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Why the World Needs Project Bonds (and Project Finance Lawyers)

Milbank, Tweed, Hadley & McCloy LLP

John Dewar

Oliver Irwin

Why Project Bonds?

Project finance is a financing technique used to fund investment across a broad spectrum of industrial activities, notably in the natural resources, telecommunications, transportation, social infrastructure, power generation, and transmission sectors. One of the primary attractions of project finance for a project's owner, typically referred to as a "sponsor", is that the cost of financing a project using this technique can be minimised to the extent that the debt incurred to finance the project will be repayable over a long period of time using the proceeds of the project's net revenues.

At the outset of any project, a sponsor will keenly assess the financial markets so as to consider how best to finance its project. As one would expect, one of the sponsor's principal considerations at this stage will be obtaining the cheapest source of debt to finance the construction of its project. Factors that will impact on a sponsor's cost of financing its project will include the project's location, the industry in which the project will operate, the identity of the sponsor(s) and the project company's contractual counterparties, however, the crucial determinant will often be one over which a sponsor has no control: the liquidity of the debt markets (bank, capital and public) at that moment in time.

Historically, commercial banks have been the primary source of project financing. However, as has been well publicised, in recent years commercial banks in developed markets have faced tighter credit constraints due to a combination of the effects of the financial crisis and the need for commercial banks to increase their capital bases. This has resulted in a period of (relative) decreased lending from these traditional providers of project finance. Many commentators predict that this trend appears unlikely to be reversed any time soon given the potential effects of Basel III, which will likely further hinder commercial banks' ability to be ready providers of project finance. One of the main impacts of Basel III, which will require commercial banks to match their liabilities (loans) to their assets, is likely to be an inability for commercial banks to provide loans with long tenors (which, as alluded to above, is an important aspect of project finance loans). As an illustration, in the period up to 2007, it was not unheard of for commercial banks to provide project finance loans with tenors of up to 30 years. Under Basel III, it seems very unlikely that commercial banks will ever be able to provide loans of that tenor again. Indeed, although attractive pricing is still available in the commercial bank market (mainly due to declining swap rates), tenors are typically much shorter, with 15-20 years normally being the maximum available.

The reduced liquidity in the commercial bank project finance market, combined with the need to finance large-scale "mega-projects" (where the debt requirement runs into billions of dollars), has necessitated the mobilisation of increasingly diverse sources of capital. Sponsors (and their respective financial and legal advisers) have sought to meet this challenge by carefully structuring multi-sourced financing packages to raise funding for projects from a wide variety of existing or "new" sources of debt, which has included (i) commercial banks from Asia, the Middle East, and Latin America, (ii) increased involvement by export credit agencies, multilateral lending agencies and development financial institutions ("public debt"), and (iii) for the stronger projects, the capital markets.

We should note at this point that although project bonds are currently in vogue, project bonds are not a new phenomenon. Sponsors have accessed the international and domestic capital markets to raise financing for projects since the 1980s. The attractiveness of the project bond market as a source of financing tends to be cyclical and, unsurprisingly, holds more appeal when the comparative cost and availability of funding from the traditional sources of project financing make it challenging or more expensive to construct a financing plan based solely on bank and/or public debt. In these circumstances sponsors may look to fund all of their debt requirements using project bonds, or integrate the project bonds with other forms of debt in a multi-sourced financing structure. The U.S. project finance market has a long history of utilising project bonds (and indeed to date most project bonds have been issued in the U.S. market for predominantly U.S. projects).

Although there is a perception amongst some sponsors that issuing project bonds can be problematic, the pricing and tenors available in today's capital markets have meant that this is a financing option that cannot be ignored by sponsors seeking to optimise their financing plans.

Problematic Project Bonds?

The steady, predictable nature of a typical infrastructure project's revenues makes projects particularly suitable for capital market investors. In most cases a project will have an offtake agreement (for example, a power purchase agreement or a concession) that will provide a secure and predictable revenue stream over a period of time exceeding the tenor of the project's debt. Furthermore, more often than not, offtake agreements are entered into with governmental agencies or supported by creditworthy entities, further enhancing the attractiveness of the revenue stream. As the long-term reliability of the offtake revenues underpins the repayment of a project bond, investors will focus close attention on ensuring that the project will in fact be able to generate robust revenues over the payback period of the project bond. An offtake agreement backstopped by a good credit and a solid pricing structure will enable potential project bond investors to be assured of a long-term, stable and predictable revenue stream.

Notwithstanding the above, issuing a project bond is a labour and time intensive process. And once a sponsor has issued a project bond, it then has to interface with a large pool of bondholders during the life of a project (rather than a group of lenders accustomed to the demands of a project financing). These two factors have meant that, historically, where possible sponsors have tended to finance their projects using the loan markets. Notwithstanding the benefit of (currently) competitive debt costs and longer tenors available from the capital markets, a decision to issue project bonds is not, therefore, one that is taken lightly by a sponsor. We have set out below some of the more pertinent considerations that need to be taken into account when making a decision to raise finance for a project in the capital markets.

Regulatory requirements

Project bonds are tradeable securities and are therefore subject to extensive and complex securities laws which seek to protect investors from abuses such as fraud, insider trading and market manipulation. The securities laws to which a project bond will be subject, which do not apply to loans, inevitably make the process of issuing a project bond more laborious than entering into a loan due to the regulatory work entailed (which can be extremely time-consuming).

Historically, the largest market for project bonds has been the U.S. market and therefore 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 competitive funding terms for their bond. As with any jurisdiction, raising capital from the public markets in the U.S. is heavily regulated by both state and federal law. The body which regulates these matters in the U.S. is called the United States Securities and Exchange Commission (SEC), and 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 SEC and imposes extensive disclosure and reporting obligations on the issuer, both prior to, and after the offering. Project bonds issued to U.S. investors under Rule 144A require underwriters to obtain so-called "10b-5" disclosure opinions which will require both sponsors' and underwriters' counsel to carry out extensive due diligence in relation to the project.

Credit rating requirements

Standard & Poor's, Moody's and other credit rating agencies regularly rate debt issuances by projects. These rating agencies publish details of the criteria they use to rate power and other projects, which, unsurprisingly, are very similar to those used by commercial banks in making their own credit assessments. The minimum required credit rating level to allow many classes of investors to acquire project bonds is an "investment grade" rating. Regardless of the strength of the sponsors or the project's risk mitigants, achieving such a rating will always be challenging if the sovereign rating of the host country lies below that level. One of the primary reasons why project bonds have in the past held little appeal for sponsors as an alternative to loans is because many project companies located in emerging jurisdictions have lacked the ability to obtain a sufficiently robust credit rating.

Consent and intercreditor issues

One of the advantages of a project bond for sponsors is that bondholders will typically have less onerous documentation requirements, which affords the project company greater flexibility as to how it constructs and operates the project (it should be noted that a sponsor will not benefit from this flexibility if the project bond forms part of a multi-sourced financing).

Despite the extensive documentation governing the project participants' relationships, issues that had not been contemplated at the time of signing can (and often do) arise during the life of any financing and, when this happens, lender consent will usually be required for an amendment or waiver of the relevant terms of the finance documentation. In the context of project bonds, this process can be problematic for sponsors as it is generally more difficult to obtain the consent required to amend (or obtain waivers of) finance documentation from a large pool of bondholders than a group of commercial banks or agencies accustomed to the demands of a project financing. In those cases where a modification of the project bond documents is required (e.g. delay of project beyond the specified contingency period), the typical mechanism of seeking consent through a trustee to procure approval for the relevant change or waiver is more complicated and potentially more time-consuming than interfacing with a bank with project finance experience to reach a solution.

As mentioned in the introduction, sponsors will now frequently employ multi-sourced financing structures for their projects, which means that it is not unusual for a project to be financed by both straight debt from the commercial loan market, public debt and project bonds form the capital markets. Incorporating a bond offering into a project's capital structure, and harmonising the intercreditor relationship between commerical banks, export credit and development agencies and bondholders (who will rank on a *pari passu* basis) requires careful handing by the lawyers. A project's financing will now often involve weaving together the intricate requirements of a wide variety of lenders. Divergent currencies, tenors and interest rate mechanisms are now only the more technical issues to address; harmonising the interests of a large group of lenders, some of whom may have a long-term focus on development or other policy matters, some of whom do not (capital markets investors being particularly driven by short-term gains from trading their project debt), can be particularly challenging.

Construction risk

Construction is generally considered to be one of the most significant risks in a project because of the project's reliance on a limited number of assets to generate revenue. It follows that construction risk, although it can be mitigated through the use of completion support, has long been regarded as being the main obstacle to project bonds being more widely used in the project finance market. Bondholders have historically been reluctant to take any form of construction risk on a project. This reluctance stems from the identities of the investor base for project bonds which typically comprises insurance companies, bank treasuries, pension funds and asset managers looking for long-term assets with predictable revenue flows.

One very popular option for sponsors is therefore to hardwire into the initial finance documentation the possibility of refinancing the initial loans with project bonds (as these will likely become available on more attractive terms once the project is fully operational, since bondholders will no longer be taking a project's construction risk into consideration when pricing the debt).

Sponsors are unlikely to seek to refinance commercial bank debt for projects financed between 2004 and 2008 as, in comparison with pricing available in the current market, the debt pricing on these projects is likely to be relatively cheap. However, using project bonds to refinance bank debt incurred from 2008 onwards on projects that are now operational is a very attractive option for sponsors.

Any credit rating assigned to a project bond during a project's construction phase will likely be heavily impacted by the construction contractor's creditworthiness. Possible ways of mitigating construction risk (and therefore improving the credit rating of a project bond) include:

- Obtaining a construction contract with a guaranteed maximum price, and thereby transferring the risk of cost-overruns during the construction period on to the contractor. The construction contract would also likely include financial bonuses and liquidated damages so as to incentivise the contractor to build the project according to the original schedule and budget and compensate the project for any loss or delay in production.
- Obtaining an on-demand, unconditional, and irrevocable letter of credit or performance bond provided by a financial institution with a strong credit rating in an amount sufficient to cover the estimated replacement costs associated with an insolvent or underperforming contractor, delays, or costs overruns.
- Implementing a financing structure that permits payment of scheduled debt service under a downside construction scenario (e.g. to address delays in project completion).

In addition to the above risks, financing a project using capital market instruments also presents a unique challenge in that a phased drawdown period typically represents a challenge for an asset class which does not, typically, provide for a phased commitment from its investors. Therefore, when issuing a project bond during the construction phase of a project there can be a significant "cost of carry", as interest will need to be paid on drawn (but unused) debt. This "cost of carry" may take away a significant part of the upside of the lower cost of funding obtained through accessing the capital markets. Arranging project bonds for projects still in their construction phase requires additional thought from those involved in structuring the deal.

Operating period risk

After the construction period, typically no significant or unforeseeable (operating) costs are required to be borne by the project, which reduces risk and (assuming the project has been constructed in accordance with its specifications) allows a steady cash flow during the payback period of the bond. This "de-risking" of the project makes a successful placement of a project bond far more straightforward. That said, a project is not entirely without risk during the operations period, as there remains a risk that the project will experience operational problems resulting in higher than expected costs, lower availability or limited 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. Projects that make use of proven technology with a long and effective track record are generally considered more likely to experience success than projects that rely on new, unproven technology.
- Obtaining sufficiently robust feedstock or fuel supply arrangements.
- Obtaining (and maintaining) comprehensive insurance policies and business interruption insurance.

Notable Project Bond Activity

The 2013 "Project Finance International" league tables showed that the global project loans market remained steady last year, recording a modest 2.6% increase from 2012 to US$204bn. Notably, however, project bonds doubled in volume from US$24.1bn in 2012 to US$49.2bn in 2013. Within that increase, the US market led the way, increasing volumes by 90% to US$13.5bn from US$7.1bn in 2012. With long-term yields for government debt at a historical low and credit spreads tightening in the capital markets in general, pricing for project bonds is at an all-time low and, as the 2013 "Project Finance International" league tables showed, this is reflected in increased activity in, and appetite for, the project bond market.

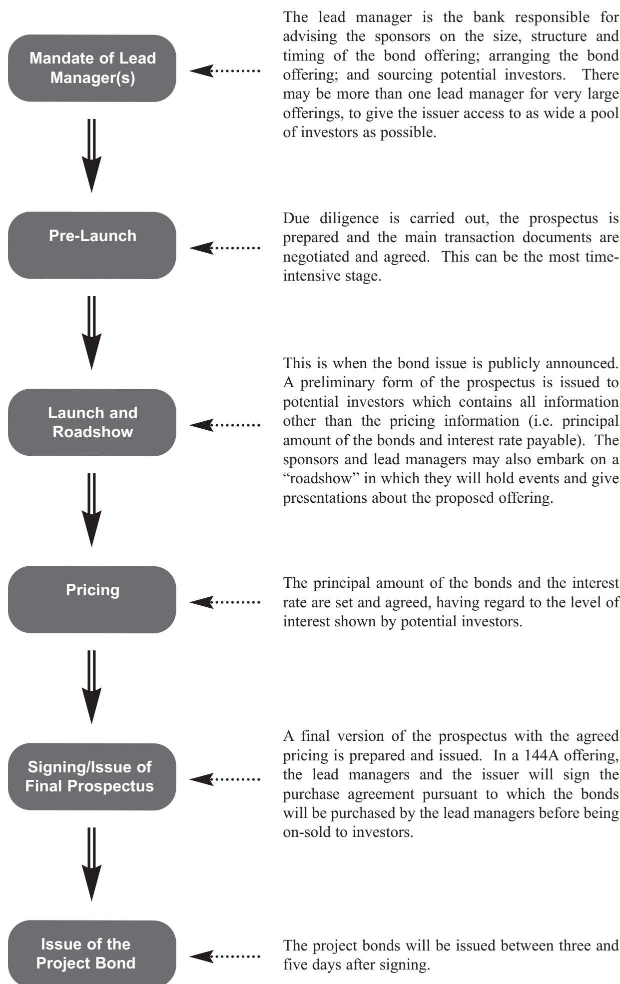
Notable capital market offerings in the Gulf Cooperation Council ("GCC") region in 2013 were the US$825 million project bond that formed part of the refinancing of the Shuweihat S2 independent water and power project in Abu Dhabi, and the US$2bn equivalent *sukuk* that formed part of the multi-sourced US$12.5bn project financing of the Sadara chemical project.

In August 2013 the Ruwais Power Company, the owner of the 459,000m^3/d and 1700MW Shuweihat S2 independent water and power project in Abu Dhabi, refinanced approximately US$2.3bn of project financed debt. Part of this refinancing package was a US$825 million project bond, which was the first project bond for an independent power project in the GCC. Many commentators predict that this refinancing will have established a template for similar assets in the region (of which there are many) to follow into the capital markets. Part of the sponsors' motivation for incorporating a project bond into the refinancing package was the desire to develop an alternative source of long term debt for their future projects, given the current scarcity of loans with long tenors available in the commercial bank market. In addition to establishing a regional template for future projects, this refinancing demonstrated the existence of a strong investor interest for project bonds for assets of this nature in this region. A number of existing independent power projects and similar projects in the region adopted mini-perm structures in the wake of the global financial crisis and we expect to see this financing structure being replicated when the time comes for these projects to refinance.

In April 2013 the Sadara Basic Services Company issued a 15.75-year US$2bn equivalent *sukuk* to finance part of the development of the Sadara chemical and plastics production complex in Saudi Arabia. *Sukuks* permit bond-like financings to be structured in a way that is compliant with *Shari'ah* law. Although to date the absolute number of *sukuk* issuances remains a small proportion of bond issuances, the GCC nations have a large pool of underutilised sovereign capital, and Islamic finance structures such as *sukuks* are an obvious fit for the region. There is a confluence of a generally-acknowledged need for infrastructure development and increasing political support for the development of Islamic finance as an alternative to conventional finance. The Emirate of Dubai in the United Arab Emirates has recently launched an effort to develop a vibrant *sukuk* market to rival those of financial centres with a longer *sukuk* track record, in particular Malaysia and fellow GCC member Bahrain. We expect to see *sukuks* become a commonplace feature of multi-sourced project financings in the GCC region.

Issuance of a Project Bond

The principal stages in a project bond issuance are set out, in brief, below:



Bondholders will principally be focused on the return which will be paid on their investment, represented by the interest payable on the bonds, and a key consideration of a potential investor in project bonds is the risk of default on payment. In evaluating such risk, investors will assess the issuer based on: (i) the information set forth in the offering document or prospectus; and (ii) the credit rating given to the issuance.

Most of the issuer's disclosure obligations are met through the information which it provides in the prospectus (sometimes called an "offering circular" or "offering memorandum"). The issuer is responsible for ensuring that all information that may be relevant to a decision to purchase the bonds, and thereby invest in the project, is included in the prospectus. The sponsors and their advisers (upon whom responsibility for the preparation of the document will fall) will need to be meticulous and exercise caution when making statements in the prospectus, because an issuer will incur liability under the anti-fraud provisions of U.S. securities laws if information in the prospectus is defective or deficient in a material respect. The prospectus will contain detailed descriptions of the project and the key project and finance documents, as well as financial information about the key entities involved in the project. There will also be a section detailing the risk factors associated with the project. All of the above will need to be factually accurate and comprehensive.

Conclusion

Commercial banks and their credit committees are reviewing project structures and credit risk with far greater scrutiny than they did before the financial crisis. This scrutiny, combined with the complexity of large-scale projects, means that many project financings are taking longer to execute than they did before the financial crisis. As lenders' documentation requirements and credit approval conditions have slowed down the timetable for the execution of transactions, the competitive edge that the loan market once enjoyed over capital markets because of its ability to execute transactions rapidly has therefore lessened, and it seems likely that if commercial banks' ability to provide long-term debt remains constrained, and the pricing of bank debt remains relatively expensive in comparison to bond yields, then more and more sponsors will shift their attention to the project bond market.

There are still risks inherent in project bonds that institutional investors have not historically been comfortable with, such as construction risk, and there will still be inherent challenges in adapting structural components of project bonds (such as long draw-down periods and higher pre-payment costs) to standard project finance transactions, but 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. However, unless all construction risks can be adequately mitigated, it will continue to be hard to close pure project bonds prior to project completion. An optimised structure would consist of a traditional construction financing provided by commercial banks and/or agency lenders and, once the project is in commercial operation, a capital market refinancing. Such a structure would avoid capital market investors having to take construction risk and would avoid the issuer bearing the cost of interest payments for non-utilised debt during the construction period. However, given the constraints that face the conventional banking market, it is not unreasonable to predict that sponsors will continue to need to turn to the capital markets as a source of funding for their projects. With time, those investors will perhaps become more accustomed to the strong credit characteristics of project debt and the unique requirements of project financing transactions, and it may be the case that capital market issuances will become increasingly common even in some of the more exotic locations around the world.

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