



# Local Shares Summary Report

**AN IN-DEPTH EXAMINATION OF THE OPPORTUNITIES AND RISKS FOR LOCAL COMMUNITIES SEEKING TO INVEST IN NEPAL'S HYDROPOWER PROJECTS**

IN PARTNERSHIP WITH



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# Local Shares Summary Report

## EQUITY PARTICIPATION

Local shares in Nepal is an evolving concept of equity participation where project affected communities have a constitutional right<sup>1</sup> to invest in a hydropower project company. Currently, an important source of capital for hydropower projects, this practice has helped build project ownership and support among communities and thereby mitigate project disruption risks.

Nepal has been leading the way in implementing this new form of local equity partnership in hydropower development. This study examines the Nepali local shares phenomenon, its potential for benefits against existing risks and opportunities, and identifies areas where there is significant room for improvement.

## EARLY EMERGENCE

The inception of the local shares practice, in its current form commenced with the development of the 22.1MW Chilime hydropower project company, a subsidiary of the Nepal Electricity Authority, when it acquiesced to local demands for equity shareholding.

The timing of this development in 2010, is of particular significance, as the company had completed almost seven years of operation and was already profitable, when the issuance of local shares was announced.

The primary driver behind the eventual vocal local demand was a keen desire of project affected communities to join the exuberance of existing shareholders, which included NEA employees and members of the public, who had been enjoying

unanticipated capital gain windfalls. Chilime's management in response, welcomed this new group of potential equity investors and worked proactively with the securities regulator, issue manager, and local communities including social volunteers and teachers to mobilize local capital, without additional costs, dispel doubts where such beliefs persisted, and promote a transparent, inclusive approach, where possible.

## LEGAL FRAMEWORK

The requirement for "...up to 10 percent..." of local shares can be traced back to the period between 2008 and 2010 when the first legal basis for local shares was established through the Securities Registration and Issuance Regulation (2008)<sup>2</sup> that provided an up to 5 percent option for public companies engaged in hydropower to set aside local shares. This was subsequently amended to "... up to 10 percent..." following immense political pressure fueled by a petition to the Supreme Court<sup>3</sup> by local communities affected by the Chilime hydropower project, along with the setting of another precedent by the 456MW Upper Tamakoshi Project that had recently negotiated a 10 percent equity stake with local communities.

A clear methodology is prescribed for hydropower companies wishing to go public, which requires an allotment of up to 10 percent of equity for local communities during the first phase of the Initial Public Offering (IPO) followed by a minimum of 10 percent equity during the second phase of the IPO for the general public.<sup>4</sup> The study also examined alternate delivery mechanisms and concluded that the current system was the simplest and most viable. However, for companies that wish to remain private, the study has identified a few alternate options.<sup>5</sup>

<sup>1</sup> The Constitution of Nepal, 2015: Article 59(5) provides that while using the natural resources by the federal, provincial or local government, the local community shall be given priority to make investment in such percentage as specified by the law on the basis of nature and size of investment.

<sup>2</sup> Rule 7(5) of this regulation reads: the body corporate, while making public issue of securities pursuant to these regulations, may reserve ... up to 5 percent for the local residents depending on the nature of business like hydropower ... out of the shares set aside for public issue. Additionally, SEBON added that the shares reserved as such shall not be eligible to be sold or transferred within a minimum period of three years from the date of allotment.

<sup>3</sup> Local communities affected by Chilime hydropower project continued to stage protests at the project site even while the case was being adjudicated at court, demanding their right to 8 percent equity, as per their agreement with the project.

<sup>4</sup> The local shares category has a lock in period of 3 years while the general public shares can be traded immediately.

<sup>5</sup> Refer to main report for more details.

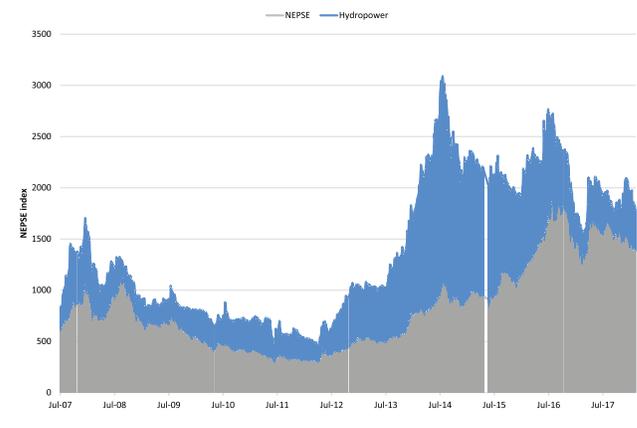
## CURRENT EXUBERANCE

Since 2010, there has been an outburst of interest from communities across Nepal to invest in local shares, as evidenced by the oversubscription of shares during the IPO of almost every hydropower company in Nepal. Nepal's politicians, policymakers, government<sup>6</sup> and the private sector have also been leveraging this overwhelming public enthusiasm to feed the political narrative that harnessing Nepal's hydro through its own resources<sup>7</sup> is the path to imminent prosperity. This unique mechanism of financing is further reinforced by hydro developers who have seen a partnership with the people pay off with dividends in the form of garnering project support, managing local expectations, and in raising project equity.

To date, 17 publicly-listed hydropower companies<sup>8</sup> have issued local shares equivalent to 10 percent of its equity. The oversubscription has been by around 30 percent on average. In the secondary market, the hydropower sub-index mirrors the volatility of the NEPSE index. In the last three years, 13 hydropower companies have gone public and raised around NRs. 1.9 billion (\$19 million) through their IPO from the general public and another NRs. 1 billion (\$10 million) from the local communities. On July 8, 2018, 456MW Upper Tamakoshi hydropower company announced a local share offering for NRs. 1 billion (\$9 million). With an increasing number of hydropower companies seeking SEBON's approval for IPOs, all of these indicators are likely to considerably increase in the coming years.

However, one major problem that exists in this apparent 'win-win partnership' is the general lack of understanding among the majority of stakeholders on how local shares actually work. Much of the rhetoric around this phenomenon has been dominated by its optimistic potential to deliver almost guaranteed profits at the individual level with little appreciation of the potential risks and challenges associated with such a market instrument.

## TREND OF HYDROPOWER INDEX<sup>9</sup>



Interviews with women and men revealed that income from shares had helped them cover hospital expenses, purchase additional land and even finance their children's education. Of particular significance cited was the benefit from bonus shares issued over the years. For example, a family of four who had purchased 160 units at IPO now had 384 units in ten years.<sup>10</sup> This was seen as equivalent to saving money, which otherwise would have been spent had they not purchased shares. For women in particular, owning an asset for the first time in their life built self-confidence, and the additional income helped provide a sense of financial security. Additionally, visits to the bank or an urban area for work related to share application or trading was eagerly anticipated by some women as an outing opportunity.

## LIMITATIONS

Attempts to gauge and learn from local communities' experiences were restricted by limited case studies as there were very few companies whose stocks were trading in the secondary market (instances where the local shares had crossed the 3-year lock in period to qualify for trading), hence, making it impossible to ascertain and learn from how the stock of companies will perform in the secondary market. What is also clear is that despite

<sup>6</sup> For example, the Vidhyut Utpadan Company, established under the Company Act with joint ownership of the MoEWRI (20 percent), NEA (10 percent), Ministry of Finance (5 percent), Ministry of Law and Justice (5 percent), Employees Provident Fund (10 percent) and Nepal Telecom (10 percent), Citizen Investment Trust (5 percent), HIDCL (4 percent) and Rastriya Beema Sansthan (2 percent) is expected to issue 17 percent of its shares to the general public, 10 percent to locals affected by its hydropower projects and 2 percent to the extremely poor.

<sup>7</sup> Such a view was expressed by MoEWRI through its official campaign slogan—*Nepal ko pani, janatako lagani* (translation: people's investment in Nepal's water resource), an effort spearheaded by the former Minister of Energy, Janardhan Sharma. Current Minister Barsha Man Pun has recently given fresh impetus to this campaign by renaming it—*Nepal ko pani, janatako lagani, barek Nepali vidhyut ko share dhani* (translation: Let the people invest in Nepal's water and let every Nepali be an electricity shareholder)

<sup>8</sup> The number is based on the publicly listed hydropower companies by the end of Fiscal Year 2016/17.

<sup>9</sup> Indicator of price movements of listed companies in the Nepal share market

<sup>10</sup> In the case of individuals who had purchased local shares of Chilime in 2010.



**Clockwise from left:** Women’s group in Rasuwa; mixed group of participants at Salme Bazar, Solukhumbu; women’s group at Lamabagar, Dolakha and; mixed group of participants at Dordi Village Municipality, Lamjung

the drop by one-third of peak prices in 2014 to today, enthusiasm for shares remain unabated.

However, there are other existing challenges associated with the hydropower local shares’ life cycle (e.g., what happens to the share value at the end of the concession period); and the challenges associated with the differing nature of project companies (e.g., what happens to companies that do not want to be listed on the stock exchange and want to remain private), for example. The resolution of these will be crucial to ensuring more clarity on the viability of local shares and its potential impacts on the hydro sector, economic impacts on individual investments, socio-economic impacts on individuals as well as the economy.

## RISKS, CHALLENGES AND OPPORTUNITIES

The current local shares model has been assessed from eight primary attributes to understand and appreciate

the potential implications on shareholders vis a vis amount of allocation, process of allocation, timing, price, eligibility, delivery model, financing and holding and divestment. The basis for the disaggregation through specific attributes are provided in the table below.

### ALLOCATION AMOUNT

There have been varying practices in relation to the amount of local shares issued or committed by hydropower companies to date. For example, 17 publicly-listed hydropower companies have issued local shares equivalent to 10 percent of its equity, while three private companies with foreign direct investments have committed to issue local shares in their project development agreements,<sup>11</sup> and some private projects and those built under direct ownership of NEA have not issued any.

The current law for allocating *up to 10 percent* is applicable only to hydropower companies that want to raise equity from the public. For other types of investments, especially mega projects with or without FDI

<sup>11</sup> Project Development Agreements of 900MW Upper Karnali, 900MW Arun 3 and 216MW Upper Trishuli 1 include commitments to grant economic interests to local people.

## LOCAL SHARES: KEY EVALUATION PARAMETERS

Themes	Description	Major Policy Question
Amount of allocation	Total shares set aside for local communities	What is the appropriate amount of shares that should be allocated to communities?
Process of allocation	Process of distributing shares to individuals	Does the distribution process consider the special aspects of issuing in rural locations and ensure fair access?
Timing	Time of issuance of local shares	Should shares be issued before or after commercial operation?
Price	Price at which shares are made available to local people	Should local shares be offered at par value or at a premium?
Eligibility	People eligible for local shares, including categorization of eligibility	Should the degree of affectedness be a criterion for share issuance?
Delivery model	Institutional mechanism for offering shares to local people	Apart from the direct shareholding model for public limited companies, what are alternative options for private limited companies?
Financing	Financing the purchase of local shares	What instruments and options can be made available for financing local share purchases?
Holding and divestment	Retention and liquidation of local shares	How do people retain or divest their local shares?

that choose to remain private, the government is relying on project-specific project development agreements (PDAs) and other contractual documents to make this provision mandatory. For example, the jurisdiction for projects that are 500 MW and above rests with the Investment Board of Nepal, which has successfully treated the local shares issuance as a PDA negotiating issue to be decided on a case by case basis. Given the huge demand for local shares, there have even been instances where some companies are including these aspirants in the promoter shares category.

### ALLOCATION PROCESS

The process of allocation of all shares by companies going public, whether in hydropower or any other sector, is guided by the Securities Issuance and Allotment Guideline 2017. SEBON has several other requirements on how companies should, through their issue manager, communicate with the public about their share offerings. For example, SEBON requires issue managers to make available the prospectus and other issuance-related documents to potential applicants should the latter

wish to inspect them. SEBON has recently introduced additional disclosure requirements as part of its efforts to enable informed investments amongst potential shareholders.

However, the allotment process for private projects, such as Upper Trishuli-1, Upper Karnali, or Arun-3 HPPs, has yet to be decided. While it is the Company's responsibility to distribute local shares in the case of Upper Trishuli-1 and Arun-3, it is the Government's responsibility for Upper Karnali, as here, the portion for local shares distribution will come out of NEA's 27% equity.

A number of problems are associated with technology which are currently being solved. Paper share certificates have now been replaced with electronic forms. Share applications are now managed online eliminating the need for time-consuming journeys and lengthy queues and instead enabling immediate refunds for un-allotted shares. Additionally, the new current bottom-up allotment model, guided by the principle of equitable distribution, ensures a minimum number of 10 shares to all aspiring retail

investors, so applicants no longer need to apply for more shares than they want to.<sup>12</sup> This is an important issue in allotment that needs to be communicated to the general public. Furthermore, NEPSE is working to operationalize online trading. These developments are expected to greatly improve operational efficiency, promote transparency and cut the risk for manipulation and delay. Given these rapid changes and considering the transition may take some time, SEBON, issue managers, banks and hydropower companies must intensify communications and public education efforts.

### TIMING

The 2016 Securities Regulation stipulates the following conditions before a company can issue shares to the public:

- Completed one year of operation, including holding an annual general meeting (AGM);<sup>13</sup>
- Obtained the required licenses and permits to develop the HPP;
- Obtained land and other infrastructure are ready for construction;
- Promoters have fully paid up their share of equity;
- Completed financial closure;
- Signed the power purchase agreement (PPA) with NEA.

The requirement of these conditions compel companies wanting to issue shares to the public to have mitigated its commercial risks. On local shares, although prevailing laws do not specifically say when they can be issued, there is an implied statement<sup>14</sup> that it must be done before the general shares issuance. SEBON further restricts persons that have acquired local shares of a company to buy shares of the same company during an IPO.

Of 17 listed hydropower companies that have offered local shares, six have done so prior to COD, while others as late as five years after COD. Companies issuing after COD were doing so to raise capital to either reduce the debt in their capital structure or inject equity into subsequent projects. For projects that have negotiated PDAs with the government and have local shares requirements, the agreement on timing for issuing local shares is conducted during project negotiations.<sup>15</sup>

While most local communities appear to assume a flexible approach on the timing of local shares issuance – from anywhere between mid construction to COD; developers looking to raise equity from the public prefer the offering during the time of construction, when the capital raised can be used to finance the project. Additionally, earlier buy-in of communities also appeared to ensure lesser demands on the project. Offering local shares after COD, as quite a few hydropower companies have done, guarantees even lesser risks to local communities; the raised fund has been used by companies to pay off loans or invest in other projects.

However, banks and financial institutions expressed their preference for local shares to be issued earlier on in the project cycle, given that increased equity during construction phase would lower their exposure in the company and help attain some protection against construction risks.

### PRICE: PAR VALUE AND PREMIUM

The initial offering of shares by all companies seeking to raise capital from the public must do so at par<sup>16</sup> value. However, companies can issue shares at a premium provided a due diligence audit has been carried out.<sup>17</sup>

<sup>12</sup> Under the current law, the allotment at IPO is done in the following manner: the process begins with all eligible applicants apportioned 10 units of shares each, thus ensuring a guaranteed minimum number of shares for everyone. Moving on to the second round, where only those who applied for more than 10 units of shares remain, each applicant, once again, are apportioned another 10 units of shares. This process of allotment is continued up until the applications outnumber the number of shares and allocation cannot be made in blocks of 10. Thereafter, the selection of recipients for allotment is done through a lottery, and the allotment process described above is followed until all shares are fully allotted.

<sup>13</sup> It should be noted that the requirement for the completion of one year of operation is for the hydropower company and should not be confused with the HPP's COD.

<sup>14</sup> This is because of the provision in the 2017 Directives, which requires companies to issue all undersubscribed local shares during the offering to the general public.

<sup>15</sup> The PDA of Upper Trishuli-1 has a provision requiring that local shares be issued within three years after financial closure. The PDA of Upper Karnali HPP requires local shares to be issued any time after COD. The PDA of Arun-3 HPP has more specific provisions: that 50% of the local shares be issued within one year of COD and the remaining be issued between years two and three after COD.

<sup>16</sup> While the Companies Act sets the par value of the share of public companies at NRs. 50 (\$0.5) or higher (but multiples of 10), the 2016 Securities Registration and Issue Regulation sets it at NRs. 100 (\$1).

<sup>17</sup> The calculation of the premium price of a company needs to be an average of the three prescribed valuation methods (capitalized earnings of the last three years, discounted cash flow method, and any internationally accepted method) or four times the net worth per share, whichever is lower: Clause 25 of Securities Registration and Issue Regulation, 2016. For private limited companies and unlisted companies, the Companies Act states that premium shares can be issued provided the company does not have negative net worth and the issuance has been authorized by the AGM.

All 17 of the listed hydropower companies have issued local shares at a par value of NRs. 100 (US\$1). The exception is Chilime, where it offered at par as well as premium. For private PDA-based projects that are required to offer local shares, the pricing<sup>18</sup> is not defined in their PDAs.

There is overwhelming evidence that local communities view local shares as an investment for which they are willing to pay. Low-cost or free options were occasionally raised as special considerations to be provided to the severely affected, the economically vulnerable, and the socially marginalized.

SEBON has been discussing the possibility of introducing other methods of price discovery in the Nepali capital market. In the new pricing regime, the price of a share at IPO would no longer be fixed by the regulator but discovered, e.g., the book building method, through a process of estimated orders from a select group of invited large institutional buyers. If this is to be implemented, then the current practice of offering shares at IPO at a par value of NRs. 100 may no longer be relevant.

### ELIGIBILITY

The Constitution of Nepal provides local communities “the priority to make investment” in any commercial use of their natural resources, but leaves some room for debate as to what constitutes a local community.<sup>19</sup> SEBON through its amended Securities Registration and Issuance Regulation in 2016<sup>20</sup> defines eligibility based on the project-affected area as per the environmental impact assessment (EIA) report.

In reality, the practice has varied from project to project, where boundaries are often negotiated to mitigate local disputes and obtain political acceptance. Some projects such as Khani Khola in Lalitpur have only issued shares to four affected village development committees while others have been extending the eligibility criteria to all residents of the district. The process thus far in defining the eligibility has focused more on reaching a political

## THE RISE OF THE PROMOTER-LOCAL SHARES

The Securities Regulation (2016) defines promoter shares as shares that are issued other than by way of IPO and requires at least 51 percent of the shareholders to be in this category. As promoters, SEBON has in place certain restrictions to ensure the success of the company, including early buy-in into the investment. Given the lack of a screening process, there is a growing trend of communities investing in promoter shares of hydropower companies, and this has become a mechanism for some companies to meet the local aspiration to invest. What makes this problematic is the lack of awareness among many investing locals of the difference between promoter and local shares, the latter being issued as part of public issuance with SEBON’s approval and subject to additional disclosure requirements intended to protect investors. While this in itself is not a major problem, what makes this problematic is the lack of awareness among many investing locals of the difference between promoter and local shares, the latter being issued as part of public issuance with SEBON’s approval and subject to additional disclosure requirements intended to protect investors.

This is problematic in places where companies have issued promoter shares, because such shares will bear more risks as it takes longer time to get profits from investment and more restrictions in the form of lock-in period for selling compared to general shares.

As of date, the Office of Company Registrar has asked the companies issuing such shares to stop the practice until further notice in order to carry our further investigations.

<sup>18</sup> For Upper Karnali PDA, it is specified that it is GON’s responsibility to grant local people economic interests in NEA’s portion of equity, without specifying the quantum. The PDA of Arun-3 HPP provides that 50 percent of the local shares shall be issued at face value within one year of COD, and the remaining shares will be issued between year 2 and 3 after COD at a market value, which will not exceed 2.5 times the initial face value. Both the PDAs for Upper Karnali HPP and Arun 3 HPP do not specify the price of its fair value shares.

<sup>19</sup> Article 59 (5) of The Constitution of Nepal, 2015.

<sup>20</sup> Clause 9 (4) of Securities Registration and Issue Regulation, 2016

settlement and less on finding a technical standardized solution that enables equity. At present, this seems to have settled largely at the district level and with a hierarchy that differentiates between the project affected and the rest of the district.

As proof of eligibility, people use citizenship certificate as their primary official document. Other documents include marriage certificate (for those married into the eligible area), birth certificates (for under-age children), and migration certificate. A few companies have also used land titles, but this has promoted an alleged trend of people purchasing land only to be eligible for local shares. There is a practice of a cut-off date for any type of migration document: while SEBON specified the cut-off date as the day prior to the issuance of shares,<sup>21</sup> this has varied from project to project.<sup>22</sup>

#### ALTERNATIVE LOCAL SHARES DELIVERY MODEL

All public hydropower companies in Nepal to date have been issuing shares directly to individuals. The need to consider alternative delivery models has emerged mainly with regard to the requirement of private hydro companies<sup>23</sup> that are contractually obliged to issue local shares but wish to do so without converting the company to a public limited. In other words, fulfil the requirement of granting local communities a stake in the project through share ownership but continue to hold the status of a private company, thereby avoiding any onerous tax implications and the pressure of dealing with thousands of shareholders.

In the absence of an existing framework to guide such companies, the study has assessed potential delivery options, whose viability is dependent on legal reforms, strengthened public understanding of the capital market and of the hydropower sector, and most importantly, political support to help win public confidence.

Discussions so far have centered around the use of special purpose vehicles (SPV), where the local communities will own and participate in the SPV, the legal entity designed to hold all of the local shares of the hydropower company.

The various institutional options<sup>24</sup> available for structuring the SPV are: i) companies; ii) cooperatives, iii) private trusts; and iv) collective investment schemes (CIS). The delivery models are structured with the following parameters:

- Only those eligible for local shares can participate in the SPV;
- Funds raised by the SPV will be used for the single purpose of investing in the shares of hydropower company where the local population have been deemed eligible to invest as affected communities;
- The activity of the SPV will be limited to holding the shares of the hydropower company and distributing the dividend to the SPV participants.

In attempts at assessing whether local communities would be open to the idea of a collective or communal shares model, a concept widely practiced in other jurisdictions, there was overwhelming evidence of mass distrust existing towards any body deemed to represent and uphold the interests of the community. SPV possibilities<sup>25</sup> discussed included municipalities, cooperatives, trusts, companies, etc.

The principal rationale for such aversion was further pointed to weak local governance, the prevalent practice of elite capture, social discrimination, among others. As a result, individuals felt they were better off making their own investment decisions, by themselves. Further, this way, they would have the flexibility to divest when required and even questioned the rationale of whether

<sup>21</sup> Securities Issuance and Allotment Guideline, Revised 2017

<sup>22</sup> For example, in Upper Trishuli-1, the cut-off date is the date on which the main construction activities are commenced, whereas in Upper Tamakoshi, this is specified as the day of financial closure.

<sup>23</sup> A 2015 study commissioned by the Investment Board of Nepal that negotiated project development agreements for 900MW Arun 3 and 900MW Upper Karnali “Options and Mechanisms for Offering Project Shares to the Local Stakeholders” proposes a publicly-held SPV model as the most suitable mechanism for the delivery of local shares as it meets the expectations of both the local people and developers but both projects are yet to proceed with a suitable mechanism. The PDA for the 216MW Upper Trishuli 1 states that local shares shall be given “in an efficient manner without affecting day-to-day operation of the company.” In the case of Bhotekoshi HPP, the company has left it to the local communities to propose a delivery structure for the offering.

<sup>24</sup> Refer to main report for more details.

<sup>25</sup> Respondents were asked if they would be open to the concept of owning local shares through these alternative mechanisms. Each of the options were not discussed in detail.

the communal ownership model would help build a better sense of project ownership amongst communities as opposed to the individual direct shareholding method, wherein each person felt they had a direct stake in the project.

There are instances internationally, e.g. in Norway, where local government bodies have invested equity in hydropower companies. Any investment returns are then used for the benefit of the communities. Most recently, local municipalities in Nepal have been set aside shares as institutional investors. For example, the Trishuli-3B hydropower project, has set aside 5 percent equity for affected municipalities of Rasuwa and Nuwakot. However, how this will be done, considering Nepal's laws currently bar government bodies from participating in income generating activities, remains to be seen.

### ACCESS TO FINANCING

Nepal Rastra Bank's (NRB) Unified Directive (17/074), under the deprived sector lending requirement,<sup>26</sup> has a provision for Banks and Financial Institutions to provide collateral-free loans of up to NRs. 50,000 (US\$ 500) per household for the purchase of local shares. This so far has remained on paper and have not been implemented by banks. Primary deterrents cited by banks include the high transaction cost and time involved for each customer, and lack of adequate human resources within banks to assess hydropower investments and so provide loans sans collateral with confidence. Banks clearly perceived hydropower a high risk sector and preferred not to lend to the sector had it not been for the NRB Directive.<sup>27</sup>

Microfinance institutions, on the other hand, with a better presence than banks in rural areas, were found to be providing loans at interest rates between 18 and 20 percent, much higher than that of commercial banks.

The consultants of an IBN commissioned study on local shares,<sup>28</sup> had identified a product to be categorized under the deprived sector lending portfolio as a Debt Linked Product on Equity/Cash Flows pledge, structured on future cash flows estimation of the parent company, that could be made available through the financial institution where the first claim to the dividend from the company shall be from the Financial Institution financing the locals for purchase of shares. This is similar to the Chilime financing model, the only difference is Chilime already had cash flows and strong reserves of dividend payments to repay loans.

Chilime is the only hydropower company to have provided institutional financing for local shares. The company entered into an arrangement with two "A" class commercial banks—Mega Bank Nepal Limited and Janata Bank Nepal Limited—with the following agreements: the banks would provide loans of up to 80 percent of the total shares allocated to each individual;<sup>29</sup> the share certificate would serve as collateral; the repayment period would be three years, which coincided with the end of the lock-in period and during these three years the banks would retain the share certificate; and full repayment would be guaranteed through the channeling of dividends per share directly from the company to the individual bank account. All this was possible because the company had been offering dividends to its shareholders within a year of its IPO. Each individual loan was relatively small; the maximum being NRs. 12,043 per person (US\$120).<sup>30</sup>

In general, people were investing "small amounts"<sup>31</sup> through savings, loans from friends and relatives, or by selling off small assets.<sup>32</sup> Others had taken loans from cooperatives and microfinance institutions at around 14-18 percent interest while a few from informal money lenders, at annual interest rates of up to 60 percent.

<sup>26</sup> As per Nepal Rastra Bank's directive, authorized class 'A', 'B', and 'C' banks in Nepal have to lend 5%, 4.5% and 4% respectively of its total loan to the deprived sector. For example, a commercial bank is required to (i) provide at least 5% of its total lending as "deprived sector lending" and, (ii) out of the said percentage, at least lend 2% in the specified sector or activities as "direct lending". The specified activities include a loan up to NRs. 50,000 (\$500) per family for subscription of the local shares reserved by the hydropower projects.

<sup>27</sup> According to NRB directive all commercial banks are required to invest at least 20 percent of their total loan portfolio in the productive sector, 12% of which should be in agriculture and energy sectors. In addition, the latest monetary policy makes mandatory for all banks to invest at least 5% of its total loan in the hydropower sector by the end of fiscal year 2017/18.

<sup>28</sup> In 2015 IBN commissioned a study to look at options and mechanisms for the share offering of the Upper Karnali and Arun 3 hydropower projects.

<sup>29</sup> It was impossible to determine the interest rate at which this loan was offered. Informally, the estimate is around 13-14 percent.

<sup>30</sup> Calculation of maximum loan given by the banks for local shares (80% of maximum (NRs.100X34 + NRs.323.7 X 36) = 80% of NRs.15053.2 = NRs. 12042.56 (\$120))

<sup>31</sup> People colloquially referred to investments of NRs. 10,000-20,000 (approximately US\$ 100-200) to as being a small amount.

<sup>32</sup> Assets included livestock, jewelry, etc.

## SHARES, HYDROPOWER COMPANIES, AND THE END OF A PROJECT'S CONCESSION PERIOD

Other than hydropower projects directly owned by the NEA, all hydropower projects in Nepal are built under the Build, Own, Operate, Transfer (BOOT) model. A key requirement in this model is that hydropower companies, at the end of the project concession period, have to transfer the project to the government. The Electricity Act (1992) specifies this period as 25 years for export oriented projects and 35 years for domestic consumption. What impact this transfer has on the hydropower company share is not a well understood either by the locals or the policymakers. The uncertainty on this issue stems from the following:

### **i) What happens during project handover:**

The Electricity Act (1992) has two provisions applicable to companies based on type of ownership. For those with a majority of foreign investment, the project is to be transferred to the government, but gets preference to renegotiate a new agreement for project operations, at a price set by a committee. However, for companies with a majority of Nepali investment, the company can renegotiate with the government and conduct business under a new agreement. This indicates that while the ownership of the project technically reverts to the government, a new agreement is renegotiable with the same company, for the purpose of operation and maintenance (O&M).

### **ii) What happens to the hydropower company after handover:**

The Electricity Act (1992) requires all hydropower companies to hand over assets of the project whose licensing period has ended, such as land, building, and equipment. The company can meanwhile continue to legally exist and maintain ownership of its other assets. Shareholders will also continue to own company shares. However, what this means for the price of its company shares, depends on how the company is structured. For a hydropower company with a

single project, unless it includes other revenue streams, the company will no longer have an income source, which is likely to result in a decrease in the price and tradability of its shares. Shareholders then have the option of amending the company objectives and pursuing other revenue streams, including a new O&M contract for its project, or completely liquidate the company. Whereas, this is not the case for hydropower companies with multiple projects in the pipeline who are likely to have an uninterrupted revenue stream, for example, Chilime Hydropower Company which owns the 22.1 MW Chilime, 102 MW Middle Bhotekoshi, 42.5 MW Sanjen and 111 MW Rasuwagadi.

Given the lack of understanding at the community level, it is important to strengthen the requirements on hydropower companies to disclose all relevant information to potential shareholders through their prospectus and other documents. See section on transforming communities into informed shareholders.

At the policy level, the bureaucracy is aware of the requirement on hydropower companies to handover the project to government, but largely uncertain about the aftermath. This is partly because they feel no urgency to act given that the first project to get to this particular stage is the Khimiti HPP in 2040. It is critical that the MoEWRI bring further clarity to this issue by stipulating a time frame for companies that hold a majority of Nepali investment to notify the government of their intent to handover the project to government or negotiate a new O&M contract. Should the company state the former, the government can choose to call for new O&M bids. Should it request for the latter, the government can negotiate a new contract with the same company. The government would need to decide the most appropriate time before the end of the concession period to do this; the earlier the resolution, the more clarity it would provide to shareholders.

## HOLDING AND DIVESTMENT

The Securities Registration and Issuance Regulation establishes the restriction of tradability of all preferentially distributed shares until the completion of a designated lock-in period. Preferentially distributed shares are any special category of shares that have been earmarked for a select group of applicants. For example, the law allows companies to set aside up to 4 percent of its IPO shares for its employees. In the hydropower sector, staff and local shares are two types of preferentially distributed shares. Under current law, both these types of shares have a lock-in period of three years, the restriction for which applies from the date of allotment of shares. The intent here is to prevent early divestiture, so as to ensure a stronger ownership of the project and a better performance of the company. There is an exception, however, that allows the trading of share even during this period, which is in the event of death of the shareholder or if the shareholder's property has to be divided amongst family members.

While holding shares, as specified in the Companies Act, shareholders can enjoy three categories of benefits.<sup>33</sup> In the event a shareholder is looking to divest shares of a listed public company, the sale has to take place in the country's only stock exchange platform, NEPSE.<sup>34</sup> In general, people seemed to treat local shares as an asset that is meant to be held rather than traded. This retention could be attributed to several issues: i) the community members view shares as a valuable asset, similar to land, that is to be retained for the long-term, and ii) they have a limited understanding of the share market. With regard to dividend collection, the switch to automation means dividends will now be transacted automatically removing the need for people to physically travel to Kathmandu to collect dividend payments.

## KEY TAKEAWAYS

In short, the following can be summarized as the key findings of this study:

- Equity is one of the major tools for community benefits; also benefits developers by ensuring locals have a stake in the project.
- Equity participation is very much in demand, but there appears to be irrational exuberance. Even though the hydro market share values have dropped by one-third since their high, it has not impacted demand for shares by locals.
- Equity shares have high risks but investors are generally uninformed. There is a critical need to stress the full portfolio of community benefits, improve information flow, and education.
- SEBON is playing a major positive regulatory role.
- Information Technology is making it possible for small investors to buy and sell as long as they have communications access.
- Finance is necessary; government has set the framework but banks are yet to respond.
- The current direct shareholding delivery model is the simplest and most feasible option for local shares. For companies wishing to remain private, earning the trust of local communities in the alternative delivery mechanisms to deliver benefits and promote local ownership are the biggest challenges.

## LOCAL SHARES MODEL VERSUS TRADITIONAL PRACTICES OF EQUITY INVESTMENT

The study looked at a few national and international examples<sup>35</sup> with equity participation of local communities and found some key distinctions between Nepal's current local shares model and other practices of equity investment.

<sup>33</sup> Benefits include in the form of: i) cash dividends: A company can offer shareholders cash dividends based on its performance, the amount of which is decided by the company's board of directors and executed upon the decision of the shareholders through the AGM; ii) bonus shares: A company also has the option to offer bonus shares to its shareholders primarily as a substitute of offering cash dividends, which is generally done to meet a capital requirement; and iii) rights shares: A company additionally has the option of raising the required capital through the issuance of rights shares, which differs from bonus shares in that shareholders are required to pump in additional funds to collect the rights shares, albeit at a par value of NRs. 100.

<sup>34</sup> There is discussion about SEBON approving the request of another private stock exchange as well.

<sup>35</sup> Case studies looked at included the Khumbu and Salleri-Chialsa Micro Hydel Projects in Nepal, Wuswatim Hydro Project and Colombia Basin Trust in Canada, and Glomma and Lagen Basin in Norway.

## DIFFERENCES IN THE PRACTICE OF LOCAL AND TRADITIONAL EQUITY INVESTMENT

	In local shares	In other practices of equity investment in HPP
<b>Financing of the equity</b>	Individuals from project-affected population finance and invest directly their portion of the equity.	Equity is usually generated through a contribution from third-party sources.
<b>Holding of the equity</b>	Equity is directly owned by individuals.	Equity is held indirectly by locals through a communal platform in the form of trusts, community groups, or local municipalities, among others
<b>Benefits of the equity</b>	Benefits from investments are accrued and enjoyed at the individual level. These include dividend payments, issue of rights and bonus shares, and capital gain.	Benefits are distributed at the community level, with some exception, where the communal benefits are then further distributed to its associated individuals, but mainly in the form of dividend payments.
<b>Risks of the equity</b>	As individual shareholders, individuals are directly exposed to equity risks.	As community shareholders, individuals are not directly exposed to risks.

Given these differences, the benefit in the offering of local shares is in the preference given to local communities to invest in what is assumed to be a profitable business undertaking, but for which there are no guarantees of returns.

## OPTIONS AND RECOMMENDATIONS

The study's findings clearly indicate that the current policy for local shares meets the constitutional objective of enabling local communities an opportunity to invest and thus accords them priority in doing so, but it is risky.

Additionally, given that the majority of these investors are either ill-informed or ill-equipped or both, further measures are necessary to mitigate risks and protect shareholders. The options and recommendations have been structured with the aim of improving and streamlining current processes, and suggests changes only where reforms are deemed to be absolutely necessary.

Further, noting the various challenges presented by the differing economics of each project, this study does not aim to present a set of prescriptive solutions or one size fits all recommendations. The study rather recognizes the need that in time, some tweaking and tailoring may be necessary to align the recommendations to suit each individual project and its local environment. As Nepal gains more experience in hydro development, the capital market in general and most importantly in the delivery

of local shares, assessing each of the options in depth and presenting a more scientific method to cater to each individual project based on size and scale, length of construction period, cost, etc. is an area policy planners and regulating agencies should be thinking about in detail in the near immediate future.

## ALLOCATION AMOUNT

*Retain the current amount of allocation of local shares for public companies:* Despite overwhelming appetite among potential shareholders to invest in local shares, SEBON's 10 percent ceiling on local shares offering by hydropower companies takes into consideration the inherent risks of investing in the capital market and thus seeks to limit the exposure of local communities, who are generally unsophisticated investors. Additionally, SEBON is of the opinion that while project-affected communities can be treated preferentially, this threshold for local shares also allows for the wider Nepali population, including those living in regions with low potential for hydropower, to have the opportunity to invest in general shares (a minimum of 10 percent). The current policy regime reflects a settlement of these interests and there is no sufficient reason to change it.

*For mega projects, the Government of Nepal should define local shares requirement in project bid documents:* SEBON's up to 10 percent policy for local shares and at least 10 percent for the general public are applicable to hydro companies going public. In contrast, mega projects that wish to issue local shares but remain private have

been negotiating and agreeing on a quantum instead of a percentage during project negotiations, which is a feasible approach given the clarity and certainty it will provide project developers, financiers as well as local communities. However, going forward, it is recommended that the Government spell out the quantum of the local shares requirement in project bidding documents during the international competitive bidding process, a practice that has already been adopted during the award of the *Super Six*<sup>36</sup> hydro projects. Inclusion of this requirement as a bid condition will eliminate the need for protracted negotiations on this issue between the government and the winning bidder.

### ALLOCATION PROCESS

#### *Promote further automation in Nepal's capital market:*

As a result of the increasing shift towards a computerized capital market in Nepal, the process of becoming a shareholder is gradually becoming less cumbersome for the public. For example, aspiring investors no longer have to deal with the inconvenience of being physically present at collection centers while applying for shares and instead can do so from anywhere as long as they have access to the online banking system. Furthermore, as a result of the integration with the banking system, the application process, especially the process of allotment, is now more efficient and secure for all investors. It is highly recommended that the relevant government agencies continue with their plans to further streamline and integrate the electronic and computerized systems into the country's capital market.

*Ensure that local communities have the necessary capacity to participate and take advantage of the modern systems:* While pushing for a more computerized process of allocation, it is important to keep in mind that there are regions in the country where information on the capital market and user platforms have not adequately reached. In some of these cases, SEBON has allowed local shares to be processed through the previous paper-based mechanism. This flexibility may be temporary, but careful attention must be paid to ensure it does not add further delays to integrate all shareholders into the new

system. Therefore, even though it may take more effort at the outset, it is recommended that there be special arrangements made by SEBON and CDS to educate and help build the capacity of local communities to use the new share application process, and ensure that the necessary support systems are in place, especially in remote and rural areas.

Ensure adequate focus on women and vulnerable populations to enable smooth transitional measures: SEBON and CDS must ensure sufficient efforts to train key women individuals of mother's groups (aama samuha), women's credit saving groups, community based user groups, etc. so that they can assist other women and poor, vulnerable and marginalized individuals in adopting and familiarising themselves with the new systems.

### TIMING OF LOCAL SHARES ISSUANCE

The timing of the local share offering is the most critical component that needs to strike a fair balance of interests between local shareholders as well as project developers. As such, the study presents options below:

- i) Two possible options for public companies, for whom the public shares issuance (up to 10 percent for local shares and a minimum of 10 percent general shares) would be applicable; and
- ii) An option for private companies that are required to issue local shares but wish to retain their company's private status.

#### *If the current practice of the local shares offering prior to general IPO is to be continued, then do so with additional safeguards for poor vulnerable households:*

The current securities regime, which establishes the timing of how early hydropower companies can issue shares to the public, requires a company to have taken care of the majority of the risks associated with project development prior to them going public. This is to ensure a certain level of protection to the public investors. The law then offers the companies the flexibility to decide on when to go for an IPO, which in reality, companies do so when they need cash the most – for many companies

<sup>36</sup> The Government in 2010 had awarded six projects called the Super six through a competitive bidding process, where the bid documents had clearly outlined the need for projects to provide 10 percent equity to local communities. The projects include Solu (23.5 MW), Lower Solu (82 MW), Khare Khola (24.1 MW), Maya Khola (14.9 MW), Singati Khola (16 MW) and Mewa Khola (50 MW).

this is when about 70 percent construction is complete to either fund further construction works while for others it is well after COD, whether it is to service their debts or invest in another project. While there are companies that have offered local shares on or after COD, requiring all companies to offer local shares post COD can be problematic for those that are genuinely seeking to raise equity from the public to develop their project. When viewed from this perspective, the current approach appears practical. However, from a benefit sharing or risk reducing perspective, this policy can only be truly effective if it is augmented by a comprehensive financial access and awareness program that will help reduce the financial risks and socio-economic vulnerabilities of the local communities. For further details, see section below on financing and informing stakeholders.

*Reverse the timing of the shares offer sequence but allow companies flexibility in the timing of offer:* The current regime requires local shares to be offered prior to the general public offer, the timing of which, on average takes place for most companies when about 70% construction is complete while for others, it is at or after COD. By seeking to reverse the sequence, but allowing the companies some flexibility in timing of offer, what is achieved are four principal objectives:

- i) Companies can directly go to the general public to raise capital (at least 10 percent) after meeting the requirements established by SEBON;
- ii) Project affected communities still get a preferential opportunity to invest but now have an added layer of protection. In the new setting, the general public, considered to be a more sophisticated subset of the public investors, can weigh in on the value of the company shares before their local counterparts. This allows local communities the benefit of observing how well the first phase of IPO performs before making their investment decisions. For example, if a company offering is heavily undersubscribed during general IPO, this could be a signal for local communities on the risks of investing in that company;
- iii) Companies are allowed a certain degree of discretion to decide when to approach the public in order to raise equity as long as SEBON requirements are fulfilled; and

- iv) The two offerings carried out in immediate sequence and through the same approval process yield in reduced shares issuance costs for the companies and an improved efficiency in the overall shares issuance process.<sup>37</sup> Furthermore, the current sequence of allotment can be maintained such that undersubscribed local shares can be allotted to those in the general shares.

One key implication of this reversal of sequencing arises only if local shares are offered after the company shares are floated to the general public and has been listed at NEPSE. Listing of shares in NEPSE would enable the process of price discovery through trading of stocks in the secondary market. That price, it should be noted, may have a value that is higher or lower than the offer price at IPO. Hence, there is a need for a policy decision that will require the offering of local shares be done at the offer price at IPO or market value, whichever is lower. If the offer price is lower than NRs. 100 (\$1), this will require another legal reform for all shares at IPO to be offered at a par value of NRs. 100 (\$1). The preferential pricing for local shares may also raise intensified interest from communities in claiming their eligibility. To avoid this, the eligibility for local shares at least for the severely affected has to be decided prior to the issuance of general shares; the cut off date being the financial closure date. See section on eligibility for more details. However, if the two offerings are carried out in tandem, as proposed in point iv above, the issue of IPO price or market price whichever is lower would not arise.

*For private companies, local shares should be offered on or after COD:* For the three private companies in the process of fulfilling their requirement to offer local shares, namely, Upper Trishuli-1, Upper Karnali, and Arun-3, the government has set different timings for each project. Going forward, the government should establish a standard requirement on timing for all private hydro companies instead of having to negotiate the timing of offering for each and every new project., The fact that i) these companies are not really looking to rely on local communities to raise capital, and ii) that the primary benefits from these companies to local shareholders are likely to be in the form of dividends, the government should require all private hydro companies to offer their

<sup>37</sup> This has already been made public but not yet practiced and implemented by SEBON.

local shares on or after COD. This way, one of the most critical risks to project development, i.e. construction risk, is eliminated, enabling the project to start to generate electricity, earn revenue, service its debts and eventually distribute dividend payments to shareholders from its profits.

### **PRICING OF LOCAL SHARES**

*Expect the current pricing mechanism to change due to newer policies being discussed:* SEBON currently requires that the offer price of shares at IPO of all companies (regardless of the sector) be set at par value. There is an exception to this rule, effective only if the company is able to fulfill a number of criteria for it to be eligible for SEBON's approval to offer shares at a premium. One of these criteria<sup>38</sup> requires the company to demonstrate a three-year history of capitalized earnings, which is not possible for most hydropower companies, especially those limited to a single HPP. Such companies will have to wait at least three years after COD, by when it will have generated some revenue. Hence, the share price of such companies at IPO and during the local share offer are likely to be at par if the existing practice of issuing shares is continued. However, in the event that SEBON allows the companies to declare an IPO with premium value based on other price discovery methods, where capitalized earnings are not necessary, then an increasing number of companies may be eligible to call for an IPO with a premium value embedded in the offer price. In such cases, the government should clarify whether to require the company to offer the shares to locals at a subsidized rate or to allow the company the right to seek premium value from the local communities.

### **ELIGIBILITY CRITERIA**

*Introduce a set of common standard definitions across all EIAs for eligibility and cut-off date:* The variation in practice in how projects have been defining eligibility for local shares has resulted in some level of confusion among stakeholders. However, this can be overcome by

introducing and enforcing a common framework that ensures consistency among all of the projects. SEBON's recent effort at regulation to align project area with the project-affected area as identified in the EIA is a commendable start. But this needs to be strengthened by ensuring that all EIAs follow a standard set of definitions for project affected people based on a degree of affectedness and the project's socio-economic area of influence, which includes direct impact areas and indirect impact areas along with administrative boundaries.<sup>39</sup> For the purpose of local shares, a common cut off date should also be identified for all projects by SEBON, which is ideally the date of the financial closure.<sup>40</sup>

*Differentiate treatment for categories within those eligible for local shares:* Categories based on affectedness will help identify communities that should receive first priority for local shares and separate them from the rest of the people residing within the administrative boundary, which is the district. Each category should receive different treatment with regards to preferential access, allotment and/or pricing. Some standard criteria on preferential allocation for all projects is difficult to prescribe given the differing degree of affectedness for each project and the population density in the severely affected areas compared to the rest of the district. However, regardless of whether the current timing of local shares is switched with the general IPO, or not, first preference in terms of allotment, financing and price should be given to the directly affected.

*Standardize proof of eligibility requirements; eliminate the use of land titles for eligibility:* Current identification requirements in the form of either a citizenship, marriage, birth, or migratory certificate should continue with a standardized cut-off date, for example, the financial closure date. Practice of using land titles, should be eliminated as this has allegedly boosted opportunistic land rush to the affected areas, also flagged by many communities as a major issue. The study further recommends that SEBON monitor the effectiveness of the

<sup>38</sup> Section 36 of Securities Issuance and Allotment Directive, Revised 2017

<sup>39</sup> Direct impact areas include areas that may be disturbed by the project's construction and installation activities, whereas indirect impact areas include areas which are not directly affected by project activities but which could potentially experience beneficial/adverse impacts from the project or may raise community expectations/concerns of such impacts. Administrative boundaries include villages, towns or districts. Refer to Hydro EIA Manual, 2018, Ministry of Forests and Environment.

<sup>40</sup> In practice, using the date of the EIA as the cut off date may be impractical given the length of time between finalizing the EIA assessment and EIA approval.

current policy requirement to grant special consideration to women, poor and vulnerable households that have difficulty in establishing proof of eligibility.

## **ALTERNATIVE DELIVERY MODELS FOR PRIVATE COMPANIES**

*Collective Investment Scheme (CIS) is a possibility but requires significant reform:* In redesigning CIS as a possible delivery model for local shares, the new regulation needs to bear in mind that the Special Purpose Vehicle (SPV) being created will be limited to collecting funds from the eligible population of a project-affected area; investing all its funds thus collected to the local shares of a particular hydropower company; holding the allotted shares for the lifetime of the project, and distributing dividends to its participants in regular intervals. Designed as a company with limited mandate and minimal asset, the SPV can also be required to have a lesser set of administrative requirements (e.g., limited roles of sponsor, fund manager, supervisor and depository resulting in reduced cost of operation) and protective measures in place (e.g., limited requirement in the capacity of the sponsor or the fund manager because of the lack of a need for active investment decisions), especially in relation to the current mutual fund regulation. These changes would have a direct impact on the associated cost of incorporating and operating the SPV. While this model does provide limited representation of local communities in the governance of the SPV, the relatively low cost of incorporation and operation and the opportunity for a market-based price efficient exit for unitholders<sup>41</sup> helps in making it a viable model for the delivery of local shares.

*The publically-listed company model is currently the best option, but requires some changes:* While the private company model is restricted by the maximum number of shareholders, structuring the SPV as a public company, whether listed or non-listed, does away with the limitation on local participation. However, the process of establishing a public company is relatively more burdensome than that of establishing other delivery models. These include requirements on initial capital and regulatory fees, which by themselves are not prohibitive in nature but needs some work around. Plus, local communities may consider them to be a nuisance

not their worth. Also, as a public company, the SPV will have to abide by the set of requirements established by SEBON prior to collecting funds from the local communities, including, among other things, conducting due diligence of and developing a prospectus for the SPV. These are extensive processes in place to protect the public investors with better disclosure of information from companies. These requirements may be appropriate for public companies that have a level of complexity, but in the case of the single-purpose SPV, this could mean avoidable paperwork and associated costs. Changing some of these requirements could help in reducing the high administrative cost associated with incorporating and operating public companies. However, as a special case where the SPV is being created to meet the interest of the hydropower companies that do not want to go public, there is a strong argument to be made for the hydropower company to pay and help set up the SPV.

Both the public option, listed or non-listed, have the potential to offer a price efficient exit to local investors after they are listed in the NEPSE and the OTC market, respectively. However, the local communities have an incentive to prefer to have their SPV listed in the secondary market so as to enable them to benefit from a better and transparent price formation. For all these benefits listed here, the public-listed company model is currently the best option for companies looking for alternative delivery models for local shares. However, the success of the delivery model depends on the willingness of the local communities to agree, accept, and abide by in the process of establishing and operating the SPV. The suggested changes here could help increase the possibility of this happening.

## **ACCESS TO FINANCING**

*Ensure effective implementation of the deprived sector lending requirement:* Given that most hydropower projects to date have been relatively small, there has been, except in Chilime, no provisioning of institutional financing for local shares. However, such financing options may be required with an increasing size and number of projects in each district and communities become eligible for a proportional increase in allotment of shares. The provisioning of alternative financing mechanisms for community members is recommended so that they will not have to seek loans at

<sup>41</sup> Albeit with value relatively less than of the shares of the company that owns the project

exorbitant rates from informal money lenders. As part of this, the government needs to develop operational guidelines and stricter enforcement to implement its deprived sector lending requirements, for example, with deferred payment options under escrow arrangement of future cash flows. Reducing the cost of borrowing is another factor that needs to be considered, which is possible if the NRB guidelines also offer a refinancing facility of loans at lower rates, which would not only enable local access to low cost loans but allow faster repayments with adequate cash flows.

**Offer alternative financing without exacerbating the vulnerabilities of the marginalised poor:** Given the risks associated with HPP and the inability of most community members to hedge, the challenge is in building their capacity to cope with inherent risks involved with equity participation along with the presence of some interceptive risk mitigation measures. To ensure the appropriate inclusion of the economically disadvantaged, there needs to be a consideration of two primary elements: how they source their fund and what financing instruments best serve their interests.

**Source of fund:** One option is that the government establish a dedicated fund to provide loans to the target population, which can be offered under relatively favorable lending terms, including the possibility of using shares as collateral. However, it is important to define the criteria for eligibility for this fund. For example, the current definition under the NRB circular, which defines the "poor section" as population with low income, women, ethnic community, differently-abled, and marginalized communities, could be taken as a basis for defining eligibility. This could further extend to households designated as those living below the poverty line. As of 2017, the government had distributed ID cards (gareeb parichaya patra) to almost 400,000 households as part of efforts to reinforce targeted programs and subsidies aimed at poverty alleviation.

Another option, likely to be more feasible for mega projects, is for project companies to arrange for financing since this is generally a relatively small target population of vulnerable people. The financing could include a mix of grant with a small portion of loan with arrangements in place to channel dividend payments to service the loans or

make periodic payments as part of the company corporate social responsibility. The details would need to be captured in the project's individual benefit sharing agreement, where women, poor, vulnerable households would be provided preferential treatment.

**Investment Instrument:** The current instrument in use to invest in local shares is equity. However, there are other possible instruments that can be considered to lessen some of the negative aspects associated with equity. Two options<sup>42</sup> have been looked at that could further reduce risk – i) convertible preferred shares; and ii) convertible debt. They are not recommended at this time but could be made available when risk of equity becomes more evident.

## HOLDING AND DIVESTMENT

**There is no sufficient reason to suggest change in the lock-in period:** The three-year lock-in period for local shares limits the liquidity of one of the most prized assets of the local people. The intent of this policy, as expressed by SEBON, is to prevent a potential elite capture of local shares immediately after it is listed and eligible for trade. This policy also ensures that local communities remain associated with the project through their shareholding for at least three years. Several stakeholders, including in the communities, had raised the need to update this policy to give local communities more control and liquidity of their assets. However, in reviewing the positions expressed by the various constituencies, the relatively small size of individual shareholding (100-200 units), and the preferential treatment in terms of pricing and timing this population is recommended to receive, there is no strong rationale to suggest the need for a change in the current regulation.

**Reinforce automation in the process of holding and divesting shares:** Automating the practice of holding and divestment will help in transforming a more efficient holding and divestment. For example, the dividends that most local investors have thus far been deprived of will now be directly deposited in their banking account. Despite the challenges of uptake for some rural investors, this transition to a computerized capital market ecosystem is highly encouraging and needs to be efficiently expedited.

<sup>42</sup> Refer to main report for more details.

**Moving towards online trading:** A critical element in the limited ability of local communities to divest at their will is the high transaction cost involved till date. To address this, the appropriate policy response would be to introduce online trading, which will also eliminate the need for brokers. Until this is achieved, requiring current brokers to offer services at the district level and allowing banks to provide brokerage facilities as an additional service is recommended.

## TRANSFORMING COMMUNITIES INTO INFORMED SHAREHOLDERS

Given the lack of clarity among local people on what may happen to their share value at the end of the project company's license period, it is important to strengthen the requirements on hydropower companies to disclose all relevant information to their potential shareholders through their prospectus and other documents.

### INFORMATION HIGHLIGHTS IN PROSPECTUS AND PROJECT WEBSITE

The prospectus as well as the project website should clearly state in a visibly highlighted box: the length of concession period, the expiry date of the project's concession period or PPA, and for projects that are within five years of achieving the end of their license period: the projected status of the hydropower company in the post-concession period and the potential impact on shareholders.

### TAILORED PROSPECTUS PACKAGE

Because a prospectus is a legal document, it is drafted in very technical manner and is extremely detailed. As a result, it reads as if the information is not written with the intent to communicate with any target audience, but in response to SEBON's disclosure requirements. When it comes to communicating such company related information the level of detailing that is found in a prospectus can be confusing, not only to the rural communities but even to the relatively more literate urban population. Furthermore, any effort to make the prospectus more accessible must take into consideration that there are varying levels of ability to absorb the information. Thus, SEBON should have three distinct

documents disseminated out together as a package with regards to the prospectus.

- i) First, despite the difficulty in accessibility of the information but for the purpose of full disclosure, several copies of the entire prospectus should be made available in a printed form to the local communities through the offices of their respective sub-national government bodies.
- ii) Second, a non-technical summary of the most relevant information of the prospectus, similar to the summary profile from the paper-based application form, should be printed and made available, especially at urban centers and also at the offices of the local bodies. These can also be handed out during training sessions (described later) to target individuals who can serve as information hubs within the social network of the local communities.
- iii) And third, a more accessible document targeting the rural communities should be developed with only the information most relevant for them. These include the conditions and restrictions in the process of application, investment risks by highlighting a few case studies such as the example of National Hydropower Company (see box below on Issue of Corporate Governance: a case study) and a brief summary on the kinds of shares and rights associated with each: local shares, promoter shares, employee shares, general public shares, etc.

### ENHANCING EDUCATION AND UPTAKE

At the other end of the communication spectrum are the recipients of the information, i.e., the local communities, and their ability to absorb whatever information is offered to them. Given their limited capacity, SEBON should, on its own and in collaboration with hydropower companies, invest in making them better informed of their investment decisions. These can be done through various literacy programs, which should include subjects on financial literacy focused on the capital market, plus courses on hydropower and the process of HPP development.

This can be done earlier in the project cycle so people become more aware of the context of hydropower development in their area. Local communities would also benefit indirectly if these literacy programs are offered to other stakeholders in the community, such as the local media as well as the elected representatives and the staff of the sub-national government offices.

Other important stakeholders include the traditional community-based networks, such as *aama samuhas*, local clubs, women's cooperatives, schools, and business associations, that can serve as trusted intermediaries to disseminate information to the target groups. As mapped earlier, these are agencies with high influence in the community and can provide the necessary guidance to those who are not able to make their own decisions. These activities can be undertaken by SEBON or a SEBON-approved/accredited training agency, and can be financed in part or whole by the hydropower companies. Increased efforts must also be made to encourage the business media and independent brokers to monitor, analyze and produce well researched information online through blogs and websites. These can play an important role in assuring that investors have improved stock market knowledge.

Along with the efforts at building capacity, any strategy to make communities more informed about local shares should include the use of multiple mediums and an understanding of the preferred time and channels/stations, programs, including the usage of door to door campaigns targeted at housewives. Long-form communication materials can include newspapers or other printed materials such as brochures, pamphlets, and factsheets. Furthermore, with the gradual penetration of social media, especially Facebook, into the rural communities, these can be an ideal two-way communication platform for relevant actors, including SEBON and companies to engage with local communities.

### **MAKING PROJECT WEBSITE A MANDATORY PLATFORM TO PROMOTE TRANSPARENCY AND ACCOUNTABILITY**

The setting up of a project website with periodic project updates should be made mandatory. Logistical challenges are often a big barrier for local communities to access the project public information center. At a time when Nepal's current internet penetration rate has reached 63%, with over 95% using 2G or 3G mobile data, an effective and cost efficient way to reach the local communities is through the internet. A website in Nepali that provides information in a simple, reader-friendly language can be relied upon as an authentic source as opposed to news or updates on social media, which may at times even be false.

## **ISSUE OF CORPORATE GOVERNANCE: A CASE STUDY**

National Hydropower Company Limited (NHPC), which has been operating the 7.5 MW Indrawati III Hydro Power Project since 1999, issued 1,400,000 units of public shares in 2004. However, it has not yet been able to distribute profit to its valued shareholders; conduct an annual general meeting in time; has a negative earning per share of NRs. 2.81(\$0.02); and a net worth per share of below NRs. 100 (\$1). This reflects a serious issue of corporate governance in the company. The problem started when its subsidiary company, Sunkoshi Hydropower Company, failed to complete the construction of the 4.5 MW Lower Indrawati Hydropower Project. This was because of management issues including construction delays and high cost overruns, especially after raising 1:1 rights shares worth NRs. 694 million in 2008. In 2014, the then Ministry of Energy, based on instructions from the Commission for Investigation of Abuse of Authority, cancelled its generation license. This resulted in a huge loan default by the company that completely ruined its balance sheet, resulting in no dividends being paid to the shareholders. Further, the promoter shares had already been converted into tradable ordinary shares. In 2011, the company's share price dropped from a high of NRs. 600 (\$6) to NRs. 37 (\$0.3). This brought to the forefront several issues of corporate governance: i) capacity of hydropower developers to utilize the money raised from public, ii) accountability of promoters who put the public investment into risks, iii) lack of education among public investors to understand and respond to the corporate malpractice, and iv) urgent need of the hydro sector regulator who can monitor issues of corporate governance to protect the investment of general citizens.

## STRENGTHENING COMMUNICATION AND PUBLIC CONSULTATION

Effective communication is a product of consistent and sustained effort to communicate. For companies, given the long gestation period of project development, they should formalize an engagement plan and also standardize all communication with local communities. This should be done as early as possible, even during the initial surveys, and sustained throughout the life of the project. Public consultations are an integral part of community engagement, and it is crucial that the hydropower company engage in continuous dialogue with the communities about potential environmental and social impacts, including community development activities, and community needs so that companies understand the expectations of local communities and vice versa. In addition to engaging with existing stakeholder groups, the hydropower company should require the project affected populations to elect their own project level committee with at least two women representatives that can work to represent genuine local interests. This committee will work with the company to develop community development plans, benefit sharing agreements, and agree on compensation, land acquisition, resettlement and rehabilitation. Two projects<sup>43</sup> that have done this have been successful in their local level negotiations with the communities that included acquisition of private land and resettlement planning. With specific regard to local shares, hydropower companies should prepare a set of messages that are factual and accessible and communicate it consistently during all its interactions with local communities and ensure adequate outreach to those unable to partake in public meetings – these can include people with diminished mobility, those occupied with household chores, adolescents or young adults attending school, among others.

## KEY OBSERVATIONS AND CONCLUSION

This section highlights the main issues of local shares that have been identified in the study. While these serve as the key takeaway points of the report, the underlying intention is also to reiterate and emphasize the context within which local shares have evolved so that the development of relevant policies in the coming days is grounded in its reality.

<sup>43</sup> Upper Karnali HPP and Arun 3 HPP.

<sup>44</sup> Chilime was constructed just two years behind schedule. In comparison, other projects have faced significant delays by several years at least.

## LEARNING LESSONS FROM CHILIME

The aspiration to invest in shares of hydropower companies, at both the local and national levels, has been propelled by the narrative established by Chilime's bullish run in the share market. But what we can learn most from Chilime, is that despite its uniqueness - of having a favorable PPA rate and entering the capital market at a favorable time - what it has established is given a momentum to the concept that with careful execution, value can be created and shared. Some of Chilime's circumstances that can be replicated and which contributed towards its success, can be summarized by the following factors. These include:

- i) The ability to build on time<sup>44</sup> and on budget and;
- ii) The ability to facilitate greater public participation in equity.

However, the caveat is that, meeting the above conditions alone, although likely to be contributable factors, will not necessarily guarantee a profitable project that can keep shareholders happy.

## THE RISE (AND FALL) OF MASS SPECULATION

The local shares phenomenon is happening at a time when Nepal has tapped only a fraction of its hydropower potential, which means that there is currently a very limited supply of hydropower company shares in the capital market. With thousands of additional MW in the pipeline and a corresponding increase in the supply of shares, there will be a natural downward pressure on the average price, which may have a significant impact on how local communities view local shares as an asset and their willingness to invest in it.

## A MARKET YET TO MATURE

The local shares regime has been in place for a very short period of time. During this period, about two dozen hydropower companies have offered or are in the process of offering local shares. In all these, local communities have participated exuberantly, placing immense faith in the performance of companies and the overall share market, albeit with limited comprehension of both. But neither the investors nor the market have had to face major adversity to date that has tested their tenacity to invest long term.

Conversely, at the tail end, only a couple of companies have completed their lock-in periods and most local investors have not had the opportunity to realize profit from their investments. However, the Nepali share market has experienced a long bearish run—a significant portion of which happened during the course of this study period—resulting in a drastic decrease in the price of hydropower company shares. Because this new price point offers lesser return, this could change how communities perceive the potential to ensure capital gains and their demand for local shares. Additionally, given the long gestation period, the associated opportunity cost, and the delayed returns from investment, local communities may no longer be attracted to shares, especially if the current market hype ends. As the market for hydropower company shares thus matures, community members may find other better short-term investments.

### **STRENGTHENING TRADITIONAL FORMS OF BENEFIT SHARING**

The impact of local shares is dependent not only on the performance of the market, but also the ability of each individual to be cognizant of and, more importantly, have the capacity to make timely investment decisions. Furthermore, in defining local shares as an opportunity to invest, there is a limitation on how socially inclusive this instrument of benefit sharing can be designed: investments naturally offer higher degree of rewards (albeit non-guaranteed) to those willing to take on larger risks. In the case of local shares, the more affluent population in the communities, with their greater financial capacity and a stronger social safety net, can have a larger appetite for risk and, therefore, the potential to reap a higher reward than their non-affluent counterparts.

Nepal has in place a number of traditional benefit sharing mechanisms<sup>45</sup> that have the potential of becoming better instruments to positively impact the lives of local communities. There are also recent efforts at institutionalizing the traditional form of equity

## **NEPAL'S ELECTRICITY SECTOR REGULATOR**

Many experts identified the need of a regulator to ensure a healthy and competitive practice in the electricity sector. SEBON's approval process for public shares is about compliance with disclosure and not about the actual risks of the company. In the banking sector, the sector specific risks of BFIs are regulated by Nepal Rastra Bank, the central bank of Nepal to ensure the soundness of the company. Similarly, Insurance Board is the regulator for the insurance companies. There is currently a lack of regulator in the electricity sector. The Electricity Regulatory Commission, established after the enactment of Electricity Regulatory Commission Act (2017) on September 4, 2017 has a mandate to, among other things, determine the power purchase rate for NEA, fix electricity tariffs after holding public hearings, and develop grid and distribution codes. While SEBON continues its role as a market regulator, the newly established Electricity Regulatory Commission can lead in coordination with other regulatory agencies in securing the health and performance of the overall electricity sector.

investment in Nepal, wherein government bodies<sup>46</sup> are being considered as investment partners in hydropower development. As practiced internationally, this set up would allow for any financial benefits accrued to be used for the development purpose at the community level. There must be increased effort by the government in strengthening these mechanisms in order to ensure that the lives of the affected communities whose resources are being exploited also benefit in the process.

<sup>45</sup> These include, among others, i) a royalty sharing mechanism that apportions back half of the revenue collected by the central government to the subnational governments through the development budget; ii) local livelihood support initiatives undertaken by HPCs that offer various types of livelihood trainings and employment opportunities to project-affected community members, iii) a community development and local infrastructure initiatives, wherein HPCs contribute to smaller community-based infrastructure like rural electrification, drinking water supply, irrigation facilities, etc.

<sup>46</sup> For example, Upper Trishuli 3 B has set aside 5 percent share ownership to the municipalities of Rasuwa and Nuwakot.

## ISSUE OF REBALANCING INCOME IN RURAL AREAS

The study demonstrates that offering equity presents too many challenges in administration and risk, and logistical challenges in identifying target groups and so other local benefit mechanisms can be much more effective, such as skill training, jobs and local business development. But the study does show particular benefits from share ownership for women,<sup>47</sup> a group that is easy to identify, and so they can be a target group for redistribution of income opportunities through equity. Efforts by hydropower companies, SEBON and the government to focus on this group have immense potential to yield tangible outcomes in terms of improved access to wealth, financial literacy, and the ripple effect on family health and education, among others.

Finally, it is important to keep in mind that local shares evolved to fulfill a specific purpose and, for the moment, it serves it well: for local communities, it offers a chance at netting the capital gains they seek; for companies, it offers the possibility of reduced project disruption due to increased local ownership. This equilibrium is likely to remain, for as long as both the local communities and the companies continue to perceive local shares as a win-win for both. However, given the uncertainty in the Nepali capital market for hydropower shares and the likely event of oversupply of such shares in the secondary market, it is difficult to predict the future direction and the impact that local shares will have on local communities. It is therefore critically important to consider carefully all of the various facets of this phenomenon in pursuing further policies to guide it.

## STUDY METHODOLOGY

**Primary sources:** As an exploratory research into the practices of local shares in Nepal, this study relied extensively on primary sources to obtain the necessary information.

### **Review of legal documents and available market data:**

This included a comprehensive examination of relevant policies and legislations, including the Constitution of Nepal, Electricity Act and Regulations, Securities Act and Regulations, Companies Act and Regulations, among others. Other key documents examined were project-specific, including power development agreements (PDA), environmental impact assessments (EIA), and company prospectuses. To examine the market performance of hydropower companies, data was obtained from government sources and from financial statements of listed companies.

**Field visits:** The team interviewed communities from fourteen project sites in four districts - Rasuwa, Solukhumbu, Dolakha, and Lamjung. Three specific criteria were used to select the projects to ensure the widest possible sampling: i) characteristics of offering local shares, ii) installed capacity range, and iii) type of investment in the project, projects with foreign direct investment, projects belonging to Nepal Electricity Authority and/or its subsidiary companies, and independent power producers.

**Focus group discussions and semi-structured interviews:** The team carried out a total of 22 focus group discussions (FGD) and 110 semi-structured interviews (SSI) with community members within the immediate project vicinity and at the district level. Best efforts were made to ensure maximum inclusivity in the FGDs, in terms of both gender and ethnicity. Four separate women-only FGDs were conducted by a female member of the study team. For respondents that did not own shares, an attempt was made to identify the underlying reasons, if any.

**Key informant interviews:** The team conducted 50 key informant interviews (KII) to explore the discourses around the emergence, adoption, and transformation of the practice of local shares in Nepal. Respondents were professionals, government officials, NEA and IPPs,

<sup>47</sup> A significant number of women now own shares, as the current share allotment is based on individual applications, with a capped amount for each applicant. Thus, most households apply for all eligible family members to maximize their chances of obtaining more shares. As a result, women are now getting an equal opportunity to take part in the process. Interviews conducted with women demonstrated perceived benefits in terms of enhanced self-esteem, improved financial awareness, access to an additional income source, among others.



and experts on project financing and capital markets. The team also interviewed representatives from various political parties and members of the parliament who have influenced their respective party's position on hydropower development.

Accounts from the field: The team conducted rapid assessments of local communities in Rasuwa and Ilam, with a special focus on marginalized peoples that have invested in local shares of Chilime Hydropower Company and the Sanima Mai Hydropower Company. The assessment of 97 respondents was intended to capture any economic changes and social empowerment as a result of owning local shares.

**Expert Consultations:** The team organized four consultations with sector experts to deliberate on policy implications of its preliminary findings. The first workshop focused on alternative delivery models of local shares. The second workshop discussed eligibility criteria for local shares. The third workshop deliberated on the

practices and challenges in the delivery of local shares. The fourth workshop focused on the status of the shares of hydropower companies at the end of the projects' concession period.

**Consultative Panel:** IFC formed a consultative panel comprising national and international experts to provide feedback and suggestions on the study. The study team presented the report to the consultative panel at different phases of the study: i) on the design of the study after the inception phase; ii) on findings after the field visits, and iii) final presentation with recommendations towards the end of the study period.

**Secondary sources:** The team reviewed various reports on benefit sharing, national and international practices of equity investments in infrastructure, local shares options, among others. Other sources included relevant newspaper articles, company documents, websites, brochures, annual reports and web portals related to information on the hydro companies and the Nepali capital market.



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