The Protectors

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Project finance bankers are anticipating greater involvement from private sector insurance companies on projects coming to market this year, with the private insurers stepping up with both comprehensive guarantees, as well as more targeted coverage specifically addressing issues ranging from spot electricity prices to currency transfer and convertibility.

The appetite of global insurance giants such as Swiss Re, AIG and Centre Re for project risk is growing, as these players seek to diversify out of traditional activities such as catastrophe insurance; and continue to add staff to their structured finance departments to assess project risk. At the same time, institutional demand for emerging markets high-yield project bonds has all but dried up, while many commercial banks are wary of project lending in the wake of economic problems in Asia and Latin America. Against this background, bankers believe the insurance companies will have an important role to play on the roster of projects in 2000 and 2001, mitigating project risk and making financing possible.

?There are a number of deals in the pipeline which involve private sector insurers,? says one New York-based banker. The return of investor demand for non-investment grade emerging market project bonds does not appear to be in sight, and the prospects for this market will not have been helped by the downgrade on January 27 by Duff & Phelps Credit Rating (DCR) of $165 million worth of TermoEmcali project bonds. These were sold at the peak of the emerging markets lending boom in April 1997, and had been rated BB+ prior to the recent downgrade to a level of CCC. The CCC rating implies considerable uncertainty exists about the timely payment of TermoEmcali's financial obligations, and DCR notes that credit protection measures on the bonds are limited.

TermoEmcali has been in trouble for some time, with the problems relating to the power offtaker, Empresas Municipales de Cali (Emcali), which is the municipal entity in the city of Cali, southwest Colombia. Emcali's monthly payments under the Power Purchase Agreement are the only source of income for the project, and DCR says it ?believes Emcali is deeply in a strained liquidity position, with delayed payments to electricity suppliers, and the restructuring of its local debt obligations?.

As of mid-January, Emcali was past due date on its November 1999 invoice for that month's capacity payment, as well as two invoices for fuel reimbursements. DCR notes that TermoEmcali could already have provided Emcali with a notice of default for past due payments beyond the 60-day period, but that the project had allowed Emcali to make partial payments for a limited period. TermoEmcali is owned 54% by InterGen, a subsidiary of Bechtel and Shell, 43% by Emcali, and 3% by Corporacion Financiera del Pacifico. The problems at TermoEmcali will have repercussions for other power deals in Latin America, as well as in other regions such as Asia.

Below investment grade project bonds had all but disappeared during 1998 and 1999, but the downgrade suggests bank lenders in power projects will also increasingly be looking for some sort of insurance coverage. Private insurers have already shown themselves willing to step up on selected projects, including last year's deal involving a merchant power plant in Colombia.

Private insurers step in

In June 1999, the Centre group, a unit of the Zurich Financial Services Group, provided project cover on the

TermoCandelaria power project in the city of Cartegena, on Colombia's northern coast. The project sponsor is KMR Power Corporation, and the project is being financed via bank debt. A $90 million senior loan was arranged by Bank of America, but Centre was able to play an important role on the subordinated tranche, always more difficult to syndicate than senior debt. This $85 million subordinated loan was developed and structured by Centre and Bank of America, and was guaranteed by Centre, which carries an AA rating from Standard & Poor's. Centre also took a $35 million participation in the senior loan. TermoCandelaria is a merchant power facility, initially selling 100% of its electricity output into the spot market.

The involvement of Centre was important in placing the financing, especially at a time during 1999 when many banks were scaling back on non-recourse project lending into Latin America. Similar structures are expected out of Latin America this year, though bankers also expect to see deals featuring limited risk coverage that falls short of a full financial guarantee.

?The appetite for full guarantees is, from the insurer's standpoint, necessarily limited, so what you are going to mainly see is partial support to render the project an acceptable risk, rather than full wraps,? says William Chew, managing director in the Standard & Poor's Rating Group in New York. ?The main agenda is to focus on relatively low-risk projects where the addition of a guarantee can help the origination of the debt and the pricing, but that is somewhat of a challenge, because if a project is able to get an investment grade rating, or even a near investment grade rating, on its own, it can very often attract a lot of interest from lenders. That part of the market will grow slowly, and in very specialised situations, but the other area where there is a current focus is the notion of targetted covers, not only political risk covers but other types of defined risk covers in order to cover the constraining risks in projects.?

Rico Baumgartner, head of project finance at Swiss Re New Markets in Zurich, agrees with the assertion that targetted risk cover is going to be the main focus of insurers, rather than comprehensive coverage. ?We work with our clients on a deal-by-deal basis, and try to enhance the project to a higher level by taking out certain kinds of risk,? he says. This could, for example, involve hedging against spot electricity prices on a coal-fired power plant deal, or providing risk cover against drought on a hydroelectric project.

?You could provide an overall credit wrap, but if you take on every kind of risk it gets too expensive, and you include a lot of things you do not want to include,? Baumgartner says. ?We try to get into areas where we can carve out very specific risks, and price them at an appropriate level which is also acceptable to the project.? These activities will often mean providing enhancement on projects in below investment grade countries, whereas the monoline insurers are likely to step up on providing AAA wraps only where a project is already investment grade. Thus full wraps are most likely to be seen in developed countries, where a project starts off at investment grade, but where a wrap will help with pricing, or allow for the placement of bonds with longer tenors.

Risky power projects in countries such as Brazil or Colombia will more likely feature limited risk coverage. One example of insurance being used in a developed country was last year's deal for Stirling Water in Scotland, where RBC Dominion Securities and SG arranged a £80 million bond offering, wrapped by MBIA-Ambac International to achieve an AAA rating. Last year, the bond markets were characterised by widening spreads between AAA bonds and lower-rated paper, which justified the cost of a monoline wrap.

So far this year, investor appetite for low investment grade paper such as BBB assets has been on the rise, so the difference in spreads between AAA and BBB rated bonds has been narrowing, which may make wraps less cost effective than they were during 1999. However, the wrap in the Stirling Water deal was also advantageous in that it provided Stirling with protection against market volatility at the time the deal was to be launched, since AAA-rated bonds are invariably easier to place than lower grade paper. And by wrapping a bond to achieve an AAA rating, project financiers are also able to issue long tenors, which better match the long life of projects such as waste water facilities. Whereas in countries such as the UK the involvement of insurers may be used to get better pricing or a longer debt term, it will not be a matter of life or death for the project. This is in direct contrast with emerging markets, where the willingness of insurers to step up risk coverage will decide which projects get financed and which do not.

This fact has been recognised by agencies such as Washington DC-based Overseas Private Investment Corporation

(Opic), which last year extended its insurance coverage to bond offerings, where it had previously only guaranteed bank debt and equity on projects. ?We have seen Opic adapt its products for the capital markets, and we are starting to see the private sector insurers come in and develop similar types of products to reduce and or mitigate these types of political risks,? says Daniel Kastholm, head of the Latin America corporate group at DCR in Chicago. ?Depending on the particular transaction, the country, and the actual terms and conditions of the policy, there is the potential for subtle differences in coverage.?

At its most basic, coverage will address currency transfer and convertibility risk, as is the case with the new Opic capital markets policies. These do not cover currency devaluation, or other commercial risks of a project, but rather protect investors against any deterioration in the ability of the borrower to convert local currency into US dollars, and the ability to transfer US dollars out of the host country to service payment of interest and principal on the bonds. But a recent report from DCR cautions that ?even with solid transfer and convertibility insurers, well written policies and adequate coverage ratios, significant political risks remain and they should not be ignored?.

?The risks of regulatory changes, political interference, breakdowns in the legal environment, exchange rate movements, political violence, expropriation and government breach of contract are all political risks that need to be adequately reflected in local currency ratings,? says DCR, noting that non-sovereign local currency ratings ?should not be unrealistically higher than the local currency sovereign rating of the host country?.

Assessing many variants of private insurance on projects is going to be a challenge for the rating agencies, and will undoubtedly lead to some tussling with project arrangers over the ratings awarded to their projects. This process will be critical in maintaining the flow of project debt, where the main challenge lies, since the big global project developers continue to have a strong appetite for taking equity risk. However, the developers are also turning to the private sector for Political Risk Insurance (PRI), as well as utilising cover offered by entities such as Opic. One country recently involved in some large insurance claims is Indonesia, where political unrest, massive currency devaluation and political violence has hurt many projects, especially in the power sector.

On February 2, a London-led syndicate of private insurers settled a PRI claim for MidAmerican Energy Holdings, based in Omaha, over the loss of its investments in independent power projects in Indonesia. The claim was for $72.5 million, which made it the largest private market investment insurance claim in more than a decade. The syndicated policy was led in London by Hiscox Syndicates and Brockbank Syndicate Management. ?Investment insurance is now a well-established asset class in the private insurance market. This is a large claim, paid in full and promptly, and without significantly affecting the capacity and appetite of insurers for similar business,? says Charles Berry, chairman of Berry Palmer & Lyle, a London-based specialised broker which placed the policy in conjunction with Aon.

Private PRI

Berry adds that the private political risk insurance market has now got to the stage where it is a pretty serious rival to the government agencies, with a number of insurers able to offer seven to 10 years of cover, and some offering as much as 15 years. Berry expects more power projects will benefit from this type of cover in coming years, despite some high-profile claims in countries such as Indonesia.

?The capacity of the market is not dictated by losses in this particular field, it is dictated by the state of the general insurance cycle,? Berry says. ?The general insurance cycle is beginning to turn, and conditions are going to get more difficult for buyers of insurance generally, which will make it more difficult for the players in the political risk market to buy reinsurance, and that may affect their capacity. Nonetheless, the principal players in the private political risk insurance market all remain committed to the business.?

The recent claim settlement related to a series of projects being developed by MidAmerican in Indonesia, utilising naturally occurring geothermal steam fields located about 160 kilometres from Jakarta on the island of Java. MidAmerican initially got its first 60MW power plant up and running, underpinned by a take-or-pay energy sales contract with PLN, the Indonesian state-owned utility. But like many other power projects in Indonesia, PLN has fallen far behind on payments, and this caused MidAmerican to suspend development of further projects at the same site which would eventually have had a total capacity of 400MW.

MidAmerican went to international arbitration over PLN's failure to honour its contracts, and won a judgement against the Republic of Indonesia, since the Ministry of Finance had made sovereign performance undertakings on behalf of PLN. The PRI cover which MidAmerican had taken out with both OPIC and with Lloyds' private market insurers covered both the risk of expropriation and any material breach of contracts by PLN of the Energy Sales Contracts, and by the Republic of Indonesia through its sovereign performance guarantees.

MidAmerican has now received full payment for these claims. In addition to the $72.5 million paid by Lloyds' syndicates, the company has also received more than $200 million from OPIC, one of the largest claims ever settled by OPIC. Such events in Indonesia, allied to other problems in Latin American countries such as Colombia, will make bank lenders more wary of non-recourse project lending, but all the signs are that insurers still have plenty of appetite for project risk, and are only just beginning their move into the project finance sector.

Private insurers are now tailoring their projects more specifically to the requirements of lenders, where the emphasis has up to now been more on the equity investment side. So far, the emphasis is also upon political risk, involving a state-owned company defaulting on payments or a government failing to honour its guarantees. But more insurers are looking beyond PRI, at providing cover for default on the part of private sector offtakers or extreme volatility on the electricity spot markets.

?Things happen pretty slowly in the insurance business,? says one observer. But with players such as AIG blasting the trail, project insurance looks set to continue to grow as an important element in project financings.