M2 Motorway refurbishment, Pakistan

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Sponsor Frontier Works Organization (FWO) and granting authority National Highway Authority of Pakistan (NHA) have met numerous delays in trying to close the M2 Islamabad to Lahore motorway refurbishment project. However, financial close looks to be finally in sight, which should kick start another moribund road project.

The $350 million refurbishment toll road project was scheduled to close on 9 October 2014. But in the latest setback the NHA has now raised concerns over how aspects of the contract are worded. While these issues are expected to be resolved in a timely manner, it has pushed financial close back to later this week (23 October 2014).

And this is not the first time the project has been subject to delays since it was awarded to FWO in April 2014, with a 20 year concession period. The project was initially slated to close in late July.

For the project to reach close, the NHA must grant its approval. That has not been forthcoming. One issue was a dispute over construction costs associated with FWO's final designs. The NHA finally granted approval in late July.

Ironically, for a project deemed politically important by Nawaz Sharif's incumbent government, protests calling on Sharif to resign caused a governmental shutdown, resulting in the NHA being unable to grant formal approval.

The project is politically important as the M2, operational and state-owned since 1997, is a major road to which there have been no significant improvements for 17 years.

Despite the sponsors awaiting financial close the project's construction is still scheduled to start at the end of 2014 in order to make sure the refurbishment is completed before the country goes to the polls in 2018.

Financing unchanged

Perhaps fortunately for FWO, the delays have not significantly affected the term sheets signed with lenders.

Four local banks were mandated to lend $240 million in debt in May, with the expectation that each would take a $60 million tranche. The debt would have a tenor of 10 years.

The four banks are:

- Muslim Commercial Bank (mandated lead arranger)
- Faysal Bank
- UBL Bank
- Askari Bank

When the NHA was disputing FWO's cost estimate for the project, there was the possibility that the debt may have to be upsized. However, the NHA in the end agreed to FWO's initial estimate, negating the need to ask the banks for more money.

But in September, after another delayed close due to the protests, the banks decided to downsize their respective tranches to around $40 million. The remaining $80 million in debt has been syndicated to six undisclosed local banks.

IJGlobal understands that the banks' decision to downsize their debt tranches on the M2 is so that they can finance another FWO project, the $60 million M-9 Hyderabad to Karachi Motorway in Pakistan. By taking less debt on the M2, all should be able to provide the $42 million required for the M9 project.

Risk transfer

The project entails the refurbishment of the 357km state owned motorway over the next three years. The firm will then operate it for the next 17 years before handing it back to the NHA under a build, operate, transfer (BOT) contract.

The sponsor FWO formed an SPV called Motorways Operations and Rehabilitation Company, of which it holds a 90% equity stake, to act as the project company. The other 10% is owned by Pakistani construction firm ZKB.

The sponsors have taken on all project risks apart from change of law and political risk. The sponsors opted to transfer these risks due to Pakistan's unstable political environment. The recent political upheaval in the country demonstrates that assurances from one government may not necessarily be respected by another administration.

Change of law risk is covered in the concession agreement, and effectively insures FWO against any retrospective legislation that would negatively impact the project. The political risk - largely the Pakistani government deciding not to allow the agreed toll rate escalations - is being assuaged by a $95 million NHA subsidy which will be placed into an interest rate bearing account. If the agreed toll rate escalations on the project are reduced or cancelled by the Pakistan government, the monies raised from the NHA subsidy will be used to offset any difference.

The toll rate escalations vary over the motorway's construction period. For the first 10-years of operation, toll rates will be escalated by 10% a year under the concession agreement. For the remaining time, an escalation rate of 7% a year will apply.

For the first three years during construction, the sponsors will not share revenues from the project. From the fourth to the eighth year, they will pay the NHA PRs1.9 billion ($19.4 million) a year, which will be raised from toll revenue.

During year's nine to 10, no revenue will be shared as the sponsors plan to pay off their debt during this period. For the remainder of the concession term, 42.19% of the gross profits per year will be paid to the NHA.

For both FWO and the NHA, ensuring the M2 closes this month is crucial. The pair have suspended formal concession agreement negotiations on the M9 Hyderabad to Karachi Motorway project until the M2 has closed. Any further delays could lead to tensions in the pair's relationship harming future projects.