At a Glance

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Risk and Private Power— A Role for the World Bank

James Bond

Nonutility private investors are an increasingly significant source of power sector investment in OECD countries, especially for power generation. This has changed the underlying structure of the electricity sector, triggering efficiency gains and cost reductions that have been passed on to the consumer. However, the trend has not yet evolved to the same extent in developing countries, despite intense interest by project sponsors. The reason is that debt financing for independent power producers (IPPs) in developing countries has been scarce. The crux of the problem is that lenders are reluctant to participate in projects in which they are open to country risk. They don't like lending when repayment of their loans could be jeopardized by arbitrary decisions by the host government. To fix this, as the risks associated with independent power projects are unbundled and distributed among participants in a deal, the lenders must be provided with appropriate cover for country risk. By contributing to a solution to the country risk problem, the World Bank could play an important role in promoting private investment in power. This Note, based on views expressed by private investors during a recent roundtable on private sector power, suggests how this role could take shape.

The potential for independent power in developing countries

There is a significant appetite among IPPs to invest in the developing world. Nearly eighty memorandums of understanding have been signed between IPPs and the Indian union and state governments. More than 100 have been signed with China. IPPs believe that power projects in developing countries have higher potential returns than those in the industrial

World Bank Group Independent Power Producers Roundtable

A roundtable was held on October 22, 1993, grouping key players in the IPP field:

- *Utilities or utilities' distributors* (e.g., AES, Enron, Hydro-Quebec, EdF)
- *Equipment suppliers* (e.g., ABB, GE)
- *Turnkey capitalists* (e.g., GE Capital, SAUR)
- *Financial institutions* (e.g., Indosuez, J.P. Morgan, Chase)
- *Project facilitators* (e.g., LeBoeuf, Lamb, Skadden, Arps)

These industry players provided a number of clear pointers on the private power role for the Bank defined in this Note.

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world, because demand for power is growing rapidly in those countries and the potential for efficiency gains is high.

IPP interest is timely. Governments in developing countries, disappointed with the performance of their public utilities and seeking new sources of *finance for power investments, are starting to court* foreign investors. India, China, Malaysia, and the Philippines are the notable cases. However, when governments try to attract private investment, they often want to lay off all project risk to the investor. While IPPs are rather good at handling most project risks, one risk they cannot manage is the unpredictable behavior of the government itself.

The problem takes form in debt financing. Independent power projects generally are developed on a project finance basis, with sponsors funding part of the project through their equity contribution. This contribution is typically 25–33 percent in developing countries and 10–15 percent or less in industrial countries. The rest is financed through debt, generally from banks. Project developers are unable or unwilling to provide corporate guarantees for the portion of the investment financed by debt, so lenders must look to the robustness of the project itself for guarantees.

To close the financing plan and actually start construction on a power installation, a sponsor therefore needs to be able to negotiate a set of agreements that satisfies not only the government and itself, but also the banks that will be financing the major part of the investment. Some of these agreements relate to the period of construction of the plant (completion guarantees, siting agreements); some to the period of operation (power purchase agreements with the purchasers of the electricity, fuel purchase agreements, agreements on dispatch); and others to the environment in which the project will be undertaken.

There is little significant difference between developing and industrial countries in the way that agreements for plant construction and operation are drawn up. By contrast, the agreements relating to the *environment of the project* differ substantially. Typically, in industrial countries, the project environment belongs to the general framework in which the power sector and private investors operate: the predictability of government decisions and enforceability of contracts, the transparency of the regulatory environment, electricity tariffs that ensure a strong financial situation for the sector, and the convertibility and transferability of currency. But this is the area where lenders for developing-country projects perceive the greatest risk. Governments may, for political reasons, make decisions relating to tariffs that render projects insolvent, or they may devalue their currencies or expropriate foreign investment. Unless lenders feel comfortable that their loans are sheltered from this country risk, they will be unwilling to support a project.

Until now, many of the private investors currently working to launch power projects in developing countries have sought to mitigate country risk simply by requiring the host government to guarantee that the rules of the game will be respected through

What is an IPP?

Independent power producers now account for about half of all new generating capacity in the United States. They generally involve investors who build a power plant and sell the electricity wholesale—either to an existing utility or to one of several large customers.

Independent power projects typically are structured on a project finance basis. Guarantees to the lenders result from the project itself rather than from the project sponsors. These projects require a fairly sophisticated set of contractual arrangements. The contracts generally include the authority to build the plant, a power purchase agreement with the utility or consumers, fuel purchase agreements, and guarantee agreements for project completion, country risk, and the like.

Initial experience with the few independent projects that have been completed in developing countries shows that private developers have a good record for project completion, plant availability, and generation efficiency.

specific support or implementation agreements. Increasingly, however, the value of such government guarantees is being questioned. If, as is usually the case, the government is unwilling to ensure that its public power utility respects the terms of a power purchase agreement, what are the chances that it will respond when its guarantee is called?

Instead, cover for this country risk could be provided in the following ways:

- *Macroeconomic reform.* The best way to address country risk is at the source of the problem: remove all the obstacles that make lenders uncomfortable. But that requires economic and power sector reforms so far-reaching that they would go well beyond a specific project, with a time scale measured in decades rather than months. (In fact, promoting private investment for power, even before the entire investment framework has been put right, can give a significant impetus to the macroeconomic reform process.)

- *Contractual mechanisms.* A second solution is to develop contractual mechanisms that address each aspect of country risk. For example, if the power utility that would normally purchase the output from the IPP is uncreditworthy, electricity could be sold directly to a small number of end users (as in the Colombia power project sponsored by the firm K&M or the Hopewell projects in China). And if the currency is not convertible, the project sponsor could enter into a special agreement with the government making its foreign exchange requirements (for parts, debt service, and dividends) available through the central bank (as in the proposed Songo-Songo project in Tanzania).

- *Obtaining cover from third parties.* Lenders could also turn to third parties for cover. Export credit agencies could provide guarantees. And the International Finance Corporation (IFC), through its "B loan," provides banks (or their regulatory bodies) with comfort against country risk. The IFC acts as lender of record, fronting for commercial banks.

More investors are now turning to the Bank and the IFC for this kind of country risk cover.

A role for the Bank in promoting independent power projects

A fairly clear consensus has emerged from industry players that the Bank can have a useful role in promoting private power, though not necessarily in developing projects itself. Instead, it should find ways to encourage others to invest. The Bank should focus on developing mechanisms to provide cover for country risk, above all to project lenders, without necessarily assuming this role itself.

The following points define a possible role for the Bank.

Dealing with the environment

- *Supporting macroeconomic reform.* Support for macroeconomic reform by its borrowers is part of the Bank's regular stock-in-trade and is probably the most effective way to address country risk. The Bank channels significant resources, both loans and staff time, to this activity: about one quarter of lending during the 1980s went to quick-disbursing structural adjustment operations, designated for macroeconomic reform.

- *Supporting power sector reform.* The Bank's ongoing program of support for power sector reform (described in the recent policy paper, *The World Bank's Role in the Electric Power Sector)* will make power sectors more attractive to private investors by removing major policy obstacles and by making power utilities creditworthy. The program encourages commercialization and corporatization of power utilities, which will make them more viable customers for power from IPPs. For example, the privatization of the Côte d'Ivoire power sector, supported by an energy sector adjustment loan from the World Bank, has lifted a major obstacle to participation by IPPs.

- *Encouraging entry of private investors.* Over and above commercialization and corporatization, the Bank has an important role in promoting competi-

tion: by helping governments to remove barriers to entry for new players (such as by eliminating statutory monopolies for public power utilities) and generally by encouraging regulation that is both transparent and open. Current World Bank support to China and India is a step in this direction.

Dealing with the players

- *Educating the counterparts.* The Bank could assist its borrowers in their dealings with the private sector using an approach developed in the early 1980s for its petroleum exploration promotion projects. For example, the Bank could fund the development of a sector legal and regulatory framework. It could fund the solicitation of bids from investors, the evaluation of the bids, and the negotiation of deals, and, in the case of private-public partnerships, it could assist with financial engineering. In some cases the Bank could also act as advisor to governments, for both government-initiated projects and unsolicited bids. World Bank financing of a project itself would not be automatic or necessarily desirable. The Bank's assistance to China and India, which includes seminars and conferences to pass on negotiating skills, reflects this approach.

- *Working with the private sector.* The Bank will seek to work with the private sector, both as a clearinghouse for information about investment opportunities and as a source of advice and best practice on how projects might be structured. For example, much of the Bank's nonconfidential country and sector data could be made available to private investors, which would reduce their development costs. The recent roundtable, which brought together thirty-five key industry players and Bank and IFC managers, is a beginning.

Dealing with the projects

- *Providing explicit guarantees for country risk.* There clearly is a need for deal-clinching guarantees to private investors, to enable them to mobilize debt financing for their projects. The form of such guarantees would depend on country creditworthiness and the structure of the project. A case-by-case approach would be required to determine whether the Bank's expanded cofinancing operations (ECOs), the sponsorship trusts managed by the Multilateral Investment Guarantee Agency (MIGA), or other mechanisms are the most appropriate. The private power operations proposed in Côte d'Ivoire and Tanzania (Songo-Songo project), both countries perceived as having high political risk, will be interesting test cases for the Bank.

- *Delivering wholesale finance.* Private sector sponsors believe that there is little role for the Bank's standard government-guaranteed loans to finance private power projects. However, there is significant scope for the Bank to develop financing mechanisms that could tap domestic savings in developing countries to fund infrastructure projects. These mechanisms could include domestic debenture markets, domestic investment guarantee agencies (as proposed for Mexico), and rating agencies.

James Bond, Principal Energy Specialist, Finance and Private Sector Development

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Comments are welcome. Please call FPD Note line to leave a message: 202-458-1111. Suzanne Smith is the editor and production manager. Her address is Room G8105, The World Bank, 1818 H Street, NW, Washington, DC 20433 or Internet address ssmith7@worldbank.org.