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Project Bonds: Growing Liquidity for Energy and Infrastructure Finance

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Introduction

Faced with continued demand for large-scale, “mega project” investment, sponsors seeking the cheapest possible debt have mobilised increasingly diverse sources of capital through carefully structured financing packages. For the past 25 years, a number of strong projects have accessed the capital markets for funding and, consequently, institutional investors have established themselves in the global project finance market. Project bonds enable sponsors to minimise the cost of finance to the extent that tenors are often longer than those available in the commercial loan market, since Basel III. For capital markets investors (typically insurance companies, bank treasuries, pension funds and asset managers looking for long term stable assets), infrastructure projects offer inflation-linked, risk-adjusted returns with low correlation to the economic cycle, thus providing for predictable, steady returns.

Unsurprisingly, the attractiveness of the project bond market as a source of financing tends to be cyclical and naturally holds more appeal when the cost of funding from other sources of project financing is comparatively high. In the context of reduced liquidity in the commercial loan market, 2013 saw the project bonds market double in volume from the previous year, to US\$49.2bn. Loan financing recovered in 2015 as a result of tightening credit conditions and aggressive commercial bank practice (in a bid to regain ground against the perceived threat posed by institutional investors). However, the latest “Project Finance International” league tables show that in 2016 the global project bond market grew again, by 23.5% on the previous year, to US\$43.6bn.

The announced refinancing of the debt used to construct the 785MW Fujairah F1 independent water and power project (IWPP) in Al Qidfa, is due to include a US\$350m project bond. This follows the precedent set by the 459,000m³/d and 1700MW Shuweihat S2 IWPP in Abu Dhabi, which in 2013 refinanced approximately US\$2.3bn of project financed debt. The US\$825m project bond issued as part of this refinancing was the first of its kind in the Gulf Cooperation Council region.

The US Federal Open Market Committee, in December, raised interest rates for only the second time in a decade and signalled that they could rise to around 1.4% by the end of 2017, thus ending the low-rate cycle. As interest rates rise, sponsors are incentivised to refinance loans as breakage costs for swaps become less punitive. Clearly the appetite for project bonds from institutional investors is out there. The use of project bonds to refi-



nance bank debt incurred from 2008 onwards will therefore be a very attractive option for sponsors.

A bond issue is a labour and time intensive process with some problematic issues specific to project financing. We set out below the key stages of an issue, followed by the more pertinent considerations to be taken into account when making a decision to raise finance for a project in the capital markets. Properly structured, project bonds cannot be ignored by sponsors seeking to optimise their financing, and refinancing, plans.

Issuance of a Project Bond

The principal stages of a project bond issuance are set out, in brief, in figure 1.

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Problematic Project Bonds?

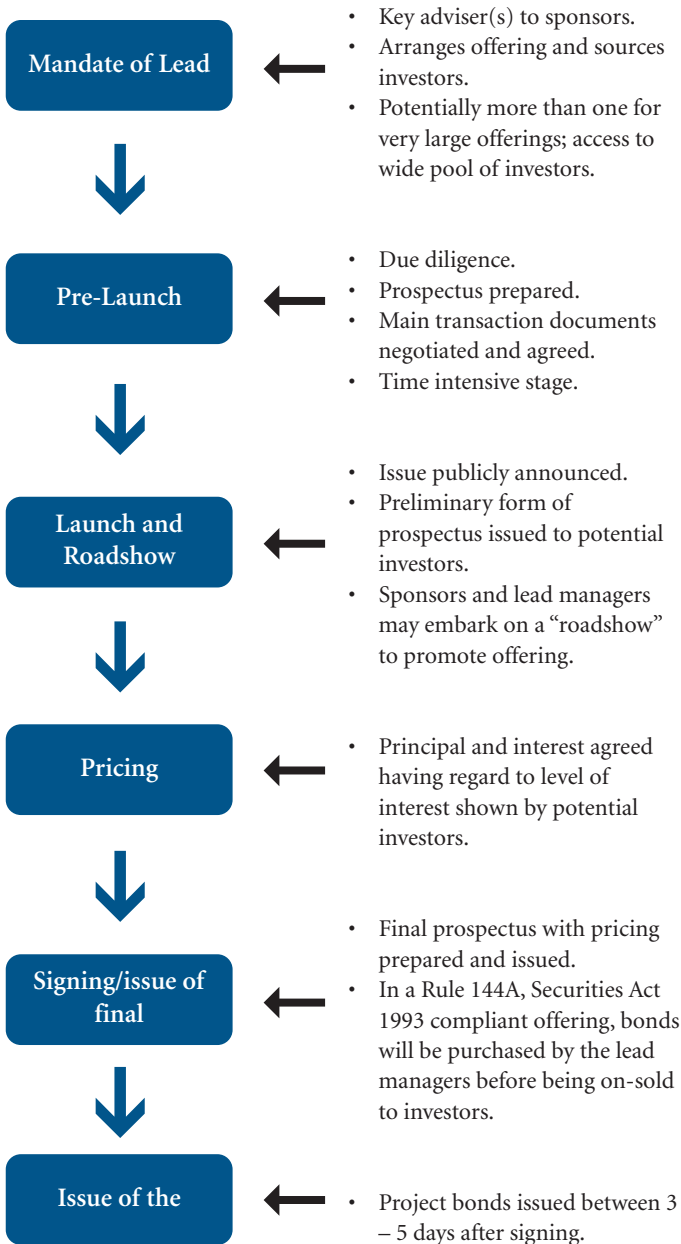
Some of the more pertinent considerations to be taken into account when making a decision to raise finance for a project in the capital markets are set out below:

Regulatory Requirements

Generally, issuers (both U.S. and foreign) will seek to structure their project bond offering so that they can make offers and sales into the U.S. market to ensure access to sufficient investor demand and therefore competitive funding terms. As tradeable securities project bonds are subject to extensive and complex

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Figure 1



securities laws. The principal legislation which applies to offerings in the U.S. is the Securities Act of 1933 and the Securities and Exchange Act of 1934. This legislation requires all offerings to be registered with the US Securities and Exchange Commission and imposes extensive due diligence, disclosure and reporting obligations on the issuer, both prior to, and after the offering. Loans are not subject to the same stringent regulations, inevitably making the process of issuing a project bond more laborious due to the compliance work entailed.

Credit Rating Requirements

Many institutional investors, which make up a large portion of the project bonds market, require as a minimum an “investment grade” rating. Regardless of the strength of the sponsors, or the project’s risk mitigants, many project companies located in emerging jurisdictions

have lacked the ability to obtain a sufficiently robust credit rating as a result of the poor sovereign rating of the host country.

Consent and Intercreditor Issues

Despite the less onerous covenant package typically contained in bond documentation as compared to a loan, events not contemplated at the time of signing will almost certainly arise during the life of any financing. Lender (bondholder) consent will usually be required for an amendment or waiver of the relevant terms of the finance documentation. In the context of a project bond, the typical mechanism of seeking consent through a trustee is more complicated and potentially more time consuming than interfacing with a bank experienced in project financing.

Reconciling the interests of a large group of lenders (potentially commercial banks, export credit and development agencies and bondholders), often with divergent interests (capital markets investors being particularly driven by short-term gains from trading their project debt), can be particularly challenging and will take careful handling by the lawyers when structuring the intercreditor mechanics.

Construction Risk

Construction is generally considered to be one of the principal risks in a project because of the project’s reliance on a limited number of assets to generate revenue. Despite the possibility of completion support, bondholders have historically been reluctant to take any form of construction risk on a project.

Possible ways of mitigating construction risk (and therefore improving the credit rating of a project bond) include:

- A fixed-price “turnkey” construction contract containing appropriate performance incentives, thus transferring the risk of cost-overruns during the construction period on to the contractor.
- An on-demand, unconditional, and irrevocable letter of credit or performance bond provided by a creditworthy institution, sufficient to cover the estimated replacement costs associated with an insolvent or underperforming contractor, delays, or costs overruns.
- A financing structure that permits payment of scheduled debt service under a downside construction scenario (e.g. to address delays in project completion).

Additionally, financing a project through the capital markets presents a unique challenge in that a phased drawdown period represents a challenge for an asset class which does not, typically, provide for a phased commitment from its investors: interest is therefore paid on drawn (but unused) debt. This “cost of carry” can potentially eliminate part of the upside of any lower cost of funding.

Arranging project bonds for projects in their construction phase requires considerable thought from those involved in structuring the deal. A popular option for sponsors is to hardwire into the finance documentation the possibility of refinancing the initial loans with project bonds, since bondholders will no longer be taking a project’s construction risk into consideration when pricing the debt. An optimised structure would consist of traditional construction financing provided by commercial and/or agency lenders and once the project is in commercial operation a capital market refinancing. Such a structure would avoid capital market investors taking construction risk and the issuer bearing the cost of carry.

Operating Period Risk

Following construction, typically no significant or unforeseeable (operating) costs are required to be borne by the project, which reduces risk and should allow a steady cash flow during the payback period of the bond. This “de-risking” of the project makes a successful place-

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ment of a project bond far more straightforward. That said, there remains a risk of operational problems increasing costs, lowering availability or limiting production.

Possible ways of mitigating operational risk (and therefore improving the credit rating of a project bond) include:

- The use of an experienced operator under a long-term service agreement (or a fully funded operations and maintenance reserve account).
- The use of proven technology.
- Obtaining sufficiently robust feedstock or fuel supply arrangements.
- Obtaining (and maintaining) comprehensive insurance policies and business interruption insurance.

Conclusion

With the right investors, a well-structured project and strong risk mitigants, the project bond market can be a very attractive alternative to other, more traditional, sources of financing. Recent years have shown ample appetite among institutional investors for infrastructure projects, and these investors have shown a willingness to compete with the commercial banks. In the context of these investors becoming ever more comfortable with project bonds and the challenges that they may pose, we expect sponsors increasingly to take advantage of the cost benefits to be had from including a bond issue in multi-sourced project debt structures and refinancings.