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The Suez Thu Duc water treatment plant project financing will likely be the first international limited recourse project financing in Vietnam to achieve financial close. With the loan documentation signed in July 2001, the sponsor (Suez, formerly Suez Lyonnaise des Eaux) and the Intercreditor Agent (Fortis Bank) expect first drawdown to occur in the coming weeks.

The financing is a tribute to the perseverance of the Suez which initiated the project in 1993, the creativity of the financial advisor and the lenders and the willingness of the Vietnamese authorities to clarify the Vietnamese legal framework.

Vietnam enacted build-operate-transfer (BOT) regulations in 1994 within the framework of the Foreign Investment Law (FIL). These initial regulations left many questions unanswered, especially in the area of financing. The amendment of the FIL in 1996 provided an opportunity to update the regulations to take into account the concerns of investors and flesh out further the legal framework applicable to BOT projects. This led the Vietnamese Government to issue Decree 62 in August 1998. Partly in response to the Asian Financial Crisis, the Government further liberalized the BOT regime by issuing Decree 02 in January 1999 amending Decree 62.

The initial project sponsors, Suez and Pilecon Engineering Berhad, were granted a 25-year BOT contract for a water treatment plant by the People's Committee of Ho Chi Minh City (HCMC PC) in November 1997, following the approval of the feasibility study by the Ministry of Planning and Investment (MPI) and the Prime Minister's Office. MPI issued the original investment license in December 1997 establishing the project company, Lyonnaise Vietnam Water Company, Ltd. (LVWC). LVWC plans to sell 300.000 m3/day of potable water on a take or pay basis to the Ho Chi Minh City Water Supply Company (WSC) pursuant to a Bulk Sale Contract signed in July 1999. The HCMC PC guaranteed the obligations of the WSC under the BOT Contract. The Ministry of Finance (MOF) in turn guaranteed the payment obligations of the HCMC PC in a Letter of Guarantee issued in August 1999.

Once completed, the project will represent 30% of the HCMC total production capacity and will supply drinkable water to approximately 1.5 million residents. The source of raw water will be the Dong Nai River pumped from the project's water intake through a new 12 km pipeline currently being constructed as part of the Asian Development Bank (ADB) Public Sector funded HCMC Water Supply and Sanitation Rehabilitation Project.

After achieving these early milestones, LVWC and its sponsors were faced with the challenges of structuring project financing in a difficult project finance market struggling with the impact of the Asian Financial Crisis where most banks had strong negative views about Vietnam. The ADB had been working on the project since 1998 and had already initiated certain aspects of the due diligence process on the basis of a co-financing structure. However, the project was now faced with potential lenders who required financing structures with country risks fully covered.

An alternative funding strategy had to be developed. The sponsors turned to Fortis Bank to assist in structuring a creative and viable financing package for the project. Export-credit based structures were first explored. However, the cost efficient construction of a water treatment facility only required a limited amount of equipment eligible for export credit financing. The solution was to devise a funding structure utilizing different sources of financing and capitalizing on the nationality of the shareholders of the project company.

Financing structure

The Thu Duc financing is a complex and innovative combination of multilateral and commercial funding sources supported by political risk insurance. The final structure combines two export credits, two extended political risk covered facilities and an ADB direct loan. ADB confirmed its initial commitment to provide a direct loan of up to $35 million.

Since the re-establishment of Belgian export credit cover for Vietnam in 1994, Fortis Bank and the Office National du Ducroire (OND), the Belgian ECA, had developed a very positive track record in Vietnam. Thus, OND had a very open and positive approach towards Vietnam country risk and could offer substantial capacity. The processing equipment of the water treatment plant (to be supplied by ONDEO ? Degremont Benelux) was selected in part because it would secure OND export credit cover for a portion of the EPC contract. OND will provide 95% political risk cover and 90% commercial risk cover for a $15 million export credit. Based on the participation of Tractebel as shareholder in the Thu Duc project, a further commitment from OND to provide a 90% extended political risk insurance for up to $30 million was obtained.

A similar approach was taken with the Malaysian Eximbank and the Malaysian export credit agency MECIB. Based on Pilecon's role in the project and the EPC contractors' commitment to subcontract a portion of the procurement to a Malaysian subcontractor and to procure a certain volume of Malaysian goods, Mexim has committed to provide a $13.6 million credit facility which will be covered by Mecib for 90%.

Finally, the financing structure was completed when Coface, the French export credit agency, agreed to join with a commitment to provide a 90% extended political risk insurance for up to $30 million based on the role of Suez as main sponsor and shareholder.

The participation of both Coface and OND into a complex BOT financing with extended political risk insurance based on the involvement of shareholders in the transaction was never tested. It required a number of amendments to their normal insurance policy as this type of insurance was usually utilized to cover investors rather than lenders. In addition, Coface and OND agreed that the extended political risk cover will not only include the standard political risk cover (war and riots, expropriation and transfer risk) but will also cover the outstanding debt in case the Vietnamese Government fails to pay termination compensation. The unique part of this cover is that the lenders are insured in either case whether the termination is caused by the Vietnamese side or by the BOT company.

With this structure in place, the project was ready to go to market for the selection of lead arrangers/underwriters. While a very comprehensive cover had been put in place, the level of residual risks to be absorbed by the commercial banks and the long tenors of up to 15 years had never been tested for the Vietnamese market. The bank market reacted extremely positively and more than 6 firm offers were received from major financial institutions proposing underwritten commitments for at least 3 times the amounts needed.

ANZ Investment Bank, Credit Lyonnais and Fortis Bank were selected as lead arrangers in August 2000. ANZ was in charge of insurance while Credit Lyonnais became the Coface Agent. Fortis Bank continued its role as co-ordinator among the different parties, model bank, technical bank and, in addition, took on the role of documentation bank.

The final $108.6 million financing structure signed in July 2001 included the following facilities:

? $31 million direct loan from ADB

? $24.5 million Coface extended political risk covered facility

? $15 million OND covered export credit

? $24.5 million OND extended political risk covered facility

? $13.6 million Mexim loan facility

Water requirements in Vietnam

HCMC is the largest urban center in Vietnam with strong industrial and commercial sectors. The city covers an area of

2,056 sq km, and is divided into administrative districts. The population of HCMC is officially about 5 million, a number that is expected to double by the year 2020. Since 1975, due to financial and other constraints only minimal investments had been made in the rehabilitation, repair, upgrading and extension in the HCMC water supply system. Consequently, the production and distribution facilities are now inadequate and are unable to meet the water requirements of the growing population, as well as those of the rapidly growing industrial and commercial sectors.

Since an adequate and reliable water supply system is a precondition to continuing development and to attracting foreign investors, the extensive rehabilitation and expansion of the HCMC water supply system is of vital importance. This is well recognized by the Government of Vietnam and the HCMC PC has accordingly assigned a high priority to the comprehensive rehabilitation and expansion of the water supply program.

Currently the HCMC PC has approved the following water projects:

? Binh An BOT Water Treatment Project (completed and operational since September 1999 with a capacity of 100,000 m3/day)

? Thu Duc BOT Water Treatment Project (to start construction with a capacity of 300,000 m3/day)

? Saigon River Water Supply Project ? Phase I and II: currently under review with the HCMC PC (one phase may be done under the BOT scheme)

? Existing Thu Duc Water Treatment Plant extension from 650,000 m3/day to 750,000 m3/day scheduled to be implemented with ADB Public Sector financing.

Drinking water supplies in HCMC are drawn from both surface and underground sources. Total daily production currently amounts to 800,000m3/day, of which 650,000m3 are produced by the existing Thu Duc Water Treatment Plant. This quantity of water (about 120 l/capita/day) does not cover the total household consumer's demand (the present daily water demand in HCMC is estimated at about 1,100,000 m3/day and likely to raise to 1,500,000 m3/day by 2010). About 60% of the population is actually connected to the distribution system.

Economic feasibility

Substantial due diligence was undertaken to assess the financial and technical capabilities of the WSC as off-taker under the Bulk Sale Contract. The WSC is a public utility fully owned by the HCMC PC. Its payment obligations under the Bulk Sale Contract are guaranteed directly by the HCMC PC and indirectly by the MOF.

In addition, due diligence revealed a utility with a sound balance sheet, with very capable management that had been operating a water loss reduction program since 1993 keeping the ?Non Revenue Water' levels at below 40%. The collection rate for consumer accounts appeared to be over 99% with disconnection for non-payment rigidly enforced. The WSC is operating its treatment plants and distribution network without receiving any government subsidy, and the present tariffs (which have been subject to regular increases over the last few years) cover its operating, depreciation and equity return costs while remaining affordable for the HCMC population.

Structure of the Thu Duc project

The overall contractual and financing structure is fairly typical for projects of this nature. The diagram below sets out a schematic representation of the major contractual arrangements and participants.

The Thu Duc legal framework

In the Thu Duc project, the BOT legal framework in Vietnam was clarified in several important respects ? thanks in no small part to the flexibility shown by the Vietnamese authorities in implementing the two main governmental decrees. As seen below, this flexibility is apparent at too many levels of the financing structure to be coincidental and augurs well for future BOT project financing in Vietnam.

Choice of foreign law

The acceptance by the Vietnamese authorities of foreign choice of law clauses was a significant step in creating a bankable financing structure. The Ministry of Justice (MOJ) and the HCMC PC demonstrated great flexibility in permitting foreign law to be chosen as the governing law for the project contracts. The MOJ provided an approval in principle and the HCMC PC agreed to amend the choice of law clauses in the existing project contracts to provide for English law as the governing law of the contract.

Step-in-rights

The Thu Duc financing structure includes a comprehensive set of step-in-rights allowing the lenders to take over all or part of the rights and obligations of the BOT company in case of default provided that the lenders fully perform the obligations of the BOT company or its foreign investors as required by the project contracts and the investment license. The documentation provides direct step-in-rights in the BOT Contract itself as well as in a comprehensive Direct Agreement between the HCMC PC and the lenders. In addition to recognizing certain rights that the lenders will have if the BOT company defaults under the credit agreements, the Direct Agreement also approves a pledge of the certificates evidencing capital contributions to the BOT company under New York law.

Foreign exchange

The foreign exchange priority status of infrastructure projects like Thu Duc, in effect deals that have not been classified by the National Assembly as projects of national importance, has been clarified. For the first time, a procedure for the grant of assistance by the State Bank of Vietnam and the Prime Minister with respect to the convertibility of Vietnamese Dong to US dollar has been outlined by the Vietnamese authorities. This confirms that the Government will look to its national reserves to facilitate convertibility even if an infrastructure project does not obtain the availability guarantees provided to projects of national importance like the power plants in the Phu My complex.

Under current Vietnamese foreign exchange control regulations, project companies are permitted to make authorized transfers from Vietnam into an authorized offshore account of the borrower in respect of amounts payable on account of principal, debt service, fees and insurance premia. Specific authorization is required to buy and repatriate foreign currencies, with authorizations usually covering the life of a project. Companies authorized to make transfers may contact the commercial bank of their choice to purchase the foreign exchange required to make the authorized transfers. The nagging question is what happens if the commercial banks contacted do not have sufficient currency.

Recent revisions to Vietnam's FIL created a three-tier foreign exchange assistance regime, divided into (i) especially important projects; (ii) infrastructure projects and other important projects (the Project); and (iii) ordinary projects (other than the foregoing). Previously, a two-tier regime operated, involving (i) infrastructure projects, projects producing import substitutes, and important projects designated by the MPI from time to time, and (ii) ordinary projects.

The new law prescribes the level of foreign exchange assistance that each type of project is entitled to receive, ranging from availability guarantees, through ?guaranteed assistance? on the balancing of foreign exchange in the event that commercial banks are unable to meet the required (and approved) needs of a project company, to (at the lowest level) simply confirming the right of a project company to contact commercial banks to buy foreign currency in accordance with Vietnamese laws. The parties proceeded on the assumption that the project was a tier two project (an assumption confirmed by the authorities). If a commercial bank contacted by LVWC does not have sufficient foreign currency to meet LVWC's conversion requirements, that bank can report to the SBV its foreign exchange position and the shortage of foreign currency for which SBV assistance is requested and start the process of ?guaranteed assistance?.

Security in Vietnam

The position in Vietnam with respect to foreign lenders taking security over movables, immovables and land use rights (LUR) continues to be of great importance to project lenders. Traditionally, Vietnamese laws and regulations evinced a strong policy against granting mortgages over LUR to foreigners and foreign entities. The policy, however, began to change in 2000, principally with the amendment of the FIL and the issuance of certain Government decrees. The changes allowed foreign bank branches operating in Vietnam and joint venture banks to take mortgages of LUR from foreign invested enterprises together with the assets located on such land. The current laws do not, as yet, go so far, as to permit foreign lenders to take such security interests ? for the moment, foreign lenders must simply accept that they will not receive security over LUR if they wish to do ?secured? transactions in Vietnam.

Vietnam is, however, proceeding with the implementation of legislative and regulatory developments directed at establishing a comprehensive legal framework for secured transactions in Vietnam, based upon a national registration system for pledges of movables, and a local registration system for mortgages of LUR and immovables. The new registration system is expected to begin functioning next year. The documentation takes this into account and the MOJ has been asked to opine on the status of security interests granted prior to the start date of the registration system.

MOJ legal opinion

The MOJ has indicated that it is prepared to issue a legal opinion at financial close covering the validity, legality and enforceability against the Vietnamese government parties of the project documents, the MOF Letter of Guarantee and its assignment and the SBV letters related to foreign exchange support for the project. In addition, the MOJ will also confirm the validity of the choice of law provisions and the arbitration in Singapore clauses.

Conclusion

The Thu Duc financing will likely set a benchmark for future BOT financings in Vietnam like the upcoming Phu My projects. It shows that committed sponsors can bring to financial close an infrastructure project in Vietnam and that the Vietnamese authorities are now prepared to do their part to facilitate access to the international capitals markets by making the adjustments to the legal framework required to implement bankable financing structures.