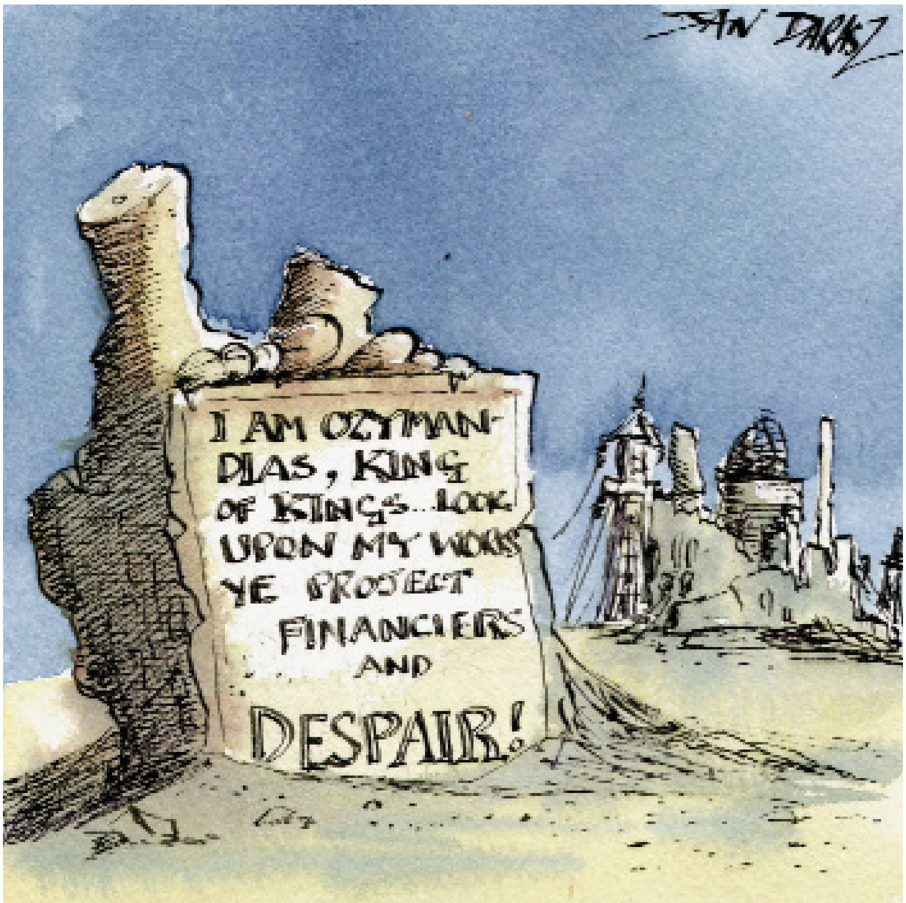
Rules for negotiating project finance deals

Phillip Fletcher explains the art of negotiating an international project financing to achieve consensus in the absence of set rules



Project finance is difficult to define but easy to recognize; it generally involves lending significant amounts of money to a thinly capitalized company whose primary assets consist of contracts and licenses, but that is where the simplicity ends. Notwithstanding the efforts of various governments to standardize private finance initiative (PFI) and similar documentation, the field defies the application of fixed rules. The range of assets financed, from underground mines to overhead cables, and the breadth of jurisdictions covered, from Canada to Mozambique, mean that even the most basic rules must flex to meet the facts and issues in question. In the absence of rigid market standards and agreed form documents, the project finance lawyer must patiently assess the economic, technical, political and legal risks presented by each project and draw on experience to help the parties reach a workable consensus in face of often unique challenges.

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The discipline is old. Some date the onset of the practice to the financing of the Panama Canal over a century ago. The big mining deals in Africa and Latin America of the 1960s and 1970s are perhaps a more realistic grounding for the field, and the development of independent power projects in the US after the 1978-1979 oil crisis gave rise to the model for many of our modern projects. Recent years have seen this model used in an ever-broadening range of countries. Although projects lawyers are clustered in London, New York and Hong Kong, as the application of project finance has spread, they are now found in almost every city where complex transactions are documented.

Twenty years ago, debate raged over whether non-recourse (project) lending violated the regulations that required commercial banks to limit themselves to "prudent banking practices". More recently, focus has been placed on the extent to which capital reserve requirements should be increased on project loans in accordance with the Basel II accord. The decades have shown that restructurings are common (perhaps due to the pervasive covenants imposed on borrowers), but losses have been relatively rare. Nonetheless, the idea that recourse on a loan should be limited to a special purpose borrower and its assets remains a focus of attention.

This has not, however, stemmed the flow of project finance deals. The world's rising demand for energy and natural resources, driven in large part by the remarkable growth in the Chinese and Indian economies, has led to a rapid growth of investment in resource extraction projects. With prices at record levels, international oil companies are exploring for energy in remote parts of West Africa, the Caspian and the Middle East, and the resulting projects often entail billions of dollars of capital costs. Many of the host countries have never seen financing, or even commercial, transactions on this scale. At the same time, a number of more developed countries have used these techniques to broaden the participation of the private sector in traditional public sector activities, ranging from utilities to roads, hospitals, schools and prisons. Although the underlying commercial law is settled in these countries, public/private partnerships have often required broad reforms of regulatory regimes to accommodate them. Thus, as project finance has moved into new areas, the legal issues have become more challenging.

The joy of the covenant

In the most basic terms, project finance is a form of secured lending. Much of the legal expertise is drawn from the discipline of banking. One who sees the beauty of the perfect covenant, the joy of an all-encompassing event of default or the elegance of a multi-tiered intercreditor agreement has the capacity to excel in the field. But the inclination to do so comes from never having outgrown the wish to play with big toys. Like asset finance lawyers, the projects lawyer needs to know how to take security, fixed or floating, over every asset imaginable, but they must also understand how the underlying facility operates and its ability to generate revenues for periods encompassing decades.

Legal analysis is but one element of the project finance due diligence effort. Technical advisers assess the physical plant, market advisers predict the availability and cost of inputs and the value of the future revenue streams, and model auditors assess the integrity of the financial models. The lawyer works with these other experts to identify risks and to generate an integrated due diligence report - often stated to be limited to legal issues, but out of necessity based heavily on contributions from a variety of experts. Out of this process the parties are asked to assess the "bankability" of a potential risk or the project as a whole.

That no project is the same should be apparent. Variables such as the robustness of the underlying economics, often tested by reference to anticipated debt service coverage ratios, the degree of complexity and reliability of the asset's technology and the stability and transparency of the host country's political and legal environment, determine how accommodating investors are likely to be in relation to legal and other risks.

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Take or pay

What are the legal issues a projects lawyer deals with in making these assessments? Few legal disciplines are not relevant. Projects lawyers use all of the skills learned in law school, bar (one hopes) criminal procedure; the law of contracts, property, trust, torts and equity feature regularly in their practice. As the financing instruments range from bank loans and capital markets instruments to political risk insurance from official credit agencies and a variety of *Shari'a* compliant instruments issued by Islamic institutions, they must be able to document the differing requirements of a wide range of markets. In fact, their expertise must extend far beyond finance papers: the best among them are able to act from the inception of a project as it progresses from negotiating its construction contracts to the day it issues a prospectus for a public issue of securities. The more modest will confess that they are merely adept at deploying the expertise of their firm across this broad range of requirements.

The most common dispute the projects lawyer encounters is over the terms and enforceability of long-term so-called take or pay contracts. These contracts, in all their permutations, underpin most big projects. The sale of power, of oil and gas, natural resources, telecommunications capacity and a range of other products is generally framed in a contract in which the purchaser agrees to take a minimum level of output at a price based on some form of set formula for a specified period. The project company is thus contractually insulated, at least to some degree, from the one thing it can least control: long term market conditions.

Minimum volume commitments can be particularly burdensome on the buyer when they are matched by a fixed or floor price on those volumes. If you try to sell 8¢ output in what has become a 2¢ market, before long the purchaser will try to find a way out of the deal. The claim could be disingenuous: "we didn't understand what the deal was about". It could be mysterious: "the contract was entered into only because you bribed our government". It might even appear reasonable: "we can't take the output because a hurricane blew away our transmission grid". It might also be on the basis of defences at law: "we are broke, we can't pay and the court says you can't make us". Or in equity: "it's unfair to make us pay this much over the market". There are court decisions in many jurisdictions addressing a broad range of such circumstances. The decisions turn on the facts of the case, the terms of the underlying agreements and the environment in which the dispute is heard.

Risk assessment

The role of the project finance lawyer is to seek to bring some advance certainty to this process by identifying the fundamental risks and getting the parties to agree who assumes them long before they arise. They focus the parties' attention on the worst case scenarios, thereby making them consider circumstances none of them wishes ever to encounter. There is rarely any debate about the effect of an act of God (most of which can be insured), but when the discussion turns to who takes the risk of an act of government, such as the imposition of a new tax or an import restriction, any of which might change the fundamental economics of the deal, the debate can be heated. No party can easily assume a risk that is beyond its control, and governments rarely reassure parties that such risks will not arise, as they generally do not wish to fetter the discretion of their successors. Whether there are price re-openers to address unanticipated shifts in market conditions can also be controversial.

These issues became heated during the crisis that hit many developing countries in the late 1990s. Currency devaluation caused the cost of debt denominated in dollars, and the price of goods and services acquired in dollars, to sky-rocket in local terms. Electric utility companies, paying for power and fuel in dollars, simply could not pass on the cost to local consumers whose incomes were set in local currency. Every defence imaginable emerged, along with notable disasters, such as the failure of Enron's Dabhol project in India, and more reasoned restructuring of power projects in Pakistan and Indonesia. Each of these had capital costs well in excess of $1 billion and thus attracted considerable attention. In the successful restructurings, lenders rescheduled debt, sponsors accepted lower returns and the tariff was consequently reduced, but perhaps more importantly (and quite unintentionally), the process took so long that the local economies had time to recover and the tariffs again became affordable. In the failed Dabhol project, amidst allegations of abuse of the original negotiating process, construction halted and the asset was left to rust, with only the litigating attorneys being the winners.

These crises hit not only developing

economies. In late 2002, the collapse of large power traders such as TXU Europe and Enron, among others, left much of the UK power generation sector insolvent. Banks assumed *de facto* ownership over much of the industry. A few years later (as power prices have recovered) the defaulted loans are trading back at par, and many banks (or the hedge funds they sold to) have recovered additional, unanticipated equity value. Having spent years as insolvency practitioners, projects lawyers are today working on floats, trade sales and other exits from these now successful investments.

London or New York?

A second area of regular focus is in respect of the selection of governing law. Sometimes the issue is limited to the choice of the law governing the loan agreement, generally as between English or New York law. The preference is perhaps less substantive than meets the eye as much of the case law in those jurisdictions on the enforceability of customary finance agreements comes to similar conclusions. The debate can nonetheless be heated in the "battle of the preferred forms". The corresponding choice of forum for dispute resolution is, however, perhaps more interesting, as a variety of parties have a preference to litigate in either London or New York and not the other.

But the question can have real substance as well. Let us take the case of a natural gas products project in a West African country. The off-take contracts, in the form of a forward purchase of future production, were between the West African producer and an offshore special purpose company incorporated in Bermuda. The Bermuda company borrowed loans to finance the purchase of the products from the producer; it then on-sold those products to purchasers worldwide and used the proceeds of those on-sales to service the loans. The financing documents were governed by New York law and the project's bank accounts were charged to the lenders under English law in London. The governing law of the off-take contract could reasonably have been chosen by reference to any of these jurisdictions. The choice could have affected fundamental issues, including the circumstances in which title to the future production effectively passed from seller to buyer and the enforceability of liquidated damages for breach. Where should disputes be heard? What law will the forum apply and will the result differ as a result? Will judgments or awards be enforced in the home jurisdiction of the assets, the borrower or the other project parties? A decision focused merely on a preference for a familiar law or forum could miss the changes in legal result that might turn on these choices.

The importance of the choice of law or forum might be even more acute when the country in which the project is located either has no tradition of reported case law or where domestic law, is, say, based on *Shari'a* principles that prohibit such fundamental elements of the transaction as the charging of interest on loans. In some cases, a choice of foreign law and a selection of a neutral forum might be helpful even if enforcing an offshore judgment back in the host country is likely to be challenging. In other cases, it might make better sense to structure the transaction to conform to *Shari'a* principles than hope for enforcement of a non-Islamic transaction.

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Creating security in a barren land

A third area of regular challenge is structuring security packages, often across jurisdictions and over diverse assets. A lender's collateral package serves two purposes: it allows the lender to deprive the borrower of the pledged assets when the loan is in default and it assures the lender that no other creditor is able to take those assets in preference to it. The availability of such packages have generally given lenders the confidence to extend long-term, (relatively) low-cost loans. Where an asset is located in a country with no filing or registration code, or where the enforceability of contractual step-in rights granted to lenders is uncertain, the challenges are considerable. In addition, some countries charge high fees for the registration of security, but often without providing certainty that such security can be enforced. In such cases, the lenders are often asked to do without the traditional security package and are asked to rely solely on pledges of offshore bank accounts, assignment of export contracts and, in some cases, security over shares.

A notable debate arose in the context of projects being developed in a Middle Eastern jurisdiction that lacks both a code governing the registration of security and even a basic insolvency law. Early projects sought creative means to allow lenders some form of security over hard assets. Solutions extended to effecting an offshore conditional sale of the assets. When the structure was put through the disclosure of a public capital markets issuance, the corresponding risk factor caused such focus on the uncertainty of the regime that the underwriters concluded it best to do without that form of collateral security. Without legislative change (which might be forthcoming), subsequent deals have also done without. Perhaps this is because the underlying economics of the projects are sufficiently robust to allow compromise on these issues. Security, however, remains a vital element of weaker transactions in other countries.

The financing of satellite projects presents similar challenges. Who would want to foreclose on a satellite orbiting the earth 35,000 kilometers above the equator? More to the point, because space is beyond the jurisdiction of individual states, where would one register the interest? Treaties have addressed how to register security over aircraft and ships, which by their nature can operate in numerous jurisdictions. But no international convention exists (though one is being formulated by Unidroit, the Rome-based International Institute for the Unification of Private Law) for the taking of security over objects in space.

This has not prevented satellites from being project financed. While the single most valuable item might be beyond the physical grasp of secured creditors, careful structuring has allowed creditors constructively to repossess satellites by taking assignments of operating agreements and licenses (where permissible), revenue-generating customer contracts and in-orbit insurance.

Ecological considerations

Back on earth, an area of increasing focus is environmental and social planning.

Local environmental legislation might simply not exist in some jurisdictions, but projects financed by national or multinational credit institutions often have to comply with World Bank or similar standards. These require the comprehensive mitigation of environmental emissions and management of the project's impact on local populations. A wide variety of non-governmental organizations (NGOs) have pressured leading commercial banks into accepting similar standards. The adoption of the so-called Equator Principles by these banks has now largely aligned their requirements with those of the World Bank. As a result, big projects generally have to meet standards that far exceed those that would be required by domestic law in the host country. Lenders have in effect assumed the role of the absent global environmental regulator.

Recognizing who has negotiating leverage in this context is perhaps more art than science

Troubled waters

A host of other challenges arise when projects encounter difficulties. For example, in a project in Florida, a change of governor led to an investigation of the legitimacy of the project's environmental permit. Unfortunately, this occurred part way through construction. A reasonable decision would have been to suspend funding under the $650 million debt facility. However, this would have caused the virtual write-off of the outstanding disbursements; there is little value in a half completed plant. The decision to continue funding and complete the project while seeking to negotiate a settlement with the environmental authorities required, at a minimum, nerve. Two tranches of senior lenders (commercial banks and insurance companies) and a syndicate of subordinated lenders had to reach that decision independently, and the construction contractor had to agree to complete the project without increasing its price despite incurring cost from delays and the uncertain circumstances. Even more remarkably, the original sponsor (an otherwise well known and successful company) had to recognize that it was now unwelcome in Florida and agree to sell (at a loss) its project to an untainted third party developer. Had the intercreditor relationships and security package addressed all of this? No. But were the rules at least enough to define the procedures by which the parties would have to reach settlement? Yes. Had any party not shown maturity and judgment, all would have been lost.

The Gulf wars gave rise to similar issues. Faced with a deteriorating environment in the region, lenders were reviewing carefully material adverse change conditions in both underwriting and credit agreements. In some cases, the condition was clear, in others not, however, the region as a whole responded in a considered manner, deferring closing dates where appropriate, accommodating price flex when needed and, more structurally, host governments agreed to absorb a certain degree of the risk associated with terrorism or war. As a result, few projects were disrupted and since then the market has flourished.

More than a lawyer

Against this mosaic of issues, the role of the project finance lawyer is not limited to answering specific legal questions, but extends also to organizing the process and setting priorities for what must be achieved. Negotiations take place among numerous parties. Each has an interest in the deal, but each interest is limited by the scope of the role and the anticipated benefits to be derived. Ask too much of any party, and they will be deterred from participating; ask too little and the overall viability and security of the project might be brought into question. A concession made to one party, for example going without the requirement for the provision of a completion guarantee, might simply impose burdens on another. Such a concession could, for example, necessitate the provision by the contractor of enhanced performance warranties, or the agreement of the off-taker to accept delays in the development schedule or an increased tariff if construction problems emerge. Trade-offs of this sort must be negotiated across legal traditions and even languages. The success of the largest projects, where the sources of debt finance might encompass export credit agencies in Asia, Europe and North America, in coordination with multilateral institutions, such as the World Bank, commercial bank lenders in London, Tokyo or New York, and perhaps regional finance institutions based in (say) Dubai or Johannesburg, is dependent on the project finance lawyer's ability to help the parties reach a workable consensus.

Recognizing who has negotiating leverage in this context is perhaps more art than science. Broadly stated, as global financial liquidity has grown and as official credit agencies have placed a high priority on encouraging global diversity of energy sources, sponsors and even host governments have gained the upper hand. The process adopted by governments of competitively tendering the opportunity to develop a project, and of sponsors in turn tendering the opportunity to finance it, has allowed the sponsor market to gain enhanced leverage over financial institutions. However, projects must still meet the benchmark of bankability and the projects lawyer is often called upon to help form a view as to whether they do. Allowing negotiating leverage to flow as the market demands, but preserving the essence of the credit, is the art of the deal.

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