Sindh Foreign Investment Hedging Policy

For Public Private Partnership Projects In Sindh

Public Private Partnership Unit Sindh
Finance Department
Government of Sindh

FINANCE DEPARTMENT
GOVERNMENT OF SINDH

This Foreign Investment Hedging policy contains mixture of targets and methods, to be approved by members of the Public Private Partnership (PPP) Policy Board. Therefore, the attached sample policy is generic and needs to be customized to suit the needs of each project. For example, calculations included in this document are for illustrative purposes only. Neither Government of Sindh (GoS) nor any of its employees accept any liability whatsoever for any loss or liability, however caused, arising from the use of this sample Foreign Investment Hedging Policy.

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1. Sindh Foreign Investment Hedging Policy for PPP projects

1.1. Mandate

One of the responsibilities of the PPP Unit is to periodically review the significant risks and opportunities that may affect the GoS and its obligations with respect to planning, and execution of project under its ambit, and to oversee the actions, systems, and controls that have been put in place to manage and monitor these risks and opportunities.

One key macro risk (outside that incorporated in concession normally) that arises in projects is the risk of devaluation in the local currency and the resulting shortfall in realized returns for a foreign developer/sponsor. Towards this end it is envisaged that a form of guarantee is made available to the Foreign Participant to provide him security regarding his returns.

1.2. Empowerment of PPP Unit for Forex Exposure Evaluation & Coverage

The PPP Policy Board will empower a PPP Unit and Sind Fund Management House (SFMH) for oversight in planning, and implementing the commitments arising due to Foreign Exchange exposure of projects. The said entities will ensure adequate procedures, limits, hedging timelines, authorized hedging products if any, hedging performance reporting guidelines, approval guidelines, and internal controls. Moreover, the liabilities and guarantees arising out of hedging cover provided by the GoS under its PPP projects would be adequately reported and documented in the contingent liability register of the PPP projects.

1.3. The Case for Foreign Investment Coverage

Private infrastructure financiers have identified Foreign Exchange Risk as a major factor in their reluctance to invest in developing country power and water projects, especially in the wake of the East Asian financial crisis (1997) and the Argentinean and Brazilian currency crises (2001-2002).

The key issue is the extent to which capital investors may be expected to bear exchange rate risk. While equity sponsors are expected to take more risk (and earn higher returns) than lenders, their preference is to bear risks they can control, such as construction or commercial risks, rather than exchange risks that they cannot mitigate. Certainly the appetite of equity sponsors for exchange rate risk is lower today than it was in the mid-1990s.

1.4. The pertinence of Foreign Financier for Infrastructure

1.4.1 Local groups may not have the capacity to put in requisite equity investment for large infrastructure projects hence foreign equity participation is desirable. At the same time foreign investors having a lower cost of capital and lack of viable opportunities are keen to invest in developing economies provided they are given assurances for any return shortfall.

1.4.2 Investments tend to be recovered over a longer period (depreciation periods of 20 years or more) increasing the risk that a currency crisis will occur at some point during the project's life, as such long enough tenors in domestic financing to match the life of the asset are not available.

1.4.3 Presence of foreign financiers and Infrastructure developers add credibility to the project which encourages participation. This in turn leads to competitive pressures and sets international benchmarks resulting in efficiencies that enable a wider spectrum of projects and improved quality of delivery.

1.4.4 Foreign participant may also work in collaboration with domestic groups. The experience of foreign investors in different regions and multiple areas allows local parties to build capacity by the process of learning by doing.

2. Forex Cover Guarantee Customized

2.1. Modalities of the Guarantee

2.1.1 Accumulated hedging cover provided by the GoS for the PPP projects shall not exceed 25% of provincial Gross Revenue Receipts ("GRR") for the preceding year; where GRR means the total budgeted receipts.

2.1.2 This policy is on valid for projects that achieve financial close by Dec 31, 2014 and GoS will bring in a revised policy to attract foreign investment after Dec 31, 2014 through the PPP Policy Board for the PPP Projects or earlier if it deems appropriate, however, the deals signed under this policy shall remain binding and enforceable during their complete contract life. if in case no new policy is issued, this policy must remain valid.

2.1.3 Without prejudice to this policy terms, the GoS has the right to negotiate even better terms than the one envisaged in this policy.

2.1.4 In regards to Equity Investment the GoS undertakes that it will furnish a guarantee outside the moving average band of devaluation that has persisted over a 10 year period immediately preceding the guarantee.

2.1.5 The envisaged threshold is (5% on 2011 basis) beyond which the GoS will compensate for the shortfall in the project's return for that year caused by the depreciation in Pakistani rupee beyond the aforementioned threshold after adjustment against the devaluation reserve. The policy guarantees a return only to the extent of exchange rate fluctuations and is by no mean a blanket approval to make good returns for project risk other than currency fluctuations.

2.1.6 The international equity Investor is required to incorporate standard risk of devaluation (5%) upfront in his annual equity returns for the prospective project if he envisages the GoS to provide hedging cover to its investment.

2.1.7 Furthermore, the hedging cover will only apply on cash injected equity in foreign exchange and not on retained earnings et al. it is not to be available on equity contributed in rupees. However, it can be available to that part of equity that is sold to a foreign investor.

2.1.8 Forex hedging cover is to be given on the date on which the equity injection has been made, and not from the commercial operations date.

2.1.9 International developers should build a devaluation reserve of about 5% every year for the cumulative accruable returns to date, any differential cover that is not utilized for a particular year will be accumulated in this reserve to be offset against subsequent deprecation beyond 5%.

2.1.10 Upon due course of the concession having been completed the equity participant will be entitled to any accumulated reserve.

2.1.11 This Guarantee is solely for the foreign based participant with duly verified credentials, financial strength, and track record.

2.1.12 Whilst the terms of this policy are defined in terms of Pakistan Rupee versus US Dollar basis, the GoS may on the merits of each case, on the basis of value for money to the project and permissibility by the State Bank of Pakistan (SBP) permit the usage of Investment in a currency denomination other than the US Dollar.

Table 1: Example of Forex Guarantee for Equity

(1)	Year x	20X0	(6)	Year x+1	20X1
(2)	Depreciation	4%	(7)	Depreciation	10%
(3)	Built-In	5%	(8)	Built-In	5%
(4)	Reserve (3) - (2)	1%	(9)	Reserve (4) + (8) – (7) < Max (4)	1% - 1% = 0
(5)	GoS Support	0%	(10)	GoS Support (7) – (8) – (9)	4%

2.1.13 In case of debt the GoS may furnish a guarantee up to the total amount of debt and interest for a period of 5 years and then on for the 6th year GoS will cover for 80% of principal, for the 7th year GoS will cover for 60% of principal, for the 8th year GoS will cover for 40% of principal and for the 9th year GoS will cover for 20% of principal. Moreover, there shall be no hedge coverage of interests after the first 5 years (See table for details)

Repayment Year	Percentage cover principal	Percentage cover interests
1 - 5	100%	100%
6	80%	0%
7	60%	0%
8	40%	0%
9	20%	0%

2.1.14 Debt hedging structure can only be allowed or changed at the discretion of the PPP Policy Board.

2.1.15 All dollar based funding will have the loan amortization incorporated in the repayment structure instead of bullet payments. Moreover, all principal repayment plans and changes in them have to be made with due approval of the PPP Policy Board.

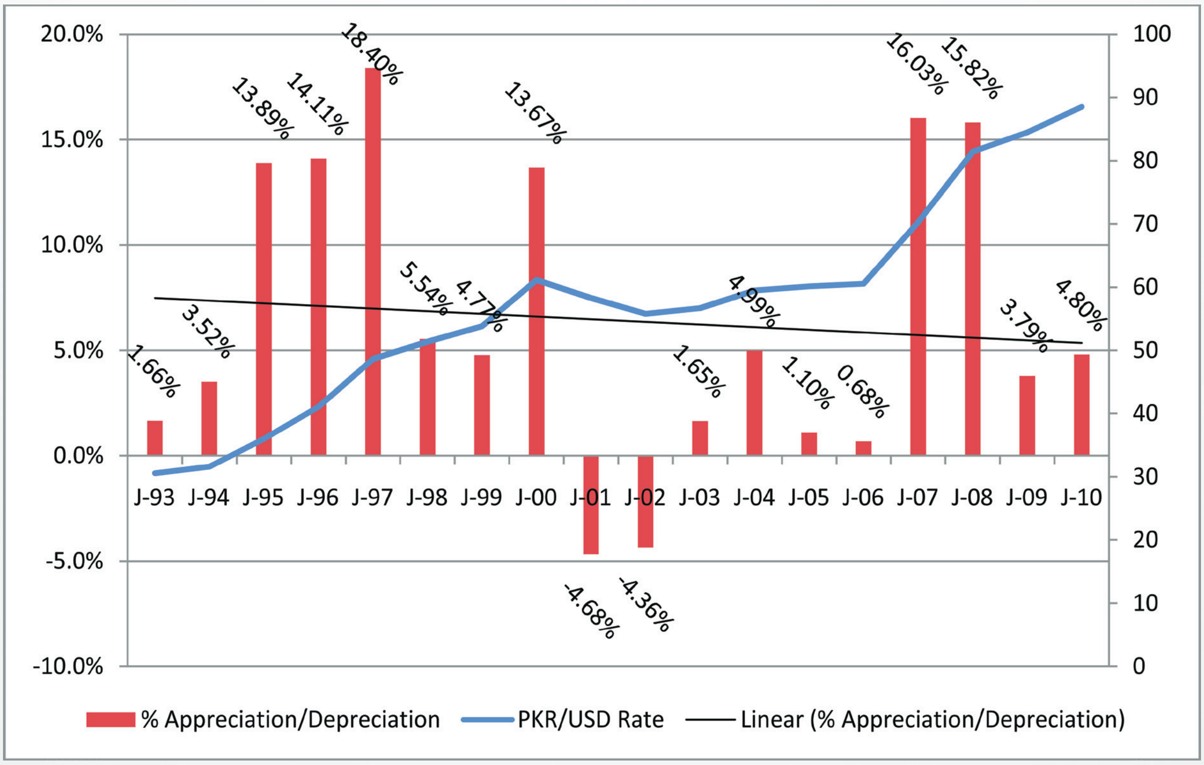
2.1.16 The foreign currency denominated loan for PPP projects has to get approval from PPP Policy Board on its reference interest rate and spread.

2.1.17 Sindh Fund Management House, on behalf of GoS, to build an annual cover/reserve of 10% for each project beyond the above stipulated threshold to cater for contingent liabilities arising out of this policy.

Table 2: Example of Forex Guarantee for Debt

(1)	Loan 1	
(2)	Rate LIBOR + 3%	0.76% + 3% = 3.76%
(3)	Depreciation	10%
(4)	GoS Support (2)+ (3)	3.76% + 10% = 13.76%

Chart 1: USD/PKR Exchange Rate & Rate of Appreciation Depreciation Since 1993



3. Annexure A

Year	PKR/USD Rate	% Appreciation/ Depreciation
Dec-93	30.037	
Dec-94	30.5346	1.7%
Dec-95	31.6082	3.5%
Dec-96	35.9984	13.9%
Dec-97	41.0771	14.1%
Dec-98	48.6359	18.4%
Dec-99	51.3309	5.5%
Dec-00	53.7791	4.8%
Dec-01	61.1329	13.7%
Dec-02	58.2714	-4.7%
Dec-03	55.7316	-4.4%
Dec-04	56.6508	1.6%
Dec-05	59.4781	5%
Dec-06	60.1297	1.1%
Dec-07	60.5368	0.7%
Dec-08	70.2383	16%
Dec-09	81.3493	15.8%
Dec-10	84.4302	3.8%
Dec-11	88.484	4.8%

3. Annexure B

3.1. Types of Foreign Currency Risks & Congruent Obligations

3.1.1. Foreign Exchange Risk

Foreign exchange risk has the following components:

Exchange rate risk, as defined here, is variability in the value of a project, or of an interest in the project, that results from unpredictable variation in the exchange rate. There are two types of exchange rate risk: project and financing related.

Project exchange rate risk arises when the value of a project's inputs or outputs depends on the exchange rate. Typical infrastructure projects sell their outputs domestically, so, valued in local currency, revenues usually are not subject to exchange rate risk. But any input that is tradable, even if it is not imported, will have a world price, so its cost, measured in local currency, will vary inversely with the exchange rate.

Financing choices affect the amount of exchange rate risk borne by different participants in the project (shareholders, creditors, customers, taxpayers). In particular, loans requiring repayment in foreign currency expose shareholders to exchange rate risk. As a result, shareholders may seek to shape the contractual arrangements to pass on some or all of the risk to the government or customers (through exchange rate guarantees or indexation of the tariff to the exchange rate).

3.1.2. Convertibility Risk:

Convertibility risk is the possibility that a firm will be prevented from exchanging local currency for foreign currency by a policy action of the government to restrict access to foreign exchange, i.e., administrative allocation of foreign exchange (rationing).

3.1.3. Transfer Risk:

Transfer risk is the possibility that a firm will be prevented from transferring foreign exchange out of the country.

3.2. The Case for Forex Coverage

The occurrence of currency crises has coincided with sharp reductions in private investment in infrastructure in developing countries. Currency crises tend to have a negative effect on all the key stakeholders in an infrastructure project. In addition to financial loss, the experience of investors is that contractual arrangements for infrastructure projects have been broken or re-negotiated. Even when projects are financed on a non-recourse basis, a currency crisis in foreign markets can negatively affect an investor's credit rating as the value of foreign assets and their expected revenues decline and investors face the choice of financing losses or writing-off their investment. Currency crises also negatively affect consumers, for example, when the consequence is that service is interrupted, quality of supply is impaired, or investment programs are suspended or postponed.

3.3. Varied circumstances that require foreign exchange cover

3.3.1. Dollar-Denominated Inputs and Expansion Costs:

Some projects have the major component of their operating costs (fuel) denominated in hard currencies In developing countries expansion of service is a major objective of privatized Infrastructure. The plant and equipment required for network extension are often manufactured outside the host country and priced in hard currencies, which means that staged investment commitments of private operators during the concession period also involve foreign exchange risk.

3.3.2. Assets Difficult to Re-Deploy:

Some projects are capital intensive, and most assets may not be re-deployed once they have been installed. It is therefore more difficult for Investors to exit from their investment in order to minimize foreign exchange losses.

3.4. Essence of Covering Investors including foreign participants

Although investors should generally face some project and all financing-related exchange rate risk, they still need to be able to recoup their costs and make a return that is reasonable given the risks they take. Not protecting investors from exchange rate risk may well imply higher tariffs.

Unless the government provides explicit guarantees in place of the implicit subsidies/guarantees in having taxpayers or customers bear the exchange rate risk the following consequences will result

3.4.1. Dollar-denominated debt financing for a large share of the project cost, may become less feasible, leading to greater reliance on local currency debt and local equity whereby the local participants will demand higher initial rates of return (required return in form of IRR) and higher project prices.

3.5. Essence of Covering Investors including foreign participants

The allocation of exchange rate risk is often done through tariff adjustment formulas that implicitly share risk through the way they adjust the tariff over time. If indexation is allowed, tariffs can reflect the exchange rate in several ways:

3.5.1 Allowed prices or revenue can be fully or partially indexed to the exchange rate.

3.5.2 Input costs that depend on the exchange rate can be treated as a pass-through, so that customers pay the actual costs of the inputs.

3.5.3 The contract can provide for a renegotiation of allowed prices or revenue if the exchange rate moves outside a specified band.

3.5.4 Parties can manage exchange rate risk in three ways:

3.5.4.1 They can influence the underlying source of the risk. Governments, for example, can reduce the rate of depreciation and the volatility of the exchange rate by keeping budget deficits small and inflation low.

3.5.4.2 They can influence the sensitivity of the value of a project or of their interest in it to the risk. Project sponsors, for example, can reduce the sensitivity of the value of their share-holding to the exchange rate by reducing the project's reliance on foreign currency debt.

3.5.4.3 They can hedge or diversify away the risk. Hedging exchange rate risks is possible in only a few developing countries. But most of the ultimate foreign shareholders of the project company—individuals with savings in mutual funds, pension plans, and life insurance—can diversify their savings, limiting their exposure to any one country's exchange rate risk (as defined).