OMANI OUD STRONGER THAN WESTERN PERFUME

BARKA WAS THE FIRST OMANI IWPP AND NOW IS THE FIRST TO BE REFINANCED. BY **ROHIT GOKHALE**, DIRECTOR, ACQUISITIONS AND PROJECT FINANCE, **ACWA POWER**, **USMAN ANWAR**, CFO, **ACWA POWER BARKA**, AND **IMRAN ABBAS**, FINANCE MANAGER, **ACWA POWER BARKA**.

The Barka I independent power and water project tendered in September 2000 was the first integrated power and water project in Oman. The project achieved financial close in May 2001, was completed in June 2003 and has been giving spectacular results for its stakeholders – in terms of availability, reliability, earnings and returns to its shareholders – retail public as well as institutional.

The project went through its first refinancing in October 2006 and was followed by a capital reduction programme to return cash to the shareholders. In the process, the company (ACWA Power Barka SAOG or APB) was the first company in Oman to reduce the par value of its shares to below OR1, taking advantage of the then recent change in law that made it possible. After the company was acquired by ACWA Power in 2010 through a competitive process run by the original majority shareholders, the company was awarded an expansion of the water desalination plant of 10MIGD based on the RO based technology.

Having gone through many firsts and path-breaking transitions in its lifetime, the project was poised for yet another one, primarily due to the terms of the existing loan agreement and to the expansion project undertaken.

The existing loan

APB's existing loan refinanced in 2006 had circa US$170m outstanding and was fully repayable by April 2018 (the expiry of the current PWPA[1]). The loan had a scheduled repayment profile with a balloon at the end of the term of around 10% of the original loan amount. The loan had a cash-sweep (read accelerated prepayment of the balloon) feature kicking in from October 2012, whereby on every repayment date, after the payment of scheduled debt service, the lenders would sweep out 95% of the cash available for shareholder distribution and apply it for the prepayment of the senior loan in inverse order of maturity – first paying out the balloon and going on further to prepay the scheduled repayments, to the extent cash was still available during the sweep period.

This loan had enabled at the bidding time (in 2001) the provision of a competitive tariff, as the balloon feature allowed the sponsors to increase the loan life and delay the repayment of loan. The loan could not be longer than the term of the 15-year (post PCOD[2]) PWPA as there was no visibility on the market and regulatory environment post the expiry of the PWPA for the lenders at the time. However, as is normal with the Omani P(W)PA model, although the PWPA ends 15 years after commissioning, the plant was expected to continue to have a robust technical life. Additionally, the company had a usufruct right over the land for 25 years from commissioning date.

The cash-sweep feature was designed to kick in only in the 10th operational year so that it was sufficiently close to the start of the un-contracted period of the business, giving some visibility of the expected revenues beyond that initial PWPA period as well as allowing the company to set an operating track record, all of which would give comfort to the lenders to provide a refinancing package that would take the repayment of loans into the as yet un-contracted period of the plant.

Performance of the company

The Barka I plant was built to international standards using tried and tested equipment. The gas turbines were supplied by Ansaldo Energia SpA using Siemens design and the steam turbines also by a subsidiary of Ansaldo; whereas the MSF-based water desalination plant was built by Hitachi Zosen using their proven designs. The plant also had an excellent operations and maintenance team that had been groomed to maintain top decile industry performance standards and had accordingly delivered a stellar operating performance thus far as far as reliability and availability were concerned. The plant had won along the way several awards for performance of the plant and for the safety environment.

The plant had also demonstrated repeatedly in annual performance tests that it had the ability to deliver additional power (about 15MW) above its contracted capacity. OPWP, the state owned off-taker and sole buyer of the plant's output, had accordingly contracted to take this additional capacity to meet its grid requirements through short-term off-take contracts. In summary, the plant and the team through its historic credentials had provided ample comfort that this plant would continue to show this performance for at least 20 years beyond the off-take contract (which is the technical life of the plant).

The financial performance of the plant had reflected its stable operations with predictable and strong financial results over the years. Barka I IWPP was also one of the early IPO listings in the power/water sector and since it's listing in the Muscat Stock Market (MSM), had delivered stable returns to the retail shareholder. For a long time it was the only company from the power sector that was listed in the MSM 30 index, which includes the top 30 companies in the market selected on their market capitalisation, liquidity and financial performance. As a result, APB had built up its own market standing quite separate from its parent ACWA Power.

The future beckons

In the meantime, a lot of changes had taken place from the time of the first financing both in the Omani electricity market and the international banking environment. The Omani economy, which is predominantly hydrocarbon-based, continued to show the promise of steady growth in line with the other regional economies. Further, the size of the population (2.8m) and its annual growth rate of 2.6% pa meant that the demand for electricity would continue to grow at a healthy rate. Oman had also in place a very prudent electricity regulatory structure (in place since June 2004), whereby a sustainable electricity industry could thrive in meeting the requirements of the consumers.

Over the recent years, the cost of setting up a power and water plant had been growing at a steady rate, which was evident in the increasing tariff that had been offered by subsequent power and water plants that were awarded the concessions for the power and water business in the Sultanate. The load centre served by the Barka I IWPP was also very close to its location (the Muscat and Sohar region) with substantial growth in domestic and industrial load predicted in the future. This would also be coupled with the decommissioning of some of the older plants in the vicinity. OPWP was managing its demand/supply balance by tendering new plants so as to keep the required reserve margin in the grid. All in all, it was clear by mid-2012 that the Barka I plant would need to keep on generating power and desalinating water much beyond the end of its contract period (until April 2018) and that it had the capability to do so in a reliable manner.

Banking world goes topsy-turvy

As far as the financing environment was concerned, the 2008 financial crisis, the resulting stricter Basel III banking reforms that were expected to take effect in the coming years and the European sovereign debt crisis had all roiled the project finance market. The effects of these on the financing environment could be summarised as below: (i) the make-up of the banks present in the region and Oman for meeting the long-term project finance requirements had changed from being predominantly European (French, UK), Japanese and to a lesser extent regional/local to being predominantly local and regional, with very few European players remaining in the long-term lending market, and that too with reduced liquidity for long-term lending; (ii) the currency of funds in terms of liquidity available for funding had changed from being only US dollars to a market where US dollar funds availability had significantly reduced but local currency funds availability had significantly increased; and (iii) the cost of raising US dollar loans for banks had significantly increased, thereby increasing the margins for the borrowers. However, the interbank benchmark rates being at historic lows, the overall cost of funds remained lower than in the past.

Expansion of the water facility

The team at APB had been pushing for a contract with OPWP for selling its surplus capacity for some time. It did manage to secure on a temporary basis the opportunity to secure an extension to the PWPA in so far as the contracted power capacity was concerned. However, given that the Sultanate's demand for water was more acute than power, after several rounds of discussions, APB was awarded a contract for a 10m imperial gallons per day (MIGD) water desalination project expansion (expansion project) earlier in the year to meet the grid requirements. The 10MIGD desalination plant would be a reverse osmosis desalination plant located in the land adjoining the existing plant.

The EPC contractor of the plant was Abeima from Spain and the plant would be constructed in 13 months from the start of construction. When complete in October 2013, it would be a record time for completion of a reverse osmosis desalination plant of similar or larger size. The EPC contract and the off-take contract for the expansion project were signed in August 2012. The financing was to be arranged subsequently by October 31 2012 prior to the start of substantial works at the plant and also coinciding with a scheduled repayment date of the original financing to avoid payment of any breakage costs to the existing lenders.

ACWA Power, the parent of APB, would step in to provide bridge financing support as required until the financing was raised for the expansion project to enable the construction to be undertaken without any delay in the schedule. There was a commitment to the Sultanate for a target delivery date and therefore ACWA Power made sure that there were no stones unturned in its efforts to meet those commitments.

ACWA Power considered it was an opportune time to consider a change in the existing financing arrangements because of the need to raise new project financing for the expansion project and the fact that there was a draconian cash sweep starting on the existing loan.

Objectives

Although it may appear that the only two objectives for ACWA Power were the earlier mentioned ones, when the teams at ACWA Power and APB sat down together to devise a plan there were several considerations as below:

- *Precedent for merchant financing* – Given the unique situation for APB wherein the expiry of its current PWPA was not far away (5.5 years), the regulatory and the market environment for power/desalination (as described earlier) was favourable, since it gave an insight on the expected revenue line beyond the expiry of the current PWPA and given APB's strong position in the Omani power industry it formed an ideal platform to set a new precedent for raising non-recourse financing that would take the revenue risk beyond the expiry of the current PWPA.
- *Precedent for local currency non-recourse financing* – Given the problems that were being faced by the developers currently due to the difficult banking environment characterised by low US dollar liquidity, high US dollar loan margins and withdrawing European banks from the MENA market (due to Basel III norms and the European sovereign crisis), ACWA Power also felt the current transaction facing APB provided an ideal opportunity to put in place a long-term non-recourse loan facility, partially in Omani rials (OR) and thereby create a new precedent for future power / water transactions. This would also open a new avenue for financing in an otherwise crowded US dollar loan market. The local currency transaction, if achieved, would also free up the US dollar lending capacity (around US$170m) that was currently locked up in the project and that could be technically recycled back into the region, and more particularly into the Sultanate of Oman.
- *ACWA Power Barka had a balance sheet of its own to support new financing* – Unlike in 2001 and 2006 (when the first financing and then the refinancing respectively were done), APB had a strong track record to show – with access to the stock market if necessary and a strong and unleveraged balance sheet. This would enable it to put in some corporate finance type structures/covenants that could be backstopped by APB itself. The hybrid of a certain corporate finance flavour along with the classical project finance would be needed to successfully put in place a first of its kind local currency long-term financing.
- *Continue the stable dividend flow to the shareholders, which would have been otherwise disrupted by the cash sweep that would have otherwise commenced by October 2012* – Last but not least, as mentioned earlier, the cash sweep would have significantly reduced the distributions that were being made to the shareholders of APB for the past 10 years and would have left the company with a fast reducing loan on its books. This was not ideal – as a utility company with robust revenue projections for the future, the shareholders deserved stable dividends to continue. The new loan facility would remove this disruption and continue the confidence enjoyed by the shareholders.

With all the above considerations in mind, ACWA Power together with APB set up a team to go about the task of negotiating and restructuring the existing loan agreements so that they could then extend into the post-PWPA period. Although Oman has a number of strong Omani banks, from ACWA Power's perspective, given the landmark nature of the transaction that needed to be achieved in quick time, ACWA Power and the team felt that the local bank candidates for the new loans would be Bank Muscat and National Bank of Oman – two banks that had done some pioneering transactions in the Omani market and had strong relationships with ACWA Power.

These banks also had the ability to take a view on the non-contracted environment after the PWPA expiry, being domiciled within the Sultanate itself. In addition to the local banks, ACWA Power also received strong interest from two regional banks but decided to go ahead with Arab Banking Corporation (Bahrain) (ABC) as part of the new restructured loans. ABC was one of the largest lenders on the existing loan and had strong relationships with both APB and ACWA Power.

The new loan transaction was structured such that there would be three tranches – (i) an Omani rial-denominated loan for replacing the existing US dollar loan, (ii) a US dollar loan for replacing the remaining part of the existing US dollar loan transaction and (iii) an Omani rial tranche for the purposes of funding the expansion project. All three loan tranches were negotiated at the same time with the purpose of achieving the financial close on all of them at the same time and before October 31 2012. In terms of the mechanics, the existing lenders would be prepaid by the new lenders coming to the transaction and immediately thereafter the terms of the existing loan transaction would be amended. The expansion facility would be drawn down gradually over the construction period of the expansion project. Some of the challenges faced and the structural features of the new loan are outlined below.

SUMMARY TERMS OF THE NEW LOAN FACILITY

	Tranche A1	Tranche A2	Tranche B
Amount/ currency	Circa OR 62.5m (US$ 162.4m equivalent)	Circa US$ 28 Million	Circa OR 16.6m (US$ 43.1m equivalent)
Final repayment date	30 April 2024	31 October 2020	31 October 2024
Names of lenders	Bank Muscat SAOG & National Bank of Oman SAOG	Arab Banking Corporation (BSC)	Bank Muscat SAOG & National Bank of Oman SAOG

Benchmark interest

Structuring the loan transaction in Omani rials posed one big challenge. There was no Omani rial benchmark interest rate that could be used by the local banks for setting the loan interest rate. About three years ago an effort in this direction had been made for the Salalah IWPP but the pricing obtained therein sounded prohibitively high to APB and its shareholders. After several rounds of deliberations, it was concluded that the best way forward would be to set a fixed rate interest for the next five years, at which time a reset clause would come into play. The parties would meet at the time and agree the new interest rate, acting reasonably and in good faith, going forward. Such a structure could be absorbed by APB due to its strong financial performance and the expected revenue line.

The loan sizing was done in such a manner that the debt coverage ratios at all times were never lower than 1.5x and significantly higher than this threshold. The time of the reset of interest rates would also coincide with the extension of the PWPA, at which time a new tariff would be agreed going forward for the plant. That milestone would be significant in the sense that it would re-affirm the financial projections that currently were made at conservative levels. It was expected that the tariffs in the extension period would be substantially higher than those currently assumed in the financial projections. There would also be a test at this time to ensure that the debt coverage ratios would be at least maintained at the level of 1.5x in the future. The above reset clause is not typical in classical project finance for power and utilities, where interest rates need to be firmed up upfront, to firm up the financial ratios. The other corporate finance features in the transaction included the following:

- *Dividends during construction of the expansion project* – As the project was undertaken by APB itself, which had strong cashflows from the existing bigger plant during the construction of the much smaller expansion project, there were no restrictions on dividend distributions from the company.
- *No debt service reserve account (DSRA) balance required* – Given the strong ratios that were projected during the term of the loan there was no requirement of DSRA balance for the new loans. This was a unique feature of the new loan that is not found in traditional loan structures. There would be a reconfirmation of the future ratios after the PWPA extension and to the extent the forward-looking DSCR ratios remained above 1.5x, the DSRA balance requirement would continue to be non-existent.
- *No minimum hedge obligations* – As a substantial amount of the loan would be fixed-rate, there were no minimum hedging requirements in the new loan agreement.

Although the above features are akin to a corporate finance structure, there was no shareholder guarantee for the benefit of the lenders and the facility was a non-recourse (to the shareholders) loan.

Cancellation of the existing interest rate swap

The other challenge was posed by the existing IRS transaction that would kick in from October 2012 and extend until October 2017. The new loan transaction would significantly reduce the US dollar loan amounts from the amounts that were hedged under the IRS. This would cause significant accounting issues as it would fall foul of the IFRS accounting standard, IAS 39. Due to the difference between the hedged amounts under the IRS transaction and the substantially lower amount of actual US dollar loan liabilities, this standard would require the recognition of the profit or loss due to the difference in the spot interest rates and the hedged fixed interest rates. This would create substantial volatility on the P&L statement.

This issue was resolved by novating a part of the IRS transaction corresponding to the notional hedged amounts above the actual new US dollar loan outstandings to another hedge bank at no consideration. The hedge bank took over the hedge transaction at no cost for its own commercial reasons – probably to settle another opposing position on its books. As a result, the remaining IRS transaction perfectly matched the actual US dollar loan outstanding on the books and there would therefore be no impact on the P&L due to the movements of spot interest rate relative to the hedged rate. This was a significant achievement as the new loan transaction would otherwise have resulted in a significant accounting impact that would have reduced the attractiveness of the refinancing transaction.

In summary, the refinancing cum expansion financing facility raised by APB was a landmark transaction in many respects, as mentioned earlier, and would set out a new path that can well be trodden by the power and water industry in the Middle East. It was the first long-term non-recourse loan transaction that

- Could be identified as a bi-currency non-recourse loan in the I(W)PP domain in Oman
- Took the post-PWPA revenue risk for a substantially long period (6.5 years)
- Was a hybrid structure not containing the traditional project finance restrictions such as the DSRA balance, dividend distributions. ■

> The loan sizing was done in such a manner that the debt coverage ratios at all times were never lower than 1.5x and are significant higher than this

Footnotes

1 PWPA means the take and pay power and water purchase agreement signed with Oman Power and Water Procurement Company (OPWP)

2 PCOD means project commercial operations date.