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PROGRESS REPORT 2016 MYANMAR



A NEW ENERGY LANDSCAPE IN MYANMAR?

Myanmar may be on the verge of a completely new energy landscape offering exciting opportunities, as well as challenges, for international investors. In coming months a new energy master plan is expected to be revealed for the Yangon Region – which accounts for almost half of all electricity produced across the country.

It is too early to tell how the sector will be re-structured. Myanmar national press has reported that the master plan will amend existing laws to allow local and foreign investors to have a stake not only in electricity generation (which is already possible) but also transmission and distribution in the Yangon Region. There has even been discussion about direct contracting by power producers to industrial end-users or industrial zones. Yangon alone has 20 industrial zones.

The shift in leadership emphasis from national to sub-national level, if it is indeed implemented as announced, shakes up many elements of an unsettled Myanmar electricity sector. The proposed reforms would represent a significant liberalization of the regional power sector – though clearly there are challenges in moving directly to such an open approach. One of the ideas floated by private stakeholders is to keep a government entity interposed in the distribution chain so as to provide access to a government guarantee and insulate the IPP from demand and credit risks. In our view, this would be critical to larger scale power developments. We

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Highlights of this note

- ▶ Evolution of the Myanmar PPAs
- ▶ Secured lending framework
- ▶ Institutional Framework

anticipate that investors would urge Myanmar to “walk before they leap” in order to maximise their potential in realising their ambitious plans.

The anticipated regional changes in the electricity sector come in the wake of what has been a progressive evolution towards a more bankable power sector in Myanmar nationally, and an evolution that has accelerated in recent years. This note summarises the treatment of some of the key terms in recent Myanmar PPAs as well the current status of other key bankability issues such as security, currency convertibility and disputes resolution. We outline the positive points and seek to identify some of the shortfalls that the new arrangements may seek to address.

Evolution of the Myanmar PPAs

On 31 March 2016, power purchase agreements were executed for some five gas-fired IPPs. This occurred just before the USDP-led Government transferred power to the newly appointed cabinet of Aung San Su Kyi’s NLD. These “March 2016 PPAs” included the internationally tendered Myingyan PPA, which was supported by the World Bank (which provided technical assistance for the

tender) as well as other international financial institutions and was awarded to SembCorp Industries (Singapore).

The March 2016 PPAs represented a significant improvement in commercial and legal terms compared to prior Myanmar precedents. This included improvements that are key to a bankable PPA, including a take-or-pay offtake commitment, force majeure provisions, tariff adjustments and termination payments. However, the March 2016 PPAs also retained some less helpful legacies from what had preceded them. When the Yangon region energy master plan is unveiled, and as further PPAs are developed nationally, investors and lenders will be keen to assess whether remaining bankability issues have been adequately addressed in order for the “international standard” of risk allocation to be achievable. We highlight some of the areas that may require monitoring below.

Take-or-pay commitment

A clear “take-or-pay” commitment guaranteeing that the IPP gets paid provided that it is available (meaning that the power purchaser takes the demand or “dispatch risk”) is the foundation of project financed IPPs in all but the most developed electricity markets. The approach adopted to date in Myanmar in seeking to achieve such an arrangement has been piecemeal and not helped by ambiguities in contractual drafting. Rather than a customary capacity/availability take-or-pay structure, many recent PPAs have favoured an approach under which the power purchaser commits to purchase a guaranteed minimum output at an agreed tariff. This commitment commonly applies on both an annual basis and in each month (based on a percentage of the power plant’s contracted output), although the precise payment arrangements still differ significantly from one PPA to the next. For example, some PPAs provide for regular payment of invoices based on the guaranteed monthly kilowatt hours only, with an annual balancing payment to compensate for any excess amounts dispatched, while other PPAs provide for regular payments based on the higher of the guaranteed monthly kilowatt hours and the actual monthly output. Notwithstanding these inconsistencies, the most recent March 2016 PPAs at least provide for a basic regular minimum payment.

This simplifies the financial modelling exercise for prospective lenders.

Force Majeure and “deemed availability”

Closely related to the take-or-pay commitment (independent of actual power demand) are further questions as to whether the IPP will be paid in two or three additional situations:

- if the power purchaser cannot take power due to force majeure affecting power purchaser or infrastructure downstream of the IPP; and
- (consistent with the customary regime in jurisdictions where power is sold to state owned power purchasers under a long term PPA) if certain “political force majeure” events prevent the IPP from being available (or prevent the IPP from being commissioned and completed in the construction period); and
- (in a gas-fired IPP where the government or power purchaser is better able to manage gas supply risks) in the event of interruptions to the gas supply.

In “conventional” international PPAs, the concepts of “availability charge”,

drafting ambiguity.

More positively, with each new PPA in Myanmar the approach appears to be increasingly sophisticated: Distinctions have now been drawn between natural force majeure events (earthquakes, floods, typhoons, etc.), governmental/regulatory force majeure events (change in law, non-renewal of permits and expropriation) and other force majeure events (strikes, acts of terrorism and sabotage) and the consequences thereof. In the most recent PPAs, governmental/regulatory force majeure events and other non-natural force majeure events affecting the IPP or the power purchaser result in PPA payments at least sufficient to cover debt service obligations and operating costs.

Tariff adjustments

The PPA tariffs have been determined and paid in US dollars. However, the experience to date in addressing modifications to the tariff have been varied.

The March 2016 PPAs did include mechanisms for adjustments to tariffs to cover increased costs of project specific government actions, as well as the wider application of changes in



“deemed commissioning” and “deemed availability” are customarily used to ensure that in all three of these scenarios fixed PPA payments are made and debt service can be honoured (as can any back-to-back “take or pay” commitments under gas supply contracts). Myanmar PPAs have been less successful in comprehensively moving the risks of these scenarios from the IPP to the power purchaser, in part due to the different structural approach of guarantying payment for actual output (as opposed to deemed or actual availability) and in part due to

laws and government interventions (e.g., environmental compliance or introduction of a grid code).

The risk of inflation causing operating and maintenance costs to reduce cash available for debt service is conventionally addressed through the use of appropriately targeted (local and international) inflation indices in tariff escalation mechanisms. However, Myanmar has generally resisted tariff adjustment structures that could allow significant tariff increases due to factors outside Myanmar or outside

the government's control. While recent PPAs have been an improvement from the earlier solution of a periodic "renegotiation", they have also included strict limits on the maximum possible tariff escalation in each contract year; more complex and targeted formulas were incorporated into just one of the March 2016 PPAs. This is already an area that will require further development to reach the "international standard".

Identity of Power Purchaser and Governmental guarantees

The power purchaser under the March 2016 PPAs was EPGE, a state-owned enterprise. As EPGE sells electricity for less than it purchases, it relies on budget appropriations from the Myanmar government (and so may not meet the credit standing typically required to support long term commitments under a PPA). Nevertheless, most IPPs in Myanmar to date do not have a government guarantee and Myanmar has been reluctant to issue guarantees for power projects for a number of reasons, some of which relate to technicalities of the public finance system and some of which reflect an institutional mind-set that is unfamiliar with the public sector guaranteeing private sector investment. Having said that, a financial framework introduced in 2016 in principle permits the Ministry of National Planning and Finance to provide guarantees within yet to be drafted "terms and conditions" which need to be approved by the National Assembly. The Myanmar government provided what effectively amounts to a guarantee of the Myingyan PPA. To ensure bankability of the project investors typically require the power purchaser to be sufficiently creditworthy to meet its obligations throughout the term of the PPA and in most developing energy markets

this has manifested itself in the form of government guarantees.

Termination payments

Significant progress was made in the March 2016 PPAs providing for termination payments to include at least outstanding debt principal on a termination in all circumstances, including on termination by the power purchaser due IPP default and termination by either party due to extended natural force majeure affecting the IPP. Upon termination in all other circumstances (e.g., power purchaser default, government force majeure) some form of equity compensation has typically also been included in termination payments - though the precise formulation for equity compensation is uniquely negotiated per project.

Areas where the termination payments could be further developed include: clarifying the circumstances where equity will also be compensated (e.g., termination on government force majeure is an area where this has not been consistent) and generally in tightening up the comprehensiveness of the regime and related definitions (Change in Law; Government Force Majeure, etc.).

Secured lending framework

The security package available to lenders in Myanmar is in principle relatively comprehensive and has many concepts that are familiar to the English common law system due to the country's history. From the perspective of international lenders, however, the legal regime is relatively untested, the level of experience of the courts in dealing with the enforcement of security is unknown and aspects of

the security regime may contradict elements of Myanmar's more recent commercial law framework. This will require careful analysis and structuring.

Enforcement of certain security (namely security over shares in a Myanmar company) requires governmental consent. To avoid this creating an unacceptable restriction on lenders' enforcement options, direct agreements between lenders and the relevant government bodies may need to be considered (including upfront approval or objective standards for any such sale of shares on enforcement). An alternative would be to establish an offshore holding company structure and ensure no change of control provisions would be triggered under the project contracts on enforcement and sale of such shares in an offshore holding company.

Scope of available security package

An IPP may provide its lenders with a mortgage or a fixed charge over a land lease (including the facilities on the land). Full diligence and appropriate local legal advice must be taken as there are some restrictions on what category or classification of land can be mortgaged (e.g., for land designated as farmland, certain further approvals are required). Myanmar law also allows a company to provide a fixed charge on its contractual rights (including a PPA) and book debts (e.g., receivables under a contract). A floating charge may be created on any other property, including bank accounts in Myanmar (see below for offshore accounts). A shareholder in a Myanmar company may also provide a guarantee in respect of a loan made to its subsidiary or create a hypothecation or a pledge on its shares in a project company. Many of these security interests were expressly recognised in the March 2016 PPAs.

Perfection

Most charges and mortgages must be registered by the Company Registrar in accordance with the Myanmar Companies Act.

Any security against immovable property must be registered with the Office of Registration of Deeds ("ORD"), with the exception of mortgage by deposit of title deed, which need not be registered since all that is required is deposit of document of title.



However, note that if a debtor is a company incorporated in Myanmar, then security (against moveable and immovable property) must be registered at DICA, in addition to any applicable ORD registration requirements.

Consents

Mortgages on immovable property must have the consent of the Myanmar Investment Commission, which is subject to conditions including the requirement that the mortgagee be able to carry on any aspect of a mortgagor's activities. Confirmation that the conditions have been considered satisfied and the consents duly given will need to be satisfactorily addressed in the conditions precedent to any financing.

Investment Protection

Under the Myanmar Investment Law of 2016, the national government is specifically prohibited from expropriating investment projects, except where necessary for the Union. In which case, the investors are compensated according to the prevailing price of the asset or assets and the profit due to be earned over the investment period. Such expropriation would in any case constitute government force majeure leading to compensation of debt and equity under a well-crafted PPA as a contractual remedy.

Further, international arbitration awards are enforceable by the Myanmar courts. In 2016 Myanmar passed the Arbitration Law. Under the Arbitration Law, Myanmar adopted much of the United National Commission on International Trade Law (UNCITRAL).

Off-shore accounts

Off-shore accounts for receipt of USD revenue has been permitted under recently executed PPAs. It is expected that this will continue to be the case as this is a likely requirement for the bankability of the PPAs. Central Bank of Myanmar (CBM) approval is required for the disbursement of revenues to an off-shore account, however since this has been agreed upon by EPGE and thereafter approved by the Myanmar Investment Commission (as a majority of the projects obtain an investment licence or "MIC permit"), no CBM limitation on such remittances is

anticipated.

Conclusions

There has been significant evolution in Myanmar PPAs towards a bankable model. It is not clear whether the precedents, and in particular the Myingyan PPA, will provide the basis for a model PPA going forward, but they do at least show what has been achieved contracting with EPGE, and with a government guarantee, at a national level.

Some of the ideas that have been floated for the anticipated Yangon Region reforms may be overly ambitious – at least for larger scale power developments and project finance. For example, the idea that the IPP might be expected to contract directly with industrial zones or industrial users would clearly raise issues for an internationally financed IPP, or a major power plant investment; it would be a requirement (in any such case) that risks of power pricing and demand, offtaker credit or fluctuations in the exchange rate of local currency – given this is a power sector in the earlier stages of development – would need to be satisfactorily addressed. A more realistic approach would appear to be for the Myanmar authorities to explore structures that maintain a contracted tariff, a customary availability charge (for the power purchaser to assume demand/dispatch risk), customary concepts of deemed availability and tariff adjustments (to isolate the IPP from certain other risks that are within the government control or that state offtakers typically assume) – and some form of government guarantee to provide the necessary backing to support the obligations of the power purchaser under the PPA. The power purchaser would then be able to on sell to distributors, which may even be owned by foreign investors to bring best practice and efficiency to power distribution. However, attracting such investment to distribution can be expected to require tariff reforms and greater visibility on demand and prospects for growth.

But Myanmar and Yangon authorities are clearly rethinking how to attract foreign investment and technical know-how to the power sector as a matter of urgency in an effort to match supply with a growing demand, as well as to develop the associated transmission

lines and other infrastructure. Whatever frameworks they unveil, it is hoped that that they will build on the progress that has been made in PPAs in the country so far. The real opportunity here may be for foreign investors with the relevant technical, commercial and finance expertise to then be proactive in making proposals to Myanmar or Yangon authorities to help them develop a bankable solution to their power and infrastructure needs.

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