CHAPTER 09 THE ROLE OF PUBLIC SECTOR LENDERS IN PROJECT FINANCING

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Introduction

'Tis a truth that's widely acknowledged
In our post-Lehman and credit crunch world,
That most, if not all, project sponsors,
At best are facing the doldrums
Through a dearth of commercial bank funding.

The crash of shutters coming down on commercial bank lending is still being heard across the globe, and although their lending windows have not been nailed shut, most banks are currently neither willing nor able to provide the volume of loans demanded by project sponsors. All too conscious of their institutions' reduced balance sheets, credit committees, never renowned for their sense of adventure, are today trumpeting a new conservatism that is seeing financing plans that replicate deals banked in recent years going back to the drawing board, while others are simply being left on shelves to gather dust.

However, before concluding that project financing is atop the same funeral pyre as its leveraged and derivative brothers, it is worth taking a step back to look at the international project finance landscape and its development. The projects market has nearly always had, and continues to have, two natural advantages over its commercial siblings: a sound foundation closely associated with economic development and experience with a diversity of funding within a single transaction. Both of these have enabled public sector lenders to take a leading role in large-scale projects.

The benefit of diversity

Complex project finance transactions have always involved the provision of a wide variety of financial products by a broad range of public and private sector investors. Indeed, the classic development paradigm involves a progression from public sector ownership of infrastructure assets to the increased participation of private sector sponsors and lenders. The ultimate result has been a decline in the reliance that projects place on the public purse, but public financing has remained a regular feature of infrastructure and other project financing.

The benefit that this gives project sponsors in the current commercial liquidity drought (and which is unavailable, in particular, to private equity sponsors) is the ability to tap, and at times rely on entirely, sources of debt finance being made available by institutions responsible for the furtherance of specific development goals and having, in addition to the requisite financial resources, the expertise to deal with the myriad political and commercial issues that arise in particular jurisdictions.

Project sponsors would have fewer worries if that were all there was to it, but before examining some of the difficulties it is perhaps worth amplifying what we mean when we refer, rather vaguely, to public sector lenders, public funding sources and the like.

Who's who, who does what, and to whom?

The various public sector funding sources around the world that provide support to infrastructure and similar projects comprise three basic categories:

- Export credit agencies;
- Multilateral and other international development financing institutions; and
- Domestic development organisations.

While there are similarities between the three categories of organisation, their differences are of greater significance as they have the biggest impact on the extent to which each can (or cannot) be of use in any particular project financing. Having been entrusted with public funding, these institutions apply credit analyses familiar to all lenders, but at the same time require adherence to the policy objectives they are designed to achieve.

Export credit agencies (ECAs)

These are institutions established by different countries (and in different guises) whose primary role is the provision of financial support (whether by way of loans or the provision of loan guarantees) for the export activities of commercial enterprises operating within their respective jurisdictions, in particular by assuming political risks. Some ECAs have been active for many years, the oldest being the UK's Export Credit Guarantee Department, which was established in 1919 to reinvigorate the UK's export trade in the aftermath of World War I. Some are still relatively young, the Slovene Export Corporation having been founded in 1992, and the ECAs of the PRC, South Africa and other growing economies only now coming to the fore of project financing. Some are very large, JBIC (Japan Bank for International Cooperation) having disbursed nearly US$10bn in the fiscal year ended March 2008, with nearly double that in the fiscal year just ended (with, most notably, large commitments to the Sakahlin II LNG project and various global stimulus programmes), with more expected in the fiscal year just commenced; US Exim has also supported nearly US$20bn worth of exports in 2008. However, all have as their primary objective the direct support of the national interests of their home countries.

In recognition of the need to create something of a level playing field for the support that the ECAs of different countries can give, and specifically to limit the natural advantage that their relative wealth gives to the ECAs (and thus the exporters) in the wealthier industrialised countries of the world, the ECAs of the Organisation for Economic Cooperation and Development (OECD) countries have bound themselves to a set of consensus rules. These ensure consistency and co-ordination among the agencies and dictate the types of support that they can offer. As many categories of assets require longer-term debt, the OECD countries have adopted somewhat more flexible debt amortisation rules governing the provision of financial support for qualifying projects. Although these consensus rules are designed to ensure level pricing across participating ECAs, those agencies able to provide direct lending (at a sovereign cost of funds) may, in today's market, have an advantage over those who simply issue loan guarantees that support loans from banks with their ever-increasing funding costs.

Some ECAs may also provide credit unrelated to exports (which is thus exempt from the consensus rules). For example, K-EXIM (of Korea) and JBIC (of Japan) will finance

projects that supply natural resources for their domestic markets. They and others, such as EDC (of Canada), may also support investment by their nationals overseas (a mission that in the US is supported by OPIC rather than US Exim). Particularly in acting as an 'untied' lender, however, ECAs must be mindful of constraints such as the WTO agreements that restrict state aid in international commerce.

Multilateral and international development financing institutions

The multilateral financing institutions are independent international organisations established by agreement between countries for the purpose of financing economic and social development programmes in developing countries, whether generally (as with the World Bank) or in a particular region (as with, for example, the African Development Bank, the Inter-American Development Bank, the European Bank for Reconstruction and Development and the Asian Development Bank). The World Bank is the principal multilateral agency and comprises the International Bank for Reconstruction and Development and the International Development Association, separate bodies that extend credit to, respectively, middle income and poor developing countries. The World Bank group also includes the International Finance Corporation (which provides project loans to private corporations) and the Multilateral Investment Guarantee Agency (which provides guarantees against losses caused by risks flowing from the imposition of currency transfer restrictions, expropriation and war and civil disturbances but extending as well to the provision of protection for losses attributable to certain contractual breaches by host governments).

While certain multilaterals were once able to extend their impact by involving commercial banks in a co-financing through a so-called B loan tranche, it is their direct lending that is now the most attractive component of their participation in projects.

The European Investment Bank (EIB) lends to projects that further policy objectives in the European Union, and in recent times it has been the saviour of a number of Europe-wide infrastructure deals (as well as a number in Africa, Asia and other emerging regions) that, but for EIB's involvement, would almost certainly have foundered for want of financing. EIB has recently announced that it is to increase its capital, an increase initially scheduled for 2010 but brought forward in response to the downturn in the markets in order to enable EIB to respond to the demands on its resources.

In addition to the multilateral organisations, there are a variety of development institutions that are organised and funded by single countries and that participate in private sector lending in qualifying countries. These include FMO (Netherlands), Proparco (France), DEG (Germany) and DBSA (South Africa). Some of these, and other institutions, may also finance investment funds (such as the Emerging Africa Infrastructure Fund) with similar missions.

The multilateral and development finance institutions differ from the ECAs, however, in that it is the interests of the people and the economies of the countries in which the relevant investment is being made on which funding decisions are founded, rather than the national interests of the countries that provide that funding.

Domestic development organisations

Unsurprisingly, domestic development institutions seek the promotion of particular goals within the borders of the countries in which they are established. These goals are generally expressed as specific economic objectives, increasingly with carefully defined environmental and social parameters, their importance to the project finance world stemming from the fact that they are often concerned with industrial and infrastructure development. For example, under a programme established by the Energy Policy Act of 2005 (which was expanded significantly under the American Recovery and Reinvestment Act of 2009), the US Department of Energy (DOE) is empowered to provide loan guarantees in connection with the development of projects within the US that involve innovative technologies, an eligible project in this context being one that employs a "new or significantly improved technology that is not a commercial technology." A similar DOE guarantee programme may extend to supporting investment in nuclear power and electricity transmission as well.

Many countries have established organisations chartered on the basis that they will have a specific focus or provide support to a particular group or sector. In the Kingdom of Saudi Arabia, for example, the Saudi Industrial Development Fund (SIDF) has an active lending role in the fulfilment of the country's programmes for industrialisation. In parallel, the Kingdom's Public Investment Fund (PIF) provides financing for commercial projects that are important to the development of the nation's economy but which, whether through insufficient experience or capital (or both), cannot be undertaken solely by the private sector. In Brazil, BNDES has taken on an increasingly prominent role financing domestic energy and infrastructure deals.

At least some ECAs, such as SACE (in Italy) and EDC (in Canada), have also been specifically charged with participating in domestic lending (at least for a limited period), and a change in OECD consensus rules in January 2009 now permits ECAs to make intra-OECD loans in project financing transactions of up to 50% (rather than 35%) of the total project debt, although this relaxation is only temporary and the limit will revert to the lower percentage at the end of January 2010.

The scale of the problem

PFI reports that, in 2008, commercial bank project loans totalled just over US$250bn, an increase of some US$30bn on 2007 (and US$150bn on 2003). Whatever the numbers for 2009 and the following few years, the level of commercial bank finance achieved in 2008 will remain the high water mark for some time. Moreover, commercial bank terms have become far more stringent; the higher cost of funds being faced by many banks has even brought into question the viability of the traditional Libor benchmark, and their ability to extend long-term debt, in particular, has become acute. Credit spreads in the bond markets have also widened substantially. This has led to an increasing gap between, on the one hand, the limited reality of private market liquidity and, on the other, the continuing aspirations of governments and sponsors around the world.

The solution

In reality, there isn't one. Alchemy remains beyond the capabilities of science. However, public lending sources are being primed to fill at least some of the hole created by departing private lenders. According to Barbara O'Boyle, head of structured

finance at US Exim, the agency is currently handling 14 project finance transactions, more than it has ever been asked to consider at one time. JBIC is being charged with expanding its traditional lending programmes to encompass broad, global stimulus lending (in some cases in co-operation with IFC, IADB and ADB), and the Japanese Parliament is giving consideration to expanding its budget. Rajesh Sharma, the head of project and structured finance at EDC, notes that "the demand for EDC financing across all industries and sectors, both domestically and abroad, is unprecedented. EDC's mandate and powers have been expanded to make complementary capacity available in Canada". Part of the response of the PIF of the Kingdom of Saudi Arabia has been the announcement of its intention to increase its funding for projects to 40% of project debt and to extend the tenor of its loans to projects from 15 to 20 years.

However, while reducing the scale of the problem, public sector measures cannot eliminate it, not least because the world's treasuries are already having to cope with countless other unexpected strains on their current (and future) budgets. There is thus, simply, an insufficiency of loan capital available to the project sponsors of the world to sustain the pace of development of recent years. Public sector lenders, which were in many respects designed to act as a catalyst or supplement to private sector lenders, now frequently find themselves as the primary lending source and, consequently, face demands that strain both their financial resources and their personnel. With the number of projects approaching SACE for support, Ivan Giacoppo and Massimo Schiró of SACE observe: "it is more important than ever that projects are soundly structured to meet our credit objectives."

The result?

- *Prioritisation:* from the perspective of governments with incipient projects;
- *Choice:* from the perspective of lending institutions (public or private) with available funds to lend; and
- *Competition* (for funding): from the perspective of project sponsors.

A strategy for competition

Project sponsors thrive on competition. The twist they face in the current environment is that the natural way to win the competition for commercial bank funding (paying more) is diametrically opposed to the natural way to win projects (charging less). Unfortunately, pricing (which here should be thought of in terms of risks assumed as well as merely fees and interest rates charged) that banks will find sufficiently attractive will all too often be anything but attractive to project sponsors and their customers. It is in this context that the benefit enjoyed by project finance comes into its own. The various public lending sources around the world can and will provide funding. That is what they are there to do, for the right projects.

Pricing is also, of course, a fundamental element in relation to the decisions of public lending institutions. However, the different policies of different public lending institutions that flow from their individual charters mean that their decisions are also influenced by a number of other factors, in many cases more difficult to define with precision. For example, investment in energy security and in particular clean (renewable) energy has gathered wide-scale political impetus and is expected to enjoy increased public sector investment. Projects that can demonstrate broad development or stimulus benefits may, in many cases, be preferred to those that simply generate superior profits.

These factors themselves have major impacts on the way in which project sponsors structure particular projects. For example, sponsors have to weigh the advantages gained on a bid from, again by way of example, funding from K-EXIM or guaranteed by KEIC by using technology A developed by a Korean manufacturer as compared with technology B from another country that may be less expensive but which, for some reason, does not qualify for funding from that country's ECA. Likewise, sponsors may need to factor in the additional expense of satisfying broader, host country development objectives if they wish to access multilateral and development institution funding.

Although it is generally accepted that structuring a financing that includes both public and private funding sources can be complex, few of the issues presented are new. Persuading the commercial lenders that will (hopefully) participate alongside an ECA in the financing of a project that disbursements of the export credit should be excepted from the general rule that different lenders' loans be disbursed pro rata is not a new issue. Nor is it novel to seek to persuade them that the participation in the financing of a multilateral agency may be a good thing (because its involvement increases the likelihood that the host government will be supportive of the project for fear of losing access to future financial support from that agency and its sisters) rather than a bad thing (because its de facto preferred creditor status means that there are circumstances in which the commercial lenders may be disadvantaged). Sponsors have frequently sought, and are once again having to seek, to persuade ECAs and multilaterals to accommodate the tenor constraints of banks by structuring financings to provide flexibility in the amortisation of commercial bank tranches, even at the cost of creating at least partial refinancing risk.

Project sponsors are also familiar with the need to be responsive to the environmental and social priorities that are important to different lenders, private as well as public, but public usually being the more stringent and taking the lead with new requirements. The Equator Principles that are now adhered to by the world's leading project financing banks were not the invention of the private sector – they were developed from and modelled on the environmental standards and social policies of, respectively, the World Bank and IFC. Project sponsors have also come to recognise the concerns of the public purse to avoid the embarrassment of corruption allegations through careful scrutiny of, in particular, the use of loan proceeds.

To ensure continued access to funding, project sponsors, and indeed host states, will need to structure their projects to satisfy the varying, and now frequently expanding, missions of public sector lenders. Whether it is promoting exports, assuring access to natural resources or stimulating job creation and development, their limited resources demand that these lenders optimise their investments, both economically and on the basis of current policy. Public sector lenders are exposed to administrative, legislative and, in some cases, judicial review of their policies and decisions, which can be heightened through the action of lobbying groups and non-governmental organisations (NGOs). With increased choice among a range of competing projects, public sector lenders will wish to ensure that their investment decisions are beyond any reproach, commercial or policy, that could affect their continuing access to public funding.

The future's not bright, nor is it black

Public lending sources have moved from the wings to take centre stage in the provision of financial support to projects across the globe. ECAs, multilateral lending institutions and domestic development organisations are increasingly providing the core debt for projects that, until recently, would have been catered for exclusively by the commercial bank or even bond markets. They have become adept at working with one another, and with other lenders, as a consolidated lender group, and this despite the hurdles posed by language, geography and differing objectives and interests. Intercreditor protocols, resolution of preferred creditor concerns, harmonisation of environmental and social requirements and even standardisation of credit requirements are being achieved through the frequency with which these lenders now work together.

At least for the next few years it is clear that public sector lenders will remain in the vanguard of project financing. It is equally clear that they will continue to respond to varying policy objectives. Against this backdrop, the successful project sponsors will be those who, having identified the tunes, tempo and direction of the public sector lenders, are able to orchestrate the greatest involvement of the private lending sector and so produce for their audience concert pieces that bring together the best of everything. *And thus…*

But there's light at the end of the tunnel,
Providing a glimmer of hope
Nay: more;
For those sponsors with the skills to engage
In the public co-lending arrangements
That abound the international stage.