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Quiet thunderstorm

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The challenges of structuring and successfully closing mega deals in troubled times. By **Rajit Nanda**, CFO, **Rohit Gokhale**, director, **Sid Tiku**, manager, **ACWA Power International**.

The credit crunch and financial crisis have not only affected the securitisation and corporate lending markets but independent power and water producers (IWPPs) as well. Against the challenges of this global financial meltdown and poor lending sentiments, the ACWA Power International (ACWA) and Korea Electric Power Corporation (KEPCO) consortium managed to shield itself from the ongoing turmoil.

Faced with the daunting task of structuring and closing a US$2.5bn transaction at the peak of the crisis, it went on to deliver a winning tariff lower by 24% to that of a competing consortium and successfully closed the transaction in a record time with "true" long-term project financing in place that was oversubscribed by about US$300m. At the same time, it happens to be the first ever IPP to have closed in the GCC region without a sovereign guarantee.

What this shows is that there is still more money in the market than good deals!

Background

Rabigh IPP is a greenfield power generation project located south of the existing SEC Rabigh power station, about 150km north of the city of Jeddah on the western coast of the Kingdom of Saudi Arabia, and comprises the design, financing, construction, commissioning, testing, ownership, operation and maintenance of a new 2x660MW heavy fuel oil-fired power plant and associated facilities; and the design, financing, construction, commissioning, testing and transfer to SEC of certain Electrical Special Facilities, all in full compliance with the Equator Principles.

It is being developed on a build, own and operate (BOO) basis by the Rabigh project company, 40% owned by ACWA Power, 40% by KEPCO and the remaining 20% by the Saudi Electric Company (SEC).

Construction of the plant and associated facilities began in July 2009, with the initial commercial operation date and project commercial operation date (PCOD) scheduled for July 2012 and April 2013, respectively.

Following PCOD, the Rabigh IPP will sell its entire power capacity and output to the SEC under a 20-year PPA. SEC will supply heavy fuel oil (HFO) to the company on an energy conversion basis, and will also be responsible for the dispatch of electrical energy from the plant. SEC will source the required HFO under a separate arrangement with Saudi Aramco.

The plant will consist of two units of 602MW net capacity each, with a total plant capacity of 1,204MW. Dongfang Electric Corporation (Dongfang) will supply the boilers, turbines, generators and auxiliary equipment, while SEPCO III will provide the engineering, procurement and supply of the balance of plant equipment, construction, installation and commissioning and project management.

Chart

SEC programme for private sector participation

The Kingdom of Saudi Arabia's electricity market is split into four operating areas: East, South, Central and West. SEC produces about 85% of the country's electricity, with the remainder produced by Saline Water Conversion Corporation (SWCC) resulting from cogeneration with desalinated water production, and Aramco and Marafiq producing a small balance.

The accelerating economic growth of Saudi Arabia's economy has led to rising demand for electricity. Although the SEC is committed to expanding power generation, transmission and distribution in order to cope with the rising demand, it realises that the large investments required for upcoming projects to fill the demand and supply gap are over and above the financial resources available at the SEC.

Thus, SEC has now embraced a concept of developing partnerships with the private sector in the field of power generation and has scheduled a series of IPPs, the first phase of which comprises the following three projects:

* Rabigh IPP – The first IPP as part of SEC's push for increased private sector participation in power generation

* Riyadh IPP – 2,000MW targeted to start operation in 2013 and currently in the tendering process

* Qurayyah IPP – Estimated capacity 2,000MW to start operation in 2014 in the Eastern region; interested parties from the private sector will be invited in 2010

Sponsors

The project's shareholding structure is as follows: ACWA Power International 40%; KEPCO 40% and SEC 20%. The main sponsors, ACWA and KEPCO, are well known players in the IPP industry with a successful track record of power project developments in Saudi Arabia and across the globe on a combined basis.

ACWA Power International, while being regarded internationally as the new kid on the block, is the most credible developer of power assets in Saudi Arabia with a unique track record of being successful in all the five I(W)PPs that have been awarded under the Kingdom's privatisation initiative on a competitive bidding framework.

It has undergone a metamorphosis on the organisation capacity build-up with a highly experienced management and development team with a stellar track record in developing and executing power and water assets in the Middle East, Asia and Africa region. This transaction represented yet another opportunity to participate in ACWA Power's aggressive expansion plans in the power sector, wherein ACWA Power has already identified and commenced work on a number of other initiatives.

KEPCO was founded in 1961 and is owned directly or indirectly 51% by the government of South Korea. It specialises in power generation, distribution and transmission and operates about 72,481MW of power generation facilities. Since the early 1990s, KEPCO has expanded its operations to cater to overseas demand for power generation and has built and operated facilities in the Far East (China and the Philippines), Africa and the Middle East.

Financing structure

The project funding plan of US$2.5bn is based on a combination of senior debt facilities made up of two Islamic tranches and the Korean Export Insurance Corporation (KEIC) covered facility, early generation revenues (EGR) and the shareholder funding.

With the exception of about US$2.7m contributed as share capital, the shareholder funding will be contributed through an equity bridge loan (EBL) facility. The uniqueness of the EBL facility is that all the shareholders themselves are providing equity as EBL lenders vis-à-vis the senior credit participants.

In accordance with the phased commissioning of the two operational blocks that constitute the plant, the project is expected to start generating EGR prior to scheduled commercial operation date. The net available cashflows after meeting all operating expenses and applicable taxes during this period will be allocated towards payment of project costs and represents the EGR

Key challenges

* *Absence of sovereign guarantee* – While this was the first IPP in the GCC region banked without an explicit government guarantee, comfort was drawn through the mitigation provided in the form of a replacement guarantee structured around an investment grade rating threshold of SEC and covenants related to the government maintaining a minimum shareholding in SEC

* *EPC contract from China* – While perception is said to be stronger than fact, it turned out to be the other way round on the Rabigh IPP project. However, it required a Herculean effort on the part of the sponsors, their engineer Black & Veatch and the independent engineer RW Beck to conclude satisfactory due diligence on the capability of Dongfang & SEPCO III to execute the EPC contract. Innumerable visits to manufacturer's site to assess their competency, higher budgeted expenditure on construction oversight with a lot of engineering staff based in China from the sponsors' side, and higher provisions for owner's contingency formed part of the several measures undertaken to ensure that this "first" of its kind attempt would not come a cropper.

* *Contagion effect of the collapse of the Saudi corporate lending market* – At a very advanced stage of due diligence, when the "club" of banks were well advanced in the credit approval process, Saudi Arabia was hit with a estimated US$$20bn corporate debt default and restructuring by two well established family-run conglomerates. This resulted in immediate withdrawal symptoms being shown by the club of banks. However, the sponsors stood up to the occasion and continued to show their commitment to the project by continuing with the pre-NTP expenses and agreeing to restructure the timing of their equity commitments. This was perceived very positively from a credit standpoint by the lenders and enabled them to be brought on board without any other fundamental restructuring of the transaction.

* *Familiarising Chinese banks with the Middle East risk allocation template* – The presence of a Chinese EPC in the project did help, but by itself was not sufficient to ensure that the Chinese banks would be able to meet the due diligence timeline of this fast-moving transaction. While most of the Islamic and International banks were comfortable with the Saudi jurisdiction and the Middle East IPP risk allocation template, the Chinese banks required a lot to be chewed over at their end in a very short timeframe. In order to facilitate this within the required timeline, the sponsors committed to allocate dedicated project financing resources to be based temporarily in China, with Standard Chartered Bank (Documentation Bank) doing an exceptionally good job of managing the due diligence and documentation towards them.

What was quite evident in the whole financing process was the spirit of camaraderie with which the banks and the sponsors worked on this transaction; each challenging the other but at the same time never losing sight of the overall timeline set at the beginning.

Global upheaval

The impact and severity of the global credit crunch was already percolating in bits and bobs from the end of 2007. The final straw that broke the camel's back was in the filing for bankruptcy protection by Lehman Brothers in September 2008. The immediate consequence of this event in the financial markets was unforeseen and unprecedented. Interbank liquidity across all currencies became almost non-existent and with counterparty risk at its height, new financings plummeted.

Unlike the usual boiler plate approach towards financing of large power projects in the region, where 100% of the long-term debt used to be committed in the form of underwriting at the bidding stage, an exclusive "club" approach was formed in November 2008 with three large Islamic financial institutions, ie, Al inma, Al Rajhi and Samba Financial, and KEIC on behalf of the international banks.

The tariff proposals were submitted on December 2 2008 and the announcement of the preferred bidder status was made on March 18 2009. Soon thereafter, the sponsors embarked upon expanding this club to bring in a few other banks from the competing sponsor consortium, which had been released of their exclusive commitments after announcement of the preferred bidder, and a few other banks that in the sponsors' view were well suited to enter the transaction.

The banks went through extensive due diligence and committed themselves to parallel negotiations with the sponsors on the financing documentation to achieve the closing in a record timeframe. Fond memories of the tough negotiations between the sponsors and the club of lenders, which went on for several days and weeks with most of them running through to the crack of dawn, still linger in the minds of several of the participants.

Given that the progress on finalisation of the project agreement and the financing documentation were happening in parallel, there was no requirement to enter and subsequently warehouse the pre-financial close interest rate swaps by the sponsors, and thus the financial close and the interest rate swaps happened almost concurrently. This resulted in a lot of temporary documentation hassles being eschewed and allowed the sponsors to focus on the actual financing documentation.

The initial MLAs, Al inma, Al Rajhi and Samba Financial, were joined by several others, resulting in the final "club" being expanded further to include Banque Saudi Fransi, National Commercial Bank and Saudi British Bank for the Islamic tranche(s); and Bank of China, Calyon, HSBC, and Standard Chartered Bank on the conventional tranche. The conventional tranche benefits from debt insurance cover provided by the KEIC. Despite the numerous challenges and the tough financing environment, the sponsors ended up raising US$291m more of project finance than the targeted amount of US$1.91bn.

While all the banks involved in the financing played a vital role, the constructive approach of Al inma, Banque Saudi Fransi and National Commercial Bank is particularly noteworthy.

This US$2.5bn transaction made history with a string of firsts, inter-alia,:

* First IPP project in the Kingdom of Saudi Arabia to be procured without a sovereign guarantee.

* First privately financed infrastructure transaction of any kind in the Middle East and North Africa (MENA) region that was structured with long-term debt on a project finance framework since the onset of the global financial crisis.

* First time major power plant equipment of Chinese manufacture and Chinese EPC contracting consortium being utilised and banked in the MENA region.

Conclusion

In conclusion, Rabigh IPP represented a significant milestone, not only in the development of the project finance market for the Kingdom and the GCC region when the world was going through one of its worst financial crises but also in being a strong vote of confidence in the continued success of the privatisation model embraced by the Kingdom.

Saudi Arabia had recently changed its mind towards two high-profile IWPPs (Raz Al Zour and Marafiq Yanbu) from a private finance to a public finance approach, thus passing mixed signals to the markets. However, the participation and support of SEC, coupled with the overwhelming success of this mega deal achieved in a record time, at a time when the there was a global meltdown of the financial markets and with so many novelties, reconfirmed that the privatisation process was firmly back on track and that true project financing could be made available to well structured projects and committed sponsors such as ACWA and KEPCO that have a proven track record.

The sound structure of the deal was evidenced by the support given by the large number of commercial banks (10) and an ECA, and also by the resulting oversubscription (about US$300m), achieved in these markets. As mentioned, it was the first infrastructure project financing (20-year long term) that was structured and closed after the start of the financial crisis.