

## TECHNICAL ASSISTANCE COMPLETION REPORT

TA No., Country and Name			Amount Approved: US\$550,000.00	
<b>TA 4604-PRC : Nanjing Water Utility Long-Term Capital Finance in Commercial Markets</b>			Revised Amount: US\$610,000.00	
Executing Agency: Nanjing Urban Construction Investment Holding (Group) Co. Ltd.		Source of Funding TASF and Cooperation Fund for the Water Sector	Amount Undisbursed: US\$4,861.71	Amount Utilized: US\$605,138.29
TA Approval Date: 28 Jun 2005	TA Signing Date: 18 Aug 2005	Fielding of First Consultants: 15 Nov 2005	TA Completion Date Original: 30 Sep 2006    Actual: 31 Mar 2008	
			Account Closing Date Original: 30 Sep 2006    Actual: 30 Apr 2008	
<p><b>Description</b></p> <p>The advisory TA was designed to help Nanjing Municipal Government (NMG) widen its funding options and provide sustainable access to private long-term capital finance market by providing support to the Executing Agency (EA), the Nanjing Urban Construction Investment Holding (Group) Co Ltd (NCIC) in the full cycle of bond issuance preparation. NCIC's subsidiary, Nanjing Public Utilities Company (NPUC) was selected as the bond issuer.</p> <p>Rapid economic growth in Nanjing over the past 20 years has increased water pollution and stressed the city's water infrastructure. Although much improvement has been made, current wastewater treatment capacity cannot meet the demands of city development and numerous opportunities still exist to reduce water pollution, protect water sources, and improve the living conditions and public health of residents. In 2003 Nanjing was selected as the PRC pilot city for the Water for Asian Cities program that is jointly sponsored by ADB and UN-HABITAT. As part of its 11<sup>th</sup> City Five-Year Plan (2006-2010), NMG developed the Integrated Water Management Initiative which includes a RMB 3.8 billion (\$1 billion) capital expenditure program through NPUC to increase wastewater treatment capacity, improve water resource management, and manage the water environment of the rivers running through Nanjing. As with other public utilities, NPUC is responsible for its own financing without reliance on government financing. With limited capital raising alternatives other than short-term commercial bank loans, NPUC sought to access the bond markets for longer-term fixed-rate financing. Bonds are particularly suitable for water utilities that have high initial capital expenditures and assets with long average lives that generate steady cash flows. Prior to the TA's commencement, applications from urban utilities for bond issues had not been successful in the PRC.</p> <p><b>Expected Impact, Outcome and Outputs</b></p> <p>The TA's expected impact was enhanced financial independence of sub-sovereign infrastructure entities and water utilities in PRC. The expected outcome of the TA was sustainable long-term access to private long-term capital finance markets for Nanjing utilities as a new funding source to finance capital improvements to support the delivery of water and wastewater services to customers. The outputs of the TA were divided into four components: (A) capacity building, including management structuring and development of corporate governance, accounting and auditing practices according to international standards; (B) development of systems needed for sustainable credit rating agency interface; (C) completion of a bond issue, with possible use of financial instruments offered by ADB's private sector operations; and (D) shadow rating coaching and presentation.</p>				

### **Delivery of Inputs and Conduct of Activities**

The TA's inputs were well-defined. ADB hired Black & Veatch (B&V) as the TA Consultant. Component D was added to B&V's work scope to provide additional support during the formal rating process conducted by Standard & Poor (S&P)<sup>1</sup>. Component C was later modified because NPUC needed additional support in the final stages of bond issuance, and ADB could not give a partial guarantee as originally contemplated. ADB was unable to follow the standard guarantee letter format used by NDRC and adopt local Chinese law as the legal basis of documentation. Moreover, ADB's guarantee could not cover default interest, damages and costs for realizing claims, nor cover a period of bond tenor plus two years as required by regulations. Component C was partly replaced by (i) advice to NCIC on financial risk management, particularly of floating rate bonds and (ii) a legal review to facilitate ADB's future provision of bond guarantees in the PRC.

The ADTA was implemented over 26 months rather than the scheduled 12 months due to the preparation of audited financial statements for NPUC, delays in NDRC approval for the bond issue, and an eight-month suspension of TA work at ADB's request due to legal constraints encountered over the proposed ADB partial guarantee.

B&V's team was highly competent, with extensive experience with water utilities and international credit rating agencies, and included a local partner, Union Securities Ltd. The consultants coordinated closely with and were well-received by NCIC.

S&P were appointed by ADB to conduct the full issuer credit rating under Component B but did not perform to expectations. The S&P team was unfamiliar with PRC laws, regulations and conditions, were not responsive to questions raised by ADB and B&V or to NCIC's assurances addressing the issues they identified to support their rating. They were also delays and a lack of thoroughness in their final report.

The main issues addressed during the course of the TA work (consisting of numerous presentations, meetings and calls, five interim reports and one final report) included:

- Review and recommendations of organizational structure, governance and financial reporting.
- Business development strategy, capital investment program and development of a financial model of NPUC cash flows to assess financial viability
- Presentation of international bond issuance practices and the credit rating process
- Identification of NPUC as bond issuer and structure of bond issue (term, interest rate, etc.) for preparation of bond issue application
- Identification of potential bond covenants
- Shadow and formal credit rating of NPUC (B&V shadow credit rating of BBB+, S&P rating of BB-), including extensive coaching for NCIC's presentation
- Legal review of impediments ADB Guarantee
- NPUC financing strategy and presentation of best practices in risk management for water utilities

### **Evaluation of Outputs and Achievement of Outcome**

The TA outputs partly achieved performance targets and indicators in the TA's design and monitoring framework. NPUC produced audited financial statements according to international standards and acted on recommendations to restructure NPUC as a more focused public utilities operation. While NCIC gave an excellent ratings presentation to S&P and were responsive to subsequent queries, NPUC did not achieve the investment-grade rating sought<sup>2</sup>. NPUC submitted the bond application in June 2006, which was approved by the National Development and Reform Commission (NDRC). An issuance was completed in December 2007 of a 10-year CNY 1.84 billion bond with a guarantee provided by China Development Bank.

### **Overall Assessment and Rating**

The ADTA is rated partly successful. NPUC successfully issued a bond after working closely with B&V and its Chinese partner, Union Securities Ltd. to prepare and submit the bond issue application. By subjecting NCIC to international rating standards, the company gained useful exposure to international practices, including credit rating and due diligence processes, business planning and cash flow forecasting, bond issuance covenants, public disclosure and corporate governance requirements, procurement of underwriters via a competitive process, and financing policies and risk management as practiced by international water utilities.

<sup>1</sup> As the shadow rating task needed to precede Components B and C, the consultant reports were submitted in the following chronological order: Component A – June 21, 2006; Component D – August 15, 2005; Component B – March 28, 2007; Component C (Phase I) – January 8, 2008; Component C (Phase II) – March 14, 2008; Final Report – March 2008.

<sup>2</sup> Credit weaknesses identified by S&P included aggressive financial leverage appetite, fungible cash flows between related entities and municipal government, moderate-to-high liquidity risk affected by indirect collection of wastewater revenue and high information risk. These risks were partially offset by NPUC's natural monopoly of water, wastewater, and piped gas operation in Nanjing, robust underlying demand and good growth prospects, and support from state ownership.

Despite introducing higher standards, factors particular to the local market still did not allow NPUC to receive the stand-alone investment-grade rating needed for NPUC to significantly expand its private investor base to more conservative institutional investors. For example, pricing regulations in PRC's water sector lack transparency relative to international peers, the financial support mechanisms from the government are not formalized, and the credit of NCIC's supporting entities (e.g., Nanjing Municipal Government) cannot be clearly measured. The ADTA also aimed to identify opportunities for ADB involvement. However, the instrument identified – an ADB partial guarantee – later faced legal and internal constraints that caused ADB to withdraw its support for NCIC's initial bond issue. As a result NPUC's bond had largely domestic characteristics and did not introduce major innovations.

In early 2008, the NDRC issued new regulations citing that guarantees are no longer a specific requirement for issue. Any form of guarantee can be used subject to compliance with the guarantee law and agreement by NDRC to the terms and conditions of the issue (any guarantees provided, however, would still need to be contracts with PRC law as the applicable law). NPUC plans to issue a second bond of CNY 1 billion in 2009 without guarantee. The new procedures have not yet been tested and it is not clear how underwriters will react to proposals by potential issuers to issue bonds without guarantees. However, we expect that the training, experience and institution-building provided by this ADTA has prepared NPUC well for this next bond issuance exercise.

#### **Major Lessons**

- The expectation that NPUC achieve investment-grade standards as judged by an international credit agency was perhaps unrealistic and unnecessary since this was a domestic bond issuance. Outside factors not entirely within NPUC's control had a considerable negative impact on the company's rating. While it proved valuable for NPUC to interact with an accredited rating agency, it should have been assured that the credit rating agency team understand the local market and laws.
- The TA could have been administered more efficiently had the constraints been identified earlier in providing an ADB partial credit guarantee. For example, ADB internal counsel could have examined the standard guarantee letter required by NDRC as part of all enterprise bond issues at the stage where B&V was evaluating PSOD's products for possible application to NCIC.

#### **Recommendations and Follow-Up Actions**

- Monitor NPUC's second bond issuance
- NCIC is seeking support from ADB to provide an equity investment in a new investment company that will finance water and environmental investments in Jiangsu Province and potentially other parts of the Yangste river catchment. We will continue discussion on this and explore other opportunities for future collaboration.
- Monitor changes in PRC regulations and internal policies that may allow ADB to provide guarantees on bond issuances by PRC companies in the future.

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