PROJECT FINANCE

Creating value in project finance

Phillip Fletcher
Milbank Tweed Hadley & McCloy LLP
London

Project finance is not for those with short attention spans. It often takes the same amount of time simply to learn the varied names on a project finance parties list as it takes to close most leveraged financings. The documentation encompasses not only the usual reams of finance and security documents found in other forms of secured lending, but also the complex commercial contracts, permits and licences that frame the terms under which the underlying project will operate. In large part due to the intricacy of the deals, project finance lawyers are often called upon to remain closely involved with them through the years over which project loans are repaid.

What is project finance? It is a means to fund investment across a broad spectrum of industries, including natural resources, telecommunications, transportation, social services and power generation and transmission. High levels of investment are needed in each of these sectors to meet the demands of growing populations and economies around the world. The cost of financing investment projects of this sort can be minimised to the extent that the sponsors can access loans that are repaid over time from the net revenues that the project generates. As the long-term reliability of those revenues underpins the repayment of the project's loans, lenders focus close attention on ensuring that the project will in fact be able to generate robust revenues over the full period that the loans are outstanding. The magic of project finance is that, when that reliability can adequately be established, it can turn a collection of permits, contracts and other promises into vibrant economic undertakings. Transformations of this nature are very much the purview of lawyers, and our contribution to the success of an investment project can thus be significant.

Although the pace of investment in the developed economies of Europe and North America has varied by country and sector, constrained in many cases by the eurozone and related financial crises, it has remained more consistent elsewhere. Economic growth has been particularly rapid in Brazil, Russia, India and China, as well as a range of other countries as diverse as Saudi Arabia, Indonesia, Mongolia, Columbia and Vietnam. As these countries host ever larger and more complex projects, creativity has been required to structure financings to meet the challenges presented by the differing, and frequently untested, legal, regulatory and political environments in those countries.

What sectors are attracting project finance activity? Concerns over climate change are leading to investment in both low carbon power and energy efficiency, while urbanisation is driving the development of utilities, roads and rail. Steadily rising oil and other commodity prices have been an important contributor to the number and scale of natural resource projects. As exploration for new resource discoveries is driven to ever more remote locations, the cost of extracting those resources (often well in excess of $5 billion per project) rises, resulting in ever larger financings and a corresponding need to mobilise diverse sources of capital.

In years past, loans to fund projects were most frequently provided by commercial banks based in London, Paris, New York or Tokyo. Many of those banks are, however, facing credit constraints that are becoming ever tighter through the implementation of the Basel III accords. The resultant liquidity gap has been filled by lenders from across Asia, the Middle East and Latin America, coupled with an ever increasing involvement of export credit agencies, multilateral development organisations and, for stronger projects, the capital markets.

PROJECT FINANCE IS A MEANS TO FUND INVESTMENT ACROSS A BROAD SPECTRUM OF INDUSTRIES

Virtually all lenders, but especially the public sector lending institutions that are now taking a leading role in funding many projects, look not only to earn a return on their loans, but also to ensure that the underlying projects meet stringent social and environmental standards. Doing so not only responds to the demands placed on them by a variety of stakeholders, including regulators and non-governmental organisations, but also helps to ensure that those projects retain the long-term support of their host state populations and governments. Project finance lawyers are thus being charged with helping to implement socially and environmentally progressive policies, something that most lawyers find to be an attractive part of their roles.

Investment levels, as with all economic activity, are cyclical, and down cycles cannot be wished away. In a diverse world, however, cycles continue to occur at different times in different places, even as the macro global economy grows ever more interdependent. Moreover, governments have come to recognise that both domestic infrastructure and access to resources are needed to maintain economic competitiveness and adequate levels of job creation, and diversify the domestic economy. These sectors thus often benefit from public sector lending, tax credits and other stimulus measures. As a result, project finance has become somewhat less prone to cyclicality than other financial sectors.

Fortunately for the lawyers named in this guide, this relative immunity to cyclicality and the growing diversity of lenders, sponsors and host states means that projects continue to be developed across the globe and the issues that they face are becoming ever more complex. The challenge for project finance lawyers is to provide the broad range of legal, language and cross-cultural skills required to address these issues. For those with the patience to navigate these challenges, the ability to help foster economic growth is both fascinating and rewarding.