Currency chameleon

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As with many organisations active in fast-changing and volatile markets, export credit agencies (ECAs) have to spend a lot of time addressing how they see their role - and what others feel their role should be. But the huge changes that have taken place, particularly in Asia, over the last few years have served to underscore the role of the ECA, according to the UK's Export Credits Guarantee Department (ECGD). "[South-east Asia's financial crisis] has highlighted the importance of ECAs taking a long-term view and providing continuity of support," says ECGD chief executive Vivian Brown.

This view is echoed by the head of the agency's Project Finance Advisory Unit, Nick George. Speaking from ECGD's offices overlooking London's Docklands, he says that "ECAs still have an important role to play. A few years ago, people were wondering if ECAs still had a future in project finance because there was relative global stability, a strong and liquid bond market and banks and private insurers were prepared to do larger and longer deals." George believes that the Asian crisis has put paid to any such questioning. "Events in Asia and elsewhere have made people think again."

When ECGD first became involved in project finance it saw its role as taking on political risk while the banks took on commercial risk. "Our expertise is in political risk," stresses George. However, times have changed and the lending environment has become much more competitive. As a result, ECGD now takes commercial risk, gets involved in limited recourse project financing, is looking at offering local currency financing and doing business in markets that are presently off-cover and is trying to forge closer links with the World Bank and IFC.

ECGD believes there is no conflict of interest in taking commercial risk for an organisation charged with "supporting as much export business as possible while limiting the risks to the taxpayer." The fact that it has to publish accounts and is accountable to the Treasury acts as a control - but "we now seek to put ourselves in the position of being one of the lenders. We assess the deal as if it was our own money," adds George.

The strong relationship between ECAs and governments raises many questions as regards adopting a truly commercial role and market concensus is that ECGD has been at the forefront of change. "The agency has made huge strides in expanding its coverage and adopting a more commercially-oriented role," says one UK-based banker. George says that project sponsors are looking for four things from an ECA: adequate cover capacity; a proactive approach; experience and flexibility.

The agency's cover schedule for project finance was relaxed in 1994 in order to enable more flexibility in assessing transactions. The number of rules and regulations applying to the sector has been cut, bringing the analytical process closer to that undertaken by a commercial lender or underwriter. The re-launched schedule allowed the agency to get involved in limited recourse transactions. "In terms of appetite for long-term risk there is clearly still a gap between us and the private sector, but it is changing and becoming much more competitive," says George.

The first deal that the agency got involved in on a limited-recourse basis was the AMEC-sponsored Manah power project in Oman. It supported a £27 million buyer credit for the deal in February 1995.

The first limited recourse financing with ECGD sole ECA came three years later - the Shandong Zhonghua Power Corp deal signed in May 1998. ECGD backed a $311 million loan towards the development of four power stations in this region of China.

Since that deal was signed, there has been a strong movement amongst the ECAs towards a one-stop shop approach. ECGD was instrumental in the establishment of this programme, whereby co-operation agreements are signed between the various agencies involved in a transaction so that the sponsor only has to deal with the leading agency. The first such agreement was signed between ECGD and Coface in 1995, and they have now extended to cover every ECA apart from US Eximbank. It seems unlikely that the US agency will get involved, as it has a slightly different remit from its competitors - that of promoting full employment.

"One-stop shops are an agreement to reinsure each other behind the scenes," says George. "Provided that both agencies are satisfied with the risk and pricing involved, then the lead agency (determined by size of commitment) will act for both. The advantage is simple, the borrower only has to negotiate one loan agreement with one ECA." This is extremely beneficial for the project sponsors, who no longer have the headache - and cost - of negotiating with two or maybe three different agencies.

George believes that the initiative signals a change in approach by the agencies. ?In terms of appetite for risk and pricing there has been a big levelling out amongst the ECAs, ECAs must now concentrate on quality of service, innovation and display a willingness to take a proactive role.? ECGD now has 13 full agreements with other ECAs covering 27 deals involving £6 billion-worth of business.

ECGD got involved in its first limited recourse project financing under this system on June 1 this year. The $25 million deal is to finance construction of a power station in the Dominican Republic. The 300MW San Pedro de Macoris project should be operational in 2002 and will be the last power plant to benefit from a long-term power purchase agreement signed with the recently privatised Corporacion Dominicana de Electricidad (CDE). Financing is in five tranches, three tranches of which cover a $95.4 million loan from KfW. This involves a $69.6 million Hermes-backed tranche, a £13.8 million ECGD-backed tranche and a $12 million unguaranteed tranche.

The project is being sponsored by Cogentrix and Commonwealth Development Corp (CDC) which are jointly providing $77 million in equity. ECGD has an £8.9 million reinsurance arrangement with Hermes. ECGD and Hermes signed a co-operation agreement in July 1998. ?This was going to be a 100% German project but Hermes decided that they wanted to involve someone else,? explains George. ?They chose ECGD because of the co-operation agreement.? The plant is being built by Siemens on a turnkey basis.

The agencies are involved on an IADB commercial lending basis and IADB has underwritten the political risks for the whole transaction. It is providing a partial-risk guarantee for $137.2 million worth of loans arranged by WestLB ? the first time that it has used a partial guarantee for a sub-investment grade territory.

A key factor in the way that co-operation agreements work is that each entity must accept the due diligence of the other. In this case, for example, ECGD is relying on the due diligence of IADB and Hermes. The logical extension of this, therefore, could be a single European agency? ?George dismisses the notion, but stresses one of the main features of ?proper? project finance is the need to share information, legal advice and analysis. ?This is driven by the cost of doing such deals. The need to agree at the outset on what information is needed has forced ECAs to cooperate. ECAs participating in project finance is one of the best examples of ECAs working together effectively. We have been very successful in this.?

Another area in which cooperation between the agencies has grown is in premiums. If agencies are going to lend on a commercial basis, then they must be prepared to offer premiums at a commercial rate. The OECD Premium Agreement came into force in April 1999, whereby minimum premium benchmarks for sovereign and country risks came into force.

The agency has put a lot of work into its harmonisation-compliant pricing system and has adopted some fundamental changes in the way premiums are calculated. Where ECGD premiums were below the OECD benchmark they have been raised, and where they were above it they have been lowered. Since the benchmark was installed there has been much greater convergence of ECA pricing ? although this just applies to sovereign risk. The agencies are now working with OECD to work out a method of harmonisation for corporate risk.

The OECD agreement has gone some way towards addressing discrepancies between agencies, but is unlikely to address sponsor complaints about ECA premiums in certain high-risk countries. In a review of ECA activity published in this magazine in October 1999, Stephane Lebeau, manager of structured finance at Electricite de France grumbled: ?When the sponsor is looking at [the] overall costs a project implies, risk premiums feature highly. In countries such as Vietnam and Laos, premiums of 15% to 20% are expected.? By setting an OECD minimum, this situation is hardly likely to improve. George dismisses this saying: ?As all ECAs have harmonised their political risk premium rates, this should no longer be a major issue in project finance.?

One area in which ECGD can rightly claim to be proactive is in examining innovative forms of finance. It is currently concentrating its efforts on the provision of local currency financing and examining ways in which it can support projects in off-cover regions. The latter is known as the ?Good Projects in Difficult Markets? scheme, the first project under which should be the Blue Stream gas pipeline in Russia. ?We have stated a willingness to look at such projects,? says George. ? We would not take straight country risk [in a market like Russia] but if we can externalise that risk by using escrow accounts and dedicated revenue flows, and the residual risks are acceptable, we may be able to support deals that would otherwise be non-starters.?

The Blue Stream project involves the construction of a 1213km pipeline from the Zapolyarnoe oil field in Russia to Turkey. The pipeline should be operational in 2001 and the offshore pipeline laying contract has gone to Saipem of Italy. The project is being sponsored by Gazprom, which will invest around $1 billion itself. The company estimates that the offshore costs of Blue Stream will run to $1.8 billion, and has arranged 14 separate loans with foreign banks and export credit agencies. ECGD is working closely with SACE and hopes to get involved under the cooperation agreement signed between the two at the end of May this year. SACE will provide the export finance and take reinsurance from ECGD for the UK portion. ?Most of the due diligence for the deal has now been completed but there are still some significant [financing] issues,? explains Robin Ogleby, senior press officer at ECGD. ?They may take a few months to wrap up.? Funds are being provided by HSBC.

The Blue Stream deal signals a significant change of tack by ECGD, and if it is successfully resolved could open up a whole new area of business for the industry.

Again, however, the question of accountability to the taxpayer raises its head when backing deals in particularly high-risk markets. The Former Soviet Union has consistently topped the list of claims markets for ECGD over the last three years ? with claims amounting to £74.5 million in 1996/7, £64.6 million in £1997/8 and £54.9 million in 1998/9. This new ?Good Projects in Difficult Markets? initiative aims to address the problem by aggressively structuring the deals to mitigate as much country risk as possible.

Another financing initiative that ECGD has pioneered is that of local currency financing ? and the agency remains one of the few ECAs willing to get involved in such deals. ECGD has supported loans in, for example, Singapore dollars, Malaysian ringgit and Japanese yen. Last year it guaranteed a total of HK$867 million to back orders won by Guildford-based bus manufacturer Dennis to supply 448 buses to Hong Kong. In June this year, the agency signed agreements with the Industrial Credit and Investment Corp of India (ICIC) and Infrastructure Development Finance Corp (IDFC) to allow UK-backed deals to be financed in rupees. These initiatives have particular significance for the agency's project finance unit, as so many infrastructure and power-generating projects generate revenue in local currency.

?For infrastructure projects that do not generate a foreign currency income stream, local currency financing provides a potential solution and overcomes the problems associated with a mismatch between currency of income and debt servicing,? says George. ?The wholesale devaluation of some Asian currencies highlighted the problem.? But ECGD was the first agency to back local currency deals in south-east Asia, and also has done deals in Poland, South Africa, India, Mexico and Egypt. Reports at the end of June indicated that ECGD may be looking at the £E1,500 million ($440 million) Beni Suef gas pipeline project in Egypt. A problem with the deal is that the sponsor wants funding to be denominated in Egyptian pounds while a large portion of the costs are in hard currency. The ECGD project team would not confirm whether this is the case.

Apart from expanding its portfolio of financing options, ECGD is also concentrating on building its relationships with other supranational organisations, such as the World Bank and IFC. The problems associated with high profile projects such as Pakistan's Hub Power project have dampened appetite for such risk, and this is where George feels that the ECAs have the most vital role to play. ?We provide leverage that will enable others to go into the deal,? he says. Better cooperation between ECAs and other supranationals is important, but as George explains, it is a ?slow process?. ?We are trying to understand each other better, reconciling different objectives and trying to avoid duplication of effort. We are also working on an agreed set of principles to be applied when a project starts going wrong.?

The project finance unit at ECGD is, therefore, determined to expand the types of cover it can offer to the industry. And the agency as a whole is determined to speed up the process. At the end of June, the agency announced that it is considering changing export underwriting rules in order to give key industries such as oil, gas and civil engineering, access to fast-track credit. The initiative is designed to help UK exporters be more competitive. ?The decision will be made on a combination of the country involved and company risk,? says chief executive Brown. But the plan could have the environmentalists baying for blood.

This issue of environmental risk is already a contentious one between ECGD and UK exporters. The agency has to sign up to the OECDs common agreement on the issue by April 2001, under which exporters will have to complete a questionnaire on the environmental and ethical impact of a project for each piece of business submitted for support. Exporters are angry that this will cause delays and make them less competitive, and argue that it is not the job of ECGD to implement the government's sustainable development policies.

However, George believes that this should not pose too much of a problem. ?These issues are always looked at for project finance deals anyway,? he says. ?But it gives us the opportunity at a very early stage to spot the small percentage of deals that could be sensitive.?

Conversely, a new initiative to fast-track certain industries will enrage the environmental lobby, as this process could be bypassed. The uproar over the agency's support for Balfour Beatty's involvement in the Ilisu dam in Turkey is an indication of the strength of the environmental lobby against some of ECGDs business.