West Banking on Gaza

01/09/2000

The financing and development of private infrastructure projects in the West Bank and Gaza (WBG) has, since the mid-1990s, been creeping along in a state of wearying uncertainty. But with the birth of the Palestinian territories' first independent power plant just south of Gaza City, the pace may just pick up.

Palestine's economic woes run deep. The constraints faced by a fledgling state hungrily vying for country-hood, political and economic independence, have taken a toll on investor confidence. Moreover, the region is beset by the fact that, as one World Bank economist puts it, ?Palestinians do not yet control the fundamentals which would facilitate investment and trade.?

Equally forbidding is the economic gravity that has weighed heavy since the Palestinian Authority's (PA) 1994 inception. A recurrent budget deficit, vast unemployment and considerable short-term economic damage from political uprisings have bleared the macroeconomic scene.

Further background obstacles persist: ?Palestinian land control is limited. It lacks a port to enable imports and exports. It is physically separated into two entities and there is a lack of certainty of movement between the two,? describes another World Banker.

And all this costs money, heightens risks and consumes valuable time. Note also the restrictions on goods and movements, the mugginess of monopolistic structures and quasi-commercial enterprises, and the odd dash of public sector corruption. They all bear the same results.

But finally, after years of emergency economic assistance, the plans seem to be working. The economic decline of 1994-97 has abated. And the Palestinian economy is growing, albeit sketchily: around 4.5% this year, with a projected growth of 5.2% in 2001. Unemployment is declining gradually, although inflation is still edging up.

Private sector job creation has improved over the last year, though overall private sector investment is still relatively low. The Palestinian Monetary Authority reports that credit to the private sector rose by 25% and bank deposits by 15% in the last year. With local funding capacity growing there is mounting public optimism about the future.

Other arguments grant the West Bank and Gaza appreciable economic potential: a low-cost, well-educated labor force steeped in entrepreneurial tradition, a ripe prospect for privileged access to international markets, a Palestinian diaspora capable of providing burly investment funds and, in theory, a largely supportive international community.

Many advisers caution that the economic decisions made today will have lasting consequences for the prosperity of future generations of Palestinians. But such decisions will also determine the viability of any future Palestinian entity. With these caveats in mind, crafting an appropriate plan for infrastructure development, basic to the strength of the area, is critical. It is also of great consequence to investors.

Legal framework

Potential project financiers and investors also seek legal comfort. An internationally familiar and inviting bed of laws needs to exist to attract more global interest. The challenge is acute, given the complex legal legacy in the WBG, comprising an exotic blend of Israeli, Egyptian, Jordanian, British and Ottoman regulations.

In 1998 the Palestinian Authority put together a legislative agenda identifying 20 key economic and commercial laws to be established to boost economic reform and to facilitate the integration of the legal systems of the West Bank and Gaza. Of the 20, six have been passed: laws governing agency, encouragement of investment, industrial zones, domestic arbitration, condominiums and labour.

The remaining 14 laws will likely see enactment soon, given, as another expert puts it, ?a collective understanding within the government that they need to move ahead with the proposed reforms.? Among them are laws concerning securities, insurance, secured lending and leasing, banking, auditing and accounting.

?Initially, it was assumed that it would be done in two years. But this didn't happen, in part because of the power wielded by stake-holder interests,? explains a foreign legal adviser. Not to mention the current weakness of the judicial system: ? Even if the necessary laws and regulatory bodies were set up, the commercial courts aren't there to adjudicate over potential issues which may arise,? laments the expert.

All these factors have heightened concerns about the PA's commitment to transparency and the rule of law, which could increase the unpredictability of doing business, weaken the fairness and competitiveness of the marketplace and deter both local and foreign investment. Still, certain truisms echo loudly: ?The transition from governance by occupation to governance by consent and rule of law requires time.?

At the behest of donor input, the PA moved to redress the weaknesses of its initial law for the Encouragement of Investment. ?While the law should have essentially enabled a company to qualify by certain clear criteria, a number of rejections have occurred because the decision making deviated from the earlier law,? contends a foreign lawyer. ?But the decisions should be based on established criteria, such as the amount of investment or the type of project. This, I think, is a concept that is now more clearly understood.?

Another concept now more easily understood, and upon which further fruitful legal reform depends, is what the World Bank calls ?economic legality?, alternately dubbed ?the cornerstone of private sector encouragement.? This is essentially another way of casting what is a written body of consistent, sound and publicly accessible laws and regulations, which fit with global norms and which ?are applied uniformly, over a period of time by capable institutions of integrity.? And the greater the economic legality, the more likely foreign investment will flow.

The Legal Development Project, being unpacked at present, is funded by a $5.5 million World Bank contribution and an additional $1 million from the UK. Says the World Bank's WBG headquarters: ?the overall program of legal development is well underway.?

Despite warranted concerns, the region still lays bare its deeper temptations to the diligent, and the vigilant. Consider, for example, Palestine's strategic geographical location, its relatively open economy with little industrial base at risk, its plausibly preferential access to US and European markets for industrial goods, and its capital intensive domestic banking system.

Privatization

One of the PA's first policy statements following its establishment was its drive to adopt a private sector-lead approach to economic growth and development. But private sector investment remains meager while vital challenges persist.

The PA has also announced a privatization strategy, central to its economic program. The authority's commercial assets, valued at $345 million and made up mainly of shares in 34 companies, are at present controlled by the Palestinian Commercial Services Company (PCSC).

A Palestinian Investment Fund (PIF) is being set up by the PA, with technical help from PricewaterhouseCoopers. The hope is that the new body will manage all the PA's assets and commercial activities, and will carry out the privatization strategy. The thrust behind all this, of course, is to increase private investment in the economy.

Future development hinges on the existence of a pulsating private sector in WBG. Clearly a business friendly environment would attract greater levels of capital investment from Palestinian and international investors alike. And, the IFC claims, private sector growth will be the primary source for expanded employment and greater government revenues. In short, it is in everyone's best interests.

Energy Sector

All this, however, is the domain of theory. In practice, the first substantial advance has surfaced in the form of a robust combined-cycle independent power plant (IPP) in Gaza.

The availability of power is key to the development of the Palestinian economy. The IPP is expected to relieve the PA's need to make large up-front investment while motivating the private sector to play a central role in the reconstruction of Palestinian territories.

Official estimates put Gaza's aggregate demand at 155MW in three years. Current peak-rate consumption rounds out to about 125MW, meaning a 30MW demand increase over that period. The present supply from the Israeli Electricity Company (IEC) is reported to be only 90MW, suggesting a relatively significant demand crunch in Gaza.

The Palestinian Energy Company (PEC) has commissioned a similar study for the West Bank territories, where total peak rate demand is approaching 350MW.

Already under construction, the $150 million IPP is slated to provide 136MW generating capacity upon completion. It should commence operations in December of this year with an initial gesture of 25MW.

The project is co-sponsored by American powerhouse Enron (50%) and PEC (50%). PEC is a consortium comprising the regional brawn of Consolidated Contractors International Company (CCC), an Athens-based construction company of Palestinian descent, the Palestine Development & Investment Company (Padico), the Arab Bank, the Arab Palestinian Investment Company, Al Akkad Group, and the Government of Palestine.

The deal is financed in part by a $90 million non-recourse loan, with a 12.5-year tenor, fully underwritten by Jordanian-based Arab Bank. A hybrid deal, the remaining cash comes from a vastly oversubscribed public offering. The IPO represents a one-third interest in the project through a local placement. The borrower is the special purpose vehicle Gaza Power Generating Company (GPGC) owned by PEC (67%) and Enron (33%).

Commenting on the deal, Arab Bank's regional manager and executive vice-president Shukry Bishara explains that ? funding is always a problem. A major project financing is always carried out by payment enhancement. But in Palestine, there is no country credit history. By successfully completing the project, we've established a benchmark through the modalities of the project.?

The plant follows the standard Build-Own-Operate (BOO) model and will be powered initially by fuel oil, though its supply will shift to natural gas, pending availability. But it marks, as Bishara puts it, ?a pilot case.?

Indeed, the IPP is profound for a slew of reasons. Says Dan Castagnola, CFO at Enron's Middle East division, ?one needs to look at the bigger picture of how we addressed this one-of-a-kind project.? He cites as initial issues security, lack of sovereignty and, moreover, no precedent for doing this type of project. ?But,? he continues, ?at the end of the day none of these points became real issues.?

To explain this result, Castagnola appeals to the following: ?security was never a substantial issue and we had tremendous support from all parties involved. As for the sovereignty issue, we assumed we'd have a hard time drafting the loan agreement. But as it turned out the English Law loan agreement drafted by the Arab Bank worked perfectly and everything followed smoothly.? Finally, he says, ?although no one has ever before financed a power plant in Gaza, we had a solid team of experts on all sides of the equation who performed due diligence to our full confidence and satisfaction.?

So far, the outcome is impressive.

But as important is the question of risk. On this issue, Castagnola dispels possible misconceptions, arguing that ?risk is a function of fundamentals. Just like any complex infrastructure project there is some element of risk. That's unavoidable. But doing a project in Gaza is no more risky than doing it elsewhere. For instance,? he adds, ?projects in other parts of the world may face many challenges due to their weak fundamentals.?

As for political risk, Marwan Salloum, CCC's commercial and legal manager on the project, explains: ?the political picture has changed tremendously in the last four years to the extent that all players felt comfortable doing a project of this kind. If the risks were overbearing, it wouldn't have been done. But,? he adds, ?it was done.?

Enron is currently in talks with OPIC which is rumored to be committing at least $45 million in political risk insurance cover.

Despite the deficient legal and regulatory framework, the project has succeeded so far. ?The IPP went ahead,? contends a World Bank expert, ?partly because of the positive boost granted by PEC, the monopoly concession. Furthermore, government sanction was critical.? And, ?the arrangement on the actual tariffs and user fees for electricity services was fixed at the outset. This was key.?

The involvement of a major American company also contributes to the project's success.

For instance, says Salloum, ?we were involved in the preliminary stages for three years prior to Enron's joining last year. The project became ?serious,' as it were, when Enron joined.?

Castagnola believes that the pricing will be ?very competitive both in the short term and the long term. Of course we need to be very competitive with both the IEC and any new entrant. The issue goes back to the question of project fundamentals, giving customers the best value for their money.? Dr. Abd Al-Rahman Hamad, the Palestinian Minister directing the Palestinian Energy Authority (PEA), maintains that prices will be ?10% to 15% cheaper? than that supplied by the IEC.

Also pivotal is the Power Purchase Agreement (PPA) in place with the PEA: a 15-year agreement with the full support of the PNA. All involved are fully confident about the PEA's creditworthiness.

Taken as a whole, the IPP represents the first step towards disconnecting Gaza from the Israeli electricity grid, a weaning process that could take at least two years. It will also spell independent electricity production for a prospectively autonomous Palestinian state. ?Gaza has experienced regular power shortages. With this plant coming on line, it will relieve some of the pressure on the Israeli government to provide the Gaza region with electricity,? says Bishara.

As Castagnola puts it, ?this project will serve as the blueprint for any future infrastructure projects in Gaza or the West Bank.?

Empowering the West Bank?

The question, then, is what is being done about the West Bank's purported power shortages and, in the broader scheme, its independence from the Israeli grid.

According to a World Bank representative, ?the major issue now is how to get additional generation to the West Bank.? Since a chunk of Israel is wedged between the West Bank and Gaza, any new network between the two regions is contingent on pending agreements with Israel. Namely, the ?peace process.'

?One alternative,? suggests the World Banker, ?would be to wheel energy through the IEC's existing lines. But again, this is a political, as opposed to a purely practical, decision. And even if it was wheeled, you'd need a happy buyer on the other side.? His conclusion: ?right now a West Bank independent from Israel doesn't make sense.?

The West Bank desperately needs to expand its transmission and distribution networks. Such World Bank shaped projects are currently under consideration.

But the case for an IPP in the West Bank is also pressing. Minister Hamad has unveiled his intentions for two IPP's in the region, with the hope of ultimately erecting a sprawling grid to connect the three WBG plants.

Says Salloum, ?Just days after the closure of the Gaza IPP, the PNA approached CCC with proposals for another IPP development in the West Bank region.? Plans for at least a first plant are, it seems, well underway. Sources suggest that the plant will be similar to the Gaza IPP, but, at 170MW, will flaunt a superior capacity. The criteria for the project are currently being studied. Arab Bank and Enron are also allegedly involved in the discussions. Funding will likely be sourced from multilaterals and export credit agencies, in conjunction with commercial bank loans.

Arab Bank's Bishara adds: ?we, as investors, look at it naturally in terms of what is needed for the economy. The Gaza project is now a point of reference from which we can either extrapolate or build upon. A world class transaction happened. Its reputation will carry forth to the West Bank and back, for power and other projects.? He adds, ?on the whole, I am very optimistic.?

Gas Exploration

With an independently powered Gaza, and in the possible wake of more, similar plants in the West Bank, natural gas supply becomes a sizeable concern.

Last October British Gas International (BG) signed a deal with the PA, granting BG the first license to explore for natural gas off the Gaza Strip, and paving the way for a possible $20 million investment. Throughout the year BG has conducted seismic tests to confirm the presence of natural gas and drilling began last month.

Hugh Miller, the Israel/WBG country manager for BG International, explains, ?we've been doing 3D seismic surveys since January and the results are very encouraging. We just began our first exploration drilling and everything is going according to plan.? He remains buoyant: ?we expect things to continue accordingly.? He is referring to an offshore development plan, yet to be implemented, which will then see gas brought ashore to the local markets. If the strategy continues to bubble with success, the company, in conjunction with potential partners, may invest sums in the region of $500 million. The gas would also be sold to the Israeli market.

Another potential source for Palestinian gas supply is the Egypt-Israel gas pipeline project. The project still languishes in its prologue. But, in theory, the pipeline could imply Egypt selling gas to the PA within three years. According to local sources, using Egyptian gas for power generation in the PA could cost a reported $0.035 pkw, half that charged by the IEC.

Need for infrastructure

Other indispensable infrastructure projects continue to break new ground. Construction has begun on a Franco-Dutch venture to develop a deep-water cargo port at Sheikh Ijlin, 4km south of Gaza City, with an alleged price tag of $80 million. CCC joins as partner, with a 33% stake in the project. It is expected to begin commercial operation within 18 months. Much like the Gaza IPP, the seaport is described by some as a symbol of sovereignty and independence, as much as being an integral link for the bolstering of the economy.

Much investment is also imperative for Palestine's archaic and, in some cases, non-existent, water infrastructure. Indeed, several Palestinian governates are deemed disaster areas because of the severity of their water shortage. According to a statement made by Dr. Khayri al-Jamal, the director of the Palestinian Water Authority, the WBG region, with a population around 2.5 million, uses less than 300 million cu.m. of water per year. In contrast, Israel, with a population of 5 million, uses approximately 1.7 billion cu.m every year. Proposals for water management facilities have been put forth, most notably by Suez Lyonnaise des Eaux. But, says the PA, more work needs to be done.

Banking sector

Work on these and other likely projects demands capital ? private capital. Unlike many developing countries, capital in Palestine is a less serious constraint to overall economic development. The relatively vast pool of unused capacity in the local banking system, almost $4 billion of it, is a potential source of growth that still remains unleveraged.

The loan deposit ratio of the domestic banking system is 34%. According to a World Bank estimate, if this ratio were to reach the 70% level (of most developing countries) more than $1 billion would shift into the Palestinian economy.

But the local banking sector is exceptionally risk averse, particularly in the absence of a supportive legal framework and experienced regulatory institutions. The 22 local banks remain liquid and lend short term, but excess liquidity is typically deposited abroad. Of this group of banks, Jordanian banks Arab Bank and Cairo Amman Bank respectively hold 40% and 20% of market share, in terms of bank deposits.

A source familiar with the local sector claims that ?the banking sector is overbanked and segmented. Not enough loans are being granted internally.? The reasons, he argues, are primarily legal, but are also linked to regional instability. ?First, the legal system needs to be properly reworked, and the monetary authority laws implemented.? He continues: ? The cross-border risk of the PA is also generally considered to be rather high.?

?The issue,? claims a World Bank economist, ?is not the ability to raise capital. The issue is how to best use that capital. We need to think about the knock-on effect of, say, creating a mortgage facility to revitalize the estate industry to in turn generate the economy.?

But progress, in terms of legal revision and political stabilization, is being made. If the banking and capital market channels receive a sufficient amount of legal and institutional supervision, and if a greater level of public confidence in capital markets is achieved, infrastructure could benefit from private savings. And the case of the Gaza power plant suggests that this is territory to occupy project financiers for many years to come.

An executive at a foreign commercial bank assesses the scene: ?project financing is based on a credit analysis of the beneficiary. In the WBG, only a small group of creditworthy developers, such as Enron and CCC, are bringing in the investments. Such financing depends on the importance of the project and who is behind it. And most local banks can't afford to play bigger roles right now.?

Concerning the prospect of heightened foreign commercial bank investment, he argues: ?the only way in which these banks will come on board will be if the PA decides to issue a bond, of perhaps 3 to 5 years, with principal and interest payments guaranteed by, say, the World Bank.?

Any bigger infrastructure projects will continue to need hefty multilateral assistance. ?I think people are still apprehensive about investing. But once there's more stability, then you will see more foreign investors willing to take the commercial risk.?

For most, the barometer, it seems, is the ?peace process.' ?Overall,? says Arab Bank's Bishara, ?when there is deeper political stability, more investors will realize that Palestine has become an extremely promising environment where the risk rewards are high.? This is but one lesson of the Gaza IPP.

Taimur Ahmad talks infrastructure development plans with Palestinian National Authority Minister, Dr. Abd Al-Rahman Hamad, Chairman of the Palestinian Energy Authority.

How did plans for an independent power project in Gaza first get underway?

For the sake of our national economy, energy is the most important sector to be developed. Initially we, as the Palestinian Energy Authority, began thinking about how to build an independent source for generating electrical energy. We approached an able selection of international companies to help us develop this sector. Finally, after we established a policy to privatize the key elements of the sector such as the generation element and the distribution element, we approached the Palestinian firm, CCC, to build the first power plant in the Gaza region. The Palestinian investors in turn approached Enron, which has much experience in dealing with such projects. They formed a company, of which Enron owns 1/3, the Palestinian company (CCC) owns 1/3, and the public owns 1/3. The electrical plant is already under construction and we're hoping that the first units will be under commercial operation by December 3rd this year.

What are the major implications of this project?

When we finish building this project, it will give a great push to investors considering this area to actually adopt some of the proposed projects, which are crucial for our economic growth and development. As long as energy is available at a competitive price, this will provide them with the incentive to develop their own projects in a competitive way. Without doubt, it has a very positive impact on our economy. We consider this project vital for Palestinian National affairs.

What impact will Enron's involvement have on the investor community?

International companies will appreciate the ease with which a major American company has invested a lot of money in this project. Of course, I expect this will attract many other international companies to the area to invest their money in similar projects. So, in theory, by bringing in an American company we are encouraging significant foreign investment in the region. Of course, we needed to do this. Without this encouragement we wouldn't be able to develop this country. So we had to do our best. We had to provide all the facilities and incentives available to help further foreign investment to the area.

What other power projects are you considering? Are there similar plans for the West Bank region?

We are trying to build two more plants in the West Bank and we're asking the private sector to come to the region and adopt these projects. As I've maintained, we are doing our best to encourage the private sector to develop the energy sector. Of course, as the public sector, we don't like to be involved in the link between the generation and distribution systems. I am negotiating with Palestinian investors and I'm confident they will help in these projects. I'm also approaching other international companies for possible involvement in this project. Ideally, we'd like to see more than one international company involved, and I think this is a realistic expectation.

What plans exist to link the grids between Gaza and the West Bank?

It is difficult to talk about a physical link between the two regions, since this will take a lot of time, pending Israeli approval and, of course, the Peace Process. As stands, however, I'm planning to have two more power plants in the West Bank region. As soon as a political solution is achieved, a prospect about which my colleagues and I are very optimistic, then we can move ahead with our plan to link these three stations together in a Palestinian grid. Another solution is to wheel electricity through the Israeli grid, again pending, of course, their approval. There are many contingencies involved.

What intentions does the Palestinian Energy Authority have for Energy sector privatization?

33% of the Gaza project is owned by the public. Three weeks ago we asked the public to buy shares, through the IPO. The bank received $78 million from the public. That's almost four times what we asked the public to share. This has further encouraged the Palestinian National Authority to adopt a private strategy, as long as the public want to be involved in such a development. So I think this will impact positively on our policy to privatize. We need to develop a lot of projects which, of course, the public sector cannot develop.

Right now we are asking a private company, the Palestinian Electricity Company, to enter a monopoly on power generation in Palestine. This company is building the power plant in Gaza. The Palestinian National Authority has committed itself to purchase power from this company through national transmission and then that will be sold to a private company, to be sold on to a distribution company.

What are the current regional demand estimates?

In Gaza our peak demand is 125MW. In the West Bank the peak demand is around 350MW. Overall, it is approaching 500MW, for the time being. In 5 or ten years, I estimate we'll see growth to between 800MW and 900MW.

How competitive do you expect pricing to be?

Up to now we have been purchasing all our consumption from the Israelis. The competitiveness of the pricing depends on the price of the fuel. We're hoping to generate electricity up to 10-15% cheaper than what we're paying right now, that is, under the Israeli Electricity Company. This is our goal and I think we will achieve it.

What incentives should foreign investors in Palestine expect?

All the taxes are waived. This is a new market for Enron. This will help them and the whole region. Likewise, similar benefits would apply to other companies investing in the region. Also, the reworking of legal framework and the new investment law are giving a lot of incentives to investors. We are doing our best to help and encourage investors to come to the area.

What other vital infrastructure projects are you considering?

As you know, we currently don't have real access to the international community. A seaport clearly would provide us with such direct access. It has been started, with finance coming from French and Dutch sources. We hope this project will be completed within two or three years. Fundamentally, it will help develop he economy.

What is the status of the water projects you are working on?

Clearly water is basic. And we are facing dire problems with water shortages. I'm approaching many international companies to build desalination plants in the region. In fact, I'm hoping the first plant will be developed within the coming year. It should provide around 60,000 cubic meters. I'm moving ahead with the projects and I'm confident about their ultimate success.

To what extent do you expect the local banking sector to gear up for Palestine's vast infrastructure demands?

Local banks certainly must be involved in developing infrastructure, but up to now there seemed little point. Now, we feel the banks are fully behind us, though up to now banks haven't favoured loans of more than 3 years. This fact hasn't really helped a lot of investors who need such loans, 15 or 20 year loans with acceptable interest rates, for their long term projects. I hope local banks will adopt a new policy. They have to be responsible for developing a lot of infrastructure by providing long term loans. They certainly have the capital. And I expect more local bank activity within the nest year. Again the Gaza power project will encourage a lot of banks to adopt Arab Bank's strategy of loaning, say, $90 million for projects of this sort, as long term loans to project companies. If the banks adopt this policy, it will obviously help us develop more projects.

What obstacles will persist in detracting from investor enthusiasm?

As long as political problems persist, it is difficult to convince a lot of investors to come to the area, given their perception of instability. We're hoping that political stability will be achieved within a couple of years from now. This will encourage more investors. After they realize that this is in fact a good market to approach, and that security and stability have been achieved, they won't have to be afraid of investing their money in the area.

What impact will a declaration of statehood have on foreign investment to the region?

We are hoping that an agreement can be achieved. I don't think that such a declaration will or will not categorically inhibit the flow foreign investment. It is more a question of the perception of stability, or lack thereof. And as long as investors remain confident that the situation on the ground is safe, investment will continue, in the way that it has already begun. To encourage investors to develop your economy you have to cultivate a satisfactory mood. The investors have to realize that this is a prime market. Ultimately, the declaration of statehood without a bilateral agreement might not be the most beneficial scenario for us. But I am confident an agreement can and will be reached.