

# World power – problems in financing Third World utilities

Financing electrical utilities in the Third World creates an array of problems. Philip H Smith, of Intercontinental Utilities Group, looks at the many pitfalls.

The power industry has seen unprecedented changes during the 1990s with the privatisation of electric utilities worldwide and the global expansion of many of these businesses into Third World economies. This has been achieved through the development of power generation projects using project finance as the major means of achieving financing objectives.

After such dramatic change this may be an opportune time to reflect upon the major issues which have made the industry think about the way it constructs and operates such projects and to judge whether project finance is the future means of funding such ventures.

In addition, there are fundamental changes taking place in the structure and ownership of the electricity industry in Europe and the US, adding an extra dimension to this evolution.

It is no coincidence that the major need for electricity is in the Third World, where demand outstrips supply tenfold, and finance is a scarce resource. It is against this background that the industry has worked for the past ten years to develop generating capacity. It would appear somewhat simplistic to assume that privately funded projects could fill the void in capacity needs, and this is borne out in reality by the relatively small number of projects completed against an increasing requirement for power – but why is this?

The main reasons are government bureaucracy and lack of local understanding of the meaning of risk and reward, and the banking community's wariness of substantial financial risks.

I have been a proponent of project finance as the major funding vehicle for the private development of power projects for some years, but believe that now the banking industry needs to analyse the lessons learnt from those projects that have been in commercial

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operations for some time, of which there are many to draw knowledge from.

### ***Serious food for thought***

To understand the way forward, we should both look back at the serious problems which investors and lenders have endured and the changing environment in which such projects are delivered. I would enumerate these as follows:



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- rigidity of structure – not enabling the project to manage itself;
- political influence – a different agenda;
- exchange rates – the passing of certainty of project returns to the utility;
- utility consultation – the need to properly bring them onside;
- legal framework – the difficulty in working with a less than perfect system;
- sovereign guarantees – changes in government and policy; and
- agency conflict – multilaterals serving more than one master.

The structures created to include high levels of project finance and to provide protection of lenders interests are in the main far too constraining and rigid in practice for the constituent parties to realistically sign agreements for as long as 30 years, despite the fact that in most cases the business is relatively simple, with one major supplier of fuel and one major offtaker of power. It is this rigidity which offtakers of electricity find puzzling and governments may find, after some time, that they are not politically acceptable.

The creation of complex structures backed by voluminous contracts are in themselves an exercise in mental gymnastics, and to try to build into such structures allowance for changes in world order would be impossible.

In nearly all cases, governments control their electricity industry and treat it as a national asset requiring extensive financial management due to its size and importance to the economy. The control over tariff pricing, in the national interest, is an important integral economic tool but mostly results in uneconomic pricing and unprofitable utilities.

I would hazard to suggest that the allocation of risk, primarily to the offtaking utility, is in practice an unrealistic arrangement with many costs, outside

FIGURE 1

**Sovereign credit quality 1992-1998**

Country	Sovereign credit rating (Standard & Poor's and Moody's)	
	1992	1998
Indonesia	BBB-	CCC+ B3
Pakistan	-	CCC- B3- (1999 Caa <sup>1</sup> )
Turkey	-	B
	Baa3	B1

of the control of parties to agreements, being attributed to a utility for which it is difficult for them to recover from consumers. The most contentious of these is changes in exchange rates which, when moving against the project equity returns and debt, become a pass through of cost to the utility at the same time that it is also likely to be a national burden. It is difficult for consumers in such circumstances to comprehend why they should accept such costs for power manufactured in their country to protect the interests of foreign stakeholders. This can potentially be an enormous burden, as witnessed in Indonesia during the late nineties, which resulted in the virtual bankruptcy of the utility; a situation which the latter found impossible to accept and resorted to renegotiation of its agreements.

**Problems with the law**

The legal framework within many Third World countries is inadequate to deal in a mature manner with sophisticated agreements and is unable to satisfy the needs of both investors and lenders alike.

Despite the fact that safeguards are included in agreements to the extent of using English law and international arbitration, all of which was clearly understood beforehand, the experience is that enforcement is a greater issue than originally envisaged with local courts taking the lead from their political masters.

In many instances the electric utility has not been consulted by government, either on its strategic considerations or the methods of implementation, leaving them with a feeling of threat both to their business and to their personnel. In such circumstances it is not difficult to appreciate the lack of co-operation and

performance of contractual obligations by the utility, whilst on the face of it an important additional form of comfort to lenders, has on occasions brought sovereign entities into direct confrontation with private investors and international lenders, as was the case in Pakistan where a change of government and policy resulted in protracted and contentious contractual wrangling. This cannot be in the best long term interests of either party and creates a lack of trust and integrity which remains with the project, the sector and in government confidence generally.

**Conflict of interests**

The long life of power purchase agreements, some up to 30 years, conflict with the many changes which take place in Third World governments whose policies may be diametrically opposed to those agreed by previous governments. The credibility against which sovereign guarantees are sought can change significantly over relatively short periods for which a 30-year agreement is unable to realistically contemplate. Figure 1 shows the significant changes in sovereign credit quality that have taken place over just six years.

Despite the involvement of many multilateral agencies – such as the World Bank and export credit agencies – to make power projects viable, the reality is that they have conflicts of interest which on occasions undermine the reasons for project support.

These surround their financial support of governments and publicly owned utilities which can place them in direct contravention of their obligations to private power projects. In such circumstances political tension is created, which does little to enhance the name of private power.

goodwill that follows between the two commercially most important parties to the arrangements, not to mention the suspicion it creates.

The provision of sovereign guarantees as a final backstop to the

**The reality**

Whilst the provision of electricity is an important economic ingredient, its characteristics make it difficult to provide without some form of long-term agreement to satisfactorily recover the heavy up-front capital costs. It is also true that to sell electricity in the open market is extremely difficult in unsophisticated environments. Furthermore, the inability to store electricity and its dependence upon other facets of the supply chain make the need for formally binding agreements that more essential.

That said, can equity investors expect to receive the levels of return they have sought when both the structure and the lenders in particular create the circumstances where most known risks are either passed through to the utility or not retained within the project? Perhaps some of the above events may make equity investors think otherwise, but the simple truth is that equity returns have fallen primarily as a result of greater investor competition and because such project structures have become more familiar, despite the fact that there have been serious issues raised by project experiences.

In the early days of private power projects the need to recognise the pioneering work carried out to create the markets into which others could more easily follow was an added ingredient to the investors' and lenders' returns. Timeframes and uncertainties needed to be rewarded. In some cases the resultant higher tariffs, originally justified, have subsequently been conveniently forgotten primarily for political reasons.

Unfortunately many of the issues raised in the previous section are the reality of dealing with Third World politics, legal frameworks and credit quality, and whilst these should be allowed for in the initial returns and the debt pricing of the project, it nevertheless does not preclude finding a more equitable and less expensive alternative through innovative contractual solutions whenever possible.

**The way forward**

Many projects built with private finance during the last decade have been borne out of the theory that larger power plants are more economical, which is primarily true, but this fails to recognise the size of obligation this creates for a single entity and the profile they

generate within the country concerned. Smaller projects with healthier levels of equity investment can achieve similar results without the larger plant notoriety, and can provide a more attractive proposition with greater commercial flexibility. The benefits could be:

- ability to raise smaller tranches of more manageable debt more effectively;
- higher equity levels providing more commercially minded operation;
- less financially profiled importance to the utility; and
- less significance politically at government level.

The costs of implementation may be proportionately greater, but smaller projects can, in the main, be brought about in more reasonable timeframes.

Much has been said about the global bond markets being readily available



to power projects, but few have taken up the challenge outside the mature power markets in sophisticated countries and those which have tended to support project finance and its structures as part of an integrated financing arrangement rather than standalone. Nevertheless this is an alternative as well as a support to project finance, but it does lack the certainty of timing and pricing so keenly important to power projects.

continue to compete, they must learn the lessons of those projects which have gone before, and show greater innovation in meeting increasingly difficult demands. ■

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There are also the evolving infrastructure funds which can provide debt as well as equity to projects, and it will be interesting to see whether these evolve as a true replacement for project finance or merely a support alongside the structured approach.

But does any of this mean an end to project finance of power projects in the future? I doubt it, but times are swiftly changing. If the banks want to



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