IPP or PPP?

01/07/2000

When it comes to inspiring private investors to run its power generation sector, few can claim Abu Dhabi's level of success. The Emirate is regarded by many as having set compelling regional benchmarks for power project financing ? with more heavyweight deals yet to come. But although its faith in private management has bred a flurry of developer (and lender) activity, the state's commitment to privatization and market structures is much less obvious.

To begin with, the Abu Dhabi government is in no need of foreign capital, with reserves of well over $100 billion. But it believes private help will inject some market discipline into its utilities, rather than letting them become extensions of the welfare state, as providers of services and employers. Or so the theory goes. It began, then, by bringing in the private sector to run, while maintaining a minority stake in, electricity generation.

With no foreign debt, some of the highest standards of living in the world, and one of the most diversified and sturdy economies in the region, the UAE has had, and will continue to have, little problem attracting yet more foreign cash to shore up, among other things, its utility efficiencies. This applies to Abu Dhabi as much as to Dubai, if the latter ever sees the need, as some would argue certainly exists, to go the private distance.

New hope

The Abu Dhabi Water and Electricity Authority (ADWEA) was conceived in 1998 out of a need for greater efficiency together with the simple realization of long-term demand crunch. Nine new state-owned companies were created, spread across generation, distribution, transmission and procurement, all licensed and highly regulated.

The question, however, was how and when to privatize, rather than just restructure. Enter White & Case, Credit Suisse First Boston, and Fichtner, as legal, financial and technical consultants to ADWEA for the first flutters of private activity in the sector: power generation.

The subsequent teamwork gave rise to the first independent water and power project (IWPP) in the world, the $596 million Al Taweelah A2 710MW/50 million gallon desalination project, commissioned by CMS Energy, whose price was one third the government's pre-privatization price. ADWEA retained its majority 60% stake in the project company.

Mandated in September 1998, it took sponsor CMS less than 12 months to attract an international team of lenders and reach financial close on April 27, 1999. This was just the beginning.

IWPP mania

ADWEA plans to increase electricity output from the present level of 2,500MW to 7,356MW by 2010. At the same time, desalinated water production is set to rise from 262 million g/d to 573 million g/d over the same period. All this to meet a budding downstream industrial base and a fast growing population.

With a highly successful project in hand, then, Abu Dhabi has moved forward full steam with its private restructuring program. Witness the second smoothly tendered IWPP, the Al Taweelah A1, awarded to a TotalFinaElf/Tractebel consortium.

At $1.3 billion, the deal is the largest yet. It came by a $1 billion loan, which successfully closed last November. As with its predecessor, the deal is notable for its tenor (18.5 years), which received strong bank backing. BNP Paribas and Citibank co-lead the deal, though the former also supported the consortium during the bid phase, before bringing Citibank into the deal.

Pricing, was also comfortable enough for a smooth sell down: 110bp during construction, notching up to 125bp-145bp during operation.

The existing facility was upgraded to 1,350MW, with water capacity increased from 29 million g/day to 40 million g/day. Bidders were asked to match prices for the previous project ? $0.224/kWh.

TotalFinaElf/Tractebel finally won against the other final listed bidder, CMS, on the basis of pricing. As with the A2, 60% of the project went to ADWEA, with the consortium picking up a 40% stake.

When the plant reaches full commercial operation, by early 2003, it is expected to supply about 25% of the emirate's power and water needs.

The transparency of the tender process is a feature which warrants significant attention. Explains an executive at a foreign power company. ?All the players knew exactly what they were facing. The tariff was set, and the rate of return was established. Moreover, the government tried to make it easier for investors to come in and do the work with the result that now, whoever can do it more competitively will win.? He is underscoring the benefits of clear and distinct guidelines in which ?all the assumptions are in place before the bid,? such that there is little room for deviating interpretations and where ?everyone plays by the same set of rules?.

So vaunted is Abu Dhabi's clarity in this regard investor appetite is deep and fierce. Ultimately, though, ?the golden rule for IPPs is that the person who can best manage the risks must take it.?

This truism will certainly play itself out in the latest round of Abu Dhabi's IWPP mania. By far the most ambitious power and water project (for the entire Gulf) is yet to surface: the 1,500MW and 100 million g/d Shuweihat project, bids for which are currently under review.

The contest for a 40% stake for this greenfield BOO scheme has been fierce. But after months of exhaustive negotiation, CMS Energy, together with International Power, has been selected as preferred bidder, beating competitors Tractebel and AES. The deal now awaits executive council approval before the signing of the power and water purchase agreement, set for July 31.

The CMS group is being backed by a banking group led by Barclays Capital and Citibank. Bank of Tokyo Mitsubishi, Royal Bank of Scotland, KfW, NBAD and ADIC have also been appointed.

The project is the largest yet. Banks are expected to provide some $1.3 billion in debt for the scheme. The deal is likely to be structured in much the same way as the Taweelah transactions, given the ever-growing trend towards contract standardization. Contract details are to be finalized by the end of October, with financial close expected, swiftly, by the end of December. The sponsor is also evaluating possible local or Islamic tranche options.

ADWEA has retained its previous legal counsel, White & Case, for this project. However, Deutsche Bank and Lahmeyer International replace the former consultants as financial and technical advisers respectively.

Private, but how private?

Part of greater fiscal discipline is opening up infrastructure to private participation, thereby forcing, in theory, the appropriate pricing of output. But before market models can be achieved, or meaningfully discussed, many issues need tackling.

There is much doubt about the nature of the privatization process itself, given that the state still plays such a dominant role in the emirate's utility sector, with the government retaining 60% stake in the projects. As one local banker puts it, ?

the main worry is whether this is privatization or something else ? that is, a form of subsidy.? He continues, ?How far can privatization really go??

This urges, among other things, legal worries. Says a local lawyer, ?there's no legal protection, for example, against developers being booted out by the majority shareholders.? Namely, the government. And this is precisely the problem.

As in any freshly privatizing state, many concerns persist. Right now, the cost of power is being subsidized by the government. If market discipline really is the aim, this will have to change. With citizens all at once having to pay for what has historically been a ?free? service, or at least one whose nominal charge has been way below production costs, some annoyance is perhaps inevitable. ?It's a question of ideology as much as it is of economics,? contends a local banker.

There have already been some increases in the charges for utilities. Over-dependence on the state may be slowly peeling back. With it should also come a stronger work ethic. Cuts in government employment will need to be replaced by greater private sector employment responsibility, to ease the inevitable transition.

Counters Abdullah Al Neaimi, director of IWPPs at ADWEA, ?it takes time to privatize effectively. Right now we're not working with fully real market models, but we're working towards them.? As such, the current situation, in which the government still maintains control over ownership and pricing of electricity and water, he suggests, might change over the next few years.

But this is hardly satisfactory for some. Says a London based international lawyer, ?the government's approach has been to bring in flash new power plants ? and they've done it beautifully, through a small, tight-knit team at the center. But they're doing it without a view towards a proper market structure.? He adds, ?if you're going to design a new market structure, you're presupposing that the state will peel back its role. In Abu Dhabi, there's no clear indication that it will ? it's much like buying a shiny new toy with no batteries.?

Adds another international banker familiar with the process, ?the benefits of having a series of IPPs are limited. The real benefits come from full privatization, and the openness to foreign investment that entails.? He adds, ?The UAE as a whole could do well to use the Omani privatization template.?

Next in line for partial privatization are several other government owned generating assets. The first of these, the acquisition and expansion of the Umm al Nar complex, is expected to be tendered towards the end of the year. The facility, with a current capacity of 1148MW/92 million g/d, is to be expanded to 1750MW/150 million g/d ? much along the lines of the Taweelah A1 IWPP. Financial, legal and technical advisory bids are currently being pitched.

Other future selloffs may include Bainounah Power company, with 1201MW/44 million g/d; Al Mirfa Power Company, with 311MW/16 million g/d; and, finally, another Al Taweelah Power company, with 1069MW/95 million g/d.

The question remains how far the privatization drive will go. ?Distribution could be privatized, but its not currently under formal scrutiny,? says Neaimi. The two possible candidates for such a move would be the Abu Dhabi Distribution Company, and the Al Ain Distribution Company. Transmission, he says, is unlikely to be privatized.

Notwithstanding privatization concerns, the Abu Dhabi independent power story has been a laudable success. And it owes much to its preemptive regulatory restructuring. The sector's regulatory environment was very carefully laid out from the outset. In fact, the emirate established the Regulation and Supervision bureau ? the first independent regulator in the Middle East. Often likened in function to the UK's independent regulator, the bureau undertakes standard regulatory activities, mitigating against monopolistic deviancy, for example, by restricting companies to no more than 25% market share without explicit consent. Indeed, this function is part of its licensing activities, which cover the entire power structure. ?You have to put the regulatory framework in place to bring in IPPs properly,? insists Mackaye. ?And, in this regard, Abu Dhabi has done a great job.?

Big deals. So where will the liquidity come from?

Abu Dhabi, with all its wealth, has had an easy time bringing private cash to bear.

That alone gives great comfort to lenders, and partially explains their willingness to invest. But, with the glut of deals yet to surface, in the UAE and regionally, the question of securing funds will become more urgent.

?Abu Dhabi's power sector has been so successful because it provided sovereign guarantees backstopping power purchase agreements. Moreover, if a project falters, the government will be there to bail it out, unflinchingly,? maintains a Gulf-based foreign banker.

The perception of credit quality for regional power transactions is, arguably, stronger than for petrochemical and industrial projects, as far as local and foreign commercial banks are concerned. A major result of this has been the extension of substantial tenors for power financings (compared to petrochemical financings), a fact nicely illustrated by the Taweelah deals. Equally, pricing on long maturity loans has been especially low.

?The process of reaching financial close on these power deals is now almost second nature,? says one local financier. ?But people are becoming more imaginative, and sharpening their pencils, while developers are becoming more acute. The only real area to shave costs now is financing.?

What next?

With a number of bulky projects coming to the region in the short term, alternative sources of funding, beyond the syndicated loan market, may gain appeal. Though opinions remain mixed about the near future for the capital markets, at least as far as impending Gulf power deals are concerned, other resources are within easy reach.

Many regional banks are in healthy shape, experiencing vast capital surpluses, partly due to oil price rises. Add the fact that the UAE, for example, lacks stringent controls on capital, allowing banks almost untrammeled access to liquidity. Most banks have vast appetite and as yet untapped lines.

But there is no doubt that an increasingly enthusiastic role will be played by the heavyweight GCC banks, such as ABC and GIB, in many large regional project financings, as is already happening. In Abu Dhabi, domestic banks, like National Bank of Abu Dhabi, Abu Dhabi Commercial Bank, and Mashreq Bank, are all expected to fine tune their project capacities in coming years, in line with the region-wide shift to longer term money.

Says UAE Central Bank Governor Al Suwaidi, ?a large part of the financing for these large infrastructure schemes could be done regionally. Its simple a matter of cooperation and coordination. But we are certainly trying to bring our banks together.?

Islamic funds

The Islamic finance market is another area that has drawn much attention in the project sector recently, especially in light of the Thuraya Satellite Telecommunications project, backed in part by Abu Dhabi Islamic Bank (ADIB). Abdul Rahman Abdul Malik, CEO of ADIB, explains that ?Islamic banking is investment banking by structure. It is development banking, not consumer banking. And with projects, our instruments become more workable.? The benefit of Islamic banks, he insists, is ?their high availability of liquidity.? He expects an increased project role for Islamic banks, which, he claims, are comfortable with long tenors.

Others, however, are less convinced about the Islamic finance market. ?People will tap Islamic financing only if commercial financing is unavailable. It brings a very complex element to the financing structure because of the requirement to hold collateral on the instruments being financed. We try to avoid this,? says a regional banker. Adds another, ?its very complex, since there's no single committee to say what's acceptable.?

Governor Al Suwaidi presents a more even-minded view: ?Islamic banking concepts are new to the international community, so its natural that they're in this controversial stage.? The problem of consensus certainly needs to be addressed, he admits. ?Across the region we need to agree on yardsticks to provide the necessary framework for Islamic institutions to develop the right instruments. We need to define the products and our prudential measures accordingly,? he continues, ? and I am urging my colleagues regionally to develop a system that is transparent, credible and equitable across the board, and progress is certainly being made.?

Capital markets

A major concern raised by many bankers is the development of regional capital markets.

?The development of the capital markets will not come without the government creating the right infrastructure for it,? explains Governor Al Suwaidi. ?We, as the Central Bank, have come far in paving the way, by way of regulation on debt instruments, for long term debt. We are now encouraging banks to offer long term deposits, to establish a market for long term financing,? he adds.

So far, the only project bond to be issued in the Gulf was the $1.2 billion issue in 1997 which fed Qatar's RasGas, a liquefied natural gas (LNG) export project. Though forecasts at the time were upbeat ? even proclaiming the eve of a new financing era ? the reality has been different. But interest in project bonds is still palpably there. In neighboring Oman, one of the banks bidding for the arranger mandate for the Oman Gas Company pipeline projects put forth a long term bond solution. The bid failed, but nonetheless demonstrates that talk has moved beyond theory.

One regional banker construes the major hurdle to potential bond issues to be pricing, explaining that commercial borrowing is still typically cheaper. But the trends are shifting, and bond solutions may yet command more credibility, particularly for LNG and power projects.

?A bond solution could make good sense for Shuweihat post-completion,? contends one foreign banker.

ECA financing may also become more commonplace as international commercial lending limits are reached. ?Of course,? explains one indigenous banker, ?that will depend specifically on how well the bank market can absorb the transactions, but still, the fact remains that ECAs are in the region to stay.?

Fostering the proper development of regional capital markets is still very much on the minds of many local financiers. Says Governor Al Suwaidi, ?it is now just a matter of time.?

Offsetting gas delays

Over the last few years, the UAE has embarked on a massive multi-billion dollar program of investment in its gas sector, vital for the introduction of gas-fired power plants and the transformation of the Taweelah commercial district into a gas-based industrial zone. Gas underlies the federation's economic diversification plans. Now, the most ambitious of its gas schemes, the Dolphin Project, is inching towards realization, albeit with delays and setbacks.

Dolphin, an agreement signed two years ago between United Arab Emirates Offsets Group (UOG) and Qatar General Petroleum Corporation (QGPC), aims to pump two billion cu.ft/d of natural gas from Qatar's offshore North Field undersea to Abu Dhabi and onward to Dubai and Oman, with a possible future link to the subcontinent.

UOG signed preliminary agreements with Mobil Oil Qatar for the supply of 300 million to 500 million cu ft/day, the upstream section of the project. A full production sharing agreement is due to be signed by the end of September.

But last month, Enron, which had signed agreements with UOG to work on the midstream part of the scheme, bowed out of the $3.5 billion project. Their departure is not believed to have undercut general confidence in the scheme itself.

The company apparently sold its stake in the project to UOG for an undisclosed sum. Accordingly, UOG has begun negotiations with other major international oil companies interested in taking over Enron's stake. In the meanwhile, UOG will own a 75.5% share in the project, with upstream strategic partner TotalFinaElf holding the remaining 24.5%.

Eight companies are reported to have expressed interest in the stake. They are believed to include Conoco, Occidental Petroleum, ExxonMobil and Chevron, BP, and Royal Dutch/Shell. Midstream work on gas transportation will require building a 350-kilometer pipeline from a processing plant in Ras Laffan, Qatar, to the Taweelah terminal in Abu Dhabi and Jebel Ali terminal in Dubai.

According to some industry sources, Enron's decision to pull out of the project may be a move in the group's global strategy to move away from an assets-based company to a trading organization. Enron has sold its 24.5% stake in Dolphin Energy Ltd., back to UOG, saying it felt it had contributed all it could to the initial stages of the project.

TotalFinaElf has also indicated it would be interested in taking a larger stake in the project.

Dolphin also recently issued prequalification invitations for international, regional and local companies to bid for five separate engineering contracts for the project. The companies have been given two weeks to submit their bids.

As the plan stands, UOG and Abu Dhabi National Oil Company (ADNOC) have also issued a joint declaration dividing up gas distribution between them. Gas from the Dolphin project will be the exclusive supply for gas fired plants, except in the western region of Abu Dhabi, and will also supply gas for ADNOC contracts with Dubai.

The effort continues. Eleven banks have been invited to bid for the financial advisory mandate, to be awarded in July.

Says a senior official at UOG: ?this project is critical for the Emirates, let alone the rest of the region, since there's such a huge need for gas right now.? In Dubai alone, the largest call on gas will come from industry, which is forecast to double its consumption in the next five years. Throughout the UAE, demand from the power sector is projected to surge some 60% in that time.

The UOG itself is becoming ever more of a presence in the domestic projects sector. It helped devise the ?Taweelah solution,? the pioneering privatization and restructuring program, and, with the probability of Dolphin, now has ?the capacity not only to initiate but to implement as well.? Continues the official, ?we're looking to become a major regional player throughout the UAE in developing and implementing projects, power and otherwise.?

Desal

But the first major project to demonstrate UOG's capacity to implement will be its $1 billion Fujairah desalination plant. UOG is expected to award the contract for the desalination and pipeline project by the end of July.

Three international companies have tendered for the desalination and power plant package. Sidem, in partnership with Hyundai Heavy Industries, has submitted a low bid of AED 2.054 billion for the 100 million g/d of water and 122 MW of power. Hanjung submitted a bid of AED 2.731 billion for 100 million g/d of water and 218 MW of power. Italy's Fisia Italimpianti has priced the package at AED 3.1 billion for 100 million g/d of water and 236 MW of power. The bidders have submitted eight proposals covering a range of desalination technologies.

Says one banker familiar with the project, ?UOG has approached this project from a strange angle ? they're going for the EPC route first, after which they hope to find a project sponsor.? But the reason for this is speed. Says an Abdu Dhabi based international lawyer, ?this project is very much at the top of the agenda. The northern emirates need water fast.? He adds, ?UOG's involvement has really given the project the kickstart it needs.?

Accordingly, to get it done swiftly, the UAE government will initially provide the funding. It may ultimately be project financed, but only post construction in 2003. The project advisory team is made up of Taylor DeJongh (financial), Fichtner (technical), and Allen & Overy and Hadaf al Dhahery (legal).