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Viewpoint

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Mitigating Currency Convertibility Risks in High-Risk Countries

A new IDA lending approach

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This Note examines how the International Development Association's lending instruments can be tailored to support foreign equity investment in projects that generate only local currency and for which currency convertibility insurance is not commercially available.

A proposed Currency Convertibility Fund, backstopped by a contingent credit from the International Development Association (IDA)—the World Bank's concessionary window for the world's poorest countries—has been designed for the Songo Songo Gas Development and Power Generation Project in Tanzania. The fund is a transitional mechanism aimed at supporting the Tanzanian government's efforts to attract foreign equity in circumstances where the private sector perceives a high level of risk and is otherwise unwilling to invest. The Songo Songo power project has suffered delays since 1997 arising from a dispute between the government and the Malaysian sponsors of another private power project. Now that this dispute is being resolved, preparation of the proposed Songo Songo project has resumed. The World Bank's support for the Currency Convertibility Fund is not due to go before the Bank's board for approval until 2000. Still, the fund may be a replicable mechanism that, by mitigating sovereign risks that investors are unwilling to bear and unable to hedge against, could help catalyze foreign equity investment in other IDA countries and in projects that generate local currency.

The government of Tanzania solicited private sector interest in a project involving the construction of a gas processing plant on Songo Songo Island and of a 220-kilometer gas pipeline. The project also includes the privatization and conversion to gas firing of a 110-megawatt generating plant owned by Tanesco, the public electricity utility. The government saw significant advantages in a public-private partnership—with a direct stake in the project, equity investors should have a strong incentive to operate the facility efficiently, and Tanzania has no expertise in gas-fired electricity generation and so could benefit from private sector technical and managerial expertise.

The project would establish Songas, a majority privately owned and managed gas and electricity utility. The project would be structured as a build-own-operate arrangement, underpinned by a power purchase agreement between Tanesco and Songas. Project costs are estimated at about US$280 million (table 1). Equity investors would provide about US$72 million, and the government would contribute about US$8 million. The remaining US$200 million would be provided to the government through a credit from IDA and a loan from the European Investment Bank, both of which would be on-lent to Songas on commercial terms. In addition, IDA would provide a contingent credit of US$35 million that would

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TABLE 1 PROJECT FINANCING PLAN
US$ millions

Source	Equity	Debt	Total
OTC (Ocelot Energy and TransCanada Pipelines, the two private sponsors)	50		50
International Finance Corporation	6		6
Commonwealth Development Corporation	6		6
Deutsche Investitions und Entwicklungsgesellschaft mbH	6		6
European Investment Bank/Tanzania Development Finance Corporation	4		4
IDA project loan (on-lent to Songas)		155	155
European Investment Bank loan (on-lent to Songas)		45	45
Government		8	8
Total	72	208	280
IDA contingent credit		35	35

Source: International Development Association.

provide limited protection to the project sponsors against the risk of currency inconvertibility.

The currency pro blem

Private involvement in the project ran into two main impediments: the unavailablity of currency convertibility insurance from public and private sources, and Tanzania's weak balance of payments performance and heavy debt burden. There were no prospects for commercial debt financing for the project because foreign commercial banks have been willing to lend only for short-term trade transactions (all export credit agencies are off cover in Tanzania). And in any event, foreign-denominated commercial debt would have exacerbated the project's foreign exchange requirements.

For these reasons, the government preferred to seek private equity in the project rather than commercial debt. But while foreign equity investors were willing to assume the construction and commercial risks associated with the project, they were not willing to take on sovereign risks against which they could not hedge. Specifically, foreign investors wanted assurances that, on project sustainability grounds, they could reasonably expect to cover the project's operations and maintenance expenditures payable in foreign exchange, and repatriate their earnings in a convertible currency.[1]

The conclusions of a World Bank study and discussions with international oil and gas companies and political insurance agencies confirmed that foreign equity investment for the project would not materialize unless IDA or other donors were willing to address the project's currency convertibility risk. The project's foreign exchange needs would be high relative to the size of the foreign exchange market. The project would require the equivalent of 8 percent of the annual volume of foreign exchange transacted in the market.

The World Bank Group examined the instruments it had available to encourage equity investment. At the time the Bank's pilot program for partial risk guarantees to private lenders in IDA countries was not available to help raise commercial debt. Moreover, the Multilateral Investment Guarantee Agency (MIGA) was unwilling to offer currency convertibility coverage on its own account because of the high perceived risk of the project. So, to maximize mobilization of private equity in the proposed project, the Bank designed a new financial mechanism, the Currency Convertibility Fund (CCF), to mitigate the risk of currency inconvertibility.

What is the Currency Convertibility Fund, and how does it work?

The CCF is a financial instrument, to be backed by a contingent IDA credit of US$35 million, that would provide the project sponsors with limited protection (up to US$35 million) against currency inconvertibility for operations and maintenance expenditures, dividends, and capital redemptions payable in foreign exchange.

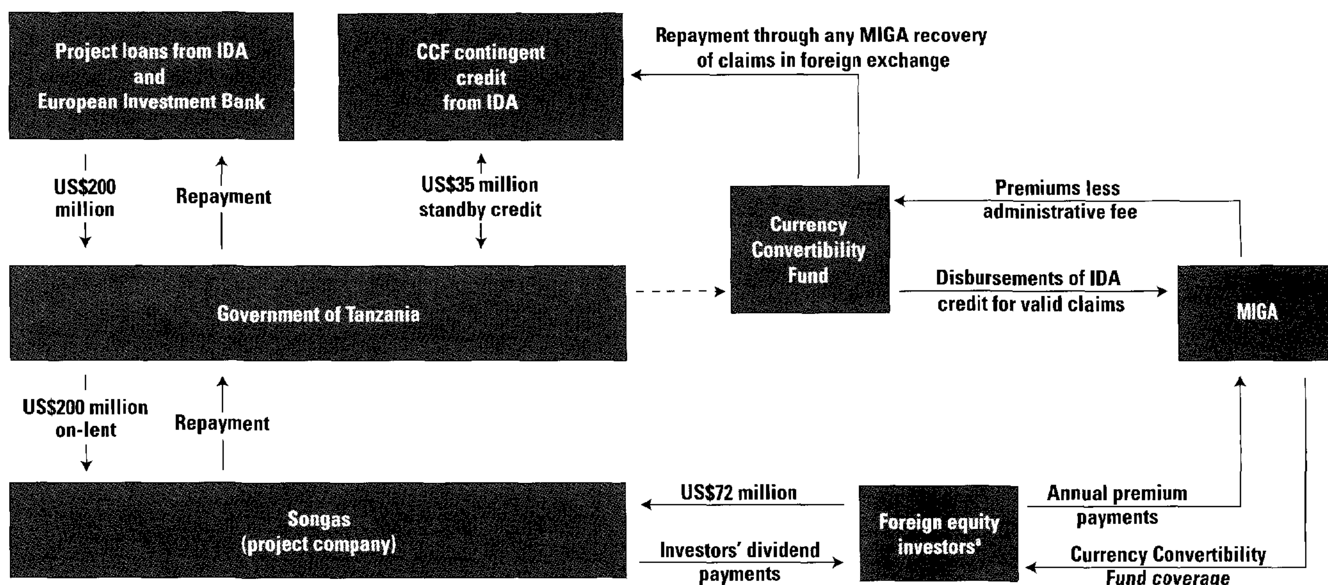
The CCF will mitigate but not eliminate the risk to Songas of currency inconvertibility. Songas's

annual foreign exchange requirements for operations and maintenance, dividends, and capital redemptions are estimated at about US$25 million, or US$500 million over the twenty-year term of the power purchase agreement. The coverage provided by the CCF would help ensure the financial viability of the project in the event of a temporary lack of foreign exchange in the market. The CCF is equivalent to about sixteen months of the project's foreign exchange requirements.

The CCF would disburse only as needed to pay valid claims submitted by the project sponsors and substantiated by MIGA, which will administer the fund on behalf of the government (figure 1). The government would issue to MIGA an irrevocable right to make withdrawals from the fund to pay eligible claims. The IDA credit (and contract of guarantee) for the CCF would have a term of fifteen years (or thirteen years of commercial operations under the twenty-year power purchase agreement). This period is considered reasonable because it reflects the time required for investors to generate adequate cash flows at the agreed tariff level, and because it will help ensure that Songas remains a going private sector concern over the long term.

The CCF is structured to discourage both the government and the project sponsors from causing a claim to be filed. For the sponsors these disincentives include an extended transfer delay period before which a claim can be filed, a less than 100 percent claim coverage ratio, and an annual stop loss. Government deterrents include mandatory use of any foreign exchange recovered by MIGA in connection with a claim to prepay the CCF credit to IDA, and IDA's option of accelerating the credit if a call is made on the CCF.

FIGURE 1 THE CURRENCY CONVERTIBILITY FUND SCHEME



Note: Arrows indicate money flows.

a. Ocelot Energy Inc. and TransCanada PipeLines (the project sponsors) are providing US$50 million in contributions. CCF coverage is being provided only for the private equity sponsors. The International Finance Corporation, Commonwealth Development Corporation, Deutsche Investitions und Entwicklungsgesellschaft mbH, and European Investment Bank are providing US$22 million in equity.

In addition to the proposed development credit agreement between the government and IDA for investment in the Songo Songo Gas Development and Power Generation Project, the CCF would involve three legal agreements:

- *The development credit agreement between the government and IDA for the credit to fund the CCF.* The proposed IDA credit of US$35 million to the government of Tanzania to fund the CCF would be provided under a separate development credit agreement because the CCF would involve terms and conditions that differ significantly from those that would govern the proposed IDA credit to the government for the investment project. For example, this agreement would contain conditions of disbursement related to the submission of documentation from MIGA substantiating that a valid claim had been filed for which payment was to be made. It would also confirm the government's assignment to MIGA of an irrevocable right to withdraw funds from the CCF credit on the occurrence of the defined events. Thus the CCF would disburse only if MIGA were to determine that the project sponsors had filed a valid claim substantiating their inability to convert or transfer operations and maintenance expenditures payable in foreign exchange, dividends, or capital redemptions in accordance with the provisions of the contract of guarantee (see below).
- *The administration agreement between the government and MIGA relating to the CCF.* This agreement would spell out the relationship between the government and MIGA with respect to the management and administration of the CCF and the responsibilities of each party, including the procedures for paying eligible claims, recovering claims, and distributing premiums.
- *The contract of guarantee between the project sponsors and MIGA spelling out the insurance coverage to be provided by the government and issued by MIGA.* The contingent IDA credit of US$35 million to be made to the government of Tanzania would provide the financial backing for MIGA to issue currency convertibility risk coverage to the sponsors up to the same amount. Thus this document would spell out the specific terms and conditions of the CCF contract of guarantee, including the items covered, the terms of coverage, and the premiums to be charged annually to the sponsors and the procedures to be followed by the sponsors before filing a claim.

Catalytic role

IDA's involvement in the project is seen as crucial to catalyze foreign private investment by alleviating equity investors' concern about noncommercial risks. This involvement is consistent with the Bank's policies to assist sector reform by involving the private sector and to assist government borrowers in attracting this private capital by alleviating investors' and lenders' concern about sovereign risk. The contingent IDA credit of US$35 million has a leveraging effect, mobilizing US$50 million of private equity and US$22 million in other foreign equity that would otherwise not have materialized.

[1] Investors were also concerned about the risk of nonpayment by Tanesco. This risk has been mitigated through a government-funded revolving liquidity facility designed to ensure complete and timely capacity and energy payments by Tanesco to Songas, and by an escrow account that would protect the project sponsors against the loss of their equity investment in the event of an incurable government default.

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