



KARNATAKA WATER AND SANITATION POOLED FUND

ICRA has assigned a conditional LAA(SO) (pronounced L double A structured obligation) rating to the Rs 1 billion long term bond programme of Karnataka Water and Sanitation Pooled Fund (KWSPF), indicating high credit quality. The rated instrument carries low credit risk. The rating factors in the various credit enhancements provided in the form of a commitment from Government of Karnataka (GoK) to make good any shortfall in the debt service amount by deducting from the State Finance Commission (SFC) devolution at source, partial guarantee from the USAID, a department of the Government of the United States (to the extent of 50% of principal outstanding) and a Bond Service Fund (BSF) of Rs 255 million provided upfront by the GoK. The rated instrument will have tenure of 15 years, with a moratorium of three years, and will not carry any Put/Call option. The instrument will have annual interest payment and repayment will start from the fourth year with the principal redeemed through twelve equal annual payments. The rating for the above instrument has been assigned based on the expected loss from the indicated returns on the instrument. The level of expected loss on the instrument is similar to the expected loss on other similarly ICRA rated long-term instruments.

KWSPF has been constituted by the GoK as a fully owned trust under the Indian Trusts Act, 1882. KWSPF would be raising funds from the market for a group of seven City Municipal Corporations (CMCs) in Bangalore Metropolitan Area (BMA) for the Greater Bangalore Water Supply and Sanitation Project (GBWASP). Although the project would cover eight ULBs, Town Municipal Council (TMC) of Kengeri would not be accessing market borrowings. The funds raised by

KWSPF through the rated bond programme would be used to develop water supply infrastructure in the ULBs. The project would be implemented by Bangalore Water Supply and Sewerage Board (BWSSB) during the period FY2006 to FY2008. BWSSB would develop source, lay trunk infrastructure, operate the entire network, provide water directly to consumers, set tariffs and collect revenues. The servicing of the debt obligation would however be done by the KWSPF from the cash flows provided by the ULBs, through a pool finance mechanism (40% of the revenue surplus of each ULB would be pooled) supported by credit enhancements.

The structured payment mechanism will be monitored by an independent trustee to ensure timely debt servicing. The structure envisages a separate issue and escrow account and a structure compliance certificate to be obtained by the KWSPF within 60 days from the date of raising funds. The ULBs are required to transfer 1/10th of the annual obligation every month into the escrow account, to ensure availability of adequate funds to cover the entire obligation 60 days before the due date. Cheques would be despatched to the bondholders 3 working days before the due date. In the event of a shortfall in the escrow account 60 days before the due date, trustee would inform the GoK to make good the shortfall by 5 days before the due date. In case shortfall persists 5 days before the due date, the BSF would get utilised to the extent of the shortfall and the same would be replenished within 60 days from the due date, by USAID (to the extent of 50% of the principal) and by the GoK (by deducting the shortfall amount at source from the SFC devolution). The pool finance mechanism attempts to diversify credit risk by pooling

resources of seven ULBs. In ICRA's view, although the dependence of the ULBs on the common policies and financial position of the GoK constrains the credit risk diversification, the risk associated with the rated bonds is mitigated by the various credit enhancements in the structured payment mechanism.

All the seven participating ULBs are governed by the Karnataka Municipalities Act 1964 (KMA), and are of recent origin, having been created in FY 1996. As a result, the ULBs are at the initial stages of the growth curve, as the city of Bangalore expands into the suburbs. Existing infrastructure in these ULBs is limited and the capital expenditure needed for provision of basic services, especially keeping in mind the population growth, is high. In the past, most of the capital expenditure undertaken by the ULBs have been out of their own resources or through grants, with little reliance on market debt. The main source of revenue for these ULBs is property taxes, with minor contribution from license fees and cess etc. In the past, development charges and stamp duty transfers used to constitute sizeable portion of its revenues, although as per a State Government Order both these revenue streams would no longer accrue to the ULBs from FY2004 onwards. Apart from their own revenue collections, the ULBs also source funds from the GoK in the form of SFC devolution and grants. The last audited accounts of these ULBs is available for FY2003. Accounts for FY2004 and FY2005 are under preparation. The revenue accounts of these ULBs were in surplus in FY2003 mainly on account of the development charges collected by the ULBs in the past. ICRA expects that these revenue surpluses would get constrained with the withdrawal of specific revenue streams mentioned above, although



the impact would be mitigated to some extent on account of the expected increase in property taxes post implementation of Self Assessment Scheme (SAS) from FY04.

Karnataka's finances continue to reflect a trend of improvement with growing revenue receipts and reducing deficit levels. The revised estimates for FY05 indicate a growth of 22% of revenue receipts supported largely by a buoyant growth of own revenues (both tax and non-tax) and healthy central transfers. While the revenue expenditures also recorded

quite a large growth at around 17%, the revenue account overall saw a surplus (nearly after a decade of revenue deficits). Consequently, despite higher capital expenditure, the overall financing gap is estimated to have improved to around Rs. 42 billion (around 3.0% of GSDP) in FY05. In recent years, the state's focus has been on fiscal discipline. Steps initiated include passage of the Fiscal Responsibility Act, drawing up of medium term fiscal reform programmes, adherence to ceilings on guarantees, apart from revenue and expenditure reform measures. Notwithstanding the recent increases

in food subsidy, waivers of farmer loans and the slowdown in power sector reform, all these efforts have had a beneficial impact on the state's finances. Overall, Karnataka's current level of indebtedness (D+G/RR of less than 2.5 times for FY05) compares quite favourably with its peer states, which along with the improving trend in finances provides comfort to ICRA's rating of LA+ for the state finances.

June 2005

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