EVOLUTION OF IPP/IWPPS IN SAUDI ARABIA

A SLEEPING GIANT AWAKENS. BY **PASCAL MARTESE**, DIRECTOR, ACQUISITIONS AND PROJECT FINANCE; **ROHIT GOKHALE**, DIRECTOR, ACQUISITIONS AND PROJECT FINANCE; AND **SOUDKI ATASS**, ASSOCIATE DIRECTOR, ACQUISITIONS AND PROJECT FINANCE, **ACWA POWER**.

The independent water and power project (IWPP) programme backed by government-owned utilities, or the classical single buyer's office, started in its true sense in Saudi Arabia with the Shuaibah IWPP, in which out of the US$1.9bn of debt, only 8.9% was Saudi riyal-denominated financing. Following Shuaibah, the financing on Shuqaiq IWPP (circa US$1.85bn of debt) was completely US dollar-based. This low level of Saudi riyal financing presents a stark contrast to the high portion of such debt in the later year projects like Rabigh 1 IPP and Qurayyah IPP (where US$1bn-equivalent was riyal-denominated, which is equivalent to 51% of the debt) – the latest project tendered by Saudi Electricity Company (SEC).

Thus, the Saudi riyal is the new kid on the block of power and water project financing in Saudi Arabia. While the spread between the US dollar and riyal cost of debt has been steadily diminishing, riyal financing has presented its own challenges – how do sponsors hedge their interest rate exposure in the absence of a long-term SIBOR swap market?

The answer lies in hedging for five-year rolling periods and, as the market of seven-year and 10-year SIBOR swaps develops, entering such market at opportune moments. A case in point is Rabigh 1 IPP, where the obligation of the project company is to hedge its SIBOR exposure every five years. However, in 2011 a window opened for entry into 10-year SIBOR swaps that was seized.

Looking forward, one should expect two trends in this space; the first is a higher frequency of opportunities for longer-tenor SIBOR swaps as more and more projects rely heavily on Saudi riyal denominated debt, and the second is the emergence of Islamic hedging, which was contracted for the first time on Rabigh IPP. The Islamic hedging option brings in more liquidity to the SIBOR hedging market and also increases the possibility of having longer-term SIBOR swaps (10 years). With these two trends firmly ensconced, one should expect local financing in Saudi riyal to play a bigger role in the future.

Given the amount of liquidity and the strength that the Saudi Arabian banks have shown, the question of resorting to capital markets as a source of financing has been naturally postponed. However, with the fourth project under the SEC IPP programme successfully coming to a close, the market has proven the low risk of these power projects, and the inclusion of capital markets as a source of financing may not be in the distant future. As of now, the bank market remains more competitive as a source of financing.

Fast and furious

Saudi Arabia's IPP/IWPP procurement programme was a late entrant compared with the IPP/IWPP procurement programmes of Abu Dhabi, Bahrain and Oman. However, Saudi Arabia's programme has proven its ability to churn out projects at a faster pace. It has also shown its efficiency and robustness through the short time that projects develop their life cycle. From bid date to signing date, projects take an average of seven to eight months.

Structuring in Saudi Arabia

The Qurayyah independent power project (IPP) was meant to be a 2,000MW gas-fired IPP. But when the bids were opened in March 2011, ACWA Power's consortium was 15% ahead of the runner-up, and it submitted an even more attractive unsolicited proposal for 4,000MW at a tariff widening the gap with the runner-up to 21%. The sponsors (ACWA Power, Samsung C&T and MENA Infrastructure Fund) had obtained commitments for roughly US$1bn (out of the US$2.1bn needed), so when SEC approved the 4,000MW project in August, the sponsors had to find another US$1bn to close the funding gap.

The financing structure was a mix of (i) export credit agency (ECA) financing, both buyer's credit with a direct US Ex-Im loan on the back of equipment supplies from Siemens in the US, a Hermes-covered (95% comprehensive insurance) loan from KfW on the back of equipment supplies from Siemens in Germany and Overseas Investment Credit from Korean Exim on the back of Samsung C&T's participation in the project's equity, split between direct funding and a covered tranche (100% payment guarantee), (ii) conventional financing with a few international banks' sour tranche becoming a staple to the sweet Kexim covered piece, and (iii) Saudi banks under an Islamic tranche in local currency.

While US Ex-Im and Hermes had a linear amortisation over 14 operational years to meet the OECD requirements of buyer's credit, others accepted a scheduled amortisation over 19.5 years with a short balloon with a six-month tail (the PPA is for 20 years). However, the balloon was to be collateralised by a gradual increase, commensurate to the forecast cashflows post debt service, of the conventional six-month debt service reserve account (DSRA).

The equity funding was a mix of a direct shareholder from MENA infrastructure fund and an equity bridge loan structured as an Islamic murabaha facility, with ACWA Power providing a corporate undertaking to its banks instead of a letter of credit. This was a first in ACWA Power's history and an important milestone for the recognition of ACWA Power's creditworthiness in its home market. Other financing features were boiler-plate in the eyes of the sponsors and the commercial lenders … until the ECAs came to the negotiation table post-bid and set their requirements.

Meeting the ECA challenge

The ECA troika came in after the bid was made, having provided only letters of intent pre-bid. Getting all of them on the same page across three different time-zones proved to be a challenge; all the more so because the sponsors were negotiating an increase of the plant capacity to 4,000MW in parallel, raising the level of environmental scrutiny of the ECAs and thus delaying their internal approval processes. A couple of face-to-face meetings proved to be necessary to come to a common understanding.

A few material concessions had to be made to close the deal: on the back of the technical due diligence, early generation revenues would not be used as a source of funding in the base case increasing the equity commitment significantly, outage assumptions would be more conservative in the base case, and the lenders would require more control over the long-term service agreement (although it was a subcontract with the operator); single-tranche refinancing conditions would be a bit stricter; a senior pari passu DSRA LC facility option had to be abandoned; mandatory prepayments would be applied in inverse order of maturity. Inter-creditors' mechanics also had to be tweaked to counterbalance the strong influence of Saudi banks (holding 50% of the senior debt) in the syndicate and give a lower control than usual to conventional lenders. Generally, the Islamic nature of the local tranche did not create material hurdles to the conventional lenders.

Giving birth to a giant

A lot of consideration was given to the hedging strategy. Unlike the US dollar-denominated tranches, the Saudi riyal-denominated tranches were not hedged beyond five years from financial close, because of the prohibitive cost between five and 10 years, and its non-existence beyond that point. The ECAs understood the constraint and agreed that the hedging obligation be on a five-year rolling basis for the 50% of the senior debt that was in local currency.

Eventually, the documentation followed its course, and the documents were executed on December 2 2011. Senior debt was not drawn before May 2012, when the EBL was fully disbursed. In February 2013, taking advantage of low rates, the borrower entered into an interest rate swap to hedge US$700m worth of Saudi riyal debt between 2016 and 2021, creating considerable value for the shareholders of the borrower and reducing the exposure to interest rate volatility risk for the lenders.

Meanwhile, construction is progressing, on schedule and on budget, with 65% of the construction completed, and the commercial operation of the first group is still targeted to be achieved in February 2014 with full commercial operation in July 2014.

Stay tuned

Given the high demand for power in Saudi Arabia, and the ability of the Kingdom's local banking market to provide the required liquidity, in addition to SEC's track record, one can only expect exciting days ahead. ■

The Qurayyah plant under construction