GETTING THE DEAL THROUGH

Project Finance

in 45 jurisdictions worldwide

2015

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Getting the Deal Through is delighted to publish the the fully revised and updated eighth edition of *Project Finance*, a volume in our series of annual reports, which provide international analysis in key areas of law and policy for corporate counsel, cross-border legal practitioners and business people.

Following the format adopted throughout the series, the same key questions are answered by leading practitioners in each of the 45 jurisdictions featured. New jurisdictions this year include include Canada, China, the Dominican Republic, Greece and India. This year the publication again includes quick reference tables, focusing on public-private partnerships in US states.

Every effort has been made to ensure that matters of concern to readers are covered. However, specific legal advice should always be sought from experienced local advisers. *Getting the Deal Through* publications are updated annually in print. Please ensure you are referring to the latest print edition or to the online version at www.gettingthedealthrough.com.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We would also like to extend special thanks to contributing editor Phillip Fletcher of Milbank, Tweed, Hadley & McCloy LLP for his continued assistance with this volume.

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The Art of Getting a Project Finance Deal Through

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What is project finance?

Project finance is difficult to define, but rather easy to recognise. It generally involves lending significant amounts of money to a thinly capitalised company whose primary assets consist of contracts and licences, but that is where the simplicity ends. Notwithstanding the efforts of various governments to standardise 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 clear market standards and agreed form documents, project finance lawyers must assess not only the legal, but also the economic, technical and political risks presented by each project and draw on experience to help the parties reach a workable consensus in the face of often unique challenges.

The discipline is old. Some date the onset of the modern practice to the financing of the Panama Canal over a century ago. The large mining deals in Africa and Latin America of the 1960s and 70s are perhaps a more realistic grounding for the field, and the development of independent power projects in the US and natural gas facilities in the North Sea after the 1978–79 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, Tokyo, Dubai and Singapore, as the application of project finance has spread, they are now found in almost every city where complex transactions are documented.

Thirty 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 III accords. The decades have shown that while restructurings are common (perhaps due to the pervasive covenants imposed on borrowers), losses have nonetheless been relatively rare.

Little has stemmed the flow of project finance deals. The world's rising demand for energy and other resources, driven in large part by the remarkable growth in the so-called 'BRIC' countries, has led to enormous investment in natural resource projects. As a consequence, international oil and mining companies are exploring for resources and developing processing facilities in ever more remote parts of Africa, Latin America, Asia and the Middle East, and the resulting projects often entail billions of dollars of capital costs. Many of the host countries have never seen transactions on this scale, and their laws and courts may never have had to consider the resulting issues. 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 may be reasonably 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.

What do project finance lawyers do?

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. A lawyer who sees the beauty of the perfect covenant, the joy of an all-encompassing event of default or the elegance of a multi-tiered inter-creditor agreement has the capacity to excel in the field. The inclination to do so comes from wanting to contribute meaningfully to real economic undertakings. Projects lawyers need to know how to take security over every asset imaginable, but they must also understand how the underlying facility operates and how to assess its ability to generate revenues for periods often spanning decades.

They must work closely with leading law firms in the project's host jurisdiction to assess the underlying legal regime in which it is being undertaken. Although the array of relevant legal issues varies by industry and country, the broad topics addressed in this guide are relevant in almost every transaction. Legal analysis is, however, but one element of the project finance due diligence effort. Technical advisers assess the physical plant, market advisers provide projections as to the availability and cost of inputs and the value of the future revenue streams, and model auditors assess the integrity of the (often hugely complex) financial models. The lawyer works with these and 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. Key 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 facility'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.

What are the legal issues that a projects lawyer deals with in making these assessments?

There are few legal disciplines that are not relevant. Projects lawyers use all of the skills learned in university; the law of contracts, property, trust, torts and equity feature regularly in their practice. The best among them are able to advise from the inception of a project as it progresses from negotiating its concession agreement and construction contracts to the day it secures financing from a full suite of lenders. As the financing sources may range from bank loans to capital markets instruments to loans from export credit and development agencies to a variety of shariah-compliant instruments, they must be able to document the differing requirements of a wide range of markets. They are also often called upon to perform the role of 'trusted adviser', looking at issues that range far beyond the true legal, and can become the focus for pulling together the multitude of differing strands that, together, create a successful project financing.

Anticipating the worst-case scenario

Perhaps the most fundamental debate projects lawyers encounter is over the terms and enforceability of long-term 'take or pay' or similar contracts. These contracts, in all their permutations, underpin most major projects. The sale of power, 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. As we have come to learn, if you try to sell 8 cent output in what has become a 2 cent 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 may even appear reasonable: 'we can't take the output because a hurricane sank our ship'. It may also be on the basis of defences at law: 'we have no money, we can't pay, and the court says you can't make us'. Or in equity: 'you treated us unfairly in persuading us to agree to pay this much over the market'. There are court decisions in many jurisdictions addressing a broad range of such circumstances. The decisions turn, of course, on the facts of the case, the terms of the underlying agreements, and the environment in which the dispute is heard.

The role of project finance lawyers is to seek to bring some advance certainty to this process by identifying the key risks and getting the parties to reach agreement about 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, by way of example, 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 assure investors that such risks will not arise as they generally wish not to fetter their own or their successors' sovereign discretion. Whether there are price re-openers to address huge, 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 across projects in Pakistan, Indonesia and India, among others. In the successful restructurings, lenders deferred principal repayments, 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 projects, amid allegations of abuse of the original negotiating process, construction halted and the assets were left to rust, with only the litigating attorneys being the winners.

London, New York or Zanzibar?

A second area of regular focus is in respect of the selection of governing law and the forum for dispute resolution. 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 first 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', as market practice does differ somewhat as to the style in which finance documents are prepared. The corresponding choice of forum for dispute resolution is, however, perhaps more meaningful, as a variety of parties prefer to litigate in either London or New York and not the other.

The question can have real substance as well. By way of example, the choice of governing law in an offtake contract, such as one documenting a forward purchase of future production, could affect key issues, including the circumstances in which title to the future production effectively passes from seller to buyer (to the extent not exclusively regulated by lex situs) and the enforceability of liquidated damages for breach. The choice of forum raises other questions in turn, including 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 borrower or the other project parties? A decision focused merely on a preference for a familiar law or forum could miss the significant changes in legal result that may turn on these choices.

The importance of the choice of law or forum may 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 shariah 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 may be helpful even if enforcing an offshore judgment back in the host country may be challenging. In other cases, it may make better sense to structure the transaction to conform to shariah principles than to hope for enforcement of a non-Islamic transaction.

Creating security in an uncertain world

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 it to deprive its borrower of the pledged assets when the loan is in default (an 'offensive' purpose), and it assures it that no other creditor may take those assets in preference to it (a 'defensive' purpose). The availability of such packages has 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 may be uncertain, the challenges may be significant. In addition, some countries charge high fees for the registration of security, but often without providing certainty that such security may be enforced. In such cases, the lenders are often asked by borrowers to do without the traditional security package and are asked to rely solely on pledges of offshore bank accounts, assignment of key export contracts and, in some cases, security over shares.

In some circumstances, there may be no clear answer at all. For example, who would fancy foreclosing on a satellite orbiting the earth 35,000 kilometres above the Equator? More to the point, because space is beyond the jurisdiction of individual states, whose laws would apply and 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. Until recently, no prospect existed for satellites. In March 2012, a new international protocol to an existing convention was adopted under the auspices of the International Institute for the Unification of Private Law (known as UNIDROIT) to provide for the registration and priority of security, title-retention and leasing interests in space assets. Known as the Space Assets Protocol, forming part of the Cape Town Convention of 2001 treaty system, it will come into force once it has been ratified by 10 contracting states and following the establishment of a functioning international registration system. While a UNIDROIT Preparatory Commission is preparing regulations and an international registry for space assets, the Protocol will not come into effect until its work is complete and the requisite number of ratifications have been deposited; however, the absence of international rules governing security over satellites has not prevented satellites from being project financed. While the single most valuable tangible item may be beyond the physical grasp of earth-bound secured creditors, careful structuring has allowed creditors constructively to repossess satellites and capture the intrinsic value of the project by taking assignments of project and operating agreements and licences (where permissible), revenue-generating customer contracts and launch and in-orbit insurance.

Ecological considerations

Back on earth, an area of increasing focus is environmental and social planning. Local environmental legislation may 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 impacts of the project, and management of the project's affect on local populations. A wide variety of non-governmental organisations have pressured leading commercial banks into accepting similar standards. The adoption of the 'Equator Principles' by these banks has now largely aligned their requirements with those of the World Bank Group. As a result, major projects generally have to meet standards that far exceed those that would be required by domestic law in the host country. Lenders have thereby assumed the role of the absent global environmental regulator.

Navigating troubled waters

A host of challenges arise when projects encounter difficulties. In addition to relatively straightforward technical mishaps and breaches of contractual undertakings, a project may simply face an adverse change in the environment in which it is being developed or operated, which may be well beyond its ability to manage. For example, in a project in Florida, a change of governor led to an investigation of the legitimacy of the grant of the project's environmental permit. Unfortunately, this occurred part way through construction. A reasonable decision would have been to suspend funding under the debt facilities. However, this would have caused the virtual write-off of the loan disbursements already made; 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 recognise that it was now unwelcome in Florida and agree to sell (at a loss) its project to a non-tainted third-party developer. Had the inter-creditor relationships and security package addressed all of this? – No. But were the rules at least sufficient to define the procedures by which the parties would have to reach settlement? – Yes. Had any party not demonstrated maturity and judgement, all would have been lost.

Far-reaching changes in regulatory and economic conditions can also impair the viability of existing projects. In the early 2000s, in the face of regulatory reform and economic recession, the collapse of large power traders such as TXU Europe and Enron, among others, left much of the UK power independent generation sector effectively insolvent. Banks assumed de facto ownership over much of the industry. A few years later (as power prices recovered), the defaulted loans traded back at par, and many banks (or the hedge funds they sold to) recovered additional, unanticipated equity value. Having spent years, essentially, as insolvency practitioners, projects lawyers then again switched focus to work on floats, trade sales and other exits from what had become very successful investments.

The Gulf Wars, and more recently the Arab Spring, gave rise to similar issues. Faced with a deteriorating environment in the region, lenders reviewed carefully material adverse change provisions in both underwriting commitments 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 host governments agreeing to absorb a certain degree of the risk associated with terrorism or war. As a result, few projects were disrupted in any of these periods, and the market has continued to flourish.

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Being more than a lawyer

Against this mosaic of issues, the role of a project finance lawyer is not limited to answering specific legal questions, but extends also to organising 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 party's 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, say, foregoing the requirement for the provision of a completion guarantee, may simply impose burdens on another. Such a concession may, for example, necessitate the provision by the contractor of enhanced performance warranties, or the agreement of the offtaker 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 will be located across the globe, is dependent on the projects lawyer's ability to help the parties reach a workable consensus.

Recognising who has negotiating leverage in this context is a subtle matter. In recent years, as global financial liquidity has become constrained, all but the largest sponsors and host governments have had to accommodate the stringent demands of lenders. In order to attract finance in this environment, projects must meet the benchmark of 'bankability', and the projects lawyer is often called upon to help form a view as to whether they do. Framing a huge number of complex issues into a manageable process for effective decision-making, while allowing negotiating leverage to flow as the market demands, is the art of getting the deal through.

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