no control over changes in law or regulation by either the provincial or central government. This being the case, they argued, they should not bear the risk of the effects of such changes. The Sponsors' view was that, regardless of the change in its form, the Power Bureau remained in a better position to control changes in law than the Sponsors did. In any case, the Sponsors needed assurance that in the event of a change in law that significantly hindered the project's ability to generate sufficient cash flow, they would be released from their obligations and compensated for sunk costs.

In the end, the Power Bureau gave in to this request. Again, the overriding factor appeared to be the genuine need for power in the province. The Power Bureau agreed that it would make the Sponsors whole in the event of a change in law resulting in a material impact on the economic benefits to the Sponsors. Woo says that the Sponsors\_ while aware that such a promise required some parallel understanding between the Power Bureau and the provincial and central governments, never inquired as to the form of that understanding. "They did something 'internal,'" she said, "that we didn't really want to know about. As long as there was some mechanism in place to protect us, we didn't care what it was."

As with the Land Agreement, the lenders later requested changes to the PPA, seeking greater clarity and risk transfer to the Power Bureau. A summary of key PPA provisions after lender renegotiation is attached to this case as Exhibit F.

Questions for consideration:

1. If you had been counsel to the lenders, which provisions do you think you would have been particularly concerned with?
2. Can you identify provisions that could have been strengthened further?
3. Does decentralization/federalism matter?
4. How does reform of the energy industry affect this project?

## The Engineering/Procurement/Construction Contracts

Unlike the land agreement and the PP A, the EPC contracts in Meizhouwan illustrate risk allocation issues that occur uniformly regardless of where a project is undertaken. They differ significantly from those other agreements in that they were not negotiated with government officials, but with foreign (U.S.-based) corporations. The EPC contracts set forth the terms by which the facility would actually be designed and built.

For the most part, the EPC contracts were offshore agreements. In other words, they were executed and performed outside of China. There are several reasons for using offshore agreements. First, the tax consequences on the contracting parties can differ greatly depending on where the agreement is based and the work is performed. Work performed offshore is not subject to local Chinese tax, which tends to be high. The second reason that offshore agreements are favored is that they are not subject to Chinese arbitration in the case of disputes. Unlike in the case of onshore agreements, parties to offshore agreements could designate the national law governing contract interpretation. To the extent possible, the parties contracted so that as much work as possible was done offshore. Only work that absolutely had to be performed in China was covered by onshore agreements.

Risk allocation in the EPC contracts was heavily negotiated. The three general for example, - did the Construction contractor accurately follow the design?; (2) the schedule of completion; and, (3) performance of the finished facility: does the finished plant do what it is supposed to, *i.e.*, produce a certain amount of power at a certain rate of efficiency, within environmental constraints? The key questions that had to be answered in each of the contracts with respect to each of these issues were:

- a. What constitutes satisfactory performance? What constitutes a breach of contract? In what cases will a party be rewarded from performing beyond the requirements of the contract, for example, by completing work early? Who is responsible for cost overruns?
- b. What are the parties' respective rights in the case of a breach? What are the appropriate liquidated damages?
- c. How are disputes between the parties to be resolved?

The control of design, construction and operating costs was extremely important in Meizhouwan. In any project, control of costs is important to economic feasibility. Proof of feasibility is obviously critical to attracting finance and capital.

Like the other agreements in the project, EPC contracts were subject to a second round of negotiation with lenders' counsel. A summary of key EPC provisions in the final contracts is attached to this case as Exhibit G.

Questions for consideration:

I. As counsel to the lenders, which areas would you be particularly concerned about?

2. How would you have attempted to modify these provisions to provide greater security for your clients?

### **Case Study Exhibits**

Exhibit A: Glossary of Project Terms

Exhibit B: PRC Wholly Foreign-Owned Enterprise Law and regulations

Exhibit C: Summary of Project Financial Structure

Exhibit D: Summary of Project Risks and Mitigants

Exhibit E: Contract for the Grant of State Land Use Right

Exhibit F: Summary of Power Purchase Agreement

Exhibit G: Summary of Engineering/Procurement/Construction Contracts