AN INTERESTING YEAR IN PROJECT FINANCE

Phillip Fletcher and **Aled Davies**, *Milbank, Tweed, Hadley & McCloy LLP*

One of the few certainties about the project finance market is that it is subject to change. The leading participants regularly issue press releases on groundbreaking transactions, often featuring new financing sources, innovative technologies or "first-in-country" deals, demonstrating that the market is (and the lawyers active in it are) both creative and dynamic. However, change is not always positive and, over the course of the past year, projects (both planned and operational) have been challenged by extraordinary volatility in the price of oil, natural gas and other commodities. What some experts had quite recently characterised as a new paradigm of elevated prices driven by the remarkable growth of various emerging economies, has reverted to what we had previously understood to be the norm: market prices vary, often dramatically, over time.

Why have commodity markets collapsed? At least in the energy sector, there has been a confluence of an economic slowdown in various emerging markets, China in particular, with a dramatic increase in shale oil and gas production in the US as a result of advances in drilling technology. Although in prior cycles lower prices were met with reductions in production by Saudi Arabia and other OPEC members, this time those producers have elected to preserve market share rather than seek to support a price floor. A variety of metals markets have similarly been adversely affected by reduced global demand.

Price risk is not the only factor that has challenged the market. Not long ago, Russia was a promising host for a variety of ambitious projects, but the prospects for a number of those deals, including the arctic-based Yamal LNG project, have been impaired by sanctions imposed as a result of Russia's involvement in Crimea and Eastern Ukraine. The result may be that Russia simply turns from European to Asian export markets, but in the current circumstances it may have to develop these projects without involvement of a number of international financial institutions, which for now are prohibited from financing at least certain of them. Turmoil in the Middle East and North Africa, let alone in Nigeria and Venezuela, has also led to disruptions in both existing and planned deals in those regions.

Nonetheless, 2014 was a very active year for project finance, with large-scale transactions closing across the globe. Perhaps the most notable development was the financing of a wide range of pipeline, LNG, petrochemical and other down-stream projects in the US. As shale production has afforded the US with what amounts to energy independence, the US has been transformed into an export platform for LNG and a hub for petrochemical and similar projects. Activity was not, however, limited to just the US; a range of large projects in regions as disparate as Australia and Saudi Arabia came to market, many of which were planned well before the onset of the current price environment. Activity levels were also underpinned by energy and infrastructure projects in Africa, which has finally emerged from being ever the "market of the future" to become a serious competitor for foreign direct investment.

However, current market conditions have muted expectations. Although momentum remains strong in the US, with both expansions of existing, as well as new, LNG export projects approaching the bank market (often with significant oversubscriptions), elsewhere conditions are more constrained. The announced cancellation of the Al Karaana petrochemicals project in Qatar is perhaps the most notable example of a project being cancelled or deferred, but virtually all international and national oil companies have announced significant reductions in capital expenditure, particularly for upstream investments. Likewise, the mining majors are deferring new projects, and junior mining companies are finding it difficult to secure funding in the face of impaired price (and thus profit) projections. Rather than invest in greenfield developments, the better capitalised natural resources companies are likely (as we have already seen, in some cases, in a very significant manner) to seek to acquire assets and even competitors to take advantage of low valuations and to achieve efficiencies.

At the extreme, low prices have placed a number of existing producers into stress. Reduced revenues have combined with corruption scandals to turn Petrobras, the Brazilian oil company, from a darling of the financial markets into a company that now has to face new challenges to sustain its Capex plans. Junior oil producers in the US have found it difficult to raise enough capital to continue to fund costly drilling programmes, and in some cases this has had an adverse impact on their ability to generate sufficient revenues to service existing debt loads. There has also been a knock-on effect on a number of oil service companies that are now finding their order books shortened.

The remarkable collapse in iron ore prices, coupled with the challenges of an Ebola outbreak, placed certain West African producers into administration, and other producers elsewhere may follow.

The current price environment has also led to heighted tension between sponsors and at least some host governments. When a project is faced with reduced gross revenues, the host government is in turn likely to receive less in royalty or tax revenues than it might have anticipated. Were that

government to have come to power having promised (as is often the case) ambitious social services programmes, it may find itself unable to meet the costs of those promises. To preserve its original cash-flow expectations, the government may then seek to secure a larger share of the remaining revenues, to the detriment of the project sponsors. Those sponsors will, unsurprisingly, frequently resist that reallocation of revenues by seeking recourse in the courts or an arbitral forum against what they assert to be wrongful expropriation. Disputes of this sort have arisen not only in relation to projects that are in operation, but also in respect of planned projects, such as the expansion of the Oyu Tolgoi mine in Mongolia, which was deferred for many months, prior to the recent settlement between the host state and the project sponsor. Lenders, too, are thus focusing greater attention on the risks posed by adverse host state relations.

Fortunately, price volatility is something that sound projects have been designed to withstand. Debt service and loan life coverage projections are generally run on conservative long-run price projections that tend to ignore peaks, and the finance terms customarily include distribution blocks, debt service reserve accounts and, in some cases, principal deferral mechanics to help ensure that debt service can continue to be met during revenue troughs. Since construction periods may last several years, at the conclusion of which market conditions may have reversed, at least some sponsors and lenders will take a longer-term view of markets, and thus well-structured projects will continue to be financed. However, the current market conditions are not being ignored by credit committees, and agreeing assumptions for projected commodity prices for base case financial models has become a more protracted discussion. Demonstrating further a lack of confidence in projections, lenders are becoming increasingly sensitised to assessing cash-flow coverage ratios at the time of completion (coupled with the release of completion guarantees).

Although a number of planned projects have been shelved, it may in fact be that they are merely being tactically deferred to await the inevitable reduction in capital costs that will result as construction and engineering firms compete for fewer available mandates. There is still perhaps a time lag in the expected cost reduction as contractors remain busy on existing projects, but it will become increasingly difficult for those firms to find new projects to fill their forward schedules. For those sponsors that can manage it, investments made at a time of reduced construction costs, and what remain historically low borrowing costs, can lead to enhanced profitability over the life of a project, particularly once commodity price cycles become more favourable. Thus, as has been the case in prior down-price cycles, the current period of low investment will likely be followed by a period of accelerated activity.

There are, fortunately, other industrial and infrastructure sectors that are somewhat insulated from the risks posed by volatile commodity markets. Population growth continues to place demands on power supplies as well as transport and telecommunications infrastructure. Government policies, based largely on carbon emissions concerns, have encouraged investment in renewables; there is also a strong prospect for nuclear power (another form of clean power) in a number of jurisdictions, including Turkey and Bulgaria. Lower oil and gas prices may also give rise to opportunities in downstream gas and petrochemicals businesses. Although reduced royalty or tax revenues have certainly led to cutbacks in public infrastructure spending in some countries, private investment continues to be encouraged by a broad range of host governments, and infrastructure and utility sector deals are being completed across the globe.

Deals are being completed not only to finance new assets, but also to fund investment in existing infrastructure and utility businesses. Pension funds, insurance companies, hedge funds and other investors have come to recognise that these businesses can provide stable, long-term returns. They have been investing in roads in France, rolling stock in the UK and transmission assets in Sweden, among other things, and these sorts of deals are being replicated in the US and elsewhere. The financings are structured on terms broadly similar to traditional project financings, and thus have presented additional opportunities for projects lawyers.

Nonetheless, for many projects lawyers the impact of the changes we have seen over the past year has been challenging, but for the best among them it has presented a range of opportunities. The boom commodity prices of recent years placed few stresses on projects, and thus there was less need to focus on and manage risk; lawyers that had access to the relevant precedents could simply repackage them into new financings. However, in periods of volatility of the sort we are currently encountering, sponsors and lenders will tend more frequently to call on lawyers who have demonstrated an ability to think through and solve complex issues – the type of lawyers that this guide terms the "who's who".

Membership in this category of lawyers is also subject to change. One cannot leave the past year without noting the departure of three of the giants of our field: Hal Moore who sadly passed away; Fred Rich, who is continuing his successful writing career; and Bill Voge, who has earned a well-deserved promotion to the chairmanship of his firm. They, together with such stars as Gary Wigmore, Graham Vinter, Anne Baldock, Alan Black, Rodney Short, Ken MacRitchie, Richard Brach and Ed Feo, all of whom retired earlier, did much to frame many of the deal structures that are now seen as customary. Fortunately, the ranks of our field remain deep, and there are many others to help our clients take advantage of the opportunities and meet the challenges presented by the interesting times in which we find ourselves.