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Project Finance and Guarantees

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Cofinancing and Financial Advisory Services Vice Presidency • Project Finance Group

World Bank Guarantee Sparks Private Power Investment in Pakistan

The Hub Power Project

What is Project Finance?

Project finance, sometimes referred to as limited-recourse finance, refers to financing structures under which lenders look to project cash flows for debt repayment and to project assets for collateral. In deciding whether or not to lend to a project, a lender bases its decision on an evaluation of a project's—not the sponsors—creditworthiness. In the event of default, the liability of project sponsors is limited to their investment in a project.

The Hub Power Project marks the first use of a World Bank guarantee for a private sector project and is a major step forward in the Bank's effort to increase private sector investment in infrastructure. In addition, the project sets several milestones for the Bank:

- *first* use of a partial risk guarantee;
- *largest* private sector infrastructure project supported by the Bank to date;
- *first* Bank-financed infrastructure fund to support private sector projects; and
- *first* co-guarantee with another financial institution, the Japan Export-Import Bank.

Financial closure occurred in January 1995, putting into place nearly US$1.8 billion in equity and long-term debt financing required to refinance construction bridge loans and complete the project. Construction of the 1,292 megawatt power plant began in early 1993 and is expected to be completed by 1997. The project is located about 40 km outside Karachi.

The Bank's guarantee, which protects commercial lenders against sovereign risks associated with the project, establishes a new method of supporting build, own, operate (BOO) projects which are normally financed on a project finance or limited-recourse basis. Prior to Hub, Bank guarantees were utilized as cofinancing instruments designed to help mobilize commercial funding for Bank-supported public sector projects. It is expected that the Bank guarantee for the Hub project will serve as a model for future guarantees in support of other BOO projects.

Project Overview

Bank involvement in the project dates back to the late 1980s, when Pakistan initiated an energy sector adjustment program with Bank assistance. A key element of the program was the opening of the power sector to private investment To this end, the Bank, along with several bilateral donors, established the Private Sector Energy Development Fund (PSEDF). PSEDF, a Government-owned facility, provides debt financing of up to 30% of the financing needs of private sector energy projects. Project sponsors are expected to mobilize 20-25% equity and raise the remaining 45-50% of the funding in domestic and international financial markets.

A special-purpose project company, Hub Power Company (HubCo), was established by private developers in Pakistan to own and operate the power station. The sponsors, which led the development and negotiation process, were Xenel Industries of Saudi Arabia and National Power of the U.K. HubCo will build, own and operate the conventional, oil-fired steam plant. The transmission interconnection between the plant and the national power grid is being handled by the Water and Power Development Authority (WAPDA), partially financed by a Bank loan.

Hub is important to Pakistan for several reasons. In addition to being the largest private sector project in the country, it demonstrates investor confidence in the expansion of the private sector's role in infrastructure development. The project also played a significant role in the formulation of the Government's long-tem strategy to attract private investment to the power sector and the development of model independent power contracts. As a result, several follow-on projects are expected to be completed relatively quickly. Finally, the project will expand Pakistan's generating capacity by approximately 20% and ease power shortages that currently constrain economic growth.

Financing Structure

The total financing of US$1.8 billion includes US$1.7 billion equivalent in foreign exchange and about US$100 million equivalent in local costs. The capital structure is 20% equity and 80% debt—the debt is mobilized on a project finance basis. Included in the financing plan are costs associated with the turnkey construction contract, development costs, interest during construction and other finance-related costs, as well as a reserve contingency fund.

Accelerability and Guarantees

If a loan is accelerable, lenders can demand payment of the unpaid balance if specified events of default occur. Under an accelerable guarantee, the unpaid balance of guaranteed exposure (which could be different than the unpaid balance) would be payable by the Bank upon call of the guarantee. Prior to call of the guarantee, however, all remedies specified in project agreements must exhausted. In contrast, under a nonaccelerable guarantee, each individual payment is, in effect, guaranteed, and the guarantee would be called each time a payment default occurs.

The Sponsors contributed a significant portion of the project's total equity. Other equity sources include Commonwealth Development Corporation (CDC) of the U.K., Entergy, Xenergy and other offshore and local investors. An innovative feature of the project's financial structure is the US$102 million global depositary receipt (GDR) issue underwritten by Morgan Grenfell, U.K., the first GDR issue for an independent power project.

The amount of debt financing required for the project (US$1.4 billion) necessitated that it be raised from a variety of sources, including PSEDF, foreign commercial banks supported by partial risk guarantees from the World Bank and J-Exim, and political risk insurance from export credit agencies of France, Italy and Japan, local commercial banks, and CDC. Other large private sector infrastructure projects will likewise be obliged to obtain debt financing from many different sources, given the exposure limitations of lenders, insurers and guarantors.

Contractual Framework

A key element of project finance is the apportioning and allocation of risks, a difficult and complex process even in developed countries. In a developing country such as Pakistan, the process is substantially more difficult. There is often a lack of precedents to build on, and the process is further hampered by and undeveloped legal regulatory environment.

Under Hub's commercial arrangements, project-specific risks (completion, performance operation and underwriting risks) are assumed by equity investors and lenders, while sovereign-or political-risks are assumed by the Government (GOP) and its agencies. These risks are identified and allocated via the project's contractual framework, which comprises the following main agreements:

- *Implementation Agreement (IA)*
  Overall project implementation is being undertaken within the provisions of this 30-year agreement between HubCo and GOP. The IA grants HubCo the sole right to develop the project and defines each party's responsibilities during the construction and operation phases of the project.

- *Power Purchase Agreement (PPA)*
  The PPA, which secures the project's revenue streams, is the most important commercial agreement. The 30-year agreement also defines the interface between HubCo and WAPDA.

- *Fuel Supply Agreement (FSA)*
  Fuel supply is secured through this 30-year agreement between the Government-owned fuel supplier, Pakistan State Oil Company, and HubCo.
- *Operation & Maintenance Agreement (OMA)*
  The OMA between HubCo and National Power International (a subsidiary of National Power, UK) has an initial term of 12 years and provides for operation and maintenance of the plant according to agreed terms and technical criteria.
- *Construction Contract*
  A fixed-price, date-certain turnkey construction contract between HubCo and a consortium led by Mitsui 7 Company of Japan was signed in 1991. In addition to Mitsui, the consortium includes Ishikawajima-Harima Heavy Industries Co., Ltd. of Japan, Ansaldo GIE, S.R.I. of Italy and Campenon Bernard SGE-SNC of France.
- *Other Agreements*
  Several other agreements/provisions are integral components of the contractual arrangements of the project. These include: (i) escrow agreements for local and offshore escrow accounts; (ii) foreign exchange risk insurance provided by the State Bank of Pakistan for a fee included in the project cost; and (iii) a shareholders' agreement and related corporate documentation

Bank Guarantee

To match project revenues with debt service, long-term financing is critical to the viability of power (and other infrastructure) projects. However, due to its poor credit standing, such long-term financing was inaccessible to Pakistan. Commercial lenders needed a creditworthy third party to back commitments made to the project by the Government of Pakistan to enable them to make long-term loans—hence the need for the World Bank Guarantee.

The Bank is providing a partial risk guarantee to a syndicate of international commercial banks. The guarantee covers, on an accelerable basis, principal repayments for up to US$240 million in loans. It would be triggered if GOP noncompliance with one or more of its obligations, as outlined in project contracts, resulted in a default in the repayment of the loans. Specifically, these obligations are delineated in the project agreements (IA, PPA, FSA—see above). The US$120 million J-Exim co-guarantee is of an identical structure. The 12 year maturity of the project's commercial loan financing is a major achievement, considering that prior to Hub, Pakistan's access to international credit markets was limited to short-term trade credit and medium-term aircraft financing.

There are three main categories of risk covered by the Bank and J-Exim

guarantees: (i) GOP guarantees of obligations (payment and supply) of state-owned entities, including WAPDA and PSO; (II) GOP payment obligations specified in the Implementation Agreement, including payments resulting from occurrence of certain *force majeure* events (*force majeure* events can be political events, such as war of civil strife, or natural events, such as lightning outside plant boundaries); and (iii) provision and transfer of foreign exchange through the Foreign Exchange Risk Insurance Scheme provided by the State Bank of Pakistan.

Risks guaranteed by the Bank were translated in GOP payment obligations so that the exact cause of a debt service default can be determined, and hence what constitutes a legitimate call of the guarantee is well defined. The Bank entered into Guarantee Agreement with the commercial banks which outlines the coverage and mechanics of the Bank's guarantee. In parallel, the Bank entered into an Indemnity Agreement with GOP counter-guarantees the Bank for any disbursement made under the terms of the Guarantee Agreement. (A counter-guarantee is a requirement of the Bank's Articles of Agreement; it takes the form of an indemnity agreement.) The Bank's US$240 million commitment under the guarantee was counted at 100% in the lending program, i.e., as if the Bank had made a loan, because the Bank is Providing coverage on the whole loan amount. (against certain risks).

The commercial banks, despite the breadth of the Bank's guarantee, are assuming substantial risks, including those associated with construction and completion of the project within budget within budget and on time and efficient plant operation. Construction cost overruns and delays, depending on their severity, would first erode returns to equity and could also jeopardize debt service. Although the debt-equity ratio grants debt providers a cushion of 20% (standby facilities are also available), lenders are still at risk in the event of a shortfall in project revenue. Cost overruns and/or inefficient management of the project during operation also could lead to debt service default.

Bank Guarantees and Private Sector Projects

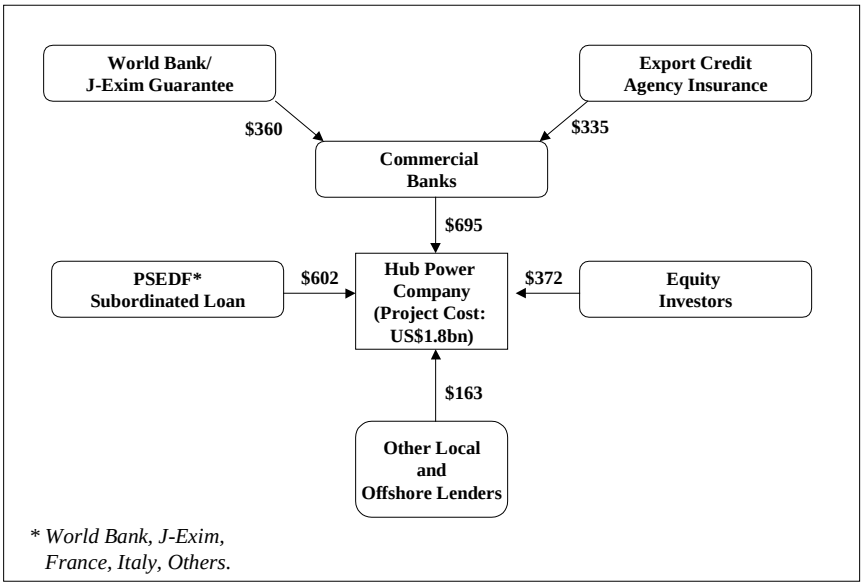
In order to streamline its appraisal of private sector projects involving Bank guarantees and shorten project development time, the Bank intends to capitalize on project reviews by other project participants. To this end, the Bank can incorporate third-party project assessments into its own appraisal. For instance, since commercial lenders will assume construction and performance risks of a project, they will closely scrutinize the project's technical and financial characteristics. If it finds them satisfactory, the Bank could incorporate the results of the analysis into its own appraisal.

The Bank's partial guarantee covers debt service default caused by nonfulfillment of government contractual obligation to a project. Therefore, and risks covered by a Bank guarantee need to be clearly defined in the commercial contracts which set out the risk sharing allocation for a build, own, operate project. To allow the Bank's guarantee to voucher these risks, they must be translated into government payment obligations. In the case of government guarantees of payment obligations of state-owned entities, this is relatively easy to quantify since payments are related to the provision of a service at a specified price. For other government obligations which could jeopardize project cash flows, such as the granting of permits, or political *force majeure*, this quantification becomes more difficult, This may be handled, as in Hub, by linking government defaults related to these events to the payment of fixed amount (defined in the Power Purchase Agreement as the capacity purchase price) which covers fixed costs, including debt service

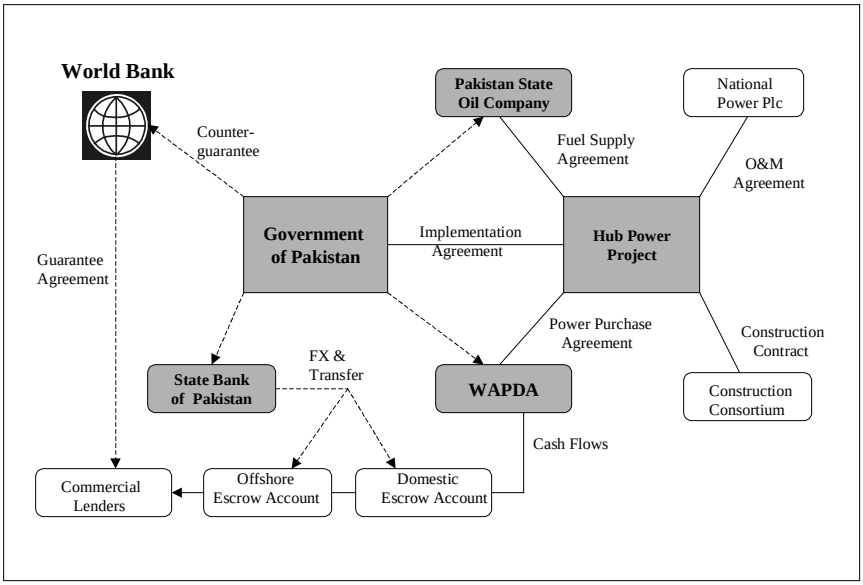
In summary, the Bank's guarantee can act as an important catalyst for mobilizing private sector financing for private sector infrastructure projects. As exemplified by the Hub Power Project, not only does the Bank guarantee provide coverage for a part of the debt financing, but the presence of the Bank in the project enhances the project's attractiveness to other providers of capital, both debt and equity.

For more information on the Hub Power Project and the Bank's partial risk guarantee, please contact Suman Babbar, CFSPF (ext. 32029) or Per Ljung, SA1EF (ext. 81933)

Funding Structure



Security Structure



*To obtain a copy of the brochure, **The World Bank Guarantee: Catalyst for Private Capital Flows**, please contact Andres Londono at (202) 473-2326, or by email at alondono1@worldbank.org*