

# **Management of Credit Risk in Hydropower Project Financing in Nepal: Dissection of Syndicated Credit Facilities Agreement**

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## ***Introduction***

The first hydropower development policy in 1991 and the subsequent Electricity Act, 1992 opened up private sector participation in power generation business under build, own, operate and transfer (BOOT) mode in Nepal. Since then, banks and financial institutions (BFIs) in Nepal are engaged in the financing of hydropower projects. Until last decade, due to the small size of projects under promotion by the private sector and the limited financing capacity of BFIs themselves, the volume of financing from BFIs was relatively small. However, such volume has increased substantially as the number of projects under implementation rose sharply during this decade accompanied by the priority sector lending requirement of BFIs mandated under the monetary policies of Nepal Rashtra Bank (NRB). Consequently, the credit exposure of BFIs from financing the hydropower projects has increased needing greater attention towards the management of credit risk.

Credit risk is normally defined as the potential that a bank borrower might fail to fulfill its obligations in accordance to the agreed terms (BIS, 2000). BFIs have minimized individual credit exposure through syndication and managed the credit risk through the Syndicated Credit Facilities Agreements (SCFA). The financing need of hydropower projects requires credit facilities such as term loan, letter of credit, bank guarantee, bridge gap loan, etc. depending on the capital structuring strategy of the borrower. The syndicated agreement signed between the consortium of banks and the developer of hydro-project makes provision for these credit facilities resulting the agreement to be termed as SCFA. This article will thus look into the recent practices and the scope of credit risk management under SCFA in Nepal.

## ***What Lenders or BFIs do in Project Financing?***

Typical characteristics of the project finance involves special purpose vehicle or company (SPV) having a high ratio of debt to equity in which lenders rely on future cash flows that project is expected to generate and security for the lenders is project company's contracts, licenses or ownership of rights to the natural resources (Yescombe, 2002). Since the gearing ratio is high in project finance and sponsors do not present guarantees (non-recourse) or pledge only limited guarantees (limited recourse) for the debt, management of credit risk

becomes critical for the lenders. Subsequently, lenders become key architect in structuring the project finance deals. The project finance deals by BFIs in Nepal are of limited recourse type where personal guarantees as well as collaterals are kept as securities by the sponsors.

When lenders enter into the discussion of financing the project and perform the due-diligence task, they mandate sponsors to incorporate varieties of covenants in each contract that SPV will sign with different stakeholders. Those covenants and the SCFA itself, to the fullest extent possible, include all the future uncertainties or events which might lead to the failure of SPV to repay the debt. First, lenders make sure that, given the project is both technically and financially viable, foreseeable project risks are allocated to the parties who shall manage them at the lowest cost. Lenders mandate the SPV to allocate risks from future uncertainties to the appropriate parties under various contracts. For example, typically lenders require SPV to sign the EPC contracts with contractors to mitigate the risk of cost and time overrun. Finally, SCFA comes into the picture where lenders list provisions to minimize the residual risks from future uncertainties including the events of default and the premium of such risk is reflected over the credit spread decided by the lenders.

**Key Provisions in SCFA for Credit Risk Management**

**Cashflow Waterfall**

The primary concern of lenders is the timely repayment of debt and interest accrued by the SPV. In hydropower project finance, revenue received from Nepal Electricity Authority

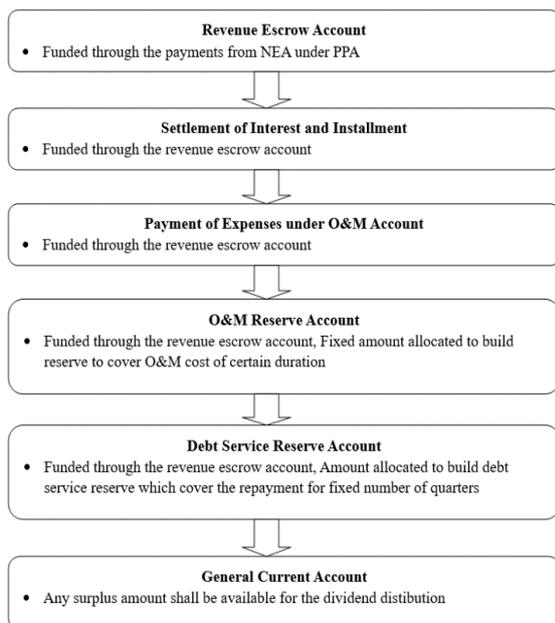


Chart 1: Cashflow Waterfall in SCFA

(NEA) through the sale of electricity under power purchase agreement (PPA) funds the payment of all expenses, loan repayment and the distribution of dividends to the sponsors. However, since the debt repayment period generally exceeds ten years and to ensure the timely repayment of loan and interest, lenders have explicit control over the revenue received; through the provision of cashflow waterfall. The general cashflow waterfall observed in SCFA among Nepali BFIs in hydropower project finance has been summarized in Chart 1. It shows the strict order

in which the revenue received is channelized into different accounts ranging from repayment

of loan to the distribution of the dividend until the loan repayment period. It can be seen that sponsors are entitled to receive dividend only when the repayment requirements of the BFIs and the payment of O&M expenses are fulfilled.

### **Events of Default and Remedy**

Another major concern for lenders is the circumstances leading to the events of borrowers'/SPV's default. Occurrence of such circumstances results in failure of lenders to receive the repayment. Generally, following circumstances are listed in SCFA which shall be termed as the event of borrowers' default.

- Failure of SPV to pay the principal, interest and other amounts as agreed upon
- Failure of SPV to perform its obligations under SCFA for a given period
- SPV declares moratorium on payment of principal and interest
- Actions of government authority that fails SPV to perform its obligations under SCFA
- Nationalization of asset
- Termination of electricity generation license and power purchase agreement
- Occurrence of delineated conditions affecting the management (BoD) of SPV
- Insolvency of the SPV

For the remedy of such events, lenders generally provide certain duration to the SPV. Given the remedy proposed by the SPV is not satisfactory, lenders will step in and control the management of the SPV. First, lender will attempt to implement remedy measures ranging from the reconstitution of board of directors (BoD), nomination of consortium representative to BoD, freezing the accounts of SPV and taking control of its operation, to the full control of entire project and its management through the consortium representatives. If these remedies cannot cure and turn ineffective, lenders will declare the default and take possession of all the pledged or mortgaged assets kept as a security. Lenders will recover all the dues through the sale or disposal of such securities.

### **Force Majeure Events and Remedy**

Similarly, the force majeure events have high potential to cause the failure of SPV in fulfilling its obligations under SCFA. However, the occurrence of force majeure events does not directly lead into the default as these events are beyond the control of both SPV and lenders. Some of the force majeure events generally listed in SCFA are outlined below.

- Occurrence of natural calamities such as earthquake, fire, flood, war, riots, etc.

- SPV cannot perform its obligations under SCFA and security documents
- Cancellation of Power Purchase Agreement
- Cancellation of Electricity Generation License

Consequently, SPV and lenders come into the table to discuss the potential ways or the course of remedial actions to deal with the exigency. Given the parties fail to agree or devise a remedial course of action during the remedy period mentioned in SCFA, the force majeure events will turn into the events of default. The remedies and course of action discussed in the previous paragraph on events of default shall be applicable afterwards.

### **Insurance**

During the implementation of the project, from construction to the end of operation period, risks which are out of the control of both SPV and lenders are covered by purchasing the appropriate insurances. Lender mandate SPV to purchase various insurance policies listed in SCFA and appoint an insurance consultant to make sure that the provisions under such, to the satisfaction of lenders and their policies, duly cover the risks associated with all assets forming part of the security. Generally, SPV should purchase the following insurances mentioned over SCFA.

- Marine-cum-Erection Insurance for hydro-mechanical, electro-mechanical and other equipment which covers all risks right from the warehouse of the vendor to the erection and commissioning at the project site.
- Construction and Erection All Risks (or Contractors All Risk) Insurance which covers the risk of material damage and third-party liability.
- Insurance that covers against fire, natural disasters, breakdown of machinery and consequential loss (loss of profit/revenue), etc.

Moreover, lenders require insurance policies to contain an 'Agreed Bank Clause' in the name of lenders. This clause entitles lenders to receive any amount which is payable under the policy by the insurer.

### **Other Provisions to Control and Minimize Credit Risk**

Above discussion presents explicit measures for the mitigation of credit risk after the occurrence of respective circumstances. However, lenders are also wary of and formulate provisions of implicit measure to prevent other situations which might lead to the failure of

SPV to repay the debt and interest accrued. Few such key provisions or arrangements positioned into SCFA are highlighted below.

- Appointment of technical and financial consultant to review the project's technical and financial viability and monitor the project during the construction and operation period.
- SPV must inject upfront equity before starting the drawdown of the debt and must finance any cost overrun using additional equity.
- SPV should agree to comply with the recommendations of the due diligence audit/assessment (DDA) report.
- Lenders have provision which require its consultant to duly verify the completed works under the invoice submitted by the SPV for drawdown or payment to the contractors.

Moreover, as discussed in the beginning, when lenders engage in the discussion of financing until the financial closure, they make sure that most of the project risks are allocated to the appropriate parties such that construction and operation of the project faces minimum obstruction.

#### ***Few Comments on SCFA in practice***

The study of few SCFAs in recent use by the BFIs appears comprehensive in addressing all foreseeable and unforeseeable events potential to materialize credit risk. However, few provisions appeared unnecessarily repetitive or confusing over different sections. For instance, the event of cancellation or termination of PPA and generation license are defined as both events of default and force majeure events. It will create confusion over the selection of remedy process. Further, the definition section needs to be duly checked and reinforced to improve the clarity (For example, transaction documents). Clarity in definition will minimize the frequency of disputes resulting from the differences in the interpretation of clauses by the signing parties.

Except the provisions discussed in earlier sections, it was found that SCFA also incorporated key provisions related to the inter-creditor agreement; a separate contract entered between the member banks of syndicate. It appears that BFIs use certain clauses instead of signing a separate agreement because there was no reference towards inter-creditor agreement in SCFA. These clauses establish the order of dividing repayment sum received from the SPV among member banks in syndication. Further, they also incorporate the brief process over the distribution of proceeds received from the sale or disposal of security assets followed by the events of default.

Moreover, as discussed previously, lenders will step-in to cure or perform remedial measures after the occurrence of events of default. If lenders are unable to cure, they will declare default with recall of facilities and, lenders begin the process of sale or disposal of security assets as per the prevailing laws and regulations. In Nepal's context as the number of hydropower developers are increasing and successfully commissioning large capacity projects, it is reasonable to have a provision of novation in between the cure period and the sale of security assets. Novation replaces a defaulting party with a new one. Novation provides an opportunity to the lenders to replace previous borrower or SPV with a new developer or SPV who is capable to undertake and cure the stressed project. However, since novation requires transfer of rights and obligation of the concessionaire or SPV to the new developer, public sector granting the concession must also formulate relevant legal provision or process to allow this.

### ***Conclusion***

The SCFA in use among Nepali BFIs appears exhaustive in covering possible future uncertainties causing credit risks. Clear and detailed provisions on cashflow cascade, events of default, force majeure events, remedial measures of such events, insurance and others have reduced the credit risk of BFIs significantly. However, proper attention should be given in improving the clarity of the agreement and the terms used thereof. Finally, against the backdrop of increasing number of hydropower developers successfully completing numerous projects, integration of novation into SCFA should be appropriate.

### ***References***

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