

Can Pakistan make good on its generous power incentives?

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A clutch of landmark renewables projects have reached close in Pakistans power sector, and a number of others are making steady progress. These deals are lending a healthy glow to the countrys project finance market. Zorlu Enerji Pakistan, a subsidiary of Turkeys Zorlu Enerji Group, FFC Wind Energy and Foundation Wind Energy have all closed on projects that had rumbled on for years. K-Water and Daewoos Star Hydro power project in Muzaffarabad is set to close in September.

But these headline power sector generation financings do not amount to a concerted effort to keep up with demand, and 30% of Pakistans population still does not have access to electricity. Sizeable thermal projects are few and far between and despite the unprecedented incentives that government offers, Pakistan has only attracted a handful of outside sponsors and lenders prepared to take the plunge, in a market described by one seasoned lender as only for the brave.

Wind wins out

Renewables are the definite bright spot, with wind leading the way. The successes are the result of a government policy to add renewables to the energy mix, by setting a target that wind should account for 5% of total power generation by 2030. Wind developments provide cheaper power than many thermal projects, which have been hit by climbing oil prices and a growing scarcity of gas reserves, while hydro takes longer to build, and increasingly has higher upfront costs.

The countrys government has earmarked land for development in the Gharo-Keti Bandar wind corridor that spreads 60km along the coastline of Sindh province, north of Karachi, with an estimated potential capacity of 20,000MW. The three projects to have closed were part of a cohort of 13 independent power projects that submitted feasibility studies for wind projects with 50MW capacities back in 2006. Four others in the group are expected to close in the next two years, including TGL in Kittikun, Gul Ahmed Wind Power, a subsidiary of Gul Ahmed Energy, Yunus Energy, part of Yunus Brothers Group and Metro Power, all with developments in Jhampir. These developers have already placed orders with Germanys Nordex for turbines and the manufacturer now says Pakistan is its most important Asian market outside China. In another development, expanding renewables developer RenuEn recently put forward plans to develop a 50MW solar project following its acquisition of Team Energy.

Investment has arrived on the back of an array of government incentives embedded in a sponsor-friendly wind tariff regime. The Pakistani government adapted the regime from those on offer to thermal and hydro IPPs since 1996. Wind developments are backed by government guarantees that eliminate most project risk for developers and lenders, leaving the only downside Pakistan sovereign risk. Robust contractual elements in deals include well structured, lengthy power purchase agreements with Pakistans state-owned National Transmission and Despatch Company (NTDC) supported by government guarantees.

Deals also benefit from a cost-plus model, under which the cost of financing is passed through in the tariff. Tariffs, determined by the National Electric Power Regulatory Authority (NEPRA) and enshrined in the PPA, are indexed every

quarter and fluctuate in line with any changes in the currency exchange rate, six-month interbank rates, inflation or fuel prices. Renewable IPPs also benefit from a guaranteed return on equity set at 17%, compared to 15% in thermal projects. The government also extends fiscal incentives to developers, including removing customs and sales duty, providing an income tax exemption, allowing for free repatriation of equity and dividends, plus the freedom to raise local and foreign finance.

Now the government is developing a new tariff that may tweak the incentives on offer. In October 2011 NEPRA approved a Rs12.61 (\$0.133) per kWh feed-in tariff for foreign-financed wind power projects, and Rs17.28 per kWh for locally financed projects that reach financial close before December 2012. These levels are designed to account for the difference between Kibor and Libor, and will still be adjusted for more fluctuations so no interest rate hedging will be required.

No currently proposed projects have closed under this new tariff or are likely to, because all projects in the pipeline will likely follow the existing system. However new sponsors sizing up the market like Malakoff and NBT Norway will probably receive the new tariff but, importantly, will have to shoulder wind risk themselves.

Under the existing system, the government guarantees wind speeds but takes the upside if wind levels are in excess of guaranteed levels. The downside of this scheme is that the government doesn't guarantee other unknowns around wind density, volatility or direction, so developers need to build in a buffer for these factors, despite the guarantees. Sponsors may favour the upfront tariff because it gives them the benefit of the wind upside but lenders may like the guarantee because it protects their base case. That said, some lenders are running their base case on P90 wind data anyhow and not just relying on the guarantee, says Bill McCormack, a partner at Shearman and Sterling in Singapore, who advised banks on the three wind projects to have closed to date.

Although a new FIT could reduce the paperwork and time spent evaluating each project, enthusiasm for change is muted. Critics say projects have closed without the benefit of a FIT and that Pakistan does not yet have the track record to change the system after such a short period of operation. A feed-in-tariff also poses challenges around the level at which government sets it and for how long generators will receive it.

The circular dilemma

Any change that may negatively influence investor sentiment is particularly worrying, given that, despite the array of inducements, many sponsors and lenders remain wary. The government's response, or lack of it, to the thermal sector's problems with rising fuel costs is one reason why. The government has declined to subsidise distribution companies for them shouldering fuel costs, and the distributors have in turn refused to pay increased tariffs to sole off-taker NTDC, which in turn has been unable to pay IPPs, which in turn held back payments to refineries and creditor banks. Now power sector receivables amount to an estimated \$4.5 billion and the overhang is strangling future development.

Cheap consumer tariffs are insufficient to cover the rising cost of procuring power that runs on fossil fuels. The government's inability to subsidise tariffs, non-payment by end-users, and losses in transmission compound the problem. The issue arises because consumers are given protection that the government can't finance. The subsidy is beyond supportability and sectoral reform is urgently needed, says one banker.

To make matters worse, while consumer tariffs are fixed at a low level, IPPs' costs are passed through on the tariff they charge and invariably rise since they are indexed every quarter. These tariff revisions are automatically reflected in power purchase prices. Although NEPRA helps determine consumer tariffs, it does not have operational independence from the government. Between November 2003 and February 2007 end-consumer tariffs remained unchanged.

Although the government takes steps to fix the problem with periodic adjustments to the consumer tariff, it is never enough to break this circular debt crisis. Any marginal increase in tariffs often simply serves to heighten worries that it will further impede revenue collection. Positively, there have been no defaults on IPP project financings, because government guarantees have been called when defaults are imminent. However Pakistan's ability to come up with the massive cash contributions necessary to support the sector is increasingly in question. Observers insist the investor

template is right. Pakistan just has to find a way of passing on the cost of electricity to consumers, and generation costs will fall as long as the tender process encourages competition among developers.

Lender luring

The problems with adequately compensating independent power producers could also depress local banks willingness to fund future power projects. Historically the local market has stumped up around a third of the debt for any given power project, with multilaterals providing the rest. Local banks provided more than \$2 billion in financing for the wave of 13 thermal IPPs running on oil and gas that became operational between 2009 and 2011. Because of the circular debt crisis these investments have turned into alarmingly high exposures. Local banks carry quite a few power sector assets in their portfolios. Any more would struggle for space, says Ayesha Sultan, a senior associate at Habib Bank in Karachi.

Banks are also facing constraints on their lending to local power distributors that, having used up their own working capital, now rely on bank loans backed by expected receivables to stay afloat. Local lenders are also choosing to take a less risky route. The government of Pakistan, which borrows domestically to fund its fiscal deficit, also effectively hoovers up local bank liquidity. The current consensus amongst local lenders is that government securities are less risky than the power sector.

Multilaterals are also growing weary. The IFC, ADB and the Islamic Development Bank have become anchor lenders, as they fulfil their mandate to support an emerging power sector. But multilaterals say they cant continue to fund projects alone. They have country and sector limits and are feeling the squeeze. For the past two years it has been only us. We cant continue to build our portfolio exposure in Pakistans power sector, says one banker at a multilateral. Multilateral presence in deals is vital, because their long and deep relationships with the sovereign make the government less willing to default on payments. But they will become increasingly selective. Encouragingly, new lenders are emerging, like Koreas Kexim, which is contributing \$110 million of the \$327 million in debt for the Daewoo-led 30-year build-own-operate-transfer concession of the 147MW Star Hydro plant.

Outside of wind there are few upcoming financings for IPPs. Following the rush of deals in recent years thermal projects are now a rarity. Thermal deals suffer from the high cost of imported fuel and Pakistans own dwindling gas reserves. Projects under the 1994 power policy were assured fuel supply for 30 years in the PPA, compared to the 2002 power policy, which assured IPPs a gas supply for three years. Many are now in trouble because of the acute gas shortage, says Shahib Raza, a lawyer at Orr Digma and Co in Islamabad.

Given that wind developments are 50MW at most, and small next to 150MW plus thermal developments, Pakistan needs to find other sources of power. Hydro is the most likely source, but the country might be able to reallocate its existing fossil fuel imports. Pakistan has the largest fleet of natural gas-powered vehicles in the world, and this gas should be diverted instead to power plants. LNG projects are under development, but still a long way off.

Despite the strong framework for power projects, a growing track record and huge unmet demand, Pakistans power sector still cannot attract the lenders and sponsors it needs. Even with a risk allocation framework that leaves government shouldering most project risk, until the various constituents of Pakistans energy sector pay their bills on time, even the most compelling projects will continue to struggle to raise financings.

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