THE CHANGING PROJECT FINANCE SEASONS

JAPAN AND THE EAST COAST OF THE UNITED STATES BOTH ENJOY FOUR DISTINCT SEASONS: FROM THE CHERRY BLOSSOMS OF SPRING, TO THE SWELTERING HEAT OF SUMMER, TO THE SPLENDOUR OF THE COLLAGE OF COLOUR IN AUTUMN THROUGH TO THE CHILLING WINDS AND POWDER SNOW OF WINTER. VERY DIFFERENT TO THE CONSTANTLY GREY AND DISMAL NIGHTS WE HAVE COME TO KNOW COMMUTING ON THE SOUTH WEST RAIL SERVICE FROM LONDON WATERLOO. BY **ALED DAVIES**, PARTNER **PHILIP FLETCHER**, PARTNER, AND **DAN BARTFIELD**, PARTNER, **MILBANK TWEED**.

The change in seasons has long been a feature for those whose lives revolve around the development and financing of projects. 2016 proved once again that the business of project finance is, like the weather patterns in our seasons, cyclical.

Commodity prices dropped precipitously from the heights of the early years of this decade and, as a consequence, the final investment decision (FID) for a number of oil and gas and mining projects has been deferred or permanently cancelled as sponsors have been forced to slash spending on capex programmes and, to our dismay, even the calibre of hotels in which they house their advisers.

With this chill in the air, 2016 did not see the volume of mega projects that we had grown accustomed to in the Middle East, Australia and the United States. A market that had been driven by project sponsors seeking to catch the wave of booming demand in China and India, or to capitalise on the availability of cheap natural gas in the United States as a result of the so-called shale gas revolution, simply went into hibernation.

Mega projects will eventually return. Where the feedstock or resource is sufficiently economic, as in the case of the massive Oyu Tolgoi copper mine in Mongolia or the Cobre copper mine in Panama, investment will proceed whatever the market price cycle.

Looking forward, the confluence of reduced engineering costs as contractors compete for fewer deals, low iron, steel, cement and energy prices, and continued low interest rates, is tempting sponsors to begin construction of projects that may not go into production for several years when output prices are likely to have increased. Eventually, supply and demand will be brought back into balance and markets will, as they always have, rebound, until the next cycle reaches its peak.

For now, a number of large LNG and petrochemical projects remain in the planning or development stage in East Africa, Papua New Guinea and North America, although progress in getting to FID is slow, and there are ambitious plans for petrochemical and refinery projects in Oman, Kuwait and Malaysia. So the mega project is not dead – it is just waiting for the shoots of green growth as spring returns.

With the commodity price cycle down, some sponsors and projects have had to weather a harsh winter. A broad range of shale gas producers in North America have lost access to sources of new capital and now face debt restructuring or insolvency.

Some of the leaders in the wind power market, such as SunEdison and Abengoa, have been forced to liquidate or restructure due to overambitious expansion plans and the withdrawal of incentive tariffs on which their business plans had been based. Various shipping markets are suffering from significant overcapacity, with many of the South Korean and other yards facing real challenges.

In the emerging markets, a variety of host governments, seeing cashflows from royalties and taxes fall below optimistic projections, are seeking to renegotiate concession and similar agreements to capture a larger share of revenues. At an extreme, civil war in countries such as Yemen has caused operations at major projects to be suspended.

During this winter season, the leading bankruptcy lawyers in the US have been spending their lives working out of sunny Houston, and a very good share of the rest of the banking and legal community has had to focus on addressing these stressed assets.

Fortunately, calm has, at least on occasion, prevailed. Some of the most significant among these stressed assets have survived this winter period because sensible sponsors, with a

With this chill in the air, 2016 did not see the volume of mega projects that we had grown accustomed to in the Middle East, Australia and the United States long-term view and desire to preserve their investments in the hopes of a more stable future, are funding operating costs and interest payments, and lenders are reciprocating by deferring amortisations, to ensure that their projects remain viable.

However, the low commodity prices have given lenders concerns as to whether some of the mega projects that are now coming up to completion will be able to meet their debt service obligations given that the projected cashflows will not be achieved absent a significant strengthening in commodity prices.

Perhaps the last time we saw such depth of concern was as a result of the post-Enron disruption in power markets; even then, patient investors generally avoided losses, and those who timed their investments wisely turned large gains when markets returned to stability – if only we had taken our fees, as we had been offered, in the then depressed shares of Drax Power.

Not all sectors, however, have suffered, and some have seen autumn shift seamlessly into spring. Power generation, both conventional and renewable projects, continue to provide a base load of work for project finance sponsors, lenders and lawyers in the Gulf region, as power and desalination plants at Sohar and Ibri in Oman, Ras Abu and Facility D in Qatar were successfully financed, along with solar projects in the UAE and Saudi Arabia. Further power and water/desalination projects are being pursued in the Gulf region as governments continue to increase power and water generation capacity.

North America remains very active in the development of renewable energy projects, spurred in part by favourable tax treatment. Europe has seen activity in the offshore wind sector, with projects such as Dudgeon and Beatrice in the UK, Eneco Luchterduinen in the Netherlands, Rentel in Belgium and MEG I in Germany.

The power sector has also remained active in the Asia-Pacific region. The Philippines, which has essentially a merchant power market, saw a number of new power plants being developed after many years of limited activity. Indonesia saw the successful closing of the Central Java Project and the Hassan hydroelectric plant, and it continues with an aggressive increase in power generation capacity with the Cirebon expansion and the new Jawa 1 LNG to power plant. Some progress is being made in finalising two new power plants at Nghi Son and Dai Hyan in Vietnam.

Power, with a more recent focus on renewables, also remains active across much of Latin America, and we have seen among the first of what we hope will be many power projects in Africa.

Whether renewables will continue to be a significant feature of the projects playing field may turn on the implementation of the 2016 Paris Climate Agreement. While it was a historical demonstration of the value placed on reducing carbon emissions, a complex interplay of political, financial and social change is needed to accomplish the goals agreed to by countries around the world.

Whether, of course, there will be a change in US government policy remains to be seen, and the implication of potentially reduced tax rates for the viability of the tax equity market in renewable projects needs to be assessed. However, in Europe and Latin America at least, this activity is likely to continue. The big question in Asia is the extent to which the Paris Climate Agreement will impact on new coal-fired power plants in the region; will there be a shift to renewable energy or gas-fired power plants?

Cheap natural gas has led to the development of CCGT power plants in a wide range of regions, and in particular North America. In more remote locations, sponsors have been seeking to develop plants fuelled with newly economic LNG supplies. How to manage the complex interface between the development of parallel gas and power projects has been a topic of attention since Portugal considered (but ultimately did not pursue) LNG as a source of fuel for the Tapada IPP in the early 1990s, but a wide variety of projects are now well under way from Chile to South Africa to Indonesia.

If LNG to power is not complex enough, spring seems to be coming to the nuclear industry after the tumult caused by Fukushima. The Barakah nuclear power plant in Abu Dhabi finally reached successful financial close, and following the confirmation of its commitment to a nuclear new-build power plant at Hinkley Point, the UK government is now engaging with Horizon and NuGen in relation to further plants. The Sinop Nuclear Power Plant in Turkey is moving into the feasibility stage and India is implementing plans for a fleet of nuclear power plants, as is Eskom in South Africa, so one can look forward to activity on one or more of these large-scale deals in the near future.

North America has seen activity around pipeline infrastructure, with six pipelines connecting US natural gas supply to Mexico, backed by offtake commitments from either CFE, the Mexican power company, or Pemex, the Mexican gas utility, reaching financial close in the last two years. It remains to be seen whether the dispute over the Dakota pipeline will allow that to be a key feature of the 2017 landscape.

In any event, barring similar disruption associated with environmental and social groups, other North American pipelines are likely to seek financing in either the bank or Term Loan B markets. What also appears to be certain is that the new administration will target growth in infrastructure investment, although the key question is how that infrastructure build-out plan will be structured and financed, particularly if fuel tax revenues remain low and other tax rates are to be cut.

Latin America too has seen a broad range of infrastructure deals involving ports, roads, pipelines and more, particularly in Colombia featuring the 4G road and other infrastructure programme; Chile with the expansion of the Santiago airport; Panama with the expansion of the Tocumen airport; Mexico; and, more recently, Argentina. Peru looks promising, but Brazil for now remains a challenge.

There are, of course, market-driven projects that will proceed whatever the season. The dramatic growth in demand for internet and voice and data communication has created a window of opportunity for independent sub-sea fibre-optic cable projects, and we can expect more of these projects including ambitious trans-Atlantic and trans-Pacific cables to come to market.

An interesting feature of 2016 is that M&A activity has picked up. Companies affected by the impact of low commodity prices have sought to raise capital to fund ongoing operations or implement strategic projects by embarking on a process of "re-cycling" projects to raise funds for new investment opportunities.

Governments continue to seek buyers for airports and other assets as a means to bridge funding gaps. This has, in turn, presented opportunities for those with access to capital (including funds and development companies backed by funds) to acquire assets either in auctions or from distressed sellers.

There has been a boom in M&A of power and oil and gas infrastructure including pipelines, tank farms, gas storage facilities and the like, particularly in North America as well as in Italy, Austria and the UK, as well as elsewhere in Europe. A lot of activity in Asia revolved around Chevron's decision to sell interests in certain oil and gas fields and their geothermal energy portfolio in the Philippines and Indonesia.

Financing such investments has required the acquisition finance and project finance teams at banks and law firms to grapple with the challenge of raising significant debt without the luxury of the time usually afforded a complete project finance due diligence process. However, this is a new area of opportunity for those lenders willing to play.

How is all of this activity being financed? The capital adequacy requirements imposed by financial regulators continue to present challenges for banks participating in the sector. This means that multilateral and export finance lenders are required to lead many of today's largest projects. Private equity houses such as Carlyle, GIP and Blackrock have all raised significant funds to invest in mezzanine and similar debt products in the power and energy sector, and insurance companies such as AIG and Allianz have announced multi-billion investment programmes in the infrastructure sector.

Japanese, and more recently South Korean, financial institutions are also seeking to mobilise trillions of yen and won from pension and insurance companies looking for a predictable and stable return.

This combination of constraints arising from capital adequacy restrictions and the increasing appetite of funds, insurance companies and pension funds to look for long-term predictable cashflows may well lead to a new source of funding plans for projects, either through development or refinancing; this is most likely to be focused on the US and European markets but, in the quest for diversification and return, may also lead to project bonds being more successfully launched in markets such as Asia.

The impact of new sources of capital has been particularly notable in the number of refinancings launched in 2016, as sponsors have sought longer tenors and/or cheaper margins.

Project finance sponsors and lenders, and their legal advisers, should embrace the challenges and opportunities that the four seasons bring. Activity will continue to adjust to the ever-changing shift in economic and political dynamics that impact the life cycle of projects. There is no reason to believe that we should be stuck in grey and dismal drizzly days simply waiting for the return of mega deals. ■

The changing seasons