

Iraq's Power Crisis and The Need To Re-Engage The Private Sector – Smartly

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The true price of Iraq's power crisis is not just the \$40bn it costs the Iraqi economy annually, but also the growing frustration of the Iraqi populace that suffers with only four-five hours of electricity each day. Given chronic power shortages, businesses are hamstrung and Iraqi factories run only a few hours a day, exacerbating already high unemployment levels. The Iraqi government has made a series of notable, but ultimately failed, attempts to engage the private sector to address this challenge. If left unchecked, the power crisis has the potential to destabilize Iraq's democratically elected government. Given competing demands on the public budget and the dearth of domestic capacity to address the problem, rather than turn its back on the private sector, Iraq must smartly re-engage private developers to help resolve this crisis.

Iraq is broken – and its power sector is a reflection of the fractured state of this fledgling economy.

Some nine years after the end of the Saddam regime, the country is still struggling with how to address the economically crippling shortfalls in its power sector. Despite \$5bn of investment in the power sector by the US Government alone,¹ and despite the intrinsic wealth implied by being the fourth largest holder of proven oil reserves in the world, Iraq's chronic power shortages are estimated to be more than 4.0gw. This gap in power supply, according to the latest Iraq Electricity Master Plan, is estimated to cost the Iraqi economy more than \$40bn annually, and leaves the average Iraqi household with power for only four to five hours on any given day.

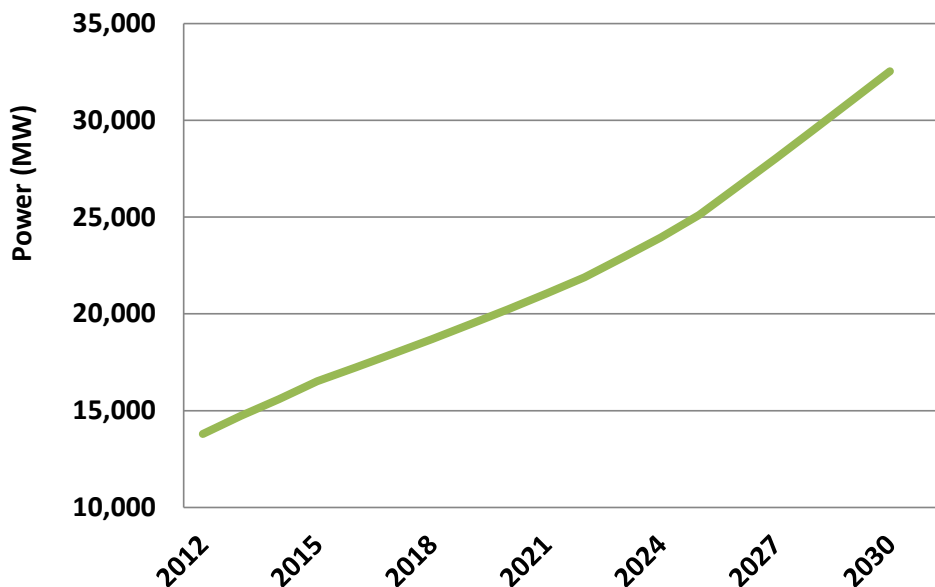
How Bad Is The Problem?

Despite some additions to capacity over the past decade, demand for electricity in Iraq has been outstripping supply. At an extreme, in July 2011 the peak demand was reportedly over 14.0gw.² Iraq's installed power generation capacity, on a nameplate basis, is estimated to be close to 9.0gw; however, true functioning capacity is reportedly less than 5.0gw.³ Unless the supply side of this equation is addressed, the problem will only worsen as the economy grows and along with it the intensity of electricity consumption per capita.

According to the master plan, in order to satisfy the projected demand over the next 20 years, Iraq will need to invest more than \$55bn in its power sector, \$29bn of which would be in generation alone.

Forecasted Demand for Electricity

Investment Required: > US\$29 Bn



Source: Iraq Ministry of Electricity, SIGIR, Taylor-DeJongh.

Iraq's power needs are immediate and the political and social pressure on decision makers to solve the problem real-time is tremendous. Lack of access to reliable electricity continues to be a key impediment to Iraq's reconstruction and development. Further, on the political front, there is a risk that Prime Minister Nuri al-Maliki's democratically elected government will face

formidable challenges in regional and national elections if it does not deliver on promises to provide electricity and other basic services.

In the face of this pressure, the Iraqi government has made a number of ambitious but spectacularly unsuccessful attempts to address the power crisis by engaging the private sector to form part of the solution – and in the process rotated through four electricity ministers in a span of 16 months.⁴

Flailing Attempts to Engage The Private Sector

Given the magnitude of investment required, and competing demands on the limited budget, the Government of Iraq (GOI) sensibly reached out to private sector power developers to help address the situation. What followed was a series of poorly constructed, overambitious and ultimately failed attempts to engage the private sector.

Initial IPP Program

Following the path of many of its neighbors in the region, the GOI aspired to implement an Independent Power Producer (IPP) program, to benefit from an influx of private capital and engineering and management expertise, together with the efficiencies that private sector investment can bring. While the notion was correct, as neighboring countries have indeed mobilized tens of billions of dollars of investment in more than two dozen IPPs, Iraq's IPP program was ill-conceived from the start.

The IPP program, launched in December 2010, with the solicitation of proposals for facilities totaling 2.75gw, was overly ambitious. Further, the GOI's lack of experience in managing such a program was evidenced in part by the unrealistic terms and conditions of the tender process:

- **Scope:** despite no track record of tendering for IPPs and limited capacity to evaluate and negotiate IPP transactions, the GOI kicked off the process by simultaneously soliciting tenders for four IPPs (2.75gw).
- **Timing:** developers were requested to prepare the proposals in two months, allowing an unrealistic period for developers to form consortia, complete due diligence and develop technical solutions and financing plans. Pleas from the investor community for a more realistic time frame (to prepare the proposals) went unheeded by the GOI.
- **Fuel Supply:** the GOI failed to provide any assurances related to the long term supply of fuel for the facilities. The fuel supply risk was to be borne solely by the project companies. This risk was misallocated given that the fuel distribution market is still largely dominated and controlled by the GOI itself.

- Financing: bidders had to commit to securing the necessary financing, hundreds of millions of dollars, within 90 days from award.
- Technology: developers did not have the freedom to choose the primary technology or vendors, but had to purchase and use the General Electric “mega-deal” turbines purchased by the GOI two years earlier, still in packing crates.
- Credit Support: the tender failed to provide for sufficient credit support for the Power Purchase Agreement (PPA), requiring bidders to rely solely on the Ministry of Electricity’s commitment.

Despite these shortcomings, six developers submitted bids in good faith. However, after bids were submitted, the GOI shocked investors by cancelling the bidding round in May 2011, with limited explanation.

Subsequent IPP Attempts

Soon after aborting the long planned, but poorly executed, competitive bidding process for IPPs, the GOI initiated a similarly ambitious process of direct negotiations with prospective IPP developers. These sole source contract negotiations eventually resulted in accusations of corruption and led to the dismissal of Raad Shallal al-'Ani, the Minister of Electricity, in August 2011. Additional contracts for 2.5gw of capacity with Korea’s STX Group also fell through when the company was reportedly unable to obtain a sufficient sovereign guarantee that represented the full faith and credit of the GOI.

Reality Check – What GOI Needs to Understand

While it was a formidable challenge to attract private sector interest in Iraq’s power sector to begin with, the aforementioned failures have made the situation even graver. The failures have damaged Iraq’s credibility with the investor community and will hamper GOI’s ability to re-engage serious developers.

However, rather than now turn its back on the private sector, and rely solely on GOI-financed engineering, procurement and construction (EPC) deals that place a significant strain on the federal budget, the GOI must undertake a honest reassessment to determine how to re-engage the private sector.

The GOI must first realize that its competition is global. The GOI will have to “de-risk” the projects and lay out a framework that will attract developers and their financiers to Iraq. There is only a select number of reputable international power developers with expertise and interest in doing business in Iraq, and a finite pool of capital with appetite for the country. To pull these

developers away from more attractive markets, the GOI must offer incentives commensurate with the added risk of doing business in Iraq. Until it establishes a track record of closing deals, honoring commitments and thereby building trust with equity investors and lenders, the GOI will have to concede more to developers and lenders than it probably wants or expects.

The reality is that Iraq has no sovereign credit rating and, outside of Kurdistan, the GOI has no track record of closing an IPP transaction; instead there is a recent history of very public botched attempts. Compounding this are the serious on-the-ground security risks and political instability. Furthermore, Iraq was recently ranked number 175 out of 184 in Transparency International's *Corruption Perceptions Index*, somewhere between Sudan and Somalia.

How to Smartly Re-Engage The Private Sector

Prior to reengaging the private sector, there are several fundamental steps that the GOI must take to foster a more enabling environment for its IPP program:

- Fuel supply – offer long term guarantees. The government must be realistic in its demands on the developers. Given the uncertainties surrounding access to fuel supplies in Iraq, this risk must be borne by the GOI. Without fuel supply guarantees from the GOI, developers will be unable to secure financing from even the most motivated of institutions, such as the export credit agencies. Without adequate financing, project developers will be unable to execute. By asking the private sector to bear the risk of fuel supply, Iraq is indirectly harming its own interests.
- GOI financial flexibility – negotiate more reasonable borrowing conditions. The GOI needs to negotiate and secure more flexible borrowing terms with the IMF and other creditors. Specifically, under its credit agreements with international lenders, the GOI needs to have the freedom to offer sovereign guarantees of a magnitude necessary to facilitate the development of critical power and infrastructure projects (as well as other high productivity sectors). The current IMF-imposed limitation on non-concessional indebtedness is a significant constraint on Iraq's ability to mobilize private investment in the power and infrastructure sectors.
- Credit quality – back-stop commitments. Along with fuel supply, the revenue stream and the credit quality of the obligor underpins the IPP business. Given the lack of creditworthiness of the Ministry of Electricity, and its non-existent track record in performing under PPAs, a sovereign guarantee from the GOI is critical. To date, securing sovereign guarantees representing the full faith and credit of the Republic of Iraq has been problematic, and letters of credit or guarantees from state banks that have been offered, are inadequate substitutes given the size of the exposure that needs to be guaranteed for large scale energy and infrastructure projects. According to sources close to GOI, the draft 2012 federal budget authorizes GOI to assume an additional \$17bn of

liabilities to support the development of infrastructure projects. If the budget is approved by parliament, and if this provision will allow the GOI to back-stop its commitments related to IPPs, it would represent a significant positive development. If not, the GOI should consider alternative mechanisms to provide security to investors and their lenders, such as pledging oil receipts.

- Sequential approach to IPP development – start off small. As opposed to the overly ambitious attempts so far – the tendering for four plants (2.75gw of IPP capacity) – the GOI needs to start small and deliver on one successful IPP deal early on. Success breeds more success, and building a track record with lenders and developers on an initial deal will allow GOI to increase its leverage in subsequent negotiations, and deliver more favorable terms for the country.
- Political support – need for unanimous political backing. To further de-risk the opportunity and provide additional comfort to investors, the GOI needs to demonstrate unanimous political support for the IPP program. Coordination between the Ministry of Electricity and the Ministry of Oil and Ministry of Finance are critical preambles to the success of IPPs in Iraq.

Conclusion

The GOI must not get discouraged by the challenges or its false starts in engaging with the private sector. The private sector can play a substantial role in resolving Iraq's power crisis, but the GOI must recognize that to attract international investment, it must set forth a more compelling and better structured opportunity. This is particularly critical given earlier failed attempts and the uncertain political and security situation in Iraq. The GOI needs to “de-risk” the opportunity from the perspective of the developers and lenders. In doing so, it will have to concede more than its neighbors on the early deals, until Iraq too has established some credibility with investors and lenders.

Notes

1. Special Inspector General for Iraqi Reconstruction, Quarterly Report, 30 October 2011.
2. Ibid.
3. Ibid.
4. The third electricity minister, Karim Aftan, is officially “on leave” as a member of the Iraqiyya Party List, which is boycotting the cabinet and parliament as a protest against Prime Minister Maliki.