

Landing the promised deals

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Last year's Cross-Israel Highway transaction promised to pave the way for significant project-finance shaped investment in the country. So far, progress has been scant, with, some argue, unflinching state monopolists threatening to keep it that way. But infrastructure and energy projects demand innovative solutions ? and, for Israel, confident private cash continues to hover within comfortable reach.

Private sector enthusiasm for livening up Israeli infrastructure is, of course, ultimately tied to macroeconomic fact. And the fact is the economy, after a spell of ill health ? spawned in part by fiscal and monetary restraint, as well as a drastic decline in foreign investment ? has perked up. Notably, the country attracted 63% more foreign investment in the first half of 2000 than in the same period of last year. Not to mention stronger export growth, and a slight swelling of real growth to 3.7%.

The upbeat mood is reflected, as well as fed, by Moody's upward revision of the country's credit rating. The rating agency, acting on its perceptions of Israel's emboldened economic performance and structural reform initiatives, upgraded the country's long term foreign currency bond and bank deposit ceilings from A3 to A2, and its short term foreign currency ceilings to Prime-1. Moody's now claims that even the ?negative developments in the sphere of geopolitics and short term vicissitudes of the peace process are now less capable of distorting Israel's economy and polity in a manner which undermines the country's creditworthiness.?

And with ever more open and competitive market oriented policies, highlighted by currency liberalization and the elimination of foreign currency controls, the long term rewards are already being foreshadowed.

A tender issue

These details aside, the question goading project market observers is why, given the vast success of Israel's largest ever deal- the Cross-Israel project ? other key infrastructure projects are not scuttling to the market as swiftly as hoped.

At \$1.35 billion, last October's closure of the long and painstakingly planned deal set what many project participants felt was a benchmark for any future project financing in Israel. As Paul Rubenstein, partner at Israeli law firm Herzog Fox, puts it, ?it was a commercial imperative that this project happen ? it should give future projects the kick start they need.?

The project, structured on a build, operate and transfer (BOT) model, involves the construction of an 86km north-south toll road around Tel Aviv, from Hedera to Gedera, as part of a planned 300km highway. The hope is to ease traffic congestion around Tel Aviv and, ultimately, to promote development of northern and southern regions of the country.

Philip Stopford, partner at White & Case, who acted as legal adviser to the government, describes the transaction as ? mammoth. It involved a fairly complicated bidding process and an immensely intricate financing structure. ? But, he continues, ?at the end of the day it was an educational process for everyone involved.?

Rubenstein echoes this sentiment: "the project involved so many new and exciting aspects that it helped dispel naivete. It familiarized us all with the techniques of project financing."

A year later, the chance to apply this much-vaunted education may have emerged in the form several other weighty infrastructure projects. "In transport," claims Rubenstein, "'BOT' is the buzzword." The buzz surrounds two proposed BOT transport projects, the Tel Aviv Metro and the Jerusalem Light Rail projects, and a much needed desalination plant.

The Israeli government initially commissioned the Tel Aviv Metro project in 1970. Thirty years later, the Ministry of Finance and Ministry of Transportation have finally signed an agreement to go ahead with the rail system. The renewed enthusiasm, suggests Moriel Matalon, managing partner at local firm I. Gornitzky & Co., is, in part, "the result of Cross-Israel's success." Discussions have recently warmed up, but the government has yet to issue its tender.

The Jerusalem Light Railway BOT tender, on the other hand, has already entertained notable interest. A total of five international and local consortia, including Canadian Bombardier and German Siemens, have qualified to advance to the final stage on their bids to build the first section of the railway system, at a cost of \$400 million. A further decision will not be published until the end of November. The project, valued at over \$1 billion, when completed will comprise eight routes, 75 stations and 34 miles of track.

The third project to be tendered on a BOT basis is the desalination plant. France's Vivendi has joined forces with Israeli Dankner Group and IDE, a joint venture Israel Chemicals Ltd. and the Delek Investments & Properties Ltd, to form a consortium to compete on the plant's tender. The tender aims to launch the project, with its estimated production capacity of 50 million cubic metres, by 2003, as an attempt to address the deepening regional water crisis.

The common theme of these projects, though, is their BOT mantle. Matalon suggests that government debate over BOT tendering rages fierce: "For BOT projects, the government's concern is cost." He continues, "their question is whether to take these infrastructure projects on their budget or to give them to private hands." He assesses government priorities thus: "Ultimately, the more crucial the project, the more likely it will be funded by the government's budget."

According to this logic, then, the expansion of Ben Gurion Airport and the Ashdod Port projects, both of which are, according to Matalon, of highest priority, will not follow the project financing route, "for fear of too great a cost."

Ultimately, explains Matalon, "the government's decision making depends on the political atmosphere at any particular time which, in turn, determines whether or not such projects are taken either on or off government balance sheet."

Nonetheless, "the government has gained considerable experience with BOT projects, having done Cross-Israel," maintains Rubenstein.

Agreed, the Cross-Israel experience was instructive. But not all agree on its lessons. Disenchantment weighs heavy for one financial adviser on the deal: "there was great reluctance on the part of the government to provide the necessary concessions. They felt the project would go ahead regardless, so they didn't care whether or not the debt would be syndicated, or on whose books it would sit." He is referring to a \$250 million portion of debt, the bulk of which is still sitting on CIT's books.

Others claim circumspection: "the government has an ambition in every tender to improve its position even further, without caring about the other parties," vents a banker close to the deal. "The Cross-Israel deal was an exception, and it will be difficult to match," he adds. "For all future projects you have to ask whether the government will really let the sponsors make any profit."

His advice to international developers, then: "if I were them I'd wait for the first draft of the tender to be issued to see

how serious the government is about a bankable deal which is sufficiently generous to the sponsors.? Cautious words indeed.

On this interpretation, progress is stalled largely by bureaucratic obstinacy. ?There are no obvious obstacles,? explains the banker, ?but things are being done very slowly. The government overestimates the value of its tenders and fails to understand the risks. Ultimately, future project financing in this country will require extremely patient players.?

Matalon, however, is more optimistic: ?Of course the financing side was difficult. But those who had the stamina and who were willing to stay, succeeded. Those less interested in it lost out. This was the price of learning.?

Privatization

Deregulation and privatization compose the government's latest economic mantra. Though the privatization program was launched initially in 1986, ministerial opposition to losing control of state owned enterprises slowed its pace. But Prime Minister Barak's government insists it will approach privatization as one of the primary targets of its economic reform. Its plans are ambitious. And the program is being attacked in two ways ? through the direct sale of state-owned companies to bidding investors and through forthright public offerings. This year, privatization proceeds are expected to reach NIS 3.5 billion.

First to be deregulated and privatized is Bezeq, the state-controlled telecoms company. In early September, the communications ministry shot down Bezeq's long standing monopoly in the domestic telephone and internet service.

Now, licenses for up to 15 years will be granted to new, competitive players, on the shrewd condition that the bidders must be 20% owned by an Israeli company and that they provide services within a year. Such provisos notwithstanding, deregulation has begun. And its scope is widening.

As Bezeq prepares for deregulation, other state monopolies look towards their private futures. ?It's a slow process,? maintains one finance ministry official, ?but we're getting there.? ?There' means disbanding all the old structures, from the telecoms sector to the energy sector, and preventing monopolies and their kin from sprouting in the revamped markets.

Energy

But although Israel in theory prefers the privatization of state-owned companies, the energy sector remains largely nationalized and state regulated. In 1996 the Israeli Electricity Corporation's (IEC) exclusive 75 year concession to generate, transmit and distribute electricity expired. It was promptly renewed for another ten years.

At that time the government did, however, pass the Electricity law, requiring the introduction of Independent Power Producers (IPP's) for 20% of the total generated electricity. Significant changes followed: the establishment of an electricity regulatory body ? and the introduction of IPPs. The IEC issued a tender in 1997 for several small IPPs totalling 65MW. Only one is currently operating, at around 10MW. Yet the Ministry of Energy has directed the IEC to purchase at least 900MW from IPPs by 2005.

Demand

Demand estimates vary, but by all accounts they will have to be revised upwards in the coming year. Israeli power demand hit an all time record of 7560MW in July, owing in part to exceptional summer heat waves and the closing of 375MW Ashkelon plant.

In addition, the IEC estimates that power demand will double every ten years. This means an increase in production to

over 10,000MW by 2002. By 2010, the IEC expects an installed generating capacity of 13,400MW ? in other words, \$1.2-1.3billion a year in extra financing for generation, transmission and distribution systems.

In June 1997, the IEC put forth its first tender for a large scale private power plant: a \$200 million, 370MW combined cycle gas turbine plant at Ramat Hovav in the Negev Desert. But the terms of the tender required all generated power to be supplied exclusively to the IEC, in apparent violation of the Electricity law.

This alleged breach has led to a protracted legal dispute between the IEC, the Ministry of Finance and the Ministry of Infrastructure. The Antitrust commission ruled that the sale of electricity solely to the IEC represents an unacceptable monopolistic practice. So the commission set out to formulate regulations overseeing links between private producers and IEC, thus causing hefty delays. Its new rules effectively bar the IEC from forcing private producers to sell power only to state utilities.

Finance and acting Infrastructure Minister, Avraham Shochat, recently signed new regulations to ease the absorption of private electricity providers by the national system. The new parameters should regulate the relationship between the IEC and all private companies hoping to supply electricity in Israel.

One such company is local developer Ofer group who, together with PSEG, won the Ramat Hovav bid in 1997, on an appeal against initially successful bidders, the Zeevi group. But the ensuing legal dispute and antitrust tussles have left the project as something of a chimera ? until now.

In fact, Moshe Katz, Ofer Group's general manager, expects to sign the power purchase agreement (PPA) with the IEC in the next few weeks. The PPA spans 20 years.

The deal, though still far from the financing stage, is allegedly priced at around \$200 million, a sum to be sourced most likely from a mixture of equity (15%-30%) and bank debt. Bank Hapoalim, lead arrangers on the Cross-Israel transaction, are rumored to be underwriting the debt in full.

Ministry officials suggest that Ramat Hovav will not start up until 2004 at the earliest.

At the IEC, the antitrust ruling sets off counterintuitive emotions. Arie Pe'er, Manager of the IEC's Operation Division, who supervises IPPs, claims that ?this was a decision that had been in the works for some time before. It was no surprise, but, of course, we support the commission's ultimate ruling.?

Pe'er also alludes to the another notoriously theoretical IPP ? a proposed 400MW combined cycle gas turbine plant, to be located in the Galilee (Alon Tavor or Lavie Industrial Zone), the tender for which has been mired in the foregoing legal clutter. Katz explains that preliminary bids are due by end November, though ?it will take at least another year to complete the tender. ? Ofer group will be bidding, and the price tag is expected to be similar to Ramat Hovav's.

The IEC currently operates according to its license to generate, transmit and distribute electricity, with an expiration date of 2006. The Ministry of Finance, in particular, is eager to introduce more competition to the sector by urging the IEC to make structural changes such as unpacking the corporation into separate generation, transmission and distribution companies. Pe'er suggests that generation will be privatized first, followed by distribution. But this is still long term talk.

In the shorter term, Israel needs gas. The government recently made the strategic decision to introduce natural gas to the electricity sector and to convert its large industries from fuel oil to natural gas. The shift is partly motivated by the familiar advantages of the fuel ? a cleaner and cheaper source than oil or coal that grants the electricity sector appreciable flexibility. Though coal is the dominant fuel, the country anticipates moving towards a 25% natural gas supply in its energy mix by 2005.

The Israeli search for a reliable gas source has been rigorous. "Gas is possibly the central concern of the Israeli energy sector right now," explains a local developer. "But substantial discoveries have been made, and there is no problem in sourcing it." The question, however, is which source will be used.

British Gas International began drilling for gas off the coast of Gaza and Israel last month. The size of the reserves is at present unclear. But its supply would ideally complement a more substantial stream from the possible Egypt-Israel pipeline, or "peace pipeline," negotiations for which, like for peace itself, are ongoing. At present, a ministerial committee is drafting a Gas Law, intended to regulate the Israel Gas Company. As further preparation for future gas flow, the IEC is sketching the conversion of several of its oil driven plants to CCGT plants. Tenders have been issued to several international firms for the supply of natural gas turbines.

Banking sector

The well-regulated local banking sector is a ready source of private capital. The sector is highly concentrated, with its five largest banks, foremost among them Bank Hapoalim, accounting for around 90% of its magnitude. But it has recently opened up to foreign competition, at a time when Israeli institutions are restructuring in the face of rising domestic competition.

Although local banks saw a rise in profits in 1999, there is growing concern over the effects of competition on the sector's profitability. Nevertheless, according to a domestic banker, the co-operation between domestic and foreign banks will trigger desired mergers while creating new business opportunities.

The gradual process of completion of the sector's privatisation along with further consolidation of the smaller banks and liberalisation of the sector as a whole should improve its competitiveness.

But, laughs another local banker, "Israeli banks display a sort of knee-jerk reaction: they want to be involved in anything that's big, simply because it's big." Stopford, however, grants local banks more depth of character and pocket: "domestic financial institutions are more comfortable than other players with the various risk profiles- they're simply more familiar with the arena," he says. "Additionally, they have a fairly large capacity for debt."

Dr. Ehud Kaufman, managing director at Bank Hapoalim, warns that unfavorable domestic circumstances, such as insufficient incentives, may have perilous results: "the local players who have developed certain capabilities in this market may just be driven overseas." But, he insists, "there is yet a lot of project finance appetite on the part of sponsors and financiers, locally and internationally. We are all still learning."

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