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Report No. P-685

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

TO

SUI NORTHERN GAS PIPELINES LIMITED

WITH THE GUARANTEE OF PAKISTAN

April 18, 1969

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A PROPOSED LOAN TO
SUI NORTHERN GAS PIPELINES LIMITED

1. I submit the following report and recommendation on a proposed loan in an amount in various currencies equivalent to US\$8 million to Sui Northern Gas Pipelines Limited (SNGPL).

PART I - HISTORICAL

2. On July 2, 1968 Executive Directors considered my Report P-617 which recommended a Bank loan to, and an IFC investment in, Dawood Hercules Chemicals Limited, to construct a fertilizer plant outside Lahore which would supply urea fertilizer to the surrounding agricultural area. At that time it was mentioned that the operation of the Dawood Hercules Plant, and a similar plant to be built in the same area by a company sponsored by the Adamjee group and American Cyanamid Company (Adamjee-Cyanamid), would require considerable quantities of natural gas from the Sui fields in Central West Pakistan for use as feedstock. I also indicated that Bank financing was under consideration for the proposed Adamjee-Cyanamid plant as well as for the necessary expansion of SNGPL's transmission facilities. The SNGPL Project had in fact been appraised in February 1968 on the assumption that SNGPL would supply natural gas for both fertilizer projects, and negotiations for a loan of \$12 million for this purpose were held in July 1968.

3. Since then the Government of Pakistan has decided that the authorization for a second urea plant in West Pakistan should go to another group (Hysesons-Kaiser) whose plans for construction were further advanced than Adamjee-Cyanamid and who proposed to construct their plant near, and draw their supplies from the neighboring Mari gas fields. In view of this, Adamjee-Cyanamid, who shared the Bank Group's view that the market prospects for nitrogenous fertilizer in West Pakistan did not warrant early construction of additional urea plant in the area, withdrew their request for Bank financing. Meanwhile SNGPL had been advised to prepare a modified project against such a contingency. This revised project was appraised in December 1968 and forms the basis of the loan which is proposed in this report.

4. The large gas field at Sui was discovered in the desert of Central West Pakistan in 1952 by Pakistan Petroleum Limited (PPL). PPL sells raw gas to SNGPL and to Sui Gas Transmission Company (SGTC). The gas purification facilities at Sui are owned and operated by SGTC which purifies gas for its own transmission system as well as for SNGPL. A Tripartite Agreement of 1964 between PPL, SGTC and SNGPL fixes the quantity and price of raw gas to be delivered by PPL to SGTC to cover the needs of SGTC and SNGPL, and the quantity and price of purified gas to be delivered by SGTC to SNGPL. This Agreement is currently being renegotiated.

5. The Bank has made two previous loans for natural gas transmission projects in West Pakistan. The first loan (99-PAK) for \$14 million was to SGTC in 1954 to help finance the construction of a pipeline from Sui to Karachi. The second (377-PAK) was a \$15 million loan to SNGPL in 1964 to help finance the extension of the Sui-Multan line northward. Both projects were successfully executed and the loans have been fully disbursed.

6. The Government of Pakistan was represented in the negotiations which took place between July 11 and July 17 last year by Mr. A.R. Bashir, Economic Minister of the Embassy of Pakistan. Representing SNGPL were Mr. S.M. Nasim, Member of Board of SNGPL and Director of West Pakistan Industrial Development Corporation (WPIDC), Mr. D.C. Floyer, Member of Board of SNGPL and Chief Representative of Burmah Oil Company in Pakistan (BOC) and Mr. M.A.K. Alizai, General Manager of SNGPL. There were no formal negotiations for the loan proposed for the revised project, but the concurrence of the Borrower and the Guarantor have been obtained for the necessary changes in the loan documents.

7. As at March 31, 1969 the Bank had made 28 loans to Pakistan, totalling about \$592 million, of which 17 are fully disbursed. The Association had made 26 credits, totalling about \$348.5 million, of which six are fully disbursed. The following is a summary statement of Bank loans and IDA credits to Pakistan as at March 31, 1969:

Loan Credit No.	Year	Borrower	Purpose	Amount (US \$ million)		
				Bank	IDA	Undisbursed
266	1960	Islamic Republic of Pakistan (Pakistan)	Indus Basin (Multipurpose)	90.0		28.5
22	1962	Pakistan	Khairpur Ground Water and Salinity Control		18.0	6.1
39	1963	Pakistan	Brahmaputra Flood Embankment		5.0	0.3
40	1963	Pakistan	Chandpur Irrigation		5.2	0.6
41	1963	Pakistan	Dacca Water Supply and Sewerage		13.2	11.5
42	1963	Pakistan	Chittagong Water Supply and Sewerage		7.0	5.1
376	1964	Trustees of the Port of Karachi	Port Development	17.0		10.0
382	1964	PICIC	Industrial Development	30.0		0.2
49	1964	Pakistan	East Pakistan Education		4.5	1.3
50	1964	Pakistan	West Pakistan Education		8.5	5.2
53	1964	Pakistan	East Pakistan Highway		22.5	20.5
54	1964	Pakistan	West Pakistan Highway		17.0	8.3
56	1964	Pakistan	Pakistan Eastern Railway		10.0	1.1
57	1964	Pakistan	Pakistan Western Railway		24.4	0.1
65	1964	Pakistan	Inland Water Transport		5.2	0.1
76	1965	Pakistan	Agricultural Develop- ment Bank		27.0	0.7
421	1965	PICIC	Industrial Development	30.0		4.0
83	1966	Pakistan	Foodgrain Storage		19.2	12.2
87	1966	Pakistan	Second East Pakistan Education		13.0	12.3
S-1	1966	Pakistan	Project Preparation Credit (Highway Engineering)		1.0	0.3
488	1967	KESC	Karachi Electric Supply	21.5		9.3
106	1967	Pakistan	Lahore Water Supply, Sewerage and Drainage		1.8	1.3
496	1967	Pakistan	Pakistan Western Railway	13.5		9.3

Loan Credit No.	Year	Borrower	Purpose	Amount (US \$ million)		
				Bank	IDA	Undisbursed
509	1967	PICIC	Industrial Development	35.0		20.8
548	1968	Pakistan	Tarbela (Multi- purpose)	25.0		25.0
117	1968	Pakistan	Second Agricultural Development Bank		10.0	6.9
549	1968	Dawood Hercules	Fertilizer Project	32.0		29.6
578	1968	Pakistan	Second West Pakistan Highway Project	35.0		34.8
136	1969	Pakistan	General Consultants for EPWAPDA*		2.0	2.0
590	1969	PICIC	Industrial Development*	40.0		40.0
145	1969	Pakistan	Telecommunications*		16.0	16.0
Loans/Credits fully disbursed				<u>214.4</u>	<u>118.0</u>	
Total (less cancellations)				<u>591.9</u>	<u>348.5</u>	
of which has been repaid to Bank and others				<u>119.3</u>		
Total now outstanding				<u>472.6</u>		
Amount sold 21.9						
of which has been repaid <u>16.8</u>				<u>5.1</u>		
Total now held by Bank and IDA				<u>467.5</u>	<u>348.5</u>	
Total undisbursed				<u>211.5</u>	<u>111.9</u>	<u>323.2</u>

* not yet effective

PART III - THE PROJECT

11. The project is more fully described in the attached Appraisal Report entitled "Appraisal of the Second Sui Northern Gas Pipelines Project," (TO-657b) dated March 21, 1969. It is designed to increase the capacity of SNGPL's pipeline system from 172 to 207 million cubic feet (MMcf) per day to enable the company to carry out its contractual obligation to deliver supplies of gas up to 35 MMcf daily to the fertilizer plant being constructed by Dawood-Hercules Chemicals Ltd. Provision has also been made in the project for completing the automation of the pipeline system and for a modest expansion of the existing distribution system to serve small industry and household requirements in certain areas.

12. SNGPL, which was incorporated in Pakistan in 1963 to take over, extend and operate gas pipelines previously owned by the Government of Pakistan and Attock Oil Company, has an authorized share capital of PRs. 400 million. It has a paid-in capital of PRs. 100 million held in equal proportions by BOC, an international oil company registered in the United Kingdom, WPIDC, a government financed and controlled investment corporation, and the general public of Pakistan. Most of SNGPL's sales are to major industrial consumers and to the West Pakistan Water and Power Development Authority for the generation of electricity. The financial condition of the Borrower is sound.

13. The total cost of the project is estimated at PRs. 85.72 million (US\$18 million) with a foreign exchange component of PRs. 44.05 million (US\$9.25 million). The proposed \$8 million Bank Loan will cover foreign exchange expenditures equivalent to PRs. 38.05 million. BOC will provide the balance of foreign exchange required (PRs. 6 million) through its participation in an offering by the Borrower of ordinary shares amounting to PRs. 18 million. WPIDC will subscribe PRs. 6 million to this issue and the remaining PRs. 6 million will be offered to the Pakistan public. SNGPL will finance the balance of local currency expenditures and any cost overruns through its own resources and by raising local loans. The conclusion of satisfactory arrangements for the provision of this financing is a condition of effectiveness of the loan (Section 7.01(a)(b) and (c)).

14. The proposed Bank loan would help finance the foreign exchange cost of the procurement and installation of high pressure transmission pipelines and compressor units, the construction of a new compressor station and additional low pressure distribution facilities in certain urban areas. In addition provision has been made in the loan to finance the foreign exchange costs of detailed engineering and the preparation of contract documents, assistance in evaluation of bids, and supervision of the construction and operation of the expanded system. These services will be provided by Burmah Oil Company (Pakistan Trading), a subsidiary of BOC, under an agreement the execution of which in a form satisfactory to the Bank is a condition of effectiveness of the loan (Section 7.01(e)).

15. The Bank has been informed by SGTC of the financial and technical arrangements it is making to purify the increased quantities of gas required by SNGPL. These arrangements are satisfactory. Negotiations are underway, however, for a revision of the Tripartite Agreement of 1964 to reflect the increased needs of SNGPL and to take into account also an increase in SGTC's charges for purification which came into effect on August 1, 1968. The execution of the amending agreement in a form satisfactory to the Bank is a condition of effectiveness of the loan (Section 7.01(d)) and is expected to be completed by May 1969.

16. Projected cash generation is adequate to ensure servicing of the total long-term debt. To help assure adequate debt service coverage, the Loan Agreement places conditions upon SNGPL's right to declare dividends (Section 5.11), incur debt (Section 5.13), and make capital expenditures outside the project (Section 5.10). To ensure further that SNGPL will be able to generate cash sufficient to meet its financial obligations, the Loan Agreement provides that SNGPL will establish and maintain tariffs for the supply of gas which will be sufficient to produce an annual return (before interest and taxes) on the value of the net fixed assets in operation of not less than 10 percent for each fiscal year through July 31, 1973 and of not less than 12 percent thereafter (Section 5.12). The Guarantee Agreement obligates the Government to grant gas tariffs to SNGPL needed to comply with this rate covenant (Section 3.06).

17. The Government of Pakistan will guarantee the loan and has informed the Bank that it intends to charge the Borrower a guarantee fee at a rate which would increase the cost to the Borrower, including the interest charged by the Bank, to 7½ percent.

18. Construction is due to begin in March 1970 and the project is expected to be completed by September 30, 1971. The schedule for construction provides for increase in pipeline capacity in phase with the scheduled completion of the new fertilizer plant. The project is technically feasible and financially viable. Work on the Dawood Hercules Fertilizer Project has begun and so far is proceeding according to schedule.

19. Fertilizer production is an important element in the Government's efforts to increase agricultural output and in particular to maintain self-sufficiency in foodgrains. The project will thus contribute materially to the economy of Pakistan. As pointed out in paragraph 7.08 of the Appraisal Report, various analyses were undertaken to compare the total costs of manufacturing the fertilizer in Pakistan with that of fertilizer imports. The rates of return for the whole complex ranged between 15 percent and 29 percent, with 20 percent being considered as the most likely return.

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

20. The draft Loan Agreement between the Bank and SNGPL, the draft Guarantee Agreement between the Islamic Republic of Pakistan and the Bank, the Report of the Committee provided for in Article III, Section 4(iii) of the Articles of Agreement and the text of a Resolution approving the proposed loan are being distributed to the Executive Directors separately.

21. The draft Loan Agreement generally follows the pattern of agreements for loans to private companies in Pakistan and of the agreement for the previous loan to SNGPL. The Borrower would modify the trust deed securing the previous Bank loan to SNGPL in order to secure this loan also by the first specific mortgage upon the Borrower's immovable and other properties and the first floating charge upon the Borrower's assets and undertaking constituted by the trust deed. (Section 5.04). Withdrawals from the Loan Account would be, unless the Bank otherwise agrees, limited to \$2,000,000 until the required deeds and other instruments have been executed and registered. (Section 2.02(b)). The Bank would be entitled to suspend the loan in the event of suspension or cancellation of the Bank loan for the Dawood-Hercules Fertilizer Project which provides the justification for the SNGPL Project. (Section 6.03(b)).

22. The draft Guarantee Agreement is in the usual form. As in the past, the execution of the Guarantee Agreement on behalf of the Guarantor, will be authorized by the President of Pakistan in the exercise of the powers vested in him by the 1962 Constitution. Following the resignation of President Ayub Khan on March 25, 1969, martial law was proclaimed in Pakistan by General Yahya Khan and the 1962 Constitution was abrogated, but provision was made for the continued application of the provisions of said Constitution relating to the office of the President and that office was assumed by General Yahya Khan.

23. A cement company has brought suit against SNGPL seeking substantial damages for allegedly wrongful delay on the part of SNGPL in providing gas to the cement company and challenging as illegal certain SNGPL rates established in an agreement between SNGPL and the cement company and approved by the Government. The suit is presently in its preliminary stages. The Bank has been advised by trial counsel for SNGPL that in their opinion the suit is without merit. The Legal Department has examined this opinion, which has been given by a well-known and experienced law firm in Pakistan, and believes that the opinion is a reasonable one.

PART V - THE ECONOMY

24. The economic mission returned from Pakistan last February. Its report on the economic position and prospects of Pakistan will be distributed during the next few days.

PART VI - COMPLIANCE WITH ARTICLES OF AGREEMENT

25. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank.

PART VII - RECOMMENDATION

26. I recommend that the Executive Directors approve the proposed loan.

Robert S. McNamara
President

Attachment

April 18, 1969