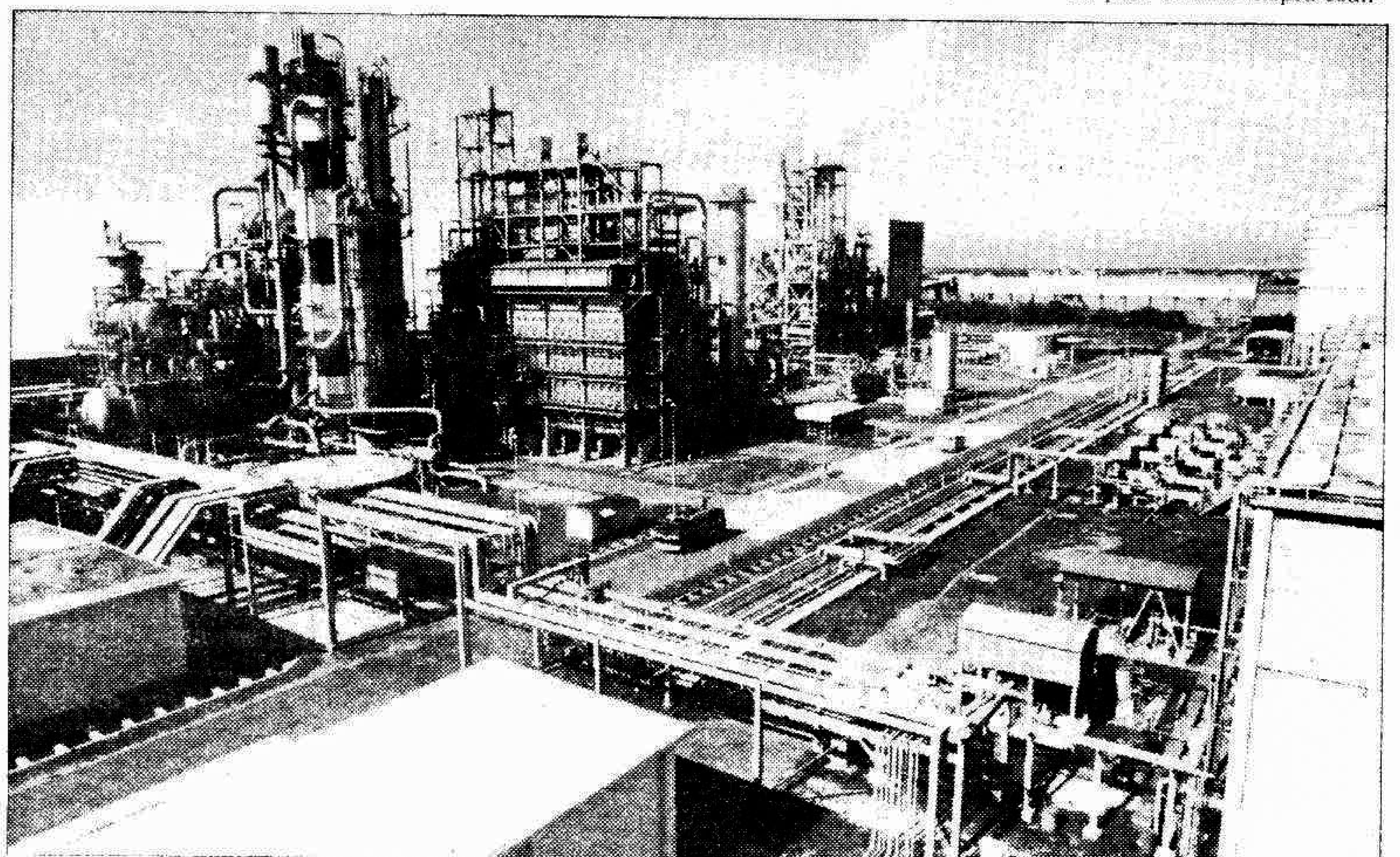
KAFCO

How the Flagship Turned Sour

Controversy over the Karnafuli Feritiliser Company continues to rage as it is seen as an uneven deal, full of complexities and contradictions, with too much for Bangladesh to sacrifice.

Toufique Imrose Khalidi investigates



The Bangladesh Chemical Industries Corporation (BCIC) which was fronting for the government in this joint venture put up US$ 37 million in local currency as its contribution to equity. In return, it was given, at that time, 34.3 per cent of the total shareholders' voting rights. Additional non-voting rights came because of Danish and Norwegian grants worth US$ 13 million routed through the government. It was also agreed that public shares worth US$ 5 million would be floated in Bangladesh. In all, 44 per cent of shares would rest in Bangladesh. But on the Kafco Board, resolutions would require at least 85 per cent of the votes for acceptance.

IN June 1994, a high-profile Japanese investment mission visited Bangladesh. Led by the Marubeni chief, top corporate managers came to "discuss and explore" prospects here. Obviously, expectations ran high both in the local business community and the government. There were no dearth of warmth and hospitality for the "mission" members.

Back in Tokyo, at the headquarters of Keidanren, Japan's elite chamber, there was only one issue that its officials were referring to as of relevance while the team left for Dhaka.

"Everything depends on Kafco," said a Keidanren executive to this correspondent in Tokyo. "Yes, this is the test case for future Japanese investment."

In Dhaka, Marubeni supremo was in no mood to talk other issues than Kafco. Will Kafco go ahead as planned? Will you continue to provide the concessions to the project? It was a puzzling situation for the top functionaries in the government including the prime minister. The obvious statements came from the Dhaka policymakers. Pledges were made to "support" Kafco.

Why was there so much of clamour? What was the deal all about? Why was not there any meeting point for both the parties?

The answers were simple. It was an uneven deal, full of complexities and contradictions. And there was too much for Bangladesh to sacrifice for something that did not look worth it.

The fertiliser project was designed to use Bangladesh's natural gas as raw material to produce urea. There was nothing wrong in it as other state-owned fertiliser plants in the country were doing the same. There were at least two other similar capacity urea-producing units already in operation. The difference was that Kafco would also produce ammonia, based on the formula of Dr Haldor Topsoe of Denmark, and that the products would be meant only for export.

But, unfortunately, crisis has been the other name for Kafco, breeding problems one after another.

The problems are only what the project's critics had foreseen years ago immediately after the deal had been put together behind the scenes. It was a complex financing package, with money coming from many different sources – from governments to aid agencies to large corporations. The promoters have portrayed it as the first-ever long-term syndicated commercial credit facility for Bangladesh and the first-ever major use of export credit finance by a borrower in Bangladesh.

Originally conceived in the early 1980s, the then government looked upon the World Bank's private sector lending arm International Finance Corporation as a major source of finance for this joint venture. In around the mid-80's, there were new interests in the plan and the IFC was abandoned as a partner. Finally, in 1990, the then industries secretary and a former BCIC chairman, Mosharraf Hossain, piloted the project at a lightning speed.

General Ershad gave Hossain a letter of authorisation providing "unlimited powers" under which he negotiated, finalised and signed what a BNP Cabinet minister scrutinising the contract later called "the most corrupt deal in Bangladesh's history".

In its full capacity, according to the deal, the plant would need 64 mmcf of gas per day, a significant part of the then production level of Bakhrabad gas field, which was to supply the gas.

Of the US$450 million needed for the project to get off the ground, it was agreed, the government and other co-owners of the project would come up with US$ 125 million as equity, borrow US$ 228 million as export credit and take US$ 100 million as commercial loan.

The Bangladesh Chemical Industries Corporation (BCIC) which was fronting for the government in this joint venture put up US$ 37 million in local currency as its contribution to equity. In return, it was given, at that time, 34.3 per cent of the total shareholders' voting rights. Additional non-voting rights came because of Danish and Norwegian grants worth US$ 13 million routed through the government. It was also agreed that public shares worth US$ 5 million would be floated in Bangladesh. In all, 44 per cent of shares would rest in Bangladesh. But on the Kafco Board, resolutions would require at least 85 per cent of the votes for acceptance.

With money came concessions from the government of Bangladesh. Gas would be cheaper for Kafco than any other consumer, mode of payment more flexible than for anybody else, taxes and duties would not be asked for in as many areas as possible (See Box 1). These were unprecedented concessions and policy breaches for one single project.

No body seemed to know what there was in the deal. Relevant ministries and government departments had only some sketchy idea of what was being doled out.

As a new government took over after the General's ouster in December 1990 through a mass upsurge, things began to take a new turn. The Deal of the Year in 1990, adjudged by the prestigious Trade and Finance, was turning sour in 1991.

A close scrutiny by government officials laid bare certain elements they did not like to see. At least two aspects of the then US$450 million project appeared to be causes for big concern – the extent of guarantee that Bangladesh was being asked to provide and the price at which gas would have to be supplied. There were also less noisy protests about environmental aspects.

This too happened when the finance ministry was asked to sign the letters of guarantee for export credit from the Japanese Export Import Bank. The ministry, which had earlier given the green signal to the draft of the letter of guarantee, found to its surprise that it contained several unacceptable clauses. And it required no less than a person than the then finance minister, a trained chartered accountant himself, to discover the significance of these clauses. Thanks to Saifur Rahman, the project went to the Cabinet. This is one project that forced many Cabinet meetings in the months leading to what was then termed a capitulation to extreme diplomatic pressure.

"It's a complete sell-out of national interests," ministers were widely quoted to have commented at the Cabinet exercises to find an honourable way-out for both sides.

The other side was indeed powerful, no less an important aid-giver than the Japanese government.

A couple of powerful Japanese companies were at the core of the crisis. Two Japanese companies – Chiyoda and Marubeni – were the contractors who together with Overseas Economic Co-operation Fund (OECF) formed Kafco Japan Investment Co Ltd to claim a 31.29 per cent stake in the company. Interestingly, these shareholders were also lenders. The two companies had earlier formed a consortium to get the crucial job of the general contractor.

[According to current equity structure, the Bangladesh government has the single largest equity (32.16% voting and 11.35% non-voting). Others are Haldor Topsoe (14.95%), which provided the process formula, Denmark's Industrialisation Fund for the Underdeveloped (IFU) (4.35%) and Commonwealth Development Corporation (4.35%) and Stamicarbon BV of Holland (1.56%). Bangladesh has three directors including the chairman on the 10-man Board, while Kafco Japan has three, Haldor Topsoe two, IFU one and CDC one.]

A September 3 1991 Cabinet meeting assigned four ministers to study the deal in detail. They were asked to review all the project documents, the economic viability of the project, terms of credit agreements, the proposed gas price, the mode of payment of gas price, among other matters. The Cabinet subcommittee was also asked to recommend a possible decision on the project.

The Cabinet felt the heat before it sat on September 30 for a second meeting in less than a month, when the Kafco lobby came to know about some of the major recommendations of the sub-committee. Reports had it, Chiyoda and Marubeni propelled the government of Japan to warn the Bangladesh government of the "serious damages that would be caused to the institutions and enterprises concerned and also for the government of Bangladesh".

Fact or fiction?

A so-called Fact Sheet circulated by the Kafco management – at helm of which was a Danish called Tore Feuk who came as a nominee of Dr Haldor Topsoe – sought to educate the senior policymakers. It tried to portray the merits of the project, describing it as a result of a 12-year-long struggle "to allow the poor underdeveloped country of Bangladesh to venture forth on its own plan of industrialisation and to make use of its natural gas resources to generate sorely needed foreign currency earnings".

The Fact Sheet also pointed out that the project had received blessings from various organs of the government at different stages of its tortuous birth over a period since 1979.

The Cabinet committee discovered to its astonishment that there was a lot more fiction than facts.

The four ministers did quite a job, unearthing the fact that the interests of Bangladesh had been systematically compromised at every stage of the processing of the deal.

The committee was particularly critical of the decision of the Ershad government to permit linking of the price of gas to be supplied to Kafco to the FOB price of urea. The four ministers also slammed the decision to accept the conditions of Bangladesh's bearing the export credit guarantee risk. The committee – two of its members were lawyers by training -- concluded that these decisions were arbitrary, mala fide, in contravention of the original promoters' agreement, and hence not binding on the Bangladesh government.

The government was now trapped in a zero-sum game. Agreeing to the terms and conditions would mean compromising the national interests to an unacceptable extent; and review and re-negotiation – which eventually became the case -- of the deal would invite another problem – making Japan, the single largest donor at that time, unhappy.

The government was angry that it all resulted from serious lapses and machinations of those within the ministries of energy and industries, both before and after the exit of General Ershad in December 1990.

The government decision to renegotiate was met with an unbelievable response from a surprised Kafco lobby. The immediate reaction was halting the plant construction work in Chittagong and ordering local employees not to report for duty from October 5.

Government gives in

After a months-long impasse, the government gave in to the Kafco cabal, agreeing "reluctantly" to provide the guarantee for the entire amount of export credit but revising the gas price to an extent. The Cabinet decision came on March 9 in 1992 after five months of stalemate marked by the stoppage of construction.

The major revisions included: 1) an increase in gas rate from $0.75 to $1 for a thousand cft.; 2) refixation of gas price after 10 years instead of 20 years as stipulated in the 1990 agreement; 3) replacement of a three-and-a-half-year deferred payment scheme by a one-year one; 4) regular audit of the escrow account by Bangladesh authorities; and 5) offer from the foreign promoters to open a foreign currency account in Bangladesh to keep all proceeds from Kafco that would not be required to be kept in the escrow account for loan repayment.

The external pressure

Interestingly, the re-negotiation coincided with the final days of preparation for the annual Aid Club meeting that year as well as discussions on financing the Jamuna Bridge project. A minister also admitted at that time that there was "no way out at this stage".

Already, a meeting on the Bridge scheduled for March 16 1992 in Washington on March had been postponed. Japan was to be one of the co-financiers of the project, which eventually materialised with Tokyo as one of the lenders. Japan had also threatened that it would stay away from a forthcoming IMF meeting that was important for Bangladesh.

But the Bangladesh ambassador in Tokyo felt the most of it. In letters to the foreign secretary in early 1992, Ambassador Mohammad Abu Hena (now the Chief Election Commissioner) painted the picture. While he vividly described the treatment meted out to him and his colleagues at the Bangladesh mission by some politicians, he also pointed out that a planned visit by the Bangladesh prime minister would solely depend on a solution to the Kafco impasse. A prime ministerial visit did take place later.

The new crisis

Today, the flagship project – hailed as the first major joint public-private foreign investment, is facing another crisis, which a long-time Kafco watcher compares with that of those days in the early 1990's when ministers sweated in many Cabinet meetings to find a way out of the uneven deal.

There are also indications that the pressures have been similar. This time, the plea is to accept a commercial settlement that would relieve the defaulting general contractor of all its obligations to the company that has lost an estimated US$ 120 million due to production losses caused by faulty and substandard equipment.

According to Kafco insiders, the deal as proposed by the general contractor would give the company only US$ 16 million in cash apart from some other minor benefits, which are well below the value of even the performance bond. But Managing Director John Wilson, an ardent advocate of the settlement, claims the deal would bring in something to the tune of US$ 50 million for Kafco.

A key complaint against the contractor is that a performance test has not cleared the plant, which should have been handed over to and accepted by the company more than four years ago. A Kafco internal document has it that "numerous technical problems" and low-quality equipment forced a series of shutdowns, causing financial losses at least to the tune of US$ 100 million till mid-1997.

Debt debacle

Last week, the company failed to meet its repayment obligation, an issue the foreign partners are clearly using to arm-twist the government to clear the commercial deal. Kafco failed to pay on February 1 and will face a large cash deficit only six months later at the beginning of August 1999, the next debt service repayment date.

This became more evident from the present management's response to the letter of Dr Manucher Towhidi, a former managing director, to the Kafco chairman. Pleading for the deal, managing director Wilson told the members of the Board: "This is critical if Kafco is to restructure its finances with the support of its lenders in an orderly fashion."

With more than US$400 million in liabilities with various lenders at the start, Kafco is still burdened with "just over US$ 300 million" loans, roughly two-thirds of which are in the Japanese currency. Now, more than US$ 190 million – including some 15-16 million in suppliers' credit, still forms the part of the loans secured with the government guarantee. Naturally, the threat involving the repayment of the debts serves as a good weapon.

The present managing director also found his predecessor's points "misinformed, misleading and incorrect" although the contents and spirit of Towhidi's arguments went much in line with the company's own previous assessments until recently and the 1991 Cabinet exercise.

Towhidi, who served five and a half years at the helm before departing last April, is unwilling to relent. A week later, he followed up his January 4 letter with another to the Kafco chairman, also the industries secretary. Going a step further, he wrote to the finance minister on Januray 17 pointing out the details of impact of the acceptance of the plant as part of the commercial settlement.

The former chief executive's second letter to the chairman however raises eyebrows. "Based on the content, and since my letter was addressed primarily to you and not the Kafco Managing Director, I can only conclude that the circular was authorised by and prepared in consultation with yourself and as such constitutes your comments and response to my letter to you," he said referring to Wilson's note accompanying the January 4 letter to the members of the Board.

"I am deeply disappointed to note that the comments in the circular are empty of substance while full of rhetoric. No attempt has been made to deal with any of the substantive issues raised in my letter, which affect Kafco's survival and the dignity and resources of the government and people of Bangladesh.

"I am indeed saddened to note that the Managing Director's attempts to 'achieve an equitable settlement with the General Contractor' has resulted in nothing more than submission to the will of the foreign commercial shareholders Marubeni, Chiyoda and Haldor Topsoe, and their ally Transammonia.

"The circular's references to 'costly litigation' and 'disrupting the harmony among the shareholders' are equally devoid of merit and substance. The Kafco Board is not a private gentleman's club, but is a forum for dealing with the harsh realities of the bankruptcy and chaos that Kafco's foreign shareholders have inflicted upon the company.

"It is not the duty of the three government directors to work harmoniously with the foreign directors. It is instead their duty to hold the foreign contractors and suppliers accountable for the way they have plundered the national assets and have misused the trust and confidence of the government and the people of Bangladesh," Towhidi said in his second letter to Industries Secretary Ejazul Huq.

The tone and tenor of his second letter to the Kafco chairman explain why he turned to Finance Minister SAMS Kibria requesting him to share it with the prime minister and other Cabinet colleagues, especially Industries Minister Tofail Ahmed.

It is yet to be known how the ministers have responded to the bid to protect Bangladesh's interests, but it is quite sure that the government, at least for the moment, has been able to block the deal, which resulted in a no-decision from the Board of Directors in its January 25 meeting.

The dilemma returns

As the pressure is mounting from the same quarters as it did in the early 1990s, the government can only count on the previous experience, in Bangladesh and in other countries. And Towhidi, a long-time insider, also spares the top government functionaries the difficult homework before a decision.

In his first letter, Towhidi explained the "consequences of the settlement and likely future shutdowns", the "impact of the settlement on other agreements" and "benefits" of the settlement".

Acceptance of the plant as it is, he warned, would mean Kafco's giving up "all its rights to compensation from the general contractor in the event of future failures of equipment caused by defects in design or construction."

Towhidi advised that the government rely on the Memorandum of Agreement (MOA) between general contractor and Kafco to settle the dispute.

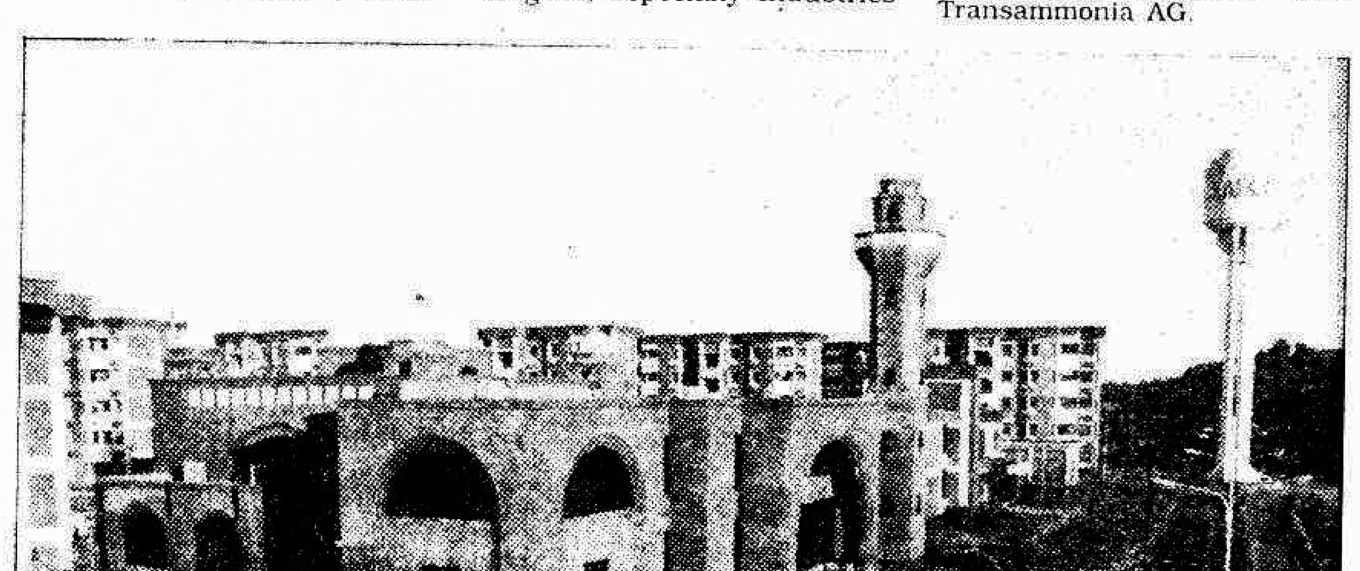
The MOA, he said, required the general contractor "to rectify some of the shortcomings of plant, arising from poor engineering design, supply of cheap, unreliable and substandard equipment, and from the failure to supply a plant according to provisions of the construction contract ... and to partially compensate Kafco for losses solely attributable to the general contractor now standing in the region of US$ 120 million."

Towhidi charged the general contractor with "reneging on the MOA, even to the extent of seeking to escape a fresh written undertaking to replace certain critical items of equipment". His letters also cautioned against the possible implications on the government guarantees if the proposed settlement went through. There were also warnings of adverse impact of the settlement on other agreements, especially ammonia and urea off-take deals with Marubeni and Transammonia AG.

Inevitably, drawing the line would be difficult for the government.

"Experience has shown whenever the government has succumbed to pressure, it has not paid off eventually," says a government official who has followed Kafco developments. "This is purely a corporate matter interfered into irrationally by foreign governments."

Can the government withstand the pressure this time?



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Down the drain

In a letter to the finance minister, former Kafco managing director Dr Manucher Towhidi presents a summary of "the enormous investment" made by Bangladesh in Kafco.

Major fiscal concessions to Kafco, unheard of previously, include:

- An income tax holiday for the first 9 (nine) years of commercial production (up to June 15, 2004), and thereafter a minimum rebate of 50% on income tax assessments, and freedom from any export sale taxes.
- A ceiling of 6.5% for import duties on capital goods, and a deferral of their payment over the first 6 years of commercial production (up to June 15, 2001).
- Reimbursement of VAT and other duties charged on gas, catalysts and chemicals etc., used in the production of ammonia and urea.
- A 10% withholding tax ceiling on dividends to foreign shareholders.
- Exemption from tax on payments to foreign lenders.
- Freedom to keep a year's anticipated requirements of foreign exchange in banks abroad (one and a half years' anticipated requirements after repayment of the "commercial loan" to Kafco syndicated by Citicorp International).

The government has given preferential access to gas to Kafco, other than during May-June 1998 (when Kafco and its Board ignored their own legal advice and provoked a cutback in gas supplies by engaging in a confrontation with the Ministry of Energy over that Ministry's legally justified request for a programme of repayment of deferred gas bills).

Production in public sector fertiliser plants has been cut back or stopped altogether for very extended periods, in order to allow gas supply to Kafco. The resulting domestic shortages of fertiliser have been met by purchases from Kafco in foreign exchange of vast tonnages of urea at international prices. The preferential treatment given to Kafco has cost the country's industries and economy dearly.

The government has also doled out deep discounts, when compared to other private sector industries, in the gas price to Kafco, which since commercial production has uniquely been linked by a formula to urea prices. An imputed VAT element is reclaimable under Kafco 's tax concessions, so that Kafco has been paying a net floor price of only 64 cents per MSCF for well over a year. These gas price discounts from May 1994 to December 1998 must total $70-80 million and must result in one of the lowest gas prices anywhere in the world.

For the second time, the government has allowed Kafco to defer about $13 million in gas bills, which with interest amount to about $20 million. The government has also subscribed to about $3.7 million in deeply subordinated Floating Rate Notes as part of the 1996 financial restructuring.

The government has made an equity investment of about $54.2 million in Kafco. By contrast, government agencies from Britain, Denmark and Japan have invested relatively small amounts, while the commercial foreign shareholders have essentially financed their share purchases out of highly lucrative and one-sided contracts with Kafco.

And, under enormous pressure from the Japanese authorities, in 1992 the government provided guarantees for 3 (three) "export credit" loans to Kafco of about $250 million. About $190 million is still outstanding under those loans. It is noteworthy that one of these "export credits" is actually a supplier's credit from the General Contractor -- Marubeni and Chiyoda -- with about $15 million outstanding.

In all, Bangladesh has poured well over $400 million, and quite possibly over $500 million, directly or indirectly into the Kafco project.