



**THE WORLD BANK**

**OBA PAYMENT MECHANISMS AND RISK MITIGATION**

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June 2004

**Final Report**

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## 1. INTRODUCTION

This paper was commissioned by the World Bank to expand on the work of a CEPA / CA Legal consortium, which was tasked with developing an appropriate payment mechanism for the channelling of connection subsidies to operators of rural energy systems in Mozambique. This work, funded by the Global Partnership for Output-Based Aid (GPOBA), considered the use of both escrow and letter of credit (L/C) arrangements to transfer output based aid (OBA) subsidies from both an International Development Association (IDA) credit and Global Environment Facility (GEF) grants to private sector providers of modern energy services.

The paper that follows attempts to put the observations made within Mozambique into a broader context, reflecting a wider range of payment mechanisms that have either been employed, or else could be considered, to transfer OBA subsidies. It hopes to advance the understanding of the different means by which OBA approaches can be operationalised, given its increasing importance within the World Bank's Private Sector Development Strategy. This was adopted in April 2002 and has elevated the OBA approach from a relatively experimental instrument, used in a handful of pilot projects, to a policy at the Bank Group level. The Strategy proposed special efforts to “focus interventions on the development results, particularly improved access to services, and on improved targeting of government funding schemes”<sup>1</sup>.

Following this introduction, in Section 2 we provide an overview of some of the relevant issues that need to be borne in mind when considering how to structure OBA payment mechanism. Following this, in Section 3 we first draw on what might be learnt from our Mozambican work – the Energy Reform and Access Program (ERAP) – as regards these issues, before extending the analysis to other OBA schemes. Finally, in Section 4 we draw some very tentative conclusions as to which payment mechanism approaches might be used where, in terms of mitigating the risks facing private sector recipients of OBA subsidies.

## 2. PAYMENT MECHANISM ISSUES

We begin by considering the need for OBA within PSP infrastructure projects, before specifically addressing the key issue of breach of contract risk.

### 2.1 Private sector participation (PSP) in infrastructure and OBA

It would be difficult to claim that the results of many years of promotion of PSP in the infrastructure within poorer developing countries have met the expectations of those who initially promoted such solutions. Whilst there has been interest in opportunities where infrastructure services have been supplied to a largely corporate customer base or for export, the application of approaches to predominantly household sectors in poorer developing countries is considerably more problematic, given doubts over the ability of households to afford the infrastructure service – not least the capital requirements of most service delivery models. In order to address this affordability problem and to make such opportunities more attractive to the private sector, OBA approaches have been developed and based around:

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<sup>1</sup> World Bank (2002), *Private Sector Development Strategy – Directions for the World Bank Group*.

- buying down the costs of infrastructure provision via the payment of connection subsidies once a new customer has been connected to an infrastructure service; and/or
- transitional subsidies to cushion the move to cost recovering tariffs; and/or
- provision of ongoing subsidies to targeted, disadvantaged groups, for instance, through delivery of payment to an operator of the difference between a life-line tariff (paid for by the household) and the full tariff – again only on the delivery of that service.

As such, there are two key objectives associated with OBA approaches:

- First, the full or partial **mitigation of key risks** facing private sector investors such as:
  - the **market risk** arising from the inability of certain groups to either pay for connection or else ongoing cost recovering tariffs; and
  - the **payment/collection risk** arising from consumers who consume services, but would be either unwilling or unable to pay full cost covering tariffs; and
- Second, the transfer of **performance risk** to private sector operators who are best placed to manage the construction and management of infrastructure networks, with subsidy payments being conditional on delivery of contracted services.

## 2.2 Breach of contract risk

OBA arrangements require governments to arrange three key functions:

- a mechanism for **channelling funding** from the awarding entity to the operator;
- a means by which allocated funds can be **protected** from third party claims; and
- a **monitoring and verification** activity, in which the operator's delivery of the service is audited.

Within a given OBA arrangement, subsidies are typically channelled to private sector operators by way of a contract – a 'subsidy contract' – which sets out the basis on which the subsidies will be received. Subsidy funds need to be made available so that they can be paid out when they become due; that is, when the operator / concessionaire has verifiably delivered on the terms of the subsidy contract.

As the contract is between a government entity and a private sector entity it creates a further risk to the private sector, namely breach of contract, one of the major four forms of political risk<sup>2</sup>. Investors are concerned about the host government failing to fulfil their subsidy contractual obligations, for a variety of reasons:

- funds allocated for subsidy payments being diverted to meet emergency situations, such as natural disasters and famines;
- external 'monitors' such as the International Monetary Fund (IMF) forbid the allocation of government funds to specific purposes in this way;

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<sup>2</sup> War, Expropriation and Currency Transfer being the other three. Where the party to the contract is not a part of national government, the risk arising may be considered to be sub-sovereign.

- third party creditors laying claim to the funds in lieu of unrelated government obligations;
- disagreement between a government entity responsible for monitoring and verification and the operator over contractual compliance; and
- change in political leadership which may bring about a shift of priorities that may provide adequate justification, from the new government's perspective, to renege on the subsidy contract.

Given the often fixed nature of the assets involved and the subsequent inability or high costs to the operator of 'taking the assets back', the risk of not receiving the contracted subsidy can substantially affect the commercial viability of the opportunity from the developer's perspective.

### **2.3 Possible mitigation mechanisms**

Because of these problems, various mitigating mechanisms can be employed to reduce the observed breach of contract risk, involving payment mechanisms (including means by which allocated funding can be protected) and monitoring and verification procedures.

#### **Monitoring and verification**

Taking the latter first, in the Mozambican context, whilst it is the government agency that is responsible for verification, operators will be offered a means of reducing any risk arising from a disagreement over compliance. In return for the posting of a conditional performance bond, subsidy payments cannot be halted by the government side, unless an independent auditor has adjudicated that material non-compliance (such as a major over-claim of connections made) has taken place giving rise to a contractual claim and a right to call on the bond. Moreover, it is recommended that flexibility is introduced into the subsidy contract by way of tolerances, which set out allowable non-compliances, such that disputes involving the call on the bond do not arise for trivial reasons (for instance, over a few disputed connections).

#### **Payment mechanisms and the protection of funds**

The approach taken in Mozambique to protect against breach of contract risk was to structure an approach in which subsidy funds were kept outside of government. In the case of subsidies funded by the IDA credit, this was achieved through issuing an irrevocable IDA backed<sup>3</sup> L/C through a local commercial bank, from which concessionaires will be able to obtain subsidy payments on the provision of agreed documentation – an L/C being a conditional but irrevocable undertaking by a bank to make payment.<sup>4</sup>

Upon receipt of a request for payment from the concessionaire, the commercial bank has no obligation to pay until the funds are received from IDA. The commercial bank will therefore seek transfer of funds from IDA before making the payment<sup>5</sup>. In the case of the GEF grants, an approach was developed by which they could be held in escrow, on

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<sup>3</sup> The L/C was backed, i.e. guaranteed, by an IDA special commitment instrument.

<sup>4</sup> More precisely, an L/C is a written undertaking by a bank (issuing bank) given to the seller / provider of service (beneficiary) at the request of the buyer (applicant) to pay a sum of money against presentation of documents complying with the terms of the credit within a set time limit.

<sup>5</sup> If the commercial bank was to be committed to pay on the L/C prior to being in funds from IDA, it would in effect be crediting IDA, with the fees likely to be higher.

behalf of both the government and concessionaire until the requirements of the subsidy contract were met – a commercial bank again being the escrow agent.

These are, however, just two approaches that have been and could be adopted, so as to mitigate the breach of contract risk. Analysis undertaken suggests that the following approaches might also be utilised:

- **‘Funded’** approaches in which funds are held, prior to their conditional disbursement, within ring-fenced vehicles, ‘managed’ by third party entities, specifically:
  - Trusts, in which funds are transferred to appointed trustees who, whilst technically owning the assets, have their payment obligations explicitly set out within a Trust Deed.
  - Managed Funds, in which government and / or donor funds are managed by an appointed Board and / or fund managers, who are responsible for disbursement according to given policies.
  - Escrow Agent approaches, in which an appointed intermediary holds funds until certain stipulations have been met.
- **Contingent** or **‘unfunded’** mechanisms, typically involving the use of an L/C guaranteed by a creditworthy third party such as the World Bank, including<sup>6</sup>:
  - The issuance of an irrevocable L/C by a commercial bank, which is used to pay out subsidies upon certain conditions being met, with the facility being reimbursed through a ‘special commitment’ from IDA.
  - The issuance of an L/C in favour of a concessionaire through a commercial bank by government, which again can be drawn on to provide subsidy funds to the Concessionaire. In the event that government fails to repay the commercial bank, an IDA partial risk guarantee (PRG) can be called to repay the bank. In the case of IDA a counter guarantee in the form of an indemnity agreement is required from the ‘host’ government before the PRG can be issued.

Further summary details regarding these arrangements are summarised in Table 1 below.

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<sup>6</sup> The specific instruments referred to are those of the World Bank, other development banks have slightly different terms and conditions.

Table 1 – Possible mitigation mechanism

Mechanism	Brief description	Ownership of 'ring-fenced' funds	Responsibility for payment function	Form of protection
Trust	OBA subsidy funds are placed in a Trust, which assumes the title to the funds with appointed Trustees establishing full control over them. The Trust Deed, specifies the terms under which subsidy payments are to be made and (where applicable, the investment policy for any un-disbursed funds). It is usually very difficult to alter the Trust Deed.	Trust	Trustees	Funded commitment
Fund Manager	OBA subsidy funds are ring-fenced vehicles, typically managed by either a Board or specially appointed fund manager, both of which act in accordance with a pre-agreed disbursement policy, which may vary in its specificity and therefore how much discretion the Board and fund manager have. Unlike the Trust, ownership of the assets remains with those providing the funds.	Varies	Fund Manager and / or Board	Funded commitment
Escrow Agent	OBA subsidy funds are placed in escrow with an Escrow Agent - usually a commercial bank. The Escrow Agent maintains sufficient funds in the account at all time to cover future payments, by requesting timely replenishment from donors / government, with payments being made according to a pre-agreed Escrow Agreement. Once in the Escrow Account, funds can be moved out only in according to the Escrow Agreement or by consent of both parties.	Joint	Escrow Agent (Commercial Bank)	Funded commitment
L/C with Special Commitment (SC)	Government requests issuance of an L/C, through a local commercial bank and in favour of the operator. The L/C is backed by a special commitment (IDA) or alternative guarantee instrument from other donors. This can be either before or after being put in funds itself (the latter case being much less onerous as the L/C is an irrevocable obligation to pay).	Government	Commercial Bank	Special commitment
Partial Risk Guarantee operationalised through L/C	Government requests issuance of an L/C through a commercial bank. Upon presentation of documents by the operator, as specified in the L/C, the commercial bank makes payment. The repayment by government of L/C disbursements is protected by a PRG in the event of non-payment by government.	Varies	Commercial Bank	PRG

In considering which approach is most useful for a given situation it is important to examine the following:

- the **providers** of the subsidies, specifically:
  - whether the subsidy is made up from specific donor commitments, hypothecated government payments, other sources (e.g. electricity levies); or indeed a mix; and
  - whether any donor support is from one or multiple donors;
- the extent to which funds can be **protected** from third parties;
- the desired **role of government**, in terms of its responsibility for the payment process (an increasingly important consideration as more and more donors elect to go for budget support rather project driven approaches);
- the **mechanisms** available to donors supporting any OBA payments, whether they are limited to provision of funded payments such as grants, or are they able to provide contingent solutions (guarantee products);
- the **intermediation cost** of the payment mechanism and how this relates to the scale of the flows of funds; and
- the structures which might be supported by the **legislative framework** within a country (for instance, whether trust or other laws exist or whether it is allowable to hold the funds off-shore).

## 2. ESCROW AND L/C MECHANISMS

In order to begin to shed some lights on these issues, we now turn to a comparison of the Escrow Agent and L/C mechanism (with special commitment) approaches considered within the context of our work in Mozambique.

### The Escrow approach

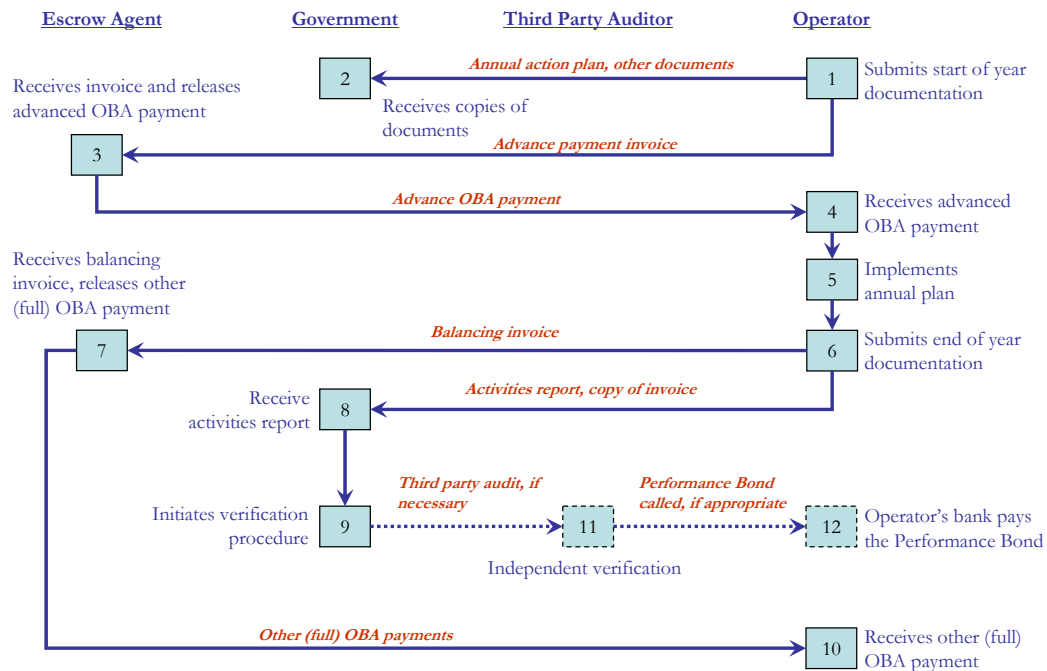
The original terms of reference called for the identification of a ‘trust agent’ rather than ‘payment agent’. We began by considering whether it was possible to set up a legal trust within which the subsidy monies might be held – and protected from third party claims. It soon became apparent, however, that a Trust, per se, was an alien concept within Mozambican law. As the local banks were more familiar with escrow accounts – which we found could offer similar protection if the funds were placed in escrow in the name of the central bank - we turned our attention to the potential for setting up a series of escrow accounts for different projects to which subsidies were to be delivered, managed collectively by a commercial bank or other qualified entity through an Escrow Management Services Agreement. This arrangement was market tested with a number of Mozambican commercial banks who appeared comfortable with such an approach.

An Escrow Management Manual was developed, based on this approach, which outlined the different activities which were to be undertaken by the ‘Escrow Agent’ and a call for expressions of interest for these services was placed within the Mozambican press. Separately, the Escrow Management Services Agreement and Escrow Agreement were also drafted, together with other bid documentation. An example of the Escrow Agreement is to be found at Appendix A.

Two approaches were considered. In the first, concessionaires were able to receive an advance payment of up to 25% of the total year anticipated subsidy and a balancing payment *prior* to the connections being verified, in return for the posting of a performance bond. In the second approach the concessionaire is not required to post a performance bond, but he is entitled to only a small (maximum 10%) advance payment, with the balance being paid post verification.

The high level actions associated with the first of these arrangements is summarised in Figure 1 below.

Figure 1 – Payment mechanism under escrow arrangements (with performance bond)



As there was no initial response to the call for expressions of interest, a short-list of institutions – agreed by the World Bank – were supplied with the bid documentation and draft Escrow Management Services Agreement. A technical and financial competition then took place in which two bids were received from Mozambican commercial banks and evaluated by the ERAP unit.

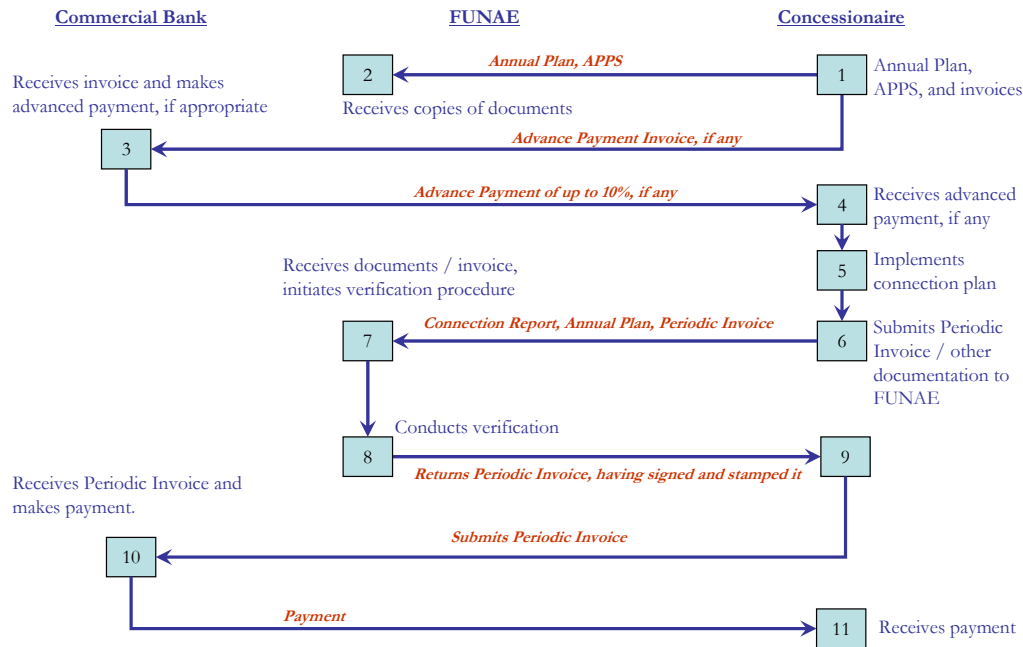
### The L/C approach

During this time, World Bank financial management staff determined that they preferred to see an approach in which IDA provided a ‘special commitment’ to a commercial bank, which would channel subsidies through an L/C structure – previously utilised, for instance, in the context of guarantee structures operated by IDA – rather than the escrow approach. This partly relates to the treatment of up front payments into escrow account, which are treated as ‘advances’ rather than ‘disbursements’ and as such the amounts in question are capped at 20% of a given subsidy payment.

As a result of this changed requirement, we developed an L/C approach and documentation (overview of the L/C process, draft L/C instrument, bid financial structure) and assisted GOM to re-bid the opportunity to the two commercial banks. As with the escrow mechanism, we structured two different approaches. One involved provision of payment pre-verification (in return for a posting of a performance bond),

the second involved post verification payments (but with no performance bond requirement). This latter approach is illustrated in Figure 2 below. A more detailed analysis of the L/C mechanism is also provided in Appendix B.

Figure 2: Payment mechanism under L/C arrangement (without performance bond)



### 3.1 Comparison of the two approaches

A number of issues come to light through a comparison of these approaches in the Mozambican context, although clearly certain aspects are country specific. These are:

- the greater simplicity of subsidy provision in single donor arrangements;
- the extent to which monitoring of the payment mechanism could be outsourced to the commercial bank; and
- the cost differences arising between the two approaches.

#### Single versus multi-donor arrangements

The first is the observation that both the escrow and the L/C payment mechanisms are most simple when there are just two counterparties – that is a single funder and private sector operator. With the escrow approach the two parties are both signatories to the escrow agreement. With the L/C mechanism it is the provider of services who is the L/C beneficiary and bank who is the issuer at the request of their client (“the Applicant”). Even though in Mozambique both IDA and GEF were involved, because of the different preferred funding mechanisms, GEF subsidies can be channelled through the escrow account with IDA funding utilising the L/C approach.

There will, however, be a further complexity if a given transaction requires both IDA and GEF funds to be drawn on. If this occurs then both L/C and escrow approaches will

need to be used in tandem, with the concessionaire having to deal with two separate mechanisms within one subsidy contract.

If another donor wishes to provide additional grant money to that of GEF's, but does not want to channel it through GEF, it may be possible to set up a multi-funded escrow account. This could add considerably to the complexity, however, if the Escrow Agent has to deal with markedly different donor contribution arrangements. As complexity increases, automacy is lost, which increases the risk facing the Escrow Agent, which may reduce appetite for the role (or at least increase its costs).

Likewise, bringing another party into the L/C arrangement would complicate matters. If, for instance, another donor were to deposit grant funds into a trust at the World Bank which could be drawn on by IDA, there may be a significant charge associated with that<sup>7</sup>.

A problem not faced in Mozambique was that of additional contributions from electricity levies and other forms of government commitment, which would add further complexity to the structure of the arrangements. The best way to deal with such multi-party arrangements would be through a Trust, but a formal Trust, as such, does not exist under Mozambican law.

### **Monitoring and verification**

The payment function itself is outsourced from government in both the escrow and L/C approaches. However, there are certain tolerances as to what might be outsourced under which of the two arrangements. Commercial banks do not like discretion so we had to be careful to make the payment mechanisms as automatic as possible. Within this, though, we felt able to place considerably more of the monitoring burden on the banks within the escrow arrangement, than we were with the L/C. This monitoring function included checking that figures within different documents matched those in others (annual plan, connections report, subsidy agreement etc.). Following advice from an expert in L/Cs this was not deemed possible within the L/C approach, with the consequent monitoring burden falling back on to government. As can be seen in Appendix C, the L/C utilised is a very simple document.

### **Intermediary costs**

As the two bidders in Mozambique submitted financial proposals for both Escrow and L/C opportunities we have some information on relative costs of the two approaches, based upon a number of indicative transaction sizes, as set out in Table 2.

*Table 2: Escrow and L/C cost ranges*

Transaction size	Range of costs as a percentage of transaction size	
	Escrow	L/C
\$1m	0% to 0.3%	1% to 8%
\$10m	0% to 0.26%	1% to 3%
\$100m	0% to 0.25%	1% to 2.8%

As can be seen, the costs of the L/C approach are considerably greater. In part this might be explained by the margin that the escrow agent will make on deposited funds (the rate of interest offered formed a key financial metric). The top end all in cost of 8%

<sup>7</sup> Any bi-lateral funds, placed in a World Bank Trust, would likely be charged a 2% annual fee.

is very high, which includes a minimum fee of \$50,000, although this may reflect a lack of understanding of the nature of the L/C. This is in spite of the fact that in order to minimise cost, we deliberately structured the requirement such that the bank did not need to pay out until it was in funds – with the 1% lower end figure being consistent with this structure. On balance, however, the escrow approach does seem better value for money, although differences between the deposit rate offered and IDA’s treasury return would also be needed to complete the analysis.

### 3.2 Other examples of OBA

In order to see how the Mozambican examples compare with other OBA structures we undertook a limited trawl of other examples that we were aware of. However, the detail available on the precise financial structures adopted is relatively limited reflecting, in part, perhaps the stage of design that they are at. Of these, as set out in Box 1, the Guatemalan rural electrification scheme provides an interesting comparator.

#### **Box 1 – Guatemala rural electrification scheme**

A fiduciary fund, operating on escrow principles, was created for the transparent administration of the financial resources required to develop the PER (the country’s rural electrification plan). The source of funding was two fold: (i) proceeds from the privatisation of distribution companies in Guatemala; and (ii) top up by the National Institute of Electrification, a Public Electric Company of Generation and Transmission (INDE). The purpose of the fund is to fund the electricity network expansion by the newly privatised distribution companies. The Fund is expected to be about US\$ 333.5m.

It is administered by Banco Agricola Mercantil de Guatemala, and its international partner the Bank of New York. The banks administering the fund are required to invest unused funds according to a specific agreement. The administration of the account is as follows:

- The Main Account is held with the Bank of New York, denominated in US\$.
- The Auxiliary Account is held with the local bank in local currency. All payments to the distribution companies are made from this account.
- A Technical Committee (TC), which is made up of technical experts from: (i) the Direction Committee of INDE; (ii) the responsible ministry; and (iii) the distribution companies (recipients of the subsidy), commissions an Independent Supervisor to carry out a verification of the work done. On the basis of a certification from the Independent Supervisor, the TC decides on whether a subsidy payment is to be made and in what value.
- The TC instructs the local bank, 30 days in advance, that a payment will need to be made to the distribution companies. The local bank ensures it has sufficient local currency in the Auxiliary Account to make the required payment.
- The agreement underpinning the fund can only change with the consent of all parties.

The key point seems to be that whilst the fund operates on ‘escrow principles’ it is not clear that an escrow account was actually set-up; that is, there does not seem to be an escrow agreement between the fund and the two concession companies. Most of the funding – from a variety of sources – is held off-shore and only brought on-shore as required. In effect, it appears to be a ‘managed fund’ with the technical committee

providing the oversight role. It is not clear, however, how much protection against claims by third parties is afforded to the concessionaires through this structure<sup>8</sup>.

In comparison, the Rural Electrification Fund in Uganda seems to have established a formal Trust, with a local bank acting as trustee. Again, the subsidies are being provided by a number of sources, including a 5% commission on bulk electricity purchases. This structure would certainly help protect the subsidy monies, although it could turn out to be relatively expensive.

### 3.3 L/Cs and PRGs

We are not currently aware of any other schemes in which an L/C has been used to protect subsidy payments in the way envisaged for Mozambique, nor are we aware of any specific situations in which a PRG has been utilised to protect subsidy payments.

Whilst using a PRG as a means of back-stopping was not explicitly considered within Mozambique, it is useful to compare the structure of it with that of the special commitment approach adopted, as illustrated in Table 3.

*Table 3: Comparison of contingent approaches*

Transaction size	Contingent approach	
	L/C (backed by special commitment)	PRG (operationalised through L/C)
Funding of subsidies	IDA credit	Various sources (grants, loans, levies, government payments)
Payment mechanism	L/C	L/C
Back-stopping of commercial bank	Special commitment	PRG

There are basically three levels to each. In the 'L/C' approach, funding is provided by IDA on its usual terms (interest rate and commitment fee on un-drawn amounts), whereas in the PRG approach funding could come from a variety of sources, including loans from other development institutions.

Both involve an L/C payment mechanism, backstopped by either a special commitment or PRG. The funding of the L/C, however, differs in that it is funded out of the IDA credit, whereas in the PRG approach it is government that has primary responsibility for this. With a given country, the costs of the PRG approach might be expected to be higher because of<sup>9</sup>:

- the costs of the PRG<sup>10</sup> compared to the special commitment (where there is no additional fee); and
- the potentially higher cost of an L/C which is drawn on before IDA puts it in funds as opposed to an approach which is pre-funded.

<sup>8</sup> It is possible that if they are held in the name of the central bank that this would suffice.

<sup>9</sup> Costs may differ between countries because of different levels of development of the financial services sector.

<sup>10</sup> Typical PRG fees involve an annual guarantee fee of 0.75% per annum (for IDA countries), an upfront fee of 1% on the guaranteed amount, plus a processing fee of up to 0.65% of a guaranteed amount.

## 4. CONCLUSIONS

The work in Mozambique and the brief review of some of the other examples of payment mechanisms allows us to provide some wider observations and tentative conclusions regarding possible options for mitigating OBA breach of contract risk and ensuring, where necessary, that allocated subsidy funds are adequately protected. Table 4 provides some of the high level advantages and disadvantages associated with each of the different forms of instruments / approaches.

Table 4: *Approach comparison*

Approach	Advantages	Disadvantages
'Trust'	<ul style="list-style-type: none"> <li>Resources from more than one funder can be pooled</li> <li>Funds are well protected</li> </ul>	<ul style="list-style-type: none"> <li>Can be expensive due to risk transfer to Trustees</li> <li>Trust concept not known in some jurisdictions</li> <li>Can be difficult to change Trust Deed once set up</li> </ul>
'Fund'	<ul style="list-style-type: none"> <li>Opportunity to pool resources</li> <li>Simple to establish</li> </ul>	<ul style="list-style-type: none"> <li>Up front funded commitment requirement</li> <li>Can be expensive depending upon role of fund manager</li> <li>Limited protection from government creditors</li> </ul>
'Escrow'	<ul style="list-style-type: none"> <li>Cost effective</li> <li>Can protect funds</li> <li>Escrow concept recognised globally</li> <li>Attractive to concessionaire who can see funds</li> <li>Simple for grant funders to use</li> </ul>	<ul style="list-style-type: none"> <li>Up front funded commitment requirement.</li> <li>Does not fit well with IDA financial management requirements</li> </ul>
'L/C' (with special commitment)	<ul style="list-style-type: none"> <li>L/C instrument widely used payment mechanisms in trade and is therefore universally recognised</li> <li>Avoids breach of contract issue</li> </ul>	<ul style="list-style-type: none"> <li>Bank's obligations needs to be very simple, which reduces ability to transfer monitoring tasks to bank</li> <li>Coordination mechanisms required for use in multi-donor situations</li> <li>Likely to be more expensive than escrow arrangement</li> </ul>
'PRG' (operationalised through L/C)	<ul style="list-style-type: none"> <li>Provides strong protection to receivers of subsidy in event of government breach of contract</li> </ul>	<ul style="list-style-type: none"> <li>PRG involves another layer of intermediation costs.</li> <li>Perceived as timely to set up</li> </ul>

### 3.4 Subsidy flows involving government entities

The key issue, in terms of which payment mechanism to use, is whether it is desired or required that all subsidy flows, or a substantive part thereof, are channelled through government or government linked entities. Where this is the case, it is likely that breach of contract insurance, obtained through a PRG will be required. There are a number of reasons why funding might flow through national government or sub-sovereign entities:

- Public resources may form a major part of any subsidy commitment. Such funding may come directly from the national budget, proceeds from privatisation of state assets, and / or imposition and collection of special taxes, or a mix of these.
- More international donors are choosing to channel development aid as budget support rather than to specific projects and programmes. Such approaches are likely to mean that governments will directly contribute to a growing share of the available subsidies.
- The understandable desire to empower local governments and increase local capacity is an additional reason to include government in the management of subsidy mechanisms.

As discussed, this gives rise to breach of contract risk and private sector concessionaires and operators will need to make a judgement as to whether this risk is acceptable or whether it needs to be further mitigated. It is likely to be less of a problem in countries with better developed institutions, stable and robust legislative and regulatory environment, and with greater political stability. The concerns will be more acute in those countries where this is not the case. However, even in a relatively well developed environment, government may be in a situation where it breaches its obligations for reasons outside of its control, such as a third party creditor obtaining access to the available subsidies. A PRG could be particularly useful in addressing this issue from the perspective of the concessionaire.

As set out, we are not, however, aware of any instances where the PRG has been used specifically for these purposes. Moreover, it may be unwise to raise this risk with the concessionaires – it is up to them to raise it as an issue if they regard it as such. The recent reduction in the amount of IDA ‘headroom’ absorbed by the PRG will no doubt make it easier for government to make the PRG instrument available<sup>11</sup>.

### **3.5 Subsidy flows not involving government**

Where flows can be kept outside of government, as in Mozambique, it can be possible to mitigate the breach of contract risk by financial structuring alone. In such an instance, the choice of approach is likely to be driven by whether a multi or single donor contribution is envisaged.

Where there is only one donor, the choice will be likely to depend on (i) the availability of instruments (such as guarantees) at the disposal of the donor in question and (ii) the likely intermediation costs. In the case of Mozambique, it was possible to utilise the contingent L/C approach as well as the escrow approach. In the end, IDA funding was channelled through the L/C as it worked best for internal financial management purposes. Many bi-lateral donors, however, with more simple instruments at their disposal, such as grants, may be likely to find the escrow approach more practicable. In the context of Mozambique, the escrow arrangement appeared best from the perspective of cost (although this may not be universal). If L/C approaches are used, however, costs can be kept down by structuring it such that the bank is in funds before payment is made<sup>12</sup>.

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<sup>11</sup> The PRG now only accounts for 25% of the headroom absorbed by a full credit.

<sup>12</sup> Note that this would not be the case where an L/C were to be used as a guarantee, as in the PRG arrangement, in which the PRG acts as a counter-guarantee from IDA to the commercial bank providing the L/C.

Both arrangements pose additional operational difficulties when multiple donors provide the OBA funding. From the perspective of protecting the funds, one solution is for the concessionaire to enter into a series of different escrow arrangements with each donor. Whilst it may be possible for donors to enter into an understanding between themselves directly, this is will, of course, be more cumbersome and may increase intermediation costs.

### 3.6 Mixed government/non government funding

Where the multiple sources of funding includes a mix of different entities, including government – as in the cases of Uganda and Guatemala – then funds will need to be pooled in some way, either using ‘managed fund’ or ‘trust’ structures. The two issues to be addressed in such arrangements are: (i) whether funding can be protected from third party creditors; and (ii) the reliability of government (and sub-sovereign) contributions to the pooled funds.

If available within a given jurisdiction, a Trust would appear to be the best way of addressing the protection, as is the case in the Ugandan example, but which is less clear in the case of Guatemala. However, even where a Trust is being used, if government commitments are being relied upon, there may be a need for an additional PRG to fully mitigate the breach of contract risk.

### 3.7 Summary

Figure 3 summarises the suggested approaches, based on the findings above, according to whether funds need to flow through government and the number of contributing sources.

Figure 3 – suggested approaches

		Flow of funds		
		All through government	Partly through government	Entirely outside of government
Sources of subsidy funding	Multiple	PRG	PRG / Trust	Trust
	Single	PRG	n / a	Escrow or L/C

As can be seen, if government is solely responsible for payment, then a PRG is probably required. At the other extreme, where government channels are avoided and there is a single supplier of subsidies an escrow or L/C approach will work, depending on the specifics of who is providing the funding. Where there are multiple sources, donors and other non-government entities, a Trust seems to be a good starting point, although where government is one of number of contributors to subsidy funds a PRG may be required to back-stop government commitments.

**APPENDIX A: EXAMPLE OF ESCROW AGREEMENT**

**TYPE 1**

Dated [*DATE*]

[*FUNDO DE ENERGIA*]

and

[*NAME OF CONCESSIONAIRE*]

and

[*NAME OF ESCROW AGENT*]  
as Escrow Agent

**ESCROW AGREEMENT**

[**DETAILS OF TRANSACTION**]

**THIS AGREEMENT** is made on [DATE] between:

- (1) **[FUNDO DE ENERGIA]**, a public institution established under the laws of the Republic of Mozambique under Decree No. 24/97 of 22<sup>nd</sup> July 2002 of [ADDRESS] (**FUNAE**);
- (2) **[NAME OF CONCESSIONAIRE]**, a company incorporated under the laws of [PLACE] having its registered office at [ADDRESS] (**Concessionaire**); and
- (3) **[NAME OF ESCROW AGENT]**, a company incorporated under the laws of [PLACE] having its registered office at [ADDRESS] as Escrow Agent (**Escrow Agent**).

**WHEREAS:**

- (A) The Government of Mozambique (**GoM**) has awarded a concession for [DETAILS OF TRANSACTION] to the Concessionaire under the terms of a Concession Agreement dated [DATE] (**Concession Agreement**).
- (B) GoM has agreed to pay a subsidy to the Concessionaire for new connections made to residential customers within the concession area under the terms of a subsidy agreement dated [ ] (**Subsidy Agreement**).
- (C) GoM has negotiated financing from the International Development Association (**IDA**) under the terms a Development Credit Agreement dated [DATE] (**DCA**). The subsidy will be paid from the funds made available by IDA to GoM under the DCA. Under the terms of the DCA, GoM is permitted to open and maintain in USD a special deposit account with a commercial bank for holding the IDA funds (**Special Account A**).
- (D) The Escrow Agent has agreed to provide certain services to [FUNAE] and the Concessionaire in connection with the draw-down of the funds from Special Account A and payment of the funds to the Concessionaire as set out in this Agreement.

**IT IS AGREED** as follows:

**1. INTERPRETATION**

- 1.1 **Definitions:** In this Agreement, unless there is anything inconsistent therewith, the following definitions shall have the following meanings

**Additional Qualifying Connection** means any Qualifying Connections in excess of Concessionaire's estimate of the total number of Qualifying Connections to be made during the relevant Year as stated in the Annual Plan Payment Schedule;

**Additional Payment** means any payment to be made to the Concessionaire in respect of the Annual Subsidy (i) when aggregated with the amounts already paid to the Concessionaire in the relevant Year brings the total amount paid to the Concessionaire in that Year to more than the Projected Annual Subsidy or (ii) is in an amount in excess of the Balance Limit;

**Advance Payment** means the advance payment to be made to the Concessionaire each Year in respect of the Annual Subsidy as set out in the Annual Plan Payment Schedule;

**Advance Payment Invoice** means the Concessionaire's invoice for payment of the Advance Payment in the form set out in Schedule 4;

**Annual Plan** means the Annual Plan to be prepared by the Concessionaire and submitted to FUNAE at the beginning of each Year in accordance with the requirements of the Subsidy Agreement;

**Annual Plan Payment Schedule** means the payment schedule of the Concessionaire's Annual Plan in the form set out in Schedule 3 of this Agreement showing the anticipated number of Qualifying Connections to be made during the Year;

**Annual Subsidy** means the amount of the Subsidy to be paid to the Concessionaire in each Year of this Agreement;

**Authenticated Copy** means a copy signed by the Authorised Signatories;

**Authorised Signatories** means those persons listed as authorised signatories of each party to this Agreement and DNE in Schedule 7 hereto together with their signatures, as amended from time to time by notice to all parties to this Agreement;

**Balance Limit** means the maximum amount that may be drawn down from Special Account A to the Escrow Account at any time specified in the Subsidy Agreement Schedule;

**Balancing Payment** means the balancing payment amount recorded in the Annual Plan Payment Schedule;

**Balancing Payment Invoice** means the Concessionaire's invoice in respect of the Balancing Payment in the form set out in Schedule 5;

**Bank Guarantee Value** means the value of the Bank Guarantee received in the Subsidy Agreement Schedule;

**Business Day** means a day (other than a Saturday or Sunday) on which banks are open for normal business in Maputo;

**Connection Fee** means the amount of Subsidy payable to the Concessionaire for each Qualifying Connection as set out in the Schedule of the Subsidy Agreement;

**Connections Report** means the annual report to be prepared by the Concessionaire in accordance with the terms of the Subsidy Agreement;

**Connections Schedule** means the schedule of the Connections Report in the form set out in Schedule 6;

**Year** means a period from [DATE] to [DATE] in any year of this Agreement;

**DNE** means the Direção Nacional de Energia within the Ministry of Mineral Resources and Energy of GoM;

**Effectiveness Date** means the date that this Agreement becomes effective pursuant to Clause 2;

**Escrow Account** means a deposit account at [ ] bank in the name of ["Bank of Mozambique re Energy Reform Access Project"] with number [NUMBER] and reference [REFERENCE] opened by the Escrow Agent to hold the Escrow Monies;

**Escrow Monies** means all monies from time to time drawn down by the Escrow Agent from Special Account A to the Escrow Account or repaid to the Escrow Agent pursuant to the terms of this Agreement together with all property from time to time representing the same, together with any accrued interest thereon;

**FUNAE Adjusted Connections Schedule** means a schedule from FUNAE in the form set out in Schedule 10;

**Independent Auditor** means the person appointed jointly by FUNAE and the Concessionaire under the Subsidy Agreement to undertake an independent audit of the connections made by the Concessionaire for the purpose of determining the Concessionaire's entitlement to payment of the Connection Fee under the terms of the Subsidy Agreement;

**Independent Auditor's Adjusted Connections Schedule** means a Schedule from the Independent Auditor in the form set out in Schedule 12;

**Independent Auditor's Payment Suspension Notice** means a notice in the form set out in Schedule 8;

**Liability** means any loss, damage, cost, charge, claim, demand, expense, penalty, judgement, demand, action proceeding or other liability whatsoever (including, without limitation, in respect of taxes, duties, levies, imposts and other charges) and including any value added tax or similar tax charged or chargeable in respect thereof and legal fees and expenses on a full indemnity basis;

**No Objection Schedule** means a notice from FUNAE in the form set out in Schedule 9;

**Notification of Second Part Audit** means a notification from FUNAE in the form set out in Schedule 13;

**Notification of Special Audit** means a notification from FUNAE in the form set out in Schedule 14;

**Projected Annual Subsidy** means the Projected Annual Subsidy shown in the Annual Plan Payment Schedule;

**Bank Guarantee** means the bank guarantee to be provided by the Concessionaire to FUNAE under the terms of the Subsidy Agreement;

**Qualifying Connection** means a new connection to a customer which qualifies the Concessionaire for a Connection Fee under the terms of the Subsidy Agreement;

**Request for Direct Payment** means a request for payment of monies from Special Account A to the Escrow Account in the form set out in Schedule 7 - World Bank Application for Withdrawal Form 1903 Request for Direct Payment;

**Services** means the Escrow Account Services to be provided by the Escrow Agent to FUNAE and the Concessionaire in accordance with the terms of this Agreement;

**Subsidy Agreement Schedule** means the schedule of the Subsidy Agreement in the form set out in Schedule 2;

**Subsidy** means the subsidy to be paid to the Concessionaire for Qualifying Connections under the Subsidy Agreement;

- 1.2 In this Agreement, unless the context otherwise requires:
- (a) references to a **party** include references to the successors or assigns (immediate or otherwise) of that party;
  - (b) references to **person** shall include any firm or body of persons whether corporate or incorporate and any person deriving title therefrom and any of their respective successors or assigns;
  - (c) words importing the singular number alone shall include the plural number and *vice versa*;
  - (d) words denoting one gender only shall include the other genders; and
  - (e) Clauses, sub-Clauses and Schedules shall, unless the context otherwise requires, be construed as references to clauses and sub-clauses of and Schedules to this Agreement.
- 1.3 **Taxes** – References to costs, charges, remuneration or expenses include any value added, turnover or similar tax charged in respect thereof.
- 1.4 **Headings** – Headings shall be ignored in construing this Agreement.
- 1.5 **Contracts** – References in this Agreement to “this Agreement” or any other document are to this Agreement and the Schedules hereto or those documents as amended, modified, supplemented or replaced from time to time and include any document that amends, modifies, supplements or replaces them.
- 1.6 **Schedules** - The following Schedules are part of this Agreement and shall have effect accordingly, and terms defined therein and not in the main body of this Agreement shall have the meanings given to them in such Schedules.

## **2. EFFECTIVENESS DATE**

- 2.1 This Agreement will become effective on receipt by the Escrow Agent of Authenticated Copies of:
- a) the Bank Guarantee;
  - b) the Subsidy Agreement.

## **3. APPOINTMENT OF THE ESCROW AGENT AND OPENING OF ESCROW ACCOUNT**

- 3.1 Each of FUNAE and the Concessionaire hereby appoints the Escrow Agent for the purposes set out in this Agreement, and the Escrow Agent hereby accepts such appointment on the terms set out in this Agreement.
- 3.2 The Escrow Agent shall open the Escrow Account within 7 Business Days of the execution of this Agreement and shall notify FUNAE and the Concessionaire of the opening of the Escrow Account and the account details within 24 hours thereof.
- 3.3 The Authorised Signatories of the Escrow Agent and FUNAE will be entitled to view the balance of the Escrow Account at any time in accordance with the Escrow Agent’s

standard security procedures or such other security procedures as may be agreed in writing between FUNAE, the Concessionaire and the Escrow Agent from time to time.

- 3.4 The Escrow Agent shall provide a monthly statement of the balance of the Escrow Account to FUNAE and the Concessionaire showing all transactions on the account in the previous [quarter].
- 3.5 The Escrow Agent will make all payments to the Concessionaire by inter-bank transfer to the account specified on the Concessionaire's invoice in the currency of payment specified by the Concessionaire.
- 3.6 If the currency of payment specified by the Concessionaire is any currency other than US\$ the rate of exchange will be the rate published in the [Financial Times on the date of exchange].

#### **4. TREATMENT DURING ESCROW PERIOD**

- 4.1 The Escrow Agent shall hold the Escrow Monies as agent of the Bank of Mozambique as banker and not as trustee. The Escrow Monies shall be held by the Escrow Agent in the Escrow Account and shall be kept separate from, and shall not be co-mingled with, any other monies.
- 4.2 Save as provided in Clause 8 (*Fees and Expenses*), the Escrow Agent shall not make any deductions from the Escrow Account by virtue of any right of set-off or claim which it may have against FUNAE or the Concessionaire. The Escrow Agent shall not release any of the Escrow Monies, except as provided in this Agreement.
- 4.3 Any interest earned or profit generated from the Escrow Account (subject to any deduction of tax at source) shall be retained in the Escrow Account.
- 4.4 The Escrow Agent shall not be under any obligation to invest the Escrow Monies and shall have express power to retain the Escrow Monies in their existing condition in the Escrow Account.

#### **5. FUNDING OF ESCROW ACCOUNT**

- 5.2 Within 2 Business Days of receipt by the Escrow Agent of an Authenticated Copy of the Annual Plan Payment Schedule, the Escrow Agent having already received the Authenticated Copies of the Bank Guarantee and the Subsidy Agreement, the Escrow Agent will draw up and present to DNE for countersignature by an Authorised Signatory of DNE a Request for Direct Payment for an amount equal to the Balance Limit.
- 5.3 On receipt of the countersigned Request for Direct Payment from DNE the Escrow Agent will present the Request for Direct Payment to the World Bank Resident Mission in Maputo for onward transmission to IDA.
- 5.4 With 2 Business Days of making any payment of Subsidy to the Concessionaire the Escrow Agent will draw up and present to DNE for counter signature by an Authorised Signatory a Request for Direct Payment for an amount equal to the sum paid to the Concessionaire in order to bring the balance of the account to the Balance Limit.
- 5.5 On receipt of the countersigned Request for Direct Payment from DNE the Escrow Agent will present the Request for Direct Payment to the World Bank Resident Mission in Maputo for onward transmission to IDA.

- 5.6 The Escrow Agent will monitor each payment requested and inform FUNAE and the Concessionaire if the funds are not received into the Escrow Account within [20] Business Days of submission of the Request for Direct Payment to the World Bank Resident Mission in Maputo.

## **6. INVOICING VERIFICATION AND PAYMENT**

### **6.1. Advance Payment**

#### **6.1.1. Invoicing for Advance Payment**

- 6.1.1.1 The Concessionaire will present to the Escrow Agent the Advance Payment Invoice for the first Year following confirmation of the receipt of the funds into the Escrow Account.
- 6.1.1.2 The Concessionaire will present to the Escrow Agent the Advance Payment Invoice for each subsequent Year 60 days prior to the end of the previous Year.

#### **6.1.2. Verification drawdown and payment of Advance Payment**

- 6.1.2.1. Within 2 Business Days of receipt by the Escrow Agent of the Concessionaire's invoice for the Advance Payment the Escrow Agent having already received of Authenticated Copies of the Annual Plan Payment Schedule, the Bank Guarantee and the Subsidy Agreement, the Escrow Agent shall verify that:
- a) the Advance Payment Invoice and Annual Plan Payment Schedule have been signed by an Authorised Signatory of the Concessionaire;
  - b) the amount invoiced is the Advance Payment;
  - c) the information recorded in the Annual Plan Payment Schedule is consistent with the information recorded in the Subsidy Agreement Schedule.
- 6.1.2.2 If the Advance Payment Invoice and supporting documentation Schedule do not conform to the requirements set out in this Clause, the Escrow Agent shall return them to the Concessionaire with a written explanation of the reasons for the return of the documents.
- 6.1.2.3 If the Advance Payment Invoice and supporting documentation conform to the requirements set out in this sub-Clause, the Escrow Agent will pay the Advance Payment Invoice.

### **6.2. BALANCING PAYMENT**

#### **6.2.1. Invoicing for Balancing Payment**

- 6.2.1.1 If the value of Qualifying Connections made in the relevant Year is less than the amount paid to the Concessionaire by way of the Advance Payment the Concessionaire will repay to the Escrow Account an amount equal to deficit difference between the value of Qualifying Connections made in the relevant Year and the amount paid to the Concessionaire by way of the Advance Payment within [10] Business Days of the end of the Year.
- 6.2.1.2 If the value of Qualifying Connections made in the relevant Year is greater than the amount paid to the Concessionaire by way of the Advance Payment but less than or equal to the amount of the Annual Subsidy stated in the Annual Plan Payment Schedule and the Balance Limit the Concessionaire will submit a Balancing Payment Invoice for

the deficit difference between the value of Qualifying Connections made in the relevant Year and the amount paid to the Concessionaire by way of the Advance Payment. The Balancing Payment Invoice shall be accompanied by Authenticated Copies of the following documents:

- a) Connections Report
- b) Connections Schedule

6.2.1.3 If the value of Qualifying Connections made in the relevant Year is greater than the amount paid to the Concessionaire by way of the Advance Payment and greater than the amount of the Annual Subsidy stated in the Annual Plan Payment Schedule or the Balance Limit the Concessionaire will submit an Additional Payment Invoice for the excess difference between the value of Qualifying Connections made in the relevant Year and the amount of the Annual Subsidy stated in the Annual Plan Payment Schedule or the Balance Limit as the case may be. The Additional Payment Invoice shall be accompanied by Authenticated Copies of the following:

- a) Connections Report
- b) Connections Schedule

#### **6.2.2 Verification and Payment of Balancing Payment**

6.2.2.1 Within 2 Business Days of receipt by the Escrow Agent of the Balancing Payment Invoice the Escrow Agent shall verify that:

- a) the invoice has been signed by an Authorised Signatory of the Concessionaire;
- b) the value of Qualifying Connections recorded in the Connections Report is greater than the amount paid to the Concessionaire by way of the Advance Payment;
- c) the value of Qualifying Connections recorded in the Connections Report is less than or equal to the amount of the Annual Subsidy stated in the Annual Plan Payment Schedule and the Balance Limit;
- d) subject to d) and e) above the information contained in the Connections Schedule is consistent with the information contained in the Annual Plan Payment Schedule;

6.2.2.2 If the Concessionaire's Balancing Payment Invoice does not conform to the requirements set out in this sub-Clause, return them to the Concessionaire with a written explanation of the reasons for the return of the documents;

6.2.2.3 If the Concessionaire's invoice for the Balancing Payment Invoice conforms to the requirements set out in this sub-Clause the Escrow Agent shall make payment of the amount invoiced to the Concessionaire within 4 Business Days of the date of receipt of the Balancing Payment Invoice.

#### **6.2.3 Verification and Payment of Additional Payment**

6.2.3.1 Within 2 Business Days of receipt by the Escrow Agent of the Concessionaire's invoice for the Additional Payment the Escrow Agent shall verify that:

- a) the invoice has been signed by an Authorised Signatory of the Concessionaire;

- b) the value of Qualifying Connections made in the relevant Year is greater than the amount paid to the Concessionaire by way of the Advance Payment;
- c) the value of Qualifying Connections made in the relevant Year is greater than the amount of the Annual Subsidy stated in the Annual Plan Payment Schedule or the Balance Limit;
- d) subject to b) and c) above the information contained in the Connections Schedule is consistent with the information contained in the Annual Plan Payment Schedule.

6.2.3.2 If the Additional Payment Invoice does not conform to the requirements set out in this sub-Clause, the Escrow Agent will return them to the Concessionaire with a written explanation of the reasons for the return of the documents.

6.2.3.3 If the Concessionaire's Additional Payment Invoice conforms to the requirements set out in this sub-Clause the Escrow Agent will make payment of the amount invoiced by the Concessionaire following the expiry of:

- a) 2 Business Days of the receipt of the Additional Payment Invoice if Escrow Agent has received a No Objection Schedule;
- b) 45 Business Days of receipt of the Additional Payment Invoice if the Escrow Agent has not received a No Objection Schedule or Notification of Second Part Audit.

6.2.3.4 If the Escrow Agent receives a Notification of Second Part Audit within 45 Business Days of the receipt of the Additional Payment Invoice the Escrow Agent will make payment of the amount invoiced by the Concessionaire following the expiry of 60 Business Days of receipt of the Notification of Second Part Audit unless:

- a) the Escrow Agent receives a No Objection Notice in which case it will make payment within 2 Business Days of the receipt of the No Objection Notice;
- b) the Escrow Agent receives a Notification of Special Arbitration Audit.

6.2.3.5 If the Escrow Agent receives a Notification of Special Arbitration Audit the Escrow Agent will make no further payment to the Concessionaire until the Escrow Agent receives the Independent Auditor's Adjusted Connections Schedule.

6.2.3.6 If the Independent Auditor's Adjusted Connections Schedule provides for an Additional Payment to be made to the Concessionaire the Escrow Agent will pay the amount of such payment stated therein within 2 Business Days of receipt thereof.

6.2.3.7 If the Independent Auditor's Adjusted Connections Schedule provides for a reimbursement payment to be made by the Concessionaire to the Escrow Agent the Concessionaire will pay the amount of such reimbursement payment stated therein within 10 Business Days of receipt thereof.

6.2.3.8 If the Concessionaire fails to repay the amount of the reimbursement payment stated in the Independent Auditor's Adjusted Connections Schedule within 10 Business Days thereof FUNAE will be entitled to make a call on the Bank Guarantee to the amount of the reimbursement payment stated therein.

6.2.3.9 The Concessionaire shall cause the Bank Guarantee to be reinstated to the Bank Guarantee Value within [20] Business Days of the call.

- 6.2.4 If the Escrow Agent receives at any time a Notice of Non-Reinstatement of the Bank Guarantee from the Independent Auditor the Escrow Agent shall not make any further payment to the Concessionaire until the Escrow Agent receives a further notice in writing signed by two Authorised Signatories of the Independent Auditor that the Bank Guarantee has been reinstated to the Bank Guarantee Value.

## **7. LIABILITY OF ESCROW AGENT**

- 7.1 The Escrow Agent shall not be liable or responsible for any Liabilities or inconvenience which may result from anything done or omitted to be done by it in accordance with the provisions of this Agreement and shall bear no obligation or responsibility to any person in respect of the operation of the Escrow Account or its application of the Escrow Monies unless such liability arises as a result of negligence, fraud or wilful default on the part of the Escrow Agent. In particular, but without limiting the generality of the foregoing, the Escrow Agent shall not be liable to FUNAE for any failure to maximise the amount of interest or other amounts earned on all or part of the Escrow Monies. Under no circumstances shall the Escrow Agent be liable for any consequential or special loss, or indirect, consequential or punitive damages, however caused or arising.
- 7.2 No implied duties or obligations shall be imposed on the Escrow Agent by virtue of its entering into this Agreement or its agreeing to provide the Services. The Escrow Agent shall not be obliged to perform any additional duties unless it shall have previously agreed to perform such duties. The Escrow Agent shall not be under any obligation to take any action under this Agreement that it expects will result in any expense to, or liability for, it, the payment of which is not, in its opinion, assured to it within a reasonable time.
- 7.3 Each of FUNAE and the Concessionaire shall separately indemnify and hold harmless the Escrow Agent for an amount equal to any and all Liabilities or obligations of any kind whatsoever (and any interest thereon) (including, but not limited to, all properly incurred costs, charges and expenses paid or incurred in disputing or defending any of the foregoing) that may be imposed on or incurred by the Escrow Agent in connection with any action, claim or proceeding of any kind brought or threatened to be brought against it as a result of its acting hereunder or as a result of any action taken or omitted to be taken by it before the date of this Agreement in preparation for acting hereunder, provided that neither FUNAE nor the Concessionaire shall have any obligation to indemnify the Escrow Agent or any of its officers and employees or any other person for any claims arising in consequence of the negligence, fraud or wilful default on the part of the Escrow Agent.
- 7.4 The Escrow Agent shall not be responsible or liable for any Liability incurred in relation to the Escrow Monies arising from any transaction made by it in good faith, or from any failure to diversify investment, or arising by reason of any other matter or thing except for any such loss or damage incurred in consequence of negligence, fraud or wilful default on the part of the Escrow Agent.
- 7.5 The Escrow Agent shall be entitled to rely on, and shall not be liable for acting upon, and shall be entitled to treat as genuine and as the document it purports to be, instruction, letter, notice or other document furnished to it by FUNAE or the Concessionaire or any lawyer or other expert in whatever format and by whatever means, including electronic, and believed by the Escrow Agent, in its reasonable discretion, to be genuine and to have been signed and presented by the proper person or persons.
- 7.6 The Escrow Agent will be entitled to rely upon, and will be protected in acting in good faith upon, the advice or opinion of, or any information (whether addressed to the Escrow Agent or not) obtained from any lawyer or other expert and will not be responsible or liable for any Liability occasioned by so acting. Any such advice, opinion

or information may be sent or obtained by letter, telex, telegram, facsimile transmission, electronic transmission or cable and the Escrow Agent will not be liable for acting on any such advice, opinion or information purporting to be conveyed by such letter, telex, telegram, facsimile transmission, electronic transmission or cable although the same may contain some error or shall not be authentic.

- 7.7 Under no circumstances will the Escrow Agent be liable to the other parties to this Agreement for any consequential loss or damage (including but not limited to loss of business, goodwill, opportunity or profit) even if advised of the possibility of such loss or damage.
- 7.8 The indemnities contained in this Clause 7 shall survive the termination of this Agreement.

## **8. FEES AND EXPENSES**

- 8.1 The Escrow Agent shall be entitled to debit the Escrow Account [quarterly] in respect of the Charges provided that the amount deducted shall not exceed the net interest earned from the balance on the Escrow Account from time to time (subject to any deduction of tax at source [and any bank or other charges]). The Escrow Agent shall provide a copy of its [quarterly] invoice to FUNAE 5 Business Days prior to debiting the Escrow Account.
- 8.2 The parties to this Agreement agree that, at the request of the Escrow Agent, the fees and expenses payable under Clause 8.1 above may be reviewed and increased from time to time but not more than once each Year in accordance with [BASIS OF REVIEW.]
- 8.3 In the event that the interest available for the payment of the Charges is less than the Charges due to the Escrow Agent at the time such Charges fall due the Escrow Agent shall submit to DNE a Request for Direct Payment for countersignature by an Authorised signatory of DNE together with its invoice in respect of the unpaid balance of the charges.
- 8.4 On receipt of the countersigned Request for Direct Payment from DNE the Escrow Agent will present the Request for Direct Payment to the World Bank Resident Mission in Maputo for onward transmission to IDA. On receipt of the funds into the escrow Account the Escrow Agent shall be entitled to debit the Escrow Account in respect of the Charges due.

## **9. MODIFICATION**

- 9.1 No variation of this Agreement (or any document entered into pursuant to this Agreement) shall be valid unless it is in writing and signed by or on behalf of each of the parties hereto.

## **10. TERMINATION**

- 10.1 On receipt of an instruction signed by an Authorised Signatory of each of FUNAE and the Concessionaire confirming that they no longer require the Escrow Monies to be held in Escrow and directing the Escrow Agent to pay all amounts in the Escrow Account (subject to the prior deduction by the Escrow Agent of any costs, fees, Charges, expenses or indemnity amounts owed to the

Escrow Agent) to [FUNAE]. Any such payment shall be a full and sufficient discharge to the Escrow Agent in respect of its obligation to FUNAE and the Concessionaire and the Escrow Agent shall, following such payment, close the Escrow Account, and this Agreement shall terminate.

- 10.2 Notwithstanding Clause 10.1, this Agreement shall terminate automatically on [DATE]. Any Escrow Monies standing to the credit of the Escrow Account at that time shall be paid forthwith to [FUNAE], subject to any costs, fees, Charges, expenses or indemnity amounts owed to the Escrow Agent.

## **11. RESIGNATION**

- 11.1 Each of FUNAE and the Concessionaire agrees that the Escrow Agent shall have the right to resign its appointment hereunder on 3 weeks' notice delivered to each of FUNAE and the Concessionaire. In the case of such resignation, the Escrow Agent shall pay any Escrow Monies standing to the credit of the Escrow Account at that time, but subject to any costs, fees, Charges, expenses or indemnity amounts owed to the Escrow Agent, such person as [FUNAE and the Concessionaire] may together direct in writing.

## **12. COUNTERPARTS**

- 12.1 This Agreement may be entered into in any number of counterparts, and by the parties hereto on different counterparts, each of which, when executed and delivered, shall be an original, but all the counterparts shall together constitute one and the same instrument.

## **13. OPERATION OF THIS AGREEMENT**

- 13.1 The parties recognise that it is impractical in this Agreement to provide for every contingency which may arise during the life of the Agreement, and hereby agree that it is their intention that this Agreement shall operate fairly as between them, and without detriment to the interest of either of them, and that, if during the term of this Agreement either party believes that this Agreement is operating unfairly, they will use their best efforts to agree on such action as may be necessary to remove the cause or causes of such unfairness, but no failure to agree on any action pursuant to this Clause shall give rise to a dispute subject to arbitration in accordance with Clause 14 hereof.

## **14. GOVERNING LAW AND DISPUTES**

### **14.1 Settlement of Disputes**

- 14.1.1. The parties shall use their best efforts to settle amicably all disputes arising out of or in connection with this Agreement or the interpretation thereof.
- 14.1.2 Any dispute between the parties as to matters arising pursuant to this Agreement which cannot be settled amicably within thirty (30) days after receipt of one party of the other party's request for such amicable settlement may be submitted by either party for settlement in accordance with the provisions specified in Sub-Clause 14.3.

## **14.2 Governing Law**

14.2.1 This Agreement is governed by, and shall be construed in accordance with the laws of the Republic of Mozambique.

## **14.3 Arbitration**

14.3.1 Any dispute, controversy or claim arising out of or relating to this Agreement or the breach, termination or validity thereof shall be settled by arbitration in accordance with the arbitration laws of the Republic of Mozambique.

14.3.2 The seat of the arbitration shall be Mozambique, the arbitration shall be conducted in Mozambique and, unless otherwise agreed by the parties, the number of arbitrators shall be three. Each party shall choose one arbitrator, and such arbitrators shall together select the third arbitrator.

14.3.3 No arbitrator appointed shall be an employee, agent or contractor or former employee, agent or contractor of either of the parties.

14.3.4 The decision of the arbitrator shall be final and binding on the parties. Any party may petition any court having jurisdiction to enter judgement upon the arbitration award. Any monetary award shall include interest from the date of any breach or other violation of the Agreement to the date on which the award is paid, at a rate determined by the arbitrators.

14.3.5 The language of any arbitration under this Agreement shall be [English.]

14.3.6 The parties hereby irrevocably waive and agree to exclude any rights of application or appeal to the courts or rights to state a special case for the opinion of the court to the fullest extent permitted by law in connection with any question of law arising in the course of the arbitration or with respect to any award made. The parties hereby, to the fullest extent permitted by law, also irrevocably waive any right to challenge or contest the validity or enforceability of this arbitration agreement or any arbitration proceedings or award brought in conformity with this clause, including any objection based on venue or inconvenient forum.

## 15. NOTICES

15.1 Any notice required to be given under this Agreement shall be delivered in person or sent by post or by fax or telex addressed to:

Escrow Agent:            [*NAME*]  
                                  [*ADDRESS*]

                                  Fax:                [*INSERT*]  
                                  Attention:        [*INSERT*]

[FUNAE]:                 [*NAME*]  
                                  [*ADDRESS*]

                                  Fax:                [*INSERT*]  
                                  Attention:        [*INSERT*]

[Concessionaire]:        [*NAME*]  
                                  [*ADDRESS*]

                                  Fax:                [*INSERT*]  
                                  Attention:        [*INSERT*]

or any other address of which written notice has been given to the parties in accordance with this Clause.

15.2 Any party hereto shall be entitled to change its address for service of notices from time to time, provided that any new address for service of notices selected by it shall be an address in Mozambique other than a post box address, and any such change shall only be effective upon receipt of notice in writing by the other parties to this Agreement of such change.

15.3 All notices, demands, communications or payments intended for any party to this Agreement shall be made or given at such party's address for service of notices for the time being.

15.4 A notice sent by one party to the others shall be deemed to be received:

On the same day, if delivered by hand on a business day and receipt thereof is acknowledged by the addressee in writing;

On the same day of transmission if such day is a business day failing which on the next following business day if sent by telex or telefax, with receipt received confirming completion of the transmission;

On the tenth business day after posting, if sent by prepaid registered mail;

On the same day of transmission if sent by e-mail, with receipt received electronically.

**MADE** on the date stated at the beginning.

Signed )  
By **[FUNDO de ENERGIA]** )  
acting by: )  
 )  
\_\_\_\_\_ )

**Signed** )  
by **[CONCESSIONAIRE]** )  
acting by: )  
 )  
\_\_\_\_\_ )

**Signed** )  
by **[ESCROW AGENT]** )  
acting by: )  
 )  
\_\_\_\_\_ )

<b>SCHEDULE 1</b>	<b>REQUEST FOR DIRECT PAYMENT</b>
<b>SCHEDULE 2</b>	<b>SUBSIDY AGREEMENT SCHEDULE</b>
<b>SCHEDULE 3</b>	<b>ANNUAL PLAN PAYMENT SCHEDULE</b>
<b>SCHEDULE 4</b>	<b>ADVANCE PAYMENT INVOICE</b>
<b>SCHEDULE 5</b>	<b>BALANCING PAYMENT INVOICE</b>
<b>SCHEDULE 6</b>	<b>CONNECTIONS SCHEDULE</b>
<b>SCHEDULE 7</b>	<b>ADDITIONAL PAYMENT INVOICE</b>
<b>SCHEDULE 8</b>	<b>INDEPENDENT AUDITOR'S PAYMENT SUSPENSION NOTICE</b>
<b>SCHEDULE 9</b>	<b>NO OBJECTION SCHEDULE</b>
<b>SCHEDULE 10</b>	<b>FUNAE ADJUSTED CONNECTIONS SCHEDULE</b>
<b>SCHEDULE 11</b>	<i>Not used</i>
<b>SCHEDULE 12</b>	<b>INDEPENDENT AUDITOR'S ADJUSTED CONNECTIONS SCHEDULE</b>
<b>SCHEDULE 13</b>	<b>NOTIFICATION OF SECOND PART AUDIT</b>
<b>SCHEDULE 14</b>	<b>NOTIFICATION OF CALL ON BANK GUARANTEE</b>
<b>SCHEDULE 15</b>	<b>ESCROW ACCOUNT DETAILS</b>
<b>SCHEDULE 16</b>	<b>AUTHORISED SIGNATORIES</b>
<b>SCHEDULE 17</b>	<b>ESCROW AGENT'S CHARGES</b>

## **APPENDIX B: LETTER OF CREDIT (L/C) MECHANISM**

The final mechanism proposed is using a donor backed L/C. An L/C is a conditional undertaking by a bank to make payment. More precisely, it is a written undertaking by a bank (issuing bank) given to the seller / provider of service (beneficiary) at the request of the buyer (applicant) to pay a sum of money against presentation of documents complying with the terms of the credit within a set time limit.

The process is structured along the following lines:

An independent commercial bank, on request from the host government (its client), issues an irrevocable L/C in favour of the beneficiary (the operator / concessionaire). By issuing the L/C, the commercial bank undertakes to pay specific sums of money to the operator against presentation of specific documentation (e.g. invoice and a self certification certificate). Once the L/C is issued, the obligations undertaken cannot be revoked by the issuer without the consent of the beneficiary. On the face of it, whether such a payment mechanism alleviates the risk depends if the commercial bank, in the eyes of the operator, is less likely to default on its obligations than the government itself.

In most cases, however, the payment risk and costs of the L/C are further minimised if the commercial bank's L/C is backed by a special commitment instrument from the donor (as opposed to either collateral or guarantees from the government). This is an undertaking by an international donor, e.g. IDA, that it will transfer required funds to the commercial bank once the operator presents required documentation.

The L/C can be structured in two ways:

- the commercial bank can pay the operator immediately upon presentation of the documents and then request reimbursement from the donor; or
- the L/C will specify that commercial bank will check and transfer the documents on to the donor and wait to be in funds before making a payment to the operator.

In the former case the commercial bank actually accepts an obligation to pay against documents and will therefore charge an appropriate fee for this, whilst in the latter it simply accepts a conditional obligation to pay upon receipt of the funds from the donor, charging a smaller fee.

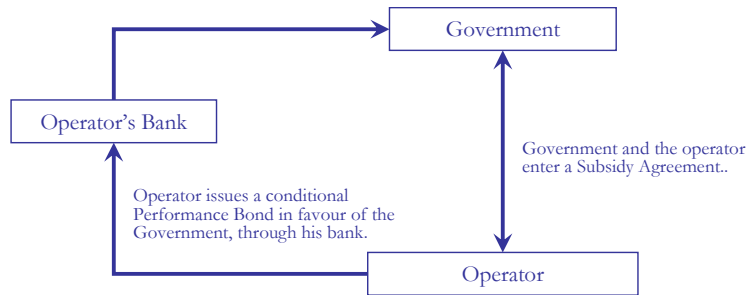
The most likely and useful L/C payment mechanism will allow payments to be made before verification by the government takes place, thus adding a much greater automacy to payments. A performance bond from the operator would, however, be required to lower the risks faced by the donors / government providing the funds.

### **L/C payment mechanism**

The L/C mechanism operates in the following, general sequence of activities.

1. The government and the operator sign a subsidy agreement. The operator issues a conditional performance bond.

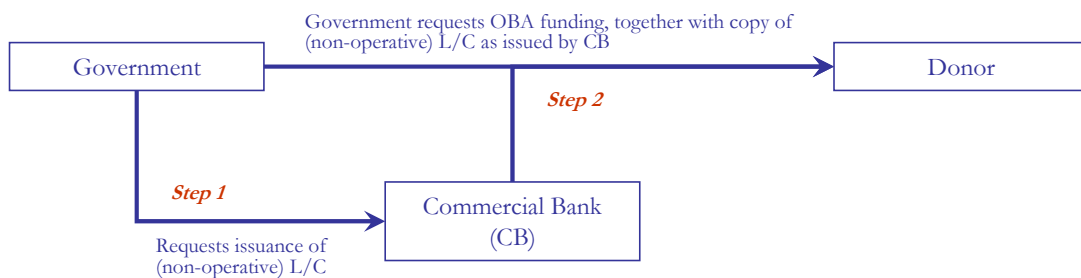
Figure A4.1 – Subsidy Agreement and performance bond



Note: A Performance Bond will be conditional in the sense that a call on the bond will have to be supported by a certificate from an Independent Auditor, certifying a breach of Subsidy Agreement by the operator.

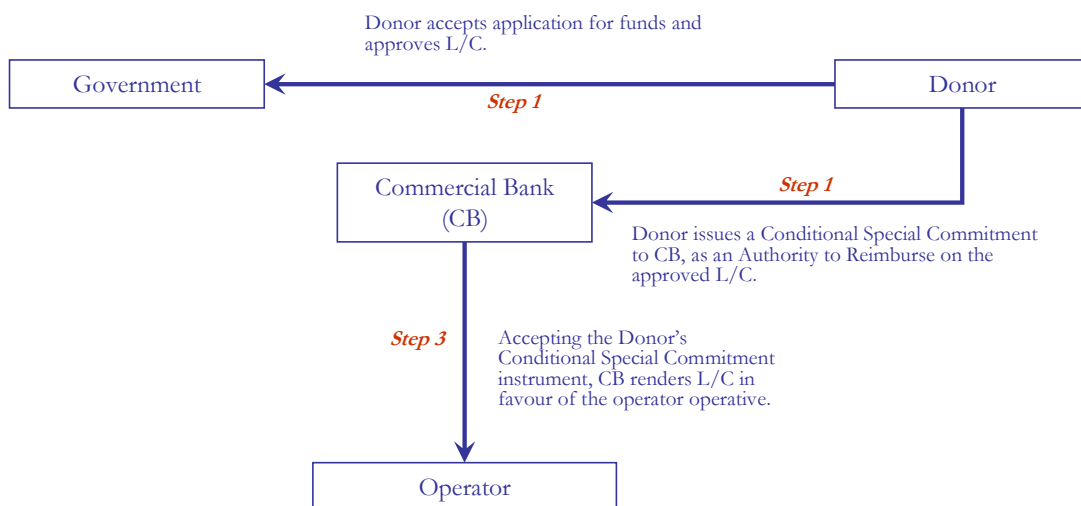
2. Government request OBA funding from the donor, and submits a draft of a non-operative L/C (marked non-operative) for approval.

Figure A4.2 – Application for OBA funding and donor approval of underlying documentation



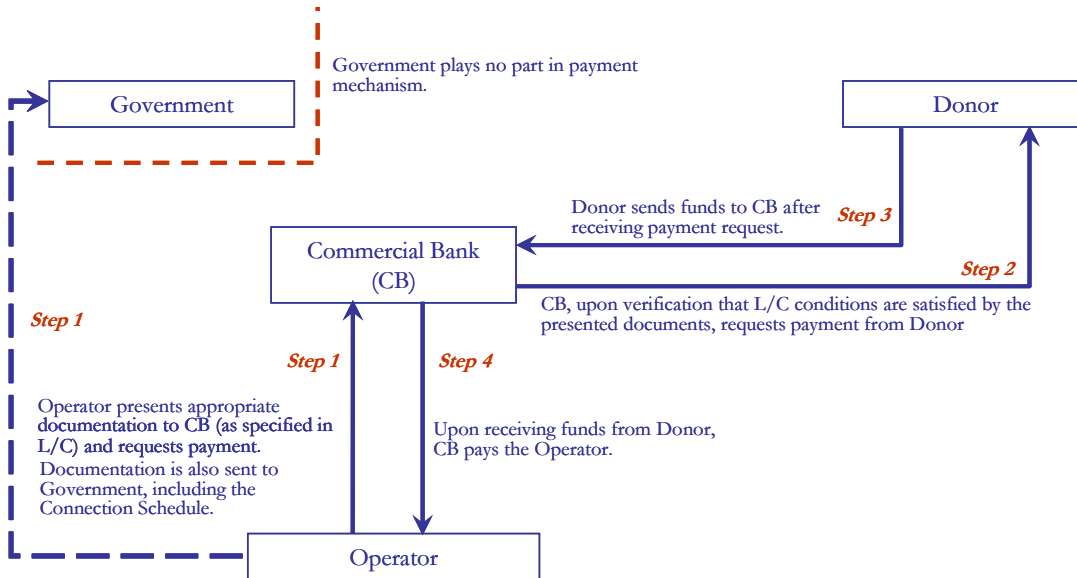
2. The donor approves OBA funding application from the government and issues a Conditional Special Commitment instrument to the commercial bank. (The conditionality of the Special Commitment ensures that the Donor can stop payments through the L/C if the exposure exceeds the value of the performance bond while the two sides are in dispute).

Figure A4.3 – The L/C is issued



- The risk of government not paying the OBA subsidy is minimised as the Government plays no part in the payment mechanism. This step is repeated as many times as is appropriate under the Subsidy Agreement.

Figure A4.4 – Upon presentation of required documentation, the OBA payment is made to the operator



## Different forms of L/Cs

There are three main forms of L/C that could be used, all irrevocable upon issuance, as instruments in the mechanism described above:

- An ordinary L/C for the total amount and full life of the Subsidy Agreement. This form of L/C allows the beneficiary to drawdown as much of the funds as his documentation will support, within the limit of the L/C.
- A revolving L/C which stipulates the maximum single drawdown allowed as well as the total cumulative amount that might be drawn under it (that is, the value of the Subsidy Agreement). This L/C is also valid for the full life of the Subsidy Agreement.
- A non-cumulative renewable L/C which is renewed on an annual basis every year for the life of the Subsidy Agreement, unless objected to by any of the parties. It is important for this form of L/C to be non-cumulative so as to avoid situations where the operator under-invoices in one year and is allowed to carry that payment obligation forward to the next periods, possibly rendering the performance bond inadequate to cover the growing L/C exposure. Details of arrangements that deal with under / over invoicing need to be dealt with in the Subsidy Agreement.<sup>13</sup>

Different situations would require different L/C structures. The structure that would probably be applicable in most cases is the non-cumulative renewable L/C, as this:

- Represents best value for money.* An ordinary L/C or a revolving L/C are likely to be much more expensive as the issuance fee for these will be charged for the full

<sup>13</sup> One way of dealing with this issue is to limit the amount that is possible to carry over as well as the number of periods that the amount can be carried over.

amount over the whole life of the Subsidy Agreement; whereas the cost of the renewable L/C will be charged on the annual value of the L/C. It is also worth noting that it may not be possible to secure either an ordinary L/C or a revolving L/C for a long period of time, say five years.

- *Allows for the non-renewal of the L/C upon expiry.* If there is a breach of the underlying Subsidy Agreement which is not amicably resolved, the renewable L/C allows the government to prevent its issuance for another period. As mentioned above, the other way of stopping the continuation of payments is if the donor withdraws the guarantee mechanism backing the L/C.
- *Allows for a smaller and therefore cheaper performance bond.* To fully protect itself from making OBA payments after dispute remains unresolved, the government would have to request a performance bond that will cover the full exposure of an ordinary or a revolving L/C, if these forms were used. In case of large projects, this is likely to be a significant amount which will considerably diminish interest in the transactions from the private sector.

Two samples of a possible renewable non-cumulative Letter of Credit, which are likely to be used in the forthcoming transactions in Mozambique, are given in Appendix 5.

## APPENDIX C: SAMPLE L/Cs

### Specimen A:

#### Commercial Irrevocable Renewable Non-Cumulative Non Operative Letter of Credit

[*Mozambican Commercial Bank name*] L/C No.: \_\_\_\_\_

We hereby issue our Irrevocable Renewable Non-Cumulative Letter of Credit in favour of: (*name and full address of beneficiary*). For account of the Government of Mozambique (*full address*) for the sum of USD [xxx] (*in words*) available for payment at our counters until [*expiry date*] against presentation of the following documents:

1. Up to USD [xxx] representing Advance Payment in respect of the subsidy payments due, against presentation of an invoice headed up 'Advance Payment Invoice' signed in original and stating that this sum represents Advance Payment due in respect of Electricity Connections to Households within Mozambique and is payable in accordance with the terms of the Subsidy Agreement, No. [xx] dated [xxx].
2. Up to a total of USD [xxx] representing balance / part of the balance in respect of the subsidy payments due, against presentation of an invoice headed up 'Balancing Payment Invoice' signed in original and stating that this sum represents balance (or part of the balance) due in respect of Electricity Connections to Households within Mozambique and is payable in accordance with the terms of Subsidy Agreement, No. [xx] dated [xxx].

Covering: "Electricity Connections to Households within Mozambique in accordance with Subsidy Agreement No. [xx] dated [xxx]."

Partial Payments are allowed.

#### Special Instructions:

1. All bank charges are for account of the applicant
2. This credit is subject to World Bank (IDA) funding and is non-operative pending receipt of their Authority to Reimburse. Upon receipt of the necessary Authority to Reimburse we shall make the credit operative advising you at the same time that all claims presented in compliance with the credit terms will be honoured by us upon receipt of funds from World Bank (IDA).
3. Without responsibility or undertaking on our part we advise you that unless objected to by any of the parties to the credit prior to its expiry (with a special Non-Renewal Amendment), upon expiry it will be automatically renewed on the same terms and conditions for a further period of one year. It is further intended that the credit be automatically renewed for a total period of [xx] years on these same terms and conditions and on the understanding that our total commitment under the credit is limited to USD [xxx] in any one year and to USD [xxx] over the total period of [xx] years, bearing in mind also that in the final year the credit may have to be amended in respect of amount in order that the total value of USD [xxx] is not exceeded.

An objection to automatic renewal of Credit is considered valid only if the special Non-Renewal Amendment is accompanied by a supporting certificate

issued and signed in original by an Independent Auditor (*company name, address*).

The Credit is also automatically renewable only on the understanding that it continues to be funded by the World Bank (IDA) for the whole period.

4. Except as otherwise expressly stated, this documentary credit is subject to Uniform Rules and Practice for Documentary Credits (1993 Revision) International Chamber of Commerce, Publication No 500.

### **Specimen B:**

#### **Commercial Irrevocable Renewable Non-Cumulative Non-Operative Letter of Credit**

[*Mozambican Commercial Bank name*] L/C No.: \_\_\_\_\_

We hereby issue our Irrevocable Renewable Non-Cumulative Letter of Credit in favour of: (*name and full address of beneficiary*). For account of the Government of Mozambique (*full address*) for the sum of USD [xxx] (*in words*) available for payment at our counters until [*expiry date*] against presentation of the following documents:

Up to USD [xxx] representing Periodic Payment in respect of the subsidy payments due, against presentation of:

An invoice headed up 'Periodic Payment Invoice' signed and stamped in original, by both the Concessionaire and FUNAE, and stating that this sum represents Periodic Payment due in respect of Electricity Connections to Households within Mozambique and is payable in accordance with the terms of the Subsidy Agreement, No. [xx] dated [xxx].

Covering: "Electricity Connections to Households within Mozambique in accordance with Subsidy Agreement No. [xx] dated [xxx]."

Partial Payments are allowed.

Special Instructions:

1. All bank charges are for account of the applicant
2. This credit is subject to World Bank (IDA) funding and is non-operative pending receipt of their Authority to Reimburse. Upon receipt of the necessary Authority to Reimburse we shall make the credit operative advising you at the same time that all claims presented in compliance with the credit terms will be honoured by us upon receipt of funds from World Bank (IDA).
3. Without responsibility or undertaking on our part we advise you that unless objected to by any of the parties to the credit prior to its expiry (with a special Non-Renewal Amendment), upon expiry it will be automatically renewed on the same terms and conditions for a further period of one year. It is further intended that the credit be automatically renewed for a total period of [xx] years on these same terms and conditions and on the understanding that our total commitment under the credit is limited to USD [xxx] in any one year and to USD [xxx] over the total period of [xx] years, bearing in mind also that in the final year the credit may have to be amended in respect of amount in order that the total value of USD [xxx] is not exceeded.

An objection to automatic renewal of Credit by Government of Mozambique is considered valid only if the special Non-Renewal Amendment is on headed FUNAE paper, signed by [*FUNAE signatories*].

The Credit is also automatically renewable only on the understanding that it continues to be funded by the World Bank (IDA) for the whole period.

5. Except as otherwise expressly stated, this documentary credit is subject to Uniform Rules and Practice for Documentary Credits (1993 Revision) International Chamber of Commerce, Publication No 500.

