THE BOTTOM LINE

The $623 million financing included the first long-term commercial loans for private power plants in Kenya and marked the first time IDA guarantees were issued in support of local investors. The guarantees minimized the government’s contingent liabilities by limiting its exposure to two to three months of payments and guarantees. They also helped to ensure consistency and predictability in government support for Kenya’s Independent Power Producer Program. Most important, they made possible the construction of 298 MW of critically needed generation capacity.

Kenya: First Commercial Financing for Power Plants Made Possible through a Series of IDA Guarantees

Background

When the projects supported by a series of IDA guarantees were being structured around 2011, Kenya had one of the best-performing power sectors in Sub-Saharan Africa, thanks to a series of reforms undertaken by the Kenyan government since the mid-1990s. The reforms, which aimed to create the basis for the sector’s long term sustainability, included (i) the separation of policy, commercial, and regulatory functions; (ii) the establishment of a sector regulator (the Energy Regulatory Commission); and (iii) the requirement that publicly owned electricity companies operate on a commercial basis supported by a system of performance contracts and with transparent financial relationships.

The reforms also established a regulatory framework that enables electricity companies to maintain commercial viability. Kenya’s 2006 Energy Act established that although electricity tariffs should be “just and reasonable,” they should be set at a level that enables the holder of an electricity supply license to: (i) maintain its financial integrity, (ii) attract capital, (iii) operate efficiently; and, (iv) fully compensate investors for assumed risks. Kenya’s tariff methodology provides incentives to Kenya Power,1 the national distribution utility and single off-taker, to make efficiency gains while at the same time passing through to end consumers fuel costs, exchange-rate fluctuations, and adjustments for inflation.

Majority owned by the government and with the balance of its shares listed and traded on the Nairobi Securities Exchange, Kenya Power is professionally managed and operates on commercial principles. Although the company showed losses in the 2000–04 period, it improved its operational performance and achieved satisfactory financial results after 2008.

By 2010 Kenya Power had signed six power purchase agreements (PPAs) with private independent power producers (IPPs), which sprang up after generation was opened to competition in 1997. Kenya Power had a good track record honoring its commitments under the PPAs, none of which was canceled. To this point, therefore, the outlook for Kenya’s IPP program appeared strong.

The picture changed, however, when the electricity sector began to face major supply deficits and power outages owing to droughts in 2009 and 2011 that significantly diminished hydropower supply, the main source of electricity in the country. Kenya Power responded by contracting for readily available emergency generation capacity to ease the supply deficit, but at a high cost—$0.321 per kilowatt hour (kWh). This put Kenya Power under financial pressure and required retail tariffs to be increased, which made electricity less affordable. The expensive and unreliable power supply took a toll on Kenya’s gross domestic product, reducing the rate of GDP growth by 1.5 percentage points in 2011.

To reduce the need for emergency generation and to expand energy access from 25 percent of the population in 2010 to 40 percent in 2030, the government decided that new thermal and geothermal generation capacity should be developed. It was intended that these would be short- to medium-term options until a more diversified portfolio of assets could be established, including imports of hydropower from neighboring countries. Because demand was

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1 Before a rebranding in 2011, Kenya Power was known as the Kenya Power and Lighting Company.
strong and power generation had already attracted private investors, the government was keen to attract more private financing into the sector, primarily for IPPs, so that public and donor funding could be directed to other priority needs.

The projects

In 2011 four IPP projects were identified as priorities to meet Kenya’s urgent generation needs and pave the way for a more diversified generation mix. Those projects were Thika Power Ltd, an 87 megawatt (MW) combined-cycle diesel plant; Triumph Power Ltd, an 82 MW combined-cycle diesel plant; Gulf Power Ltd, an 80 MW single-cycle diesel plant, and a 48 MW expansion of OrPower Ltd, an existing geothermal plant developed as a private IPP.

Kenya Power selected private sponsors for the first three projects through a competitive tender process. In that tender, Kenya Power obtained levelized tariffs ranging from $0.22 to $0.24 per kWh. OrPower’s expansion had a levelized tariff of $0.11 per kWh. The total cost of all four projects was $623 million.

Kenya Power signed a 20-year PPA with each of the four IPPs in which capacity and energy charges were agreed. The tariff methodology provided that fuel-cost and exchange-rate risks would be passed through to consumers and that interest-rate risk would be assumed by the private sponsors.

The challenge

The priority projects were tendered at a time when financial markets were still suffering the impact of the 2008 global financial crisis and project financiers remained very risk averse. Moreover, the financial situation of Kenya Power had begun to deteriorate, driven in part by ambitious network expansion plans. To complicate matters further, Kenya’s political stability came into doubt after the civil unrest that followed the 2007 presidential elections and concerns over the upcoming 2013 presidential elections.

During the project tender process, it became clear to Kenya Power that it would not be able to attract investors unless it offered important credit enhancements, such as sovereign guarantees. The Kenyan government, however, was constrained in its ability to provide such guarantees because of its limited fiscal space and a tight debt ceiling previously agreed with the International Monetary Fund.

In the new environment Kenya Power found it difficult to continue offering the security packages that it had provided to the first six IPPs. Those security packages had become financially onerous for Kenya Power, mainly because commercial banks required that payment security issued to IPPs on Kenya Power’s behalf be fully collateralized with cash. This very inefficient use of Kenya Power’s liquidity diverted funds that were badly needed to finance operations and its investment program.

The solution

Kenya Power, the Kenyan government, and the World Bank Group (WBG) agreed to explore credit-enhancement options that would make private investors more comfortable about financing the

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“Kenya Power, the Kenyan government, and the World Bank Group agreed to explore credit-enhancement options that would make private investors more comfortable about financing the much-needed new capacity. This had to be achieved while minimizing the government’s contingent liabilities and Kenya Power’s financial cost.”

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**Box 1. Features of IDA guarantees for IPP projects in Kenya**

The IDA guarantees provide liquidity support to private financiers in case of:

- Kenya Power’s defaults on its ongoing payment obligations under the PPAs, including capacity, energy, and fuel payments; or
- The government’s defaults on its payment obligations arising from an event of **force majeure**, natural or political, that constrains Kenya Power’s funding, as stipulated in the government’s Letter of Support.

**Highlights of the guarantee structure**

Objectives: To improve the creditworthiness of Kenya Power and the government of Kenya, and to limit the government’s direct support to manageable levels.

Letters of credit backstopped by IDA guarantees cover the following payment obligations of Kenya Power:

- Three months of capacity and energy payments;
- Two months of fuel payments; and,
- Rolling cover.

To match the underlying financing terms, each letter of credit has a maximum term of 15 years from the date of effectiveness of each IDA guarantee. The letters may be invoked from the date the covered power plant is commissioned.
“IDA guarantees for the priority projects were structured … to ensure timely payments of energy, capacity, and fuel charges so that investors would know that the projects’ cash flow would be protected against payment defaults by Kenya Power, whether these stemmed from its own failures or from government interference.”

Figure 1. Structure of credit-enhancement package to facilitate private investment in new power generation capacity

much-needed new capacity. This had to be achieved while minimizing the government’s contingent liabilities and Kenya Power’s financial cost. After a market-sounding exercise, a credit-enhancement package for the priority projects was put together. The package consisted of guarantees from the International Development Association (IDA), a member of the WBG, to backstop ongoing payments under the PPAs, as well as insurance policies from WBG’s Multilateral Investment Guarantee Agency (MIGA) to cover termination payments (figure 1). In addition, the International Finance Corporation (IFC) provided long-term debt financing for two of the four projects.

IDA guarantees for the priority projects were structured with a dual goal (box 1). One was to ensure timely payments of energy, capacity, and fuel charges so that investors would know that the projects’ cash flow would be protected against payment defaults by Kenya Power, whether these stemmed from its own failures or from government interference. The second goal was to create a process to make sure that if a payment default were to occur, remedial actions would be taken over a 12-month period to reinstate the liquidity protection and keep it in place for the full 15 years of the underlying financing.

Both goals were accomplished with the use of standby letters of credit backstopped by IDA guarantees (see figure 1). Commercial banks issued letters of credit to the project companies as a payment security for Kenya Power’s ongoing payment obligation under the PPAs. The instruments allow project companies to withdraw funds if Kenya Power fails to make a payment on time. In case of withdrawals, Kenya Power or the government of Kenya is obliged to repay the
WBG support ensured the mobilization of private financing for badly needed additional generation capacity that otherwise would not have been achieved. The crucial value of the IDA guarantee was in enabling the IPP projects to be bankable, thereby catalyzing financing.

**Benefits of World Bank Group support**

WBG support ensured the mobilization of private financing for badly needed additional generation capacity that otherwise would not have been achieved. The crucial value of the IDA guarantee lay in enabling the IPP projects to be bankable, thereby catalyzing financing. The four supported IPPs reached financial closure between October 2012 and December 2013, ensuring that the much-needed additional generation capacity will be delivered.

Three of the four IPPs attracted long-term commercial financing (table 1), the first to do so in Kenya. IFC and other development financial institutions played a critical role in providing debt financing. These projects have become benchmarks for long-term financing in Kenya and Africa.

Table 1. Financing of the Kenyan IPP projects (US$ million)

<table>
<thead>
<tr>
<th>Source</th>
<th>Amount (US$ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>All sources</strong></td>
<td>623</td>
</tr>
<tr>
<td>Debt</td>
<td>474</td>
</tr>
<tr>
<td>IFC A</td>
<td>58</td>
</tr>
<tr>
<td>IFC B (commercial loan)</td>
<td>27</td>
</tr>
<tr>
<td>IFC C</td>
<td>5</td>
</tr>
<tr>
<td>African Development Bank</td>
<td>37</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>181</td>
</tr>
<tr>
<td>Equity</td>
<td>86</td>
</tr>
<tr>
<td>Project sponsors</td>
<td>149</td>
</tr>
</tbody>
</table>


WBG support secured several positive outcomes, such as:

- Minimizing the contingent liabilities of the government of Kenya by making it unnecessary for the government to provide a full-fledged explicit sovereign guarantee to investors and lenders in support of Kenya Power’s entire payment flows over the duration of the PPA (estimated at $4.3 billion). IDA guarantees limit the government’s contingent liabilities to $166 million, the amount of the counter-guarantee that the government was required to provide for IDA guarantees.
- Helping Kenya Power avoid the need to issue standalone letters of credit with full cash collateral, thus allowing its scarce resources to be redeployed for much-needed operational and investment purposes. Furthermore, the new generation capacities allowed for a retirement of the expensive diesel fuel emergency power plants.
- Ensuring consistency and predictability in government support to the Kenya IPP Program.
- Promoting South–South investment because IPP equity investors were either local or originated from other emerging markets (table 2).

Through the combination of IDA guarantees, MIGA insurance, and IFC long-term financing, the use of WBG resources was optimized for
Keny A: IDA Gu ArAnTees enAble FIrsT CoMMerCIAl FInAnCInG For PoWer PlAnTs

Kenya. Scarce IDA resources were sparingly used to provide payment security, while more readily available MIGA resources were deployed to cover the relatively larger amounts of support required for termination coverage. IFC, for its part, provided critical long-term funding in a country environment where such a long tenor was scarce. IFC further supported South–South and local investors. These investors have an appetite for investments in Africa but relatively limited ability and experience in structuring and implementing projects.

Table 2. Sponsors of the Kenyan IPP projects

<table>
<thead>
<tr>
<th>Power plant</th>
<th>Sponsor(s)</th>
<th>Share (percent)</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thika</td>
<td>Melec PowerGen</td>
<td>90</td>
<td>Affiliate of Lebanon-based Matelec Group</td>
</tr>
<tr>
<td></td>
<td>African Energy Resources</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Triumph</td>
<td>Board Holding</td>
<td>40</td>
<td>Family-owned company whose largest shareholder is a Kenyan national</td>
</tr>
<tr>
<td></td>
<td>Other African companies</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>Gulf</td>
<td>Gulf Energy Ltd</td>
<td>50</td>
<td>Africa-based</td>
</tr>
<tr>
<td></td>
<td>Multiple Hauliers</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Noora Power</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Trustee of Kenya Power Pension Fund</td>
<td>10</td>
<td>Passive investor</td>
</tr>
<tr>
<td>OrPower (expansion)</td>
<td>Ormat International Inc.</td>
<td>100</td>
<td>U.S.-based</td>
</tr>
</tbody>
</table>

— = data not available.

“Three of the four IPPs attracted long-term commercial financing, the first to do so in Kenya. These projects have become benchmarks for long-term financing in Kenya and Africa.”

The peer reviewers for this note were Clive Harris, who manages the Public–Private Partnership Practice in the World Bank’s Cross-Cutting Solution Global Practice, and Richard MacGeorge, a lead infrastructure finance specialist in the Bank’s Energy and Extractives Global Practice.
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