Project Finance and Guarantees

April 1995

Private Sector and Infrastructure Vice Presidency • Project Finance Group

Guarantees Improve Terms of China's Private Borrowing

The Yangzhou and Zhejiang Thermal Power Projects

China suffers from a shortage of electrical power. The difference between peak demand and supply of electricity is currently estimated to be 10-20 percent in most areas. In addition, China's economy is projected to grow by at least 8-9 percent annually over the next five years. In order to meet the parallel increase in electricity demand and overcome the current shortage, China will require about 100,000 megawatts of new power-generating capacity by the year 2000. This additional capacity will require investment of approximately US$15-20 billion per year, much of which is expected to come from off-shore sources.

In 1993, China borrowed approximately US$6.8 billion in world financial markets. A significant portion of this borrowing was raised by large Government agencies, such as the China International Trust and Investment Company (CITIC) and Guangdong International Trust and Investment Company (GITIC), which have access to foreign exchange. Though China's sovereign debt carries an above-investment-grade rating (BBB+/A3), it has been unable to attract long-term private debt capital—the average maturity of its 1993 borrowings was only about six years. Lack of long-term financing can be an impediment to development because infrastructure projects require long-term debt in order to match debt service with revenues.

Over the past year, World Bank guarantees enabled China to obtain long-term (15-year) private financing at favorable terms for two public sector infrastructure projects, the Yangzhou and Zhejiang thermal power projects. The guarantee for the Yangzhou project marked the first use of a World Bank guarantee in China, while the guarantee for the Zhejiang project, in addition to enabling China to borrow long-term funds, presented an opportunity to improve the terms of the financing while reducing guarantee coverage. The Zhejiang guarantee also incorporates a guarantee release option for lenders, the first time such an option has been included in a World Bank guarantee.

The Projects

Both projects involve construction of large, coal-fired thermal power plants and expansion of related transmission networks. The projects will be implemented by the state-owned provincial utilities on Jiangsu and Zhejiang. Total financing is US$1.1 billion for the 1,200-megawatt Yangzhou project and US$1.6 billion for 1,800-megawatt Zhejiang project. The projects represent a major expansion in the generating capacity of their respective provinces (about 15% in Jiangsu and 27% in Zhejiang). The Bank is also providing direct loans to each project.

The Bank's Guarantees

Partial credit guarantees were used for both projects. The partial credit guarantee covers a portion of a financing against all risks. This contrasts with the partial risk guarantee, which can cover up to the entire amount of a financing against specific risks.

The guarantees were structured to extend the maturity of commercial loans and provide

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The Bank's guarantee takes one of two forms: partial credit or partial risk. *Partial credit* guarantees are typically used for sovereign borrowings to extend maturity. *Partial risk* guarantees, in contrast, are typically used to attract private financing to private sector projects which would not otherwise be able to obtain financing. In these cases, the Bank backs government obligations made to a private sector project. The Hub Power Project in Pakistan, which reached financial closure in December 1994, used partial risk guarantees to mobilize US$360 million of its financing. It will be the subject of a future Project Finance and Guarantees issue.

Public Disclosure Authorized

Guarantee fees for private sector projects are coverage-specific and are set on a project-by-project basis. The fee ranges from 0.40% to 1.0% per year and is applied on the guaranteed amount. However, to maintain its uniform pricing policy, the Bank returns to the government any guarantee fee exceeding 0.25%, thereby making the net cost to the government 0.25%

China with greater flexibility in accessing world financial markets, e.g., interest rate (fixed or floating) and currency (to match procurement contracts). At the same time, the Government and Bank wished to minimize their exposure under the guarantee. The borrowing terms and guarantee structure for each project are summarized in the table on the following page.

The Bank's guarantee for Yangzhou covers, on an accelerable basis, repayment of principal outstanding from year 10.5 onward on a US$120 million equivalent loan, comprised of dollar and yen tranches. This means that lenders are taking risk on principal repayments and interest payments due prior to year 10.5.

The guarantee for Zhejiang improved on the Yangzhou structure by covering, again on an accelerable basis, repayment of principal outstanding from year 11 onward on a US$150 million equivalent loan, also structured in two tranches as in Yangzhou. In addition to stretching the uncovered term of the loan, the pricing on the Zhejiang loan was improved, resulting in a lower borrowing coast to China.

Benefits of the Guarantees

The Bank's guarantees offer China several benefits:

- Maturity—the 15-year maturity for both financings is significantly longer than that available to China without use of the Bank's guarantee (about six years at the time of the Yangzhou transaction).
- Cost—the financing cost is very competitive (see summary table)
- Flexibility—China was able to target the specific market, currencies and interest rates which best fit project needs.
- Leverage—for the Yangzhou project, the guarantee helped China raise US$120 million equivalent while utilizing Bank exposure amounting to only 22% of this amount (US$26 million equivalent, present value basis); for the Zhejiang project, the guarantee is helping China raise US$150m equivalent while utilizing Bank exposure of 20% of this amount (US$30 million, present value basis).

Additionally, the guarantee offers several advantages to lenders. The guarantee provides private lenders an opportunity to participate in a World Bank-appraised project in an important and growing emerging market, in addition to the direct benefit derived from the guarantee itself.

The lenders also have the benefit of an optional cross default provision under the World Bank Loan Agreement, which entitles the Bank to suspend or accelerate all of its loans in the event of default under the commercial bank loan agreement. Reciprocally, the commercial loan agreements also have cross default provisions vis-à-vis the events of default under the Bank loan agreement.

Cost of the Guarantees

Two fees are charged for the World Bank's partial credit guarantee. A standby fee of 0.25% is charged on the present value of the maximum guaranteed exposure during the noncallable period. (The present value is calculated using the Bank's long-term borrowing cost in the currency/ies of the guaranteed financing.) A guarantee fee, in this case 0.25%, is charged on the guaranteed amount during the callable period. The guarantee structure of each project, including the Bank's exposure, is depicted in the diagrams on the following page.

These fees, which are paid by the borrower (in this case, the Government of China), can be paid either on an installment (periodically) or up-front (lump sum) basis. For the Yangzhou project, fees were paid up-front, while for the Zhejiang project, fees will be paid in installments.

A guarantee release option is included in the Zhejiang guarantee, giving lenders the option to cancel the guarantee in exchange for additional loan interest. This option is designed to encourage lenders to re-examine China's credit to take advantage of the higher spread and cancel the guarantee on a voluntary basis. The financial cost to China of the borrowing would remain unchanged.

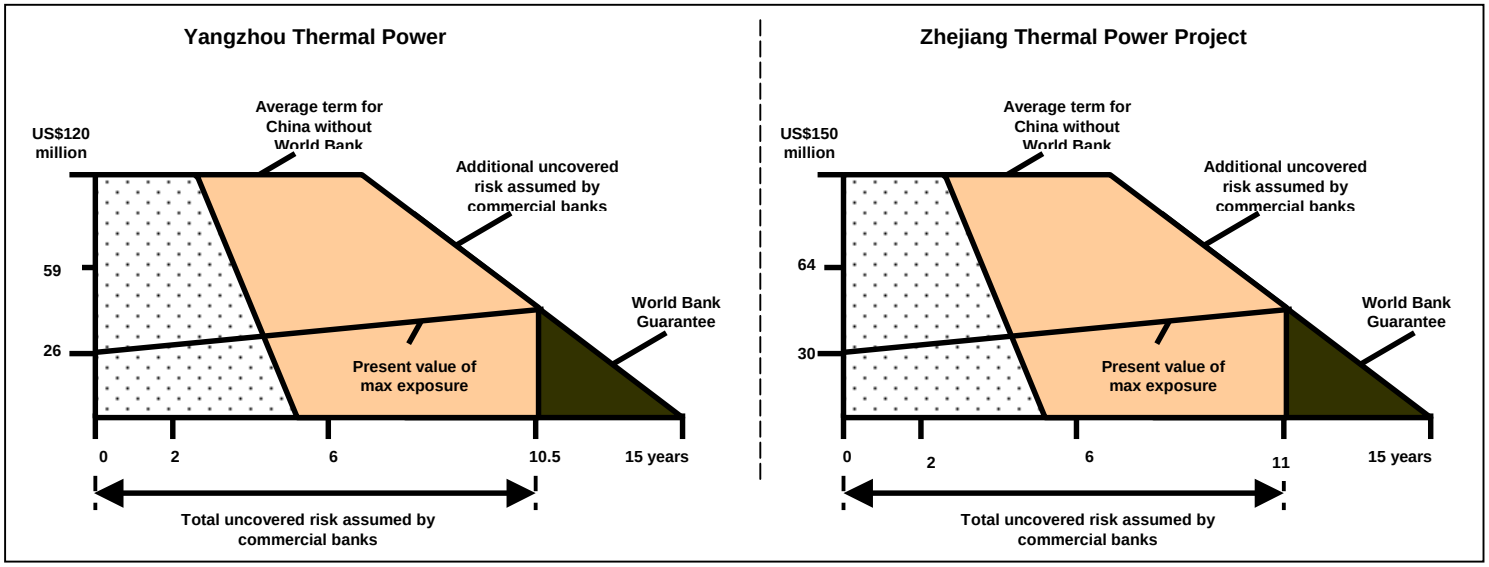
Lending Program Treatment

Partial credit guarantees are counted in a country's lending program at the present value of the maximum exposure. The Yangzhou project, for example, has nominal exposure of US$57 million, or US$26 million in present value terms, since the guarantee is not callable until year 10.5 of the loan (see diagram below).

This leverages the lending program by US$94, or by a ratio of 3.6:1. The Zhejiang project has a leverage ratio of 4:1.

For more information on the Yangzhou, and Zhejiang guarantees, please contact *Mr. Kyoichi Shimazaki* (tel. 202-473-4835), *or Ms. Tomoko Matsukawa* (tel. 202-473-1225)

Guarantee Structures



China: Summary of World Bank-Guaranteed Financings

	Yangzhou	Zhejiang
Financial Closure	May 1994	March 1995 (expected)
Financing Mobilized Under Guarantee	US$120m equivalent in two loans: • US$90m syndicated Eurodollar loan from commercial banks • US$30m equivalent Japanese yen loan from insurance companies	US$150m equivalent in two loans: • US$100m syndicated Eurodollar loan from commercial banks • US$50m equivalent Japanese yen loan from insurance companies
Borrower	People's Republic of China	People's Republic of China
Beneficiary	Jiangsu Provincial Electric Power Co.	Zhejiang Provincial Electric Power Co.
Maturity/Grace	15/5 years	15/5 years
Interest Spread	US$ Loan: LIBOR + 0.4% J¥ Loan: Fixed at 0.3% over the Japanese Long-Term Prime Lending Rate (LTPR) for the first ten years, re-fixed at LTPLR flat for remaining 5 years.	US$ Loan: LIBOR + 0.345% J¥ Loan: Fixed at 0.05% over the Japanese Long-Term Prime Lending Rate (LTPR) for the first ten years, capped at 5.15%, re-fixed at LTPLR flat for remaining 5 years.
Guarantee Coverage	Accelerable guarantee covering principal outstanding over years 10.5 – 15.	Accelerable guarantee covering principal outstanding over years 11 – 15.
World Bank Exposure Under Guarantee	US$59m (48% of total loan)	US$64m (43% of total loan)
Lender's Guarantee Release Option	None	After year 5
World Bank Lending to Project	US$350m	US$400m

To obtain a copy of the brochure, *The World Bank Guarantee: Catalyst for Private Capital Flows*, please call (202) 458-0834. Please direct editorial comments to Andres Londono, tel. (202) 473-2326.