

## **Excise Tax considerations by Enemalta**

Reference is being made to the concession made by Enemalta to pay excise tax on behalf of Electrogas as per the provisions of the Conversion Term Agreement entered between the parties.

### The Situation

Although an Implementation Agreement was in force such that both the Gas Facilities and the Electricity Facilities had reached an advanced stage of completion, the parties (Enemalta and EGM) were **still awaiting the endorsement from the European Commission of the Security of Supply Agreement**. Until that point, both parties had the right to terminate the agreement which would have resulted in Enemalta taking over the facilities at cost (plus a project management fee).

In the meantime, the **capital costs incurred by Electrogas on the project had increased significantly from Euro 350 million to around Euro 500 million largely because of additional investment in Storm Mooring Equipment to protect the FSU during bad weather**.

Moreover, **due to the prolonged negotiations, EGM had lost the rights over chartering the FSU originally contemplated in their tender** and had to source an alternative at a considerably higher charter operating cost.

The consortium faced several **other unexpected issues which meant that their expected internal rate of return (IRR) reduced considerably from around 11% to about 6% throughout the lifetime of the project**. This fact confirms that the project was subject to considerable construction and interface risks.

Moreover, **the original financial model prepared by EGM for their lenders did not factor in the Excise Tax** which meant that the Internal Rate of Return would have been reduced even further. **This notwithstanding, the project would still have been commercially attractive for both parties**. This is mainly because most of the commercial gains would have been made through differences between the **Guaranteed Heat Rate** and the **Actual Heat Rate** arising from the use of the Electricity Facility. The lower the heat rate, the higher the efficiency and profitability.

**In simple terms, the Heat Rate is a factor used to convert Gas Prices into Electricity Charges and represents the overall efficiency of the plant. Guaranteed Heat Rates were requested as part of the tendering process which would be used as the basis for determining Energy Delivery Payments irrespective of the actual heat rates. A Guaranteed Heat Rate provided Enemalta with more stability and predictability in the actual costs to be incurred for disbursements against Energy Delivery Payments.**

The **Guaranteed Heat Rate** pledged by EGM was set at 7.2 but varied depending on several factors such as dispatch patterns, ramp up and ramp downs amongst others. The **Actual Heat Rate** was expected to be lower (by about 4-5%). This mechanism incentivized EGM to maximise the maintenance and efficiency of the plant since lower actual heat rates would mean higher levels of profitability. In this context, **the project became attractive largely because of the potential gains made from the difference between the Guaranteed Heat Rate and the Actual Heat Rate.** Such gains however could not be factored in by the Banks since they were hard to measure and predict.

#### Options faced by Enemalta

At the time EGM requested Enemalta to bear the cost of Excise Tax, the project was already at an advanced stage of completion. Given that EGM were still entitled to contractually terminate the agreement pending the endorsement of the Security of Supply Agreement, Enemalta had two options to consider.

##### **(i) Reject EGM's request to bear the cost of the Excise Tax**

Under this option, EGM would have relinquished the project as it would have been entitled to do so in terms of the prevailing Implementation Agreement. **This would have required Enemalta to take over the project (including all operational contracts) and reimburse the capital costs incurred until that point plus a project management fee.** Although this option would have been feasible, Enemalta would still have been required to source the financing necessary to take over the operation. **The cost of the excise tax would still have been borne by Enemalta since it would have become the owner of the facilities.** Moreover, the debt associated with the project would have significantly increased the gearing ratio of the company at that point in time.

##### **(ii) Concede the request to bear the Excise Tax Costs and negotiate other Terms**

Under this option, EGM would remain responsible for financing, managing and operating the project subject to Government conceding the payment of the Excise Tax Cost. The operational risks of the project would continue to be borne by EGM which would still be required to provide the Gas and Energy requirements under the new conversion term agreement.

### Negotiated Additional Benefits

To counterbalance the additional costs to be borne by Enemalta, the following additional benefits were negotiated:

1. **A Heat Rate Credit equivalent to 10% generated from the proceeds arising from gains made by EGM from the difference between the Guaranteed Heat Rate and the Actual Heat Rate of the Energy Facilities.** Enemalta was entitled to the upside risk but was not exposed to any downside risk arising in the case where the difference was negative. Assuming a gain of 4% on the Actual Contract Quantities (ACQ) of Gas of 14,000,000 MMBTU this translates into 560,000 MMBTU of LNG that could be sold in the open market. During the year 2022 alone, the average price of European Natural Gas (Not in liquified form) amounted to around US\$ 40 /MMBTU. With a share of 10% of proceeds, Enemalta would have benefited from around **US\$ 2.2 million** during that year.

2. **Additional Penalties for non-performance.** These include:

- Delivery Gas Credits** payable to Enemalta as a result of Turbine Outages capped to **€1.5 million** each year
- Gas Facilities Credits** payable to Enemalta due to the availability of the Gas Facilities falling below 90% of the contracted capacity capped to **€1.2 million**.
- FSU Unavailability Credits** payable to Enemalta due to the FSU not being available to receive a gas cargo (in the case where LNG is supplied by Enemalta during the Energy and Gas Conversion Term) capped to **\$1.5 million** each year.
- Trip Credits** equivalent to **€10,000** per plant trip beyond a stipulated number of reasonable trips per year.

### Negotiated Package

These discussions were complementary to a comprehensive Enemalta-Electrogas Negotiated Package which comprised further issues :

The Enemalta Negotiations Team had long discussions with Electrogas team on different aspects of the agreements. This involved inputs from specialists, banks to make sure project is bankable. This involved multiple aspects of the final agreement which included various positives for Enemalta.

Enemalta required a balanced approach to ensure that project would be bankable and viable and ensuring that returns were fair (confirmed by the EC).

More specifically the final package included:

- **Fixed price for 5 years and an indexed price for a further 5 years.**
- **A reduction of the LNG supply requirements from 16m MMBTU to 14m MMBTU.**
- **The contract period of LNG supply as stipulated in the tender was 18 years and this was reduced to 10 years.** This was done in light of Government's vision for the implementation of a pipeline. The option of renegotiating a gas deal in the future is still an option. Alternatively Enemalta could procure it's own Gas. **This provides flexibility.**
- **After the 10 years Enemalta negotiated the option to either keep using the Electrogas Gas facilities or exercise the Gas exit option and take over the Gas facilities.** This gave Enemalta more options depending on progression in the implementation of pipeline and the policy of Government at the time. **Gas exit option reduces EGM IRR 7.5% to 6% in favour of Enemalta.**
- **Guaranteed availability payments reduce over time even though Electrogas reduces its efficiencies due to plant degradation.** This results in savings for Enemalta.
- **In the tender model, the Heat Rate efficiency was regressive as the heat rate increases over time. Enemalta negotiated that heat rate would be reset after every machine overhaul.** This would result in savings for Enemalta.
- **Tender stipulated a guaranteed heat rate for payment.** In practice operators will improve efficiency and make a profit by burning less gas and selling this. **Enemalta negotiated that when heat rate gains are**

**made the corporation would receive 10% of the proceeds. This is a significant gain.**

- **Benefits on Energy delivery payments and increased flexibility. Also the take or pay obligation allows Enemalta to sell on the market if required.**

It is worth highlighting as a side point that the projected capital expenditure increased from 350m to over 500m. However, there was **no impact on tariffs or Enemalta payments** unlike the cost overruns in other capital projects such as the interconnector project. The downside was borne by Electrogas.