UAE

Thuraya closed

The project financing for the Thuraya satellite has finally closed. The sponsor, led by UAE telecom Etisalat, had put in some bridge financing while the full project loan was finalised. Equity is US$500m.

The loan totals US$600m. ANZ and SG are taking US$200m each with Union National Bank taking US$100m and Abu Dhabi Islamic Bank taking a further US$100m in a separate Islamic tranche. Due to the need to get the deal finally done, the arrangers have not bought in any co-arrangers. Syndication is due after the summer breaks.

The loan has a 7 year tenor. Pre-completion and pre-positive cash flow generation, it has a guaranteed margin of 70bp. Once it becomes non recourse, the margin jumps to near 200bp and then falls in line with cash flow and debt repayments. There is a figure of cash flow at which the limited recourse portion kicks in which has been reported at US$100m pa but this has not been confirmed.

The deal can be pre-paid by the sponsor at any time. It is expected the project will become cash flow positive a year to a year and a half after launch.

The Islamic tranche ranks pari pasu to the commercial loan. Implementing it within the financing structure did cause some delays but it is not the first time it has been done. A similar deal was put in place on the Equate petrochemical project financing in Kuwait.

On Thuraya, Abu Dhabi Islamic Bank has taken ownership of the project’s ground station. This will enable it to receive rent, rather than interest which is against Islamic law, from the project. If the project faces difficulties, the ground station ownership will be put into a pool along with all the other company assets. These will then be shared out evenly among all the financiers.

The covenants on the financing are cash flow based. The banks have insisted the cash flows are already remitted to the company rather than based on outstanding payments. This is because the satellite will operate in areas where cash payments are a problem.

The satellite is a regional satellite. It is being built by Hughes and will be launched next year. It will prove GSM type services to areas not already covered by ground based networks. Its footprint will cover South Asia, Middle east, north Africa and parts of Europe.

The system is said to offer a cheap service at around US$0.50 a minute. The price of the Thuraya phones is still under discussion. Competition could come from other satellites or expansions of GSM networks.
Thuraya challenges the way investors perceive the Middle East

Financing for the launch of a new satellite – Thuraya – covering the Middle East has challenged ways in which project financiers look at the region. Opportunities for project financiers are now going beyond the oil and gas sectors. Thuraya is an example of this trend.

Among the projects in the pipeline is the UAE-based Emirates Telecommunications Corporation (Etisalat) project. It will build and launch a satellite. The satellite will operate from a fixed orbit and provide services to mobile users in the region. The range of the satellite will cover the Middle East, part of Europe, North Africa and South Asia.

Thuraya’s shareholders include regional players such as Etisalat, Arab Satellite Telecommunications Organization and Bahrain Telecommunications. Financing for the Thuraya project comes from a $500 million equity portion and $600 million of debt. Debt is split between a $500 million loan and a $100 million Islamic tranche. Syndication will be launched by the end of July 1999.

The size of the Islamic tranche represents an important step for the future of Islamic financing in the region. Arrangers of the financing are SG, ANZ, Union National Bank and Abu Dhabi Islamic Bank.

Thuraya is the first pan-Arab telecom project financed internationally. Guy Du Parc Braham, assistant director at SG in London says that the $100 million Islamic tranche is valuable for banks on a security perspective.

Nick Avery, partner at Ashurst Morris Crisp in London told Project Finance that Thuraya represents an important transaction that challenged financiers to follow ⬢

⬢ the normal course. Thuraya is another example of the attention given by local and international project financiers to the UAE. Thuraya follows the successful financing of Taweeleh water & power project (see Project Finance, June 1999).
In order to understand the role of Islamic finance in the field of infrastructure and project financing, it is important to do a quick review of the evolution of Islamic finance.

The period between 1970 and 1980 marked the early beginnings of Islamic finance in which the concept of Islamic finance was translated into reality by a group of visionary Islamic financial institutions. In this period the funds of the Islamic investors were generally invested in short term low value added documentation-related businesses.

Most of the focus was on trade finance and the favoured instruments was the Morabaha (cost plus financing). The limitations of the Organization of Islamic Countries (OIC) macro economic framework and the sectors infancy were the major impediment.

As we move on to the period from 1980 to 1998, we see a gradual evolution of Islamic finance in which we start to witness tenure stretching, covenant-based project finance, Islamic tranches in big ticket deals and a significant improvement in the documentation capabilities of Islamic financial institutions.

During this period the Islamic financial industry has become a big provider of cross-border finance in a belt of Islamic countries in the OIC world and therefore an important player in infrastructure and project finance. This makes Islamic finance increasingly relevant for multinationals and corporates who do business in the OIC world.

Islamic financial institutions, being closer to the risk, can understand the risk better and price it better. In this role, institutions like Kuwait Finance House, Al-Rajhi, DMI have all reached the league tables of Euromoney’s Capital DATA as providers and arrangers of trade and project finance in Islamic countries.

A competitive pricing for OIC risk leads to a natural tie up of export credit agencies. We are seeing a variety of structures cropping up – both melded export credit agency guaranteed and clean portions are being structured. There are a range of examples where big ticket transactions have been done in which Islamic financial institutions have partnered with export credit agencies.

Some of the projects in which Islamic financial institutions have participated are Turkey’s Tekfen Motorway, Mersin and Tag Motorway, Iski Water Pipe Line, Ankara Great Motorway, Izmir Ring Road, the Hub Power Project in Pakistan and the Kuwait Petrochemicals Project.

In the field of infrastructure, although a late comer, Islamic finance is coming under the leadership of the Islamic Development Bank (IDB) that has created a dedicated infrastructure fund. We are clearly seeing new opportunities arising out of Islamic financial institutions’ ability to originate, structure and document the increasingly complex transactions. The dedicated IDB infrastructure fund along with the mezzanine tranche will play an important role in increasing the embedded capital of the OIC member countries.

Together these measures will increase the embedded capital of the OIC world and give increasing relevance to Islamic finance in the field of project finance.

The expected growth in interest in Islamic financing techniques in the Middle East has not materialized.

Islamic banks' involvement in project financing has been a frequently discussed topic for some time now. In the recent past, Islamic financial institutions have played a major role in several projects in their target markets. However there have also been several instances where initial and active interest by Islamic financing failed to materialize eventually.

Instances of successful participation by Islamic financial institutions were: Equate Petrochemical Co., Kuwait, where Kuwait Finance House (KFH) successfully structured and provided a $200 million lease financing for 8-10 years; Overseas Light Train Project in Kuala Lumpur where a Middle East-Malaysian joint venture played a major role; and Malaysian Airlines Aircraft Sukook financing based on aircraft sell-lease back structures where Middle East Islamic financial institutions were involved – but eventually it fell through due to East Asian economic problems.

High hopes were expressed of growing interest of Islamic financing in various petrochemical projects in the Middle East countries. They do not seem to have materialized.

Assets as well as liabilities of Islamic banks have traditionally been mainly short-term, barring some real estate investments. This is primarily due to investors' liquidity preference as well as serious limitation on maturity mismatch at Islamic banks. As such relatively only a small proportion of funds has been available from Islamic financial institutions for medium-long term financing.

Another factor has been the absence of Islamically approved structures. This was mainly due to inadequate research in the past in this field by the Islamic institutions themselves who were content with the traditional business. The third factor was the major reliance for business in their domestic markets by the Islamic institutions. Excessive emphasis on doing business conservatively even at low margins has also been a reason as has been the absence of the lender of last resort in many countries where these Islamic institutions operate.

Nevertheless participation in project finance is still a hot topic because of continued interest by the Islamic banks to diversify their portfolios for better return and safety, and increased frequency of such financing in their domestic and regional markets. Recent interest by major Islamic institutions in expanding international activities has also resulted in the structure of several Sharia-approved products that fit the project financing requirements. Equate was an excellent example of this where, once enthused to work with the project, KFH not only structured a mutually acceptable lease structure but also successfully found ways, duly approved by Sharia, to work alongside the conventional term loan lenders.

Islamic finance capital markets are still in the developmental stage. There may be important domestic projects where local Islamic institutions may play a major role but expecting this to happen on consistent basis on a global or even regional level would be difficult. Recent severe economic problems spreading throughout the world are another setback which may lead Islamic banks back to their traditional business and markets.
Countries in the Middle East have large infrastructure development needs, especially in power, water and telecoms. Germana Canzi looks at some projects in the pipeline.

You cannot afford to wait

Most Middle East countries have three things in common: a growing population, the need to replace aging infrastructure in the power sector and an increasing desire by governments to move closer to balancing the budget. For these and other reason, opportunities for private participation projects in the infrastructure sector are increasing.

According to Capital DATA ProjectWare, there are 298 projects in the pipeline in the Middle East, excluding oil, gas and petrochemicals projects. Most projects are concentrated in the infrastructure, road and water sector. Most are concentrated in Israel and Saudi Arabia. But there are reasons to believe that other countries such as Jordan or Iran might become increasingly interesting for project financiers.

Spurring on these changes is the World Bank. It has been pushing for the region’s governments to increase the use of build-operate and build-operate-transfer projects, which have so far been used only for a handful of projects. The sectors most likely to be affected by this change in attitude are electricity generation, water production, wastewater treatment and transportation.

An emerging market

Jordan is one country which is luring in sponsors and investors. Reasons for the change in sentiment stem from political stability and support from the US, to the fact that the king and the government are committed to economic development. Says one source: “It is one of the friendliest locations of the Middle East and it is a very benign environment. In addition, because of the pressures on the Jordanian budget, the government is looking at international markets in order to finance projects on an off-balance sheet basis.”

Privatization is high on the political agenda in Jordan. A UK-Jordanian consortium is developing Jordan’s first independent power project. The $300 million concession is the country’s largest privatization deal. The World Bank is involved in the financing with Fieldstone and Atlas Investment. Gibb is the technical partner and Arnold & Porter is the legal adviser.

The project involves developing a 300MW to 450MW power plant at Al-Samra, north of the industrial city of Zarqa. The project, now in tender, will be offered on a 25-year, build-operate basis and it is a key landmark deal in the International Monetary Fund-led privatization programme.

Among the bidders are: ABB Energy Ventures, National Power, Mitsubishi, Electricité de France, AES, Ansaldo Energia and Tractebel. The contract will be awarded nine months after the presentation, which was due in mid-June 1999. Commercial operations of the first unit are expected to begin by the end of 2002.

If the deal goes well, Jordan will attract further attention from power project developers, as electricity consumption in the country has increased an average of 8% since the 1990s. Forecasts indicate that there will be further growth as a consequence of the construction of fertilizer plants and of an increase in tourism.

Reforms in the power sector have also helped progress. These included the division of the Jordan National Electric Power Company (Nepco) into three separate subsidiaries. The company will operate in transmission, while generation and distribution will be privatized. The government has also taken initial steps for the creation of an independent regulatory authority to control the tariffs for future deals between independent power producers and Nepco.

Another project being developed in Jordan is the Aqaba railway project, which involves the construction of a 22.5km rail link to the Elshidiya mines. HSBC is financial adviser and Opic will finance the project. A source defines this as a “groundbreaking deal”. Foreign investors will be watching carefully to assess the potential for further investment opportunities in the country.

Beyond oil and gas

The water issue is crucial in the Middle East. Scarce water supplies carry many political implications. Israel and Jordan have recently had a dispute over water resources and the topic has been the subject of the peace treaty between the two countries. In the Middle East – if one includes North Africa – about 45 million people lack access to safe water and more than 80 million lack access to safe sanitation services. According to Jamal Saghir, sector manager at the World Bank’s infrastructure division in Washington DC, water losses in Jordan, Lebanon, Yemen and West Bank/Gaza vary from between 50% and 55% of water provided to the systems. Only 20% of urban wastewater is treated compared to 60% to 70% in the US and Europe. “We all need to increase our efforts to address these problems. And the private sector should play an important role,” says Saghir.

In Jordan, France’s Suez Lyonnais des Eaux is involved in a project in a joint venture with a local partner to develop Greater Amman water and wastewater system. Another very large water project is in the pipeline in Kuwait, which will be developed on a build-operate basis.
But for many the Tawellah power and desalination project (see Project Finance, June 1999, p.13) is the landmark deal for the region. The deal, which signed earlier this year, has given a positive sign to the market that projects can be financed successfully in the Middle East.

**Infrastructure needs**

According to the World Bank’s Saghiri, the public sector in the Middle East has done a poor job of managing infrastructure. Only the countries of the Gulf Cooperation Council countries and Israel provide infrastructure services comparable in quality and coverage to those countries with similar income levels.

According to his indication, the potential market for private participation in the region could be more than $45 billion to $60 billion over the 10 years, more than three times the amount provided by international financial institutions. In the water sector in particular, the number of water projects worldwide with private participation reaching financial close has increased tenfold between 1990 and 1997 compared to the previous decade.

Most countries in the region have launched privatization programmes. Egypt has recently accelerated its programme, while Jordan and Yemen have been slower. In the Gulf Cooperation Council countries, there has been considerable discussion and studies of privatization issues but very little action except in Kuwait and Oman. Saudi Arabia, though, is preparing comprehensive privatization and public-private participation programmes.

**Developing telecoms**

One of the most innovative projects being financed in the Middle East is the Thuraya Satellite Network project which involves the launch of a new satellite that will provide services for mobile users in the Middle East, north Africa, part of Europe and south Asia. In December 1998, the Thuraya Satellite Telecommunications Company mandated a consortium of four banks as lead arrangers for its $600 million financing facility: Abu Dhabi Islamic Bank, ANZ, SG and Union National Bank. The financing has a seven-year tenor and includes an Islamic tranche of $100 million, which is being managed by Abu Dhabi Islamic Bank.

As Project Finance goes to press, the consortium, whose mandate was based on an underwritten offer, is arranging the bank facility through local, regional and international syndication. Financing is expected to close shortly.

But there are also a number of smaller telecom projects in the pipeline in Jordan, Kuwait, Oman, Qatar and Iran. Another project is Tep8 in Saudi Arabia, a $5.5 million telephone expansion project, to be awarded to contractors this year.

The Saudi government has also recently corporatized – through a $600 million loan for STC – the telecom company. And a source anticipates that the government will list shares of the company on the stock exchange. According to the source, “the establishment of STC has broken the deadlock for banks for financing projects of this kind in the Middle East.”

**New power opportunities**

Power remains among the most rapidly developing sectors. In Saudi Arabia, a key development has been the establishment of Saudi Electricity Company (SEC), initially owned 100% by the government. The company, under which other utilities such as Scoco will be rolled, will be involved in generation and build-operate-transfer projects. It is not clear, though, whether the company will also be involved in distribution and transmission.

The Gulf Development Council, for example, has set up a new body to oversee the linking of the national grids of the six member states. This is an important development for a project that had been in the pipeline for more than 10 years and had been on hold because of the reluctance of Gulf States to give power to a higher authority. Once up and running, the project is likely to create opportunities for the construction of new power stations to cover the power shortage of Gulf Cooperation Council countries. In the future, there might also be more opportunities for merchant power plants.

The interconnection grid project is likely to be carried out in three phases. In the first $2.5 billion stage, the national grids of Bahrain, Kuwait, Qatar and Saudi Arabia will be linked. In a second phase, the national grids of Oman and the United Arab Emirates will be connected. In a third phase, the project will link the two countries with the rest of the Gulf.

The project will have an interesting impact on opportunities for the project finance market. Says Steve Wardlaw, senior solicitor at Arnheim, Tite & Lewis in London: “There is already a huge demand for project finance transactions in this region and this project could suddenly create a far bigger market for project finance and independent power projects. And it will create far more flexibility as to where to build the power plants.”

“But a lot of issues remain unresolved,” admits Wardlaw. In the United Arab Emirates one of the problems is on a regulatory level, as each of the states has a different legislation in terms of privatization. Also, each state is at a different stage of deregulating its electricity sector. While the United Arab Emirates have almost completely liberalized the electricity market, Saudi Arabia is still combining the four power companies into one.

The interconnector project is also likely to have an impact on projects in Iran. Says Wardlaw: “Iran is crying out for infrastructure development and power. Clever project financiers should lobby to have the grid interconnected with Iran. This means that potentially you can start by building power plants on the Kuwait border. This is a market that will be developing in the future.”

Changes in the political picture in Iran since 1997, following the election of Mohammed Khatami, have eased relations between this country and the west – including the US. As a result, opportunities are more positive. Over the past six months, the pace of change has accelerated considerably.

Several Western European countries have sent in official trade delegations, including Italy and the UK. And their respective export credit agencies reopened credit lines which have been closed for years. This will open up opportunities for all sectors of the economy, as the government has made it one of its priorities to reduce the country’s economic dependency on oil. The policy has been established in the five-year plan that starts in April 2000.

According to a report prepared by UK law firm Ashurst Morris Crisp, while the country’s infrastructure is in remarkably good shape – considering the country’s isolation in the past years – a significant amount of investment will be needed in the power transmission sector, transport and telecoms. The government is also keen to promote investment in non-hydrocarbon natural resources and has recently enacted a new mining code.

But, as Steve Atkinson, director of project finance at ANZ in Bahrain points out: “Iran is still going through a phase of acceptance by the international financial community.”

The list of projects in the pipeline in the Middle East is growing and includes private power generation in several countries of the Gulf Cooperation Council, privatization of telecom networks in Jordan, Saudi Arabia, Oman and the West Bank and Gaza, wastewater projects in Tunisia and water conveyor projects in Lebanon and Jordan. Saghiri’s report estimates the potential value of private infrastructure projects in the region – including North Africa – at $45 billion, 3% of global private infrastructure investments.

Projects such as Tawellah can provide a blueprint for other deals in the region. But, says Atkinson: “There are structures and solutions that are already tested. The question is how quickly these countries will adapt existing models. But some time will be lost if they attempt to reinvent the wheel.”
When Benazir Bhutto unveiled her ambitious power policy in 1994, it was the envy of other emerging markets. But, as power producers face tariff cuts and the threat of default on their loans, where did it all go wrong and how can it be put right? Lucy Baker reports.

An affair to remember

When the going gets tough, the tough get going. On January 15 1999, Pakistan's prime minister, Nawaz Sharif, formally handed control of the state-owned Water and Power Development Authority (Wapda) to the army. In a last-ditch attempt to save the authority from financial collapse, soldiers are patrolling the country reading electricity meters, delivering bills and staffing complaint centres to try to stamp out electricity theft.

This is a bizarre twist in a complex tale which has dominated Pakistan's political agenda for the past five years.

In March 1994, former prime minister Benazir Bhutto unveiled an incentives package – including a bulk power tariff of $0.65 a KiloWatt hour for the first 10 years' sales – designed to attract private investors into generation. 34 contracts were issued under the scheme (see table) and by the middle of 1997, 19 such projects, all of them thermal, had reached financial close. The signed projects have a combined capacity of 3,150MW.

But the new Sharif government declared itself unhappy with its predecessor's initiative, claiming that the agreed tariff would bankrupt the offsetakers, Wapda and the Karachi Electric Supply Corporation (Kesc). It also claimed that the foreign exchange needed to buy imports to run the plants would not be available and the distribution networks of Wapda and Kesc would be unable to cope with the additional supplies.

In June 1998 the government publicly accused a number of independent power companies of corruption and of violating their project agreements, serving intent of cancellation notices to eight companies and terminating the contract of a ninth. Six companies were put under a 90-day notice to answer unspecified corruption and kickback charges. But the project that has borne the brunt of the government's wrath is Hubco, the deal that preceded the 1994 power policy.

Hubco: A never-ending story?
When the $1.64 billion Hubco power project signed in October 1994, it set a series of precedents (see deal box). The deal was the first independent power project to be financed in south Asia. It was also the largest financing for a private sector project in Asia and it provided a framework for the Bhutto government's 1994 power policy. At the time it was difficult to see how the deal could fail. But the events of the past 12 months have meant the project company stands vilified in front of the project finance market and some fear that the project may default on its loans or require refinancing.

The situation stems from accusations from the head of Pakistan's Ehtesab accountability bureau, Saif ur Rehman, that Hubco management offered bribes in 1994 to the then prime minister, Benazir Bhutto, and her husband, Asif Zardari, in exchange for changes to the original independent power producer (IPP) contract.

The contract had been agreed by Bhutto and then Sharif under previous terms of office. Rehman claims that this led to a sharp increase in the power tariff which the offsetaker, Wapda, is unable to pay. Criminal charges have been pressed against Hubco in the
Hub power plant

Latest reports say Hubco and the government of Pakistan have reached a standstill agreement on litigation pending against both parties. This is the first significant sign that the disputes over the project may soon be resolved.

Signing date: October 2 1994
Location: Hub, Balochistan, near Karachi
Cost: $1.64 billion
Description: The project involves the construction and operation of a 1,292MW oil-fired power plant
Sponsors: National Power and Xenel Industries
Arrangers: National Development Finance Corporation, Bank of Tokyo, Crédit Lyonnais, Citibank, NatWest Markets, Mediocredito Centrale and Sakura
Participants: Habib Bank, Muslim Commercial Bank, Industrial Credit & Investment Corporation of India, United Bank, Allied Bank of Pakistan, Industrial Development Bank of India, National Bank of Pakistan, National Development Finance Corporation and Saudi Pak Industrial & Agricultural Investment
Multilateral agencies: World Bank and Jexim
Export credit agencies: Miti, Coface and Sace
Financial adviser to the consortium: PricewaterhouseCoopers
Legal adviser to the consortium: Clifford Chance
Legal adviser to the lender: Allen & Overy
Financing: This is split into eight tranches.
- Tranche one is a PRs3.012 billion ($100 million) term loan lead-arranged by Pakistan’s National Development Finance Corporation, funded by official agencies including the World Bank. Participants in this tranche are: Habib Bank, Muslim Commercial Bank, Industrial Credit & Investment Corporation of India, United Bank, Allied Bank of Pakistan, Industrial Development Bank of India, National Bank of Pakistan, National Development Finance Corporation and Saudi Pak Industrial & Agricultural Investment.
- Tranche two is a $240 million, 12-year term loan, denominated in Ecu, French francs, Yen and U.S. dollars, lead-arranged by Bank of Tokyo, Crédit Lyonnais, NatWest Markets, Citibank and Sakura. The World Bank is providing multilateral support.
- Tranche three is $120 million, 12-year term loan denominated in Yen: It is arranged by Bank of Tokyo International, Citibank International, Crédit Lyonnais, Sakura and NatWest Markets and the multilateral agency is Jexim.
- Tranche four is a $195 million, 12-year term loan, denominated in Ecu and lead-arranged by Bank of Tokyo, Crédit Lyonnais and Mediocredito Centrale.
- Tranche five is an $86 million 12-year term loan denominated in Yen. It is lead arranged by Bank of Tokyo, Crédit Lyonnais, NatWest Markets, Citibank and Sakura. The export credit agency is Miti.
- Tranche six is a $45 million, 12-year term loan denominated in French francs. The lead arranger is Bank of Tokyo and the export credit agency is Coface.
- Tranche seven is a $148.8 million equity portion. The participants are National Power, Xenel Industries, Commonwealth Development Corporation, Entergy, Pakistan Power, Xenergy and K&M Engineering.
- Tranche eight is a $222.7 million equity portion. Private investors can purchase ordinary shares on the Karachi stock exchange and global depositary receipts on the Luxembourg stock exchange.

Contractors: Mitsui, Ansaldo, British Electric International and K&M

arbitration. Khairi hopes that this outcome will be repeated in the case of Hubco.

Both National Power and Citibank are also involved in the $1.6 billion Kapco privatization of Wapda’s Kot Addu power plant. Like Hubco, the Kapco team has been accused of bribery and charging excessively high tariffs, but this project is having a far easier time than Hubco. Says Smith: “Hubco is the largest

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**List of original 34 power projects.**

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<th>Project</th>
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<td>AES Leipzig</td>
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<td>AES Kunita</td>
<td>552</td>
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<td>AES Krumbach</td>
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<td>AES Luxemburg</td>
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<td>AES Neuss</td>
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The Islamic factor

One aspect which could further complicate the status of Pakistan's independent power producers (IPPs) is the government's commitment to Islamicizing Pakistan. In 1998 prime minister Sharif tabled 15th amendment to the country's constitution to entrench the injunctions of Islam as the supreme law of Pakistan. If the amendment is passed, the government would be obliged to enforce Shariah law. This could make some elements of the IPPs' contracts unenforceable, such as the payment of interest on loans (see Project Finance November 1998).

According to John Dewar, a partner at law firm Milbank, Tweed, Hadley & McCloy in London, which acted on among others the Saba and Uch projects, the amendment may be more of a political gesture than serious will on the part of the government to introduce Islamic law: "For the moment the status quo ante goes on."

The World Bank: caught between rock and a hard place?

Participation of the World Bank is key to the conclusion of the IPP issue. Many see the bank as a difficult one as it has a vested interest in both the government and the IPPs, but it has managed to use its position as a mediator to force the introduction of measures aimed at ending the disputes.

On January 21 1999 the World Bank announced the approval of a $350 million Structural Adjustment Loan to support the government of Pakistan in improving governance in key public sector activities, including power. A prerequisite of this loan was under-supply. In February 1999 Pakistan agreed to supply 300MW of electric power daily to India for the next 10 years, with the tariff and other commercial terms to be decided by both countries. But talks have reached a deadlock over price. According to Indian power ministry officials, Pakistan was asking for seven US cents for one unit of power, while India's best offer was just three cents. Says an official from Power Grid, India's central transmission utility: "Pakistan wants us to foot the bill for the fixed costs, but since it is not generating the power for India and giving us its surplus, it is fair that we pay only variable costs."

Roush power

The project has been held up because Wapda did not grant the grid connection until February 1999 — a year late. The plant is in test operation, coming on-line in the third quarter of 1999. The sponsors are in the process of securing an increase in financing to cover the extra costs of the delay. Says a spokesman from contractor and equity participant Siemens: "We want to stay in the market and wait until it starts. Pakistan is no place for making a quick dollar."

**Signiﬁcation date:** March 31 1996

**Cost:** $307 million

**Location:** Sidhni Barrage, near Lahore, Punjab

**Arrangers:** ANZ and National Development Finance Corporation

**Sponsors:** Roush Finance and ESB International

**Legal advisers to the Consortium:** PricewaterhouseCoopers and ANZ

**Financial advisers to the Loan:** Afriﬁ, and Angell, Norton Rose, Vellani & Vellani and Latham & Watkins

**Description:** The existing proceeds are to help finance a 412MW build-operate-power project in Punjab, Pakistan

**Financing:** This includes a $140 million sub-debt loan from the National Development Finance Corporation — financed in equal parts by the World Bank and Jexim — a $33 million loan backed by a Hermes guarantee, a Dm20 million ($11.05 million) loan provided by Deutsche and a commercial loan of $137 million arranged by ANZ. The project also involves a $7 million working capital facility. The sponsors contribute $137 million, which will be raised by Siemens Project Ventures (52.35%), Roush Finance (40.35%) and ESB International (7.3%)

**Turnkey contractor:** Siemens

Exploding the myths

The IPP situation was not helped by the Pakistani government's decision to test-fire a ballistic missile on April 14 1999 in response to earlier testing performed by India. In May 1998, the countries carried out a similar series of tit-for-tat nuclear tests (see Project Finance, July 1998).

Following the first round of tests, Pakistan's currency plunged and its foreign exchange reserves fell to $410 million. The Karachi Stock Exchange also hit an all-time low of 768 points and the US imposed sanctions on both India and Pakistan. Prime minister Sharif said this was the price Pakistan had to pay for becoming a nuclear power.

Ironically, Pakistan has turned to India for a possible resolution to its problems in the power sector, attempting to strike a deal to export what it claims is a surplus in its electricity output — in fact Pakistani households regularly experience power cuts as a result of...
The government issued notices of intent to terminate in July 1998, after levelling allegations of corruption against the project company. The company threatened to take the government to international arbitration with the support of the International Chamber of Commerce, subsequently withdrew its arbitration request in exchange for the government withdrawing its allegations of corruption. The situation remains unresolved as the government has asked the company to lower its tariffs. Says a source at sponsor AES: “There is no room for tariff reductions in the project structure. This is not over yet. We have sent over our response and are awaiting the government’s reaction.”

The company is also awaiting the formation of a ninth independent IPP committee. Says the source: “The government did not like the previous committees and does not seem satisfied with this one. But we think this committee is superior to its predecessors. Our meetings are business-like and people are willing to listen.”

Signing date: May 15 1995
Cost: $344 million
Location: District of Muzaffargah, Pakistan
Sponsor: AES
Arrangers: International Finance Corporation (IFC), Bank of Tokyo, Deutsche and Sanwa
Financial adviser to the utility/government: IFC
Legal adviser to the consortium: Chadbourne & Parke
Legal adviser to the lenders: Allen & Overy
Description: Proceeds are to support the construction and operation of a 362MW oil-fired power plant in the province of Punjab. The project will be developed on a build-own-operate basis. Wapda will be the off-taker under a 30-year power purchase agreement. The plant began commercial operation on November 6 1997
Financing: This is made up 28% equity from AES and IFC and loans from commercial banks and IFC (72%) on a limited recourse basis. The commercial bank loan is for $20.250 million ($208 million) and will carry a 95% political risk guarantee from Jexim. Nichimen is guaranteeing the balance. The IFC’s $40 million loan for its own account was signed on April 7th 1995. The Jexim guarantee was signed on May 15, 1995
Contractors: Nichimen and Mitsubishi Heavy Industries

the setting up of the National Electric Power Regulatory Authority (Nepra), an independent IPP committee which will provide an orderly framework to resolve the disputes.

The other main objective of the loan is to restore the financial viability of Wapda and Kesc by ensuring that line losses are reduced, distribution is improved, and cross-subs between energy utilities and governments are settled. The World Bank then hopes that the state companies will be privatized. This would not affect the contracts of the IPs as the government would still be bound to guarantee the off-take payments. On April 7 1999 it was announced that the Pakistani government has set September 1999 as the deadline for the sale of a management stake and 51% equity stake in Kesc.

Another multilateral, the Asian Development Bank, is also providing aid to help Pakistan. On March 31 1999, the bank announced a $300 million loan to be repaid over 15 years, including a grace period of three years. And in December 1998 Pakistan, reeling under the economic and financial turmoil brought about by the US sanctions, negotiated a resumption of a $1.56 billion loan programme from the International Monetary Fund.

But as Project Finance goes to press, the Pakistani government and IPPs are awaiting what could be a significant breakthrough both for the Pakistani economy and the IPPs. The move involves the restructuring of the country’s commercial debt by its London Club creditors. The Paris Club, which restructured $3.5 billion of bilateral debt in February 1999, has recommended the initiative, which could help provide an orderly framework for resolving the IPP disputes. Pakistani finance minister Ishaq Dar is to meet private commercial lenders to reschedule up to $850 million of commercial credit.

Says Douglas Strong, director and head of infrastructure and mining at ANZ in London: “There are separate negotiations going on and everyone is waiting for the first domino to fall.” Strong believes the proposed restructuring will stabilize Pakistan’s economic situation and provide a better environment for the resolution of the IPP disputes. Stephen Crew, head of global project finance at the bank agrees: “We may not be around the corner yet, but at least we can see the corner coming.”

This seems to be the view of most of those involved in the IPPs. The bulk of projects are expected to come on line this year once the remaining notices of intent to terminate are withdrawn. And this could lead the way for future investment in the country, which has been stagnant since the IPP disputes began. Strong and Crew suggest that a potential growth sector is water, where projects could be financed by sponsor equity in local currency.

One undeterred foreign sponsor is Synergics Development of the US. The company has announced plans to invest nearly $1 billion in two hydroelectric projects with a total generating capacity of 684MW. A power-purchase agreement is expected to be signed between the Wapda and the US company by the end of March 1999.

Synergics plans to develop a 600MW plant at Kohala in Azad Kashmir and an 84MW plant in Matinba in the north-west frontier province. It proposes to charge $0.4-0.5 a KiloWatt hour and transfer the company - at no charge - to the government of Pakistan after 20 years.

It is unlikely that these deals will secure financing in the near future. Says ANZ’s Crew: “Even with the spruiced policy-management spring-clean in Pakistan, the credit committees of international commercial banks will need a lot of persuading to back big-ticket non-recourse deals there in the foreseeable future.”

John Dewar, a partner at law firm Milbank, Tweed, Hadley & McCloy in London sums up the mood of all those who have shared the Pakistani IPP experience: “It’s been quite a performance.”

Liberty power project

The project has been delayed by negotiations over tariffs. Since the project signed, Tenaga has become the sole sponsors and will acquire 100% of the equity. Tenaga will also accept the end-finance liability, which has yet to be quantified. Says Jim Romanos, director of infrastructure at the Commonwealth Development Corporation (CDC) in London: “We are not making any new investments in Pakistan at the moment. We will wait and see what happens in the future.”

Signing date: May 3 1997
Cost: $264 million
Location: Mirpur Methi near Dharki, Sindh region
Sponsors at the time of signing: Tenaga Nasional, Infrastructure Capital Group, Entergy, Union Texas Petroleum, CDC, Asian Infrastructure Development
Arranger: ANZ
Financial adviser to the consortium: ANZ
Legal advisers to the consortium: Allen & Overy and Milbank, Tweed, Hadley & McCloy
Legal advisers to the lenders: Norton Rose, Linklaters & Alliance and Clifford Chance
Description: A standard independent power project in the Sindh region of Pakistan. The proceeds are to purchase a 235MW gas turbine and a 235MW steam turbine.
Financing: This consists of a $184 million term loan and an $80 million equity tranche.
Contractor: Descon Engineering
Equipment supplier: Ansaldo Energia
Projects cancelled due to lack of demand: Enron’s Enpak project, Tractebel’s Khalpey project and Southern Electricity’s Ketti Bandar project

May 1999 ProjectFinance
In the Name of God, the Merciful, the Compassionate


Praise be to God, the Lord of the Worlds, and prayer and peace be upon our Prophet Mohammed, his family, companions and followers.

The Fatwa and Sharia Supervisory Committee of The International Investor held several meetings during 1998. During these regular meetings, all matters such as enquiries and contracts relating to the company’s new operations of the year, which were referred to the committee by the Management of the company, were discussed and appropriate recommendations, decisions and Fatwas were made.

In the light of the statements made and submitted by the committee’s secretary, the committee hereby declares that the company has acted in compliance with the rules and regulations of the Islamic Sharia in respect of all its contracts and transactions.

Ahmed Beza’i’a Al-Yaseen Chairman  Dr Khalid Al-Madikhour Member
Dr Mohammed Fawzi Faidhulla Member  Dr Mohammed Abdul Ghaffar Al-Sharif Member

In addition to The Fatwa and Sharia Supervisory Committee, The International Investor has been privileged to be guided, since its inception, by an International Advisory Sharia Committee, outside Kuwait. This Committee has assisted with further scrutinising of the company’s activities, to ensure that they are compatible with the principles of Islamic Sharia.

This Committee comprises the following members:
His Eminence, Sheikh Abdulla Ibn Abdul Aziz Ibn Aqeel Chairman
His Eminence, Sheikh Saleh Ibn Abdul Rahman Al-Hussain Deputy Chairman
His Eminence, Sheikh Mustafa Ahmed Al-Zarqa’a Member
His Eminence, Sheikh Abdul Rahman Ibn Abdulla Ibn Aqeel Member and Secretary

The International Investor takes this opportunity to extend its thanks to the Ulema, for its efforts in directing the company.
Pakistan banks face lottery ban

By Farhan Bokhari in Islamabad

The Pakistani government said yesterday that it would not challenge a decision by the highest Islamic council this week that bank lottery schemes were un-Islamic.

The decision could be the first step towards eventual elimination of lotteries in Pakistan, bankers said.

The Council of Islamic Ideology (CII) said plans launched by the country's largest banks that would have given account holders prizes in special draws constituted *riba* or usury.

The council was asked by the finance ministry to consider schemes such as the *Crore-patti* (multi-millionaire) launched by Habib Bank, the largest public sector bank, and *Muslin-manal* by Muslim Commercial bank, the fourth largest bank.

The council said a lottery where many individuals were asked to deposit money but only a chosen few got the final benefit was against Islamic tenets.

Ishaq Dar, the finance minister, told journalists yesterday the lottery schemes were a "gimmick".

"The common people will benefit," he added. "The winners were only a few."

Bankers said the council's decision applied only to the schemes by banks for which its opinion was sought. However, they warned that there was now a precedent for the country's Islamists to challenge the government's prize bonds schemes, in existence for years.

The move reminded many of a decision in the early 90s, by the federal *shariat* court, the highest Islamic court, that all interest-based transactions were illegal. The government subsequently appealed against that decision in the supreme court where a decision is still awaited.

Bankers have said that moves to restrict interest-based transactions were likely to create difficulties for Pakistan's banking system, weighed down under an estimated Rs150bn ($3bn) in bad debts.

The lottery schemes were another effort to attract fresh deposits in order to improve the financial state of the banks.
Factoring Cyclicality Into Corporate Ratings

Standard & Poor's credit ratings are meant to be forward-looking; that is, their time horizon extends as far as is analytically foreseeable. Accordingly, the anticipated ups and downs of business cycles—whether industry-specific or related to the general economy—should be factored into the credit rating all along. This approach is in keeping with Standard & Poor's belief that the value of its rating products is greatest when its ratings focus on the long term, and do not fluctuate with near-term performance. Ratings should never be a mere snapshot of the present situation. There are two models for how cyclicality is incorporated in credit ratings. Sometimes, ratings are held constant throughout the cycle. Alternatively, the rating does vary—but within a relatively narrow band.

Cyclicality and business risk

Cyclicality is, of course, a negative that is incorporated in the assessment of a firm's business risk. The degree of business risk, in turn, becomes the basis for establishing ratio standards for a given company for a given rating category. (The ratio guidelines that Standard & Poor's publishes are expressed as a matrix, so that the degree of business risk is explicitly recognized.) The analysis then focuses on a firm's ability to meet these levels, on average, over a full business cycle, and the extent to which it may deviate and for how long.

The ideal is to rate "through the cycle" (see chart 1). There is no point in assigning high ratings to a company enjoying peak prosperity if that performance level is expected to be only temporary. Similarly, there is no need to lower ratings to reflect poor performance as long as one can reliably anticipate that better times are just around the corner.

The rating profile of the chemical industry offers a good illustration of Standard & Poor's long-term approach. Ratings for the major industry participants have been highly stable over a 12-year period, which has included two full industry cycles.

However, rating through the cycle is often the incorrect model. One reason is that rating through the cycle requires an ability to predict the cyclical pattern—and this is usually difficult to do. If indeed there is such a thing as a "normal" cycle, it is rare. The phases of the latest cycle will probably be longer or shorter, steeper or less severe, than just repetitions of earlier cycles. Management's determination to learn from previous cycles itself implies that "things will be different this time." Interaction of cycles from different parts of the globe, and the convergence of secular and cyclical forces further complicate things.

Moreover, even predictable cycles can affect individual firms so as to have a lasting impact on credit quality. For example, a firm may accumulate enough cash in the upturn to mitigate the risks of the next downturn. (The Big Three automobile manufacturers have been able—during the most recent cyclical upswing—to accumulate huge cash hoards that should exceed cash outflows anticipated in future recessions.) Conversely, a firm's business can be so impaired during a downturn that its competitive position may be permanently altered. In the extreme, a company will not survive a cyclical downturn to participate in the upturn.

Accordingly, ratings may well be adjusted with the phases of a cycle. Normally, however, the range of the ratings would not fully mirror the amplitude of the company's cyclical highs
or lows, given the expectation that a cyclical pattern will persist. The expectation of change from the current performance level—for better or worse—would temper any rating action, even absent a totally clear picture of the cyclical pattern. In most cases, then, the typical relationship of ratings and cycles might look more like chart 2.

The ratings of the forest products industry reflect such a pattern.

Sensitivity to cyclical factors—and ratings stability—also varies considerably along the rating spectrum. The creditworthiness of non-investment-grade firms is, almost by definition, more volatile. Moreover, the lowest credit rating categories often connote the imminence of default. As the credit quality of a company is increasingly marginal, the nature and timing of near-term changes in market conditions could mean the difference between survival and failure. A cyclical downturn may involve the threat of default before the opportunity to participate in the upturn that may follow. Accordingly, cyclical fluctuations will usually lead directly to rating changes—possibly even several rating changes in a relatively short period. Conversely, a cyclical upturn may give companies a breather that may warrant a modest upgrade or two from those very low levels.

In contrast, companies viewed as having strong fundamentals—that is, those enjoying investment-grade ratings—are unlikely to see their ratings changed significantly due to factors deemed to be purely cyclical—unless the cycle is either substantially different than anticipated or the company’s performance is somehow exceptional relative to what had been expected.

Analytical challenges

The notion of “rating through the cycle,” while conceptually appealing, presupposes that the characteristics of future cycles are readily foreseeable. The very term “cycle” seems to imply regularity. In actuality, this is seldom the case.

Cyclicality encompasses several different phenomena that can affect a company’s performance. General business cycles, marked by fluctuations in overall economic activity and demand, are only one type. Demand-driven cycles may be specific to a particular industry. For example, product-replacement cycles lead to volatile swings in demand for semiconductors. Other types of cycles arise from variations in supply, as seen in the pattern of capacity expansion and retrenchment that is characteristic of the chemicals, forest products, and metals sectors. In some cases, natural phenomena are the driving forces behind swings in supply. For example, variations in weather conditions result in periods of shortage or surplus in agricultural commodities.

The confluence of different types of cycles is not unusual. For example, a general cyclical upturn could coincide with an industry’s construction cycle that has been spurred by new technology. The interrelationship of different national economies is an additional complicating factor.

All these cycles can vary considerably in their duration, magnitude, and dynamics. For example, the unprecedented eight years of uninterrupted, robust economic expansion in the U.S. that followed the 1982 trough was totally unforeseen. On the other hand, there was no basis to assume in advance that the downturn that followed would be so severe, albeit relatively brief. Indeed, at any given point, it is difficult to know the stage in the cycle of the general economy, or a given industrial sector. A “plateau” following a period of demand growth might indicate that the peak has been reached—or it could represent a pause before the resumption of growth.

Even general downturns vary in their dynamics, affecting industry sectors differently. For example, the soaring interest rates that accompanied the recession of 1980-1981 had a particularly adverse affect on sales of consumer durables, such as automobiles. Sometimes, sluggish demand for large-ticket items can spur demand for other, less costly consumer products.

In any case, purely cyclical factors are difficult to differentiate from coincident secular changes in industry fundamentals, such as the
emergence of new competitors, changes in technology, or shifts in customer preferences. Similarly, it may be tempting to view cyclical benefits—such as good capacity utilization—as a secular improvement in an industry's competitive dynamics.

A high degree of rating stability for a company throughout the cycle also should entail consistency in business strategy and financial policy. In reality, management psychology is often strongly influenced by the course of a cycle. For example, in the midst of a prolonged, highly favorable cyclical rebound, a given management's resolve to pursue a conservative growth strategy and financial policy may be weakened. Shifts in management psychology may affect not just individual companies, but entire industries. Favorable market conditions may spur industry-wide acquisition activity or capacity expansion.

Standard & Poor's is also cognizant that public sentiment about cyclical credits may fluctuate between extremes over the course of the cycle, with important ramifications for financial flexibility. Whatever Standard & Poor's own views about the long-term staying power of a given company, the degree of public confidence in the company's financial viability is critical to have access to capital markets, bank credit, and even trade credit. Accordingly, the psychology and the perceptions of capital providers must be taken into account.