Symposium on Electricity/Energy Markets in Africa and their Intersections with International Economic Law: From Electricity Market Reform to Contingent Liabilities

By:

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I. Introduction

Electricity market structures come in different shapes and forms. Many have given rise to new players, particularly in power generation. Private participation brings advantages but also challenges to a sector that cannot be looked upon in isolation from the broader macroeconomic perspective. What are those advantages and challenges? How do they play out in Sub-Saharan Africa? Contingent liabilities have become a buzz word around infrastructure project

development, but what exactly are they and how concerned should governments be? And most importantly, what can be done to tackle them?

II. The Eternal Allure of the Electricity Market Structure

First, there was the structure. Then came the reform and an endless debate on the merits and flaws of a model centred around the vertically integrated public utility. Ever since Chile pioneered the vertical and horizontal unbundling of the power sector in the early 1980s, many other countries have implemented some level of reform, hailing the benefits of private sector participation in certain segments of the electricity value chain. While the advantages of private participation in transmission and distribution remain debatable, there is no longer much questioning on the benefits of opening generation to competition.

The rationale for it, however, and the extent to which market forces influence price-setting is not necessarily the same for every jurisdiction. The benefits of allowing private sector participation in power generation can range from attracting alternative forms of financing to fostering innovation and technical expertise, knowledge transfer, and increasing security of supply. Fostering competition can be beneficial either by letting the market set the spot price or by reducing the tariff through the pressure of competitive bidding for long-term contracts.

Reforming the market structure to improve efficiency and achieve the above objectives continues to have some allure, but a word of caution should be headed to simple comparisons or replication of foreign models. The electricity market structure of a country is ultimately dependant on that country's geography, regional integration, political and cultural heritage, and macroeconomic considerations. Such structure is not an end but the starting point to understanding that country's specificities and challenges.

As of 2016, according to research by Anton Eberhard and Catrina Godinho, 19 countries in Sub-Saharan Africa followed the traditional state-owned vertically integrated model; 19 countries with that model also allowed some degree of participation of the private sector in power generation through independent power producers (IPPs); and 10 countries, having undergone some form of vertical unbundling, allowed private participation through IPPs or concessions.

III. The Role of Independent Power Producers (IPPs)

Despite the different figures across the continent regarding access to electricity, with a few countries reaching over 90% of the population and others with rates as low as 7%, most African governments have policies in place to pursue more widespread electrification, the increase of renewable energy generation and security of supply. Given the amount of investment that is needed to achieve these goals, many countries have turned to the private sector to harness its expertise, mobilise financing and accelerate the process by procuring IPPs to develop power generation projects feeding into the grid.

These utility-scale IPPs can vary immensely, depending on the technology they deploy, their installed capacity, the amount of investment and size of the project, but all have in common the fact that they entail the mobilization of funding and the allocation of risks between the public and the private partners in accordance with project finance principles and mechanisms.

IPPs are a valuable contribution to African governments' electrification objectives, but it is paramount that the set of contractual documents governing the rights and obligations of the parties be reflective of a balanced risk allocation that sets the basis for such long-term relationship and minimizes the chances of renegotiation. Some of those obligations, however, are at the heart of a growing concern for African governments and stakeholders over a topic that intersects power project development with sovereign debt management.

IV. The Intersection Between Power and Sovereign Debt

At the core of utility-scale IPP projects lies the principle of the allocation of risks between the IPP and the public utility/government. The IPP will typically be responsible for mobilising financing, building, and operating the power plant, and providing ancillary services. It will therefore take on risks associated with the performance of any of those tasks in accordance with certain standards, notably to produce (or make available) and sell a given amount of electricity. The public partner will typically guarantee access to land, issuance of permits and licensing, provide assurances with regards to the political and legal framework, and, most importantly, undertake to purchase a given amount of the electricity produced by the IPP.

In some cases, notably where the public utility is not particularly creditworthy, credit-enhancement mechanisms will be mobilized to backstop its payment obligations for the purchase of power under the power purchase agreement (PPA), such as guarantees from sovereigns and multilateral development banks. Indemnification provisions are also negotiated and included in the contractual documents to account for the possibility of early termination of the project by an event of default or force majeure. All of these can give rise to significant payment obligations by the utility and/or government. Depending on many factors, such claims could reach millions of USD and take a government by surprise if not previously assessed and disclosed.

The potential responsibility on the part of the government to step in for the utility in the event of default has planted the seed of fear and made many African governments apprehensive about the issuance of sovereign guarantees, in their various forms. These potential liabilities are technically called "contingent liabilities" and have been the topic of endless writing and discussions by experts from across the world. But what is the nature of these liabilities? How "dangerous" can they really be? And what can governments do about them?

V. Beyond the Jargon – What are Contingent Liabilities?

Contingent liabilities are a particularly technical and complex topic, which helps explain why there are so many misconceptions – but also such suspicion – around them. There is no single definition of the expression, but a particularly eloquent one can be found in the handbook *Understanding Sovereign Debt: Option and Opportunities for Africa:* they "represent potential financial claims against the government that have not yet materialized, but that could trigger a financial obligation or liability under certain circumstances". Two key elements can be derived from this definition: there is some level of uncertainty around (i) the likelihood/unlikelihood that the triggering event will materialize and (ii) the amount of outlay and timing of the payment obligation if it does.

Contingent liabilities are typically divided into two broad categories, which have larger implications on the risks they give rise to and the tools that can be used to mitigate them. Implicit contingent liabilities are political or moral obligations of a government created by the expectation that the government will intervene

in the event of a crisis or a disaster, such as by providing natural disaster relief or subsidising a public utility in financial distress. Explicit contingent liabilities, on the other hand, are legal obligations for a government to make payments if a certain conditional event occurs or is triggered. Explicit refers to the fact that the liability is explicitly recognized by contract or law and a prime example is a sovereign guarantee or other financial guarantees, including those issued for IPP projects.

What both categories have in common is that they represent a significant source of fiscal risk, because if/when the event that turns the contingent liability into a direct/actual liability materializes, that can lead to large increases in public debt and trigger fiscal crises. Depending on the accounting and reporting standards in use by a given country, contingent liabilities may or may not be properly captured in budget documents and financial statements, which has led to some beliefs that they represent “no-cost” because they are “off balance sheet”. This is the reason behind one of the most common misconceptions around contingent liabilities that has equated them to “hidden deficits”, according to Kharas and Mishra. Severe fiscal crises triggered by the materialization of contingent liabilities linked to public-private partnerships in Latin America and Europe have however revealed the true nature of this misconception. The body of knowledge around contingent liabilities has grown to be more comprehensive and practice has evolved in the meantime, with a clear tendency towards disclosing contingent liabilities as a key factor in managing these fiscal risks successfully.

VI. The Sovereign Guarantee Conundrum

The other misconception, which is widespread on the African continent, is that issuing sovereign guarantees is risky because that creates a liability for the government, so it is preferable to develop an IPP project without the issuance of such guarantees. The concern is not completely unfounded, as issuing a sovereign guarantee does create a contingent liability, which, if the triggering event materializes, will become a direct liability of the government. In such case, the government does become liable for the payment of potential significant amounts, which is evidently cause for concern.

However, as we saw in the beginning, most Sub-Saharan African countries have an electricity market structure based on the prevalence of the public utility, regardless of some level of unbundling or private participation. Many of these utilities are therefore State-owned entities (SOE), whose budgets may depend largely on capital injections from the State budget. If a public utility starts missing payment obligations under a PPA because it is in financial distress, the government will implicitly be forced to intervene as the main shareholder of that SOE. And because a public utility verging bankruptcy poses a risk to the country, the government will eventually face the moral and political obligation to save that sector to avoid the collapse of the whole economy – a textbook case of an implicit contingent liability.

Which brings us to one of the key takeaways of this short incursion through the world of contingent liabilities: the development of IPP projects where the buyer of electricity is a public utility creates (even in the absence of a sovereign guarantee) implicit contingent liabilities. There can therefore be a rationale for the issuance of sovereign guarantees, depending on the specific circumstances of the country and the project, as making explicit an implicit contingent liability can be useful to limit the exposure of the government and to have some visibility on the amount of outlay that may be required if that contingent liability materializes.

VII. Let us not be Fooled – How to Mitigate and Manage Contingent Liability Risks

Contingent liability risks arising from the development of utility-scale IPPs, regardless of whether a sovereign guarantee is issued or not, should be mitigated and managed from as early as the decision-making process on whether to pursue that project and, if so, whether to explicitly guarantee some of the inherent obligations. Clear legal frameworks articulating processes for such assessment are a helpful tool, which can provide guidance for decision-makers and record-keeping for the monitoring of long-term obligations.

Tools such as contingency reserve funds and caps or ceilings on the issuance of guarantees or IPP-related contingent liabilities have become very common in the management of such risks. Perhaps most importantly, the clear trend towards disclosure of information on contingent liabilities has become a staple

of fiscal risk management based on transparency.

VIII. Conclusion

In Sub-Saharan Africa, where the state-owned vertically integrated model is the norm, opening power generation to private participation has allowed the deployment of IPPs to help achieve electrification objectives and security of supply. IPP project development entails the allocation of risks between public and private parties and the assumption of their respective rights and obligations. Contingent liabilities generated by IPP project development have gained prominence as a valid concern for African governments. To harness the benefits of IPPs while protecting their public finances, governments can put in place risk management tools that help limit their exposure, notably by disclosing contingent liabilities and anticipating those risks rather than being surprised by them. After all, information is power.

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