

Project Finance—The Lender’s Perspective

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Introduction	52
“The Positives”	54
Project vehicles/ownership arrangements	56
Support arrangements	57
Deal-specific features	60
Drawdown	60
Funding options	61
Hedging	62
Bank remuneration	65
Repayment	65
Security	66
Covenants, representations and warranties	67
Default	69
“The Not So Positive”	70
Conclusion	74

INTRODUCTION

The technique of project financing evolved around the concept of risk and particularly the idea of shifting it. Parties faced with the opportunity of developing a project but unwilling or unable to assume all of the risks involved looked for other parties to share those risks with them. Project finance emerged as a device which enabled those risks to be shifted and project lenders have played a key role in developing the concept and assuming risk themselves. Their efforts over the last 30-odd years in Australia have undoubtedly allowed many projects to proceed which may not otherwise have been undertaken.

And yet, risk is a dynamic concept which therefore requires dynamic management. Have lenders—and the format of project financing documentation—been flexible enough to achieve this?

The key to the successful shifting of risk in these deals often lies in the network of contractual arrangements which underlie the transaction. To the delight of the lawyers involved, all these arrangements are documented and add to the mountain of paperwork that typifies these

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financings. The extensive documentation of project finance deals is not just a recent trend. Lenders involved in CSR Limited's (CSR) Delhi transaction (1982) noted that that project financing involved more paper work than the rescheduling of the entire Polish sovereign debt outstanding at the time.

This perceived need in project financing to cover possible eventualities in such detail is interesting when considered in the context of studies undertaken on the objectives of contract law.¹ Formal contracts are said to be utilised (i) as a communication device both within the contracting organisation and with the other contracting parties; (ii) in recognition of third party interests (where the third party, for example, a financier, requires the existence of a formal contract, say, for security purposes); (iii) in anticipation of specific problems; and (iv) to provide stability. But even in formal contracts, significant reliance is usually placed on the rules which form part of the body of contract law. These allow for certainty without the need to specify comprehensively what happens in each situation. Contingencies for which no precise arrangements have been made in the contract are covered in accordance with these standard provisions. Therefore, if the parties to a contract are happy with how contract law allocates risk as between them, there is no need to spell out the consequences in each situation.

The length and detail of project financing documents seem to fly in the face of the above proposition. I believe the answer is that contracting parties in these situations do not like how the standard rules allocate risks. Sometimes the success of the transaction depends on overturning or overriding standard rules. For example, in the Eraring Power Station financing in 1981, the project financing documentation specifically attempted to override principles of frustration as they may have applied to the power purchase agreement between the power station owners and the State electricity authority.² Standard penalties in these situations may also not be appropriate. For example, a damages claim against a sponsor of a failed, and therefore possibly worthless, project may have little purpose if the sponsor has no other assets.

The comprehensiveness of project financing documentation should not however eclipse the importance of "commerciality" in these transactions.

Often practical considerations may rule out all but a few options. A project facility may, for example, include a right by the lender to review the loan at, say, the halfway mark and, if the review is not, in the opinion of the lender, satisfactory, to declare the outstanding moneys to be immediately due and payable. This right may, however, practically, be of little benefit if the project is encountering difficulties. Assuming the lender only has recourse to project cashflows for debt repayment at the time, there will certainly not be sufficient surplus cash to repay half the debt in one go nor are the chances of having the debt refinanced by a

1. T. Daintith and G. Teubner (eds), *Contract and Organisation Series A—Legal Analysis in the Light of Economic and Social Theory* (1986), pp. 164-169.
2. G. F. K. Santow, "Governmental Financing of Infrastructure—Legal, Political and Financial Restraints" [1983] *AMPLA Yearbook* 85 at 110.

new lender high. The documentation may give the lender an “out” but, in practice, it may be of little use unless the project (and therefore the loan) is already doomed.

Commercial reality is a principle which, at the end of the day, overrides any legal formulation. But what the documents do need to do is to provide a framework within which to examine the alternatives and allow for the efficient implementation of the practical options.

One of the main claims of those promoting the project financing technique over the years has been its ability to tailor “project-specific solutions” and indeed the area provides the lawyer with one of those rare chances to be truly creative. The laws of contract, credit and security have proved very flexible in this field, accommodating considerable innovation without the need for legislation.³

The lawyer will be presented with a broadly agreed allocation of risks relating to a project. The risk categories (completion, operating, economic, political and so on) are well known and have been extensively covered elsewhere.⁴ The parties have agreed, on a commercial basis, on how these risks are to be allocated between them and often the types of structures which will be used to achieve this. There will however be many points of detail yet to be considered and legal obstacles which may impede implementation of the transaction as the commercial parties originally foresaw it.

They will look to the lawyer to find the path around the obstacles and to give effect to the commercial objectives.

Equally as critical to the success of these transactions (and often overlooked) is the need to ensure that the parties have a realistic view of what is achievable through project financing—that the objectives are understood and the limitations of the technique are also grasped.

Where project financings (and here I talk about the technique, not the project) have failed, I believe they have generally done so on this ground.

But let us first look at the positive achievements in the field.

“THE POSITIVES”

The creativity of project financing lawyers and also tangible evidence of the flexibility of lenders in accommodating borrowers’ requirements can most visibly be seen in the range of structures which, over the years, have been devised to undertake and implement these projects. In referring to structures, there are three broad categories which I would like to consider:

- (a) the type of vehicle used to undertake the project and the nature of its legal interest in the project;

3. R. S. McCormick, “Legal Issues in Project Financing” (1983) *Journal of Energy and Natural Resources Law* 21 at 43.
4. P. K. Nevitt, *Project Financing* (4th edn, 1983), Chs 2 and 3.

- (b) the type of support arrangements (most usually a key contractual underpinning) that have been used to get projects off the ground; and
- (c) the deal-specific features which form an integral part of the financing which have assisted the parties in addressing key risks.

Lender flexibility has been evident in all three: in all three categories, simply in the preparedness to think laterally and be able to achieve the desired result through novel approaches; in the second and third categories, in particular, by recognising that these facilities will remain in place for many years, that unexpected events will intervene, that project performance will not always live up to expectations and that the financing structure must be flexible enough to accommodate such fluctuations.

Before even looking at the structures, lender flexibility is evident in the approach to the credit analysis of project financing opportunities. Lenders in these situations have an armoury of “rules of thumb”. Many of these will be familiar to you but include, in the most basic form, debt service cover ratios, that is, the factor by which the forecast project cashflows under an agreed financial model will cover debt service obligations. The actual number required will vary from bank to bank, according to the nature of the project and the general economic and lending climate at the time and will, of course, be different depending on whether “base case” (that is, “best guess”) assumptions or “downside” assumptions are used in calculating the cashflows. By way of general guideline, for, say, a gold project, where there is an ability to hedge future prices and therefore obtain a high certainty about future cashflows, a debt service cover ratio of approximately 1.5 under base case assumptions could be satisfactory. For projects with higher market or other risks, the ratio will need to be higher. In the case of “build/own/operate” or “build/own/transfer” projects (discussed in greater detail below) where future cashflows are generated under an irrevocable contractual commitment by a government authority, the cover ratio may be lower and of the order of 1.25 or 1.3. The financial model will also be used to run cases assuming downside scenarios and, obviously, the objective is to ensure that, under these assumptions, the cover ratio does not fall below 1, which would indicate an inability of the project to service debt. The buffer implicit in these ratios, that is the amount over 1 that is required, reflects the lender’s understanding that adversity will strike the project during the loan life and that a buffer is necessary to ensure that, when these downside scenarios do come to pass, the project will still be able to repay its debt.

Similarly, lenders to mining projects will look for a “reserve tail”—an amount of economically recoverable ore reserves which remain unexploited at the scheduled maturity date. This again allows for the situation where, due to adverse factors, project cashflow is insufficient to retire the debt within the scheduled loan term. A lender will seek to ensure that, in such a situation, reserves still remain to be exploited at the scheduled maturity date which will hopefully ensure that the loan can be fully repaid, even if at a later date. Again, depending on the level of risk

involved, a reserve tail of 30-50 per cent of the original reserves may be required for this purpose.

Flexibility evident in the credit analysis continues through to the structuring of the transaction and here I return to the three types of structures mentioned earlier.

Project vehicles/ownership arrangements

The more conventional ownership arrangements need little elaboration: project sponsors establish one or more special purpose companies to own the project, provide some form of completion support (that is, to ensure that the project is completed in accordance with agreed physical and performance tests), fund it with equity and assist in the raising of limited recourse debt. These arrangements are often seen in the context of an unincorporated joint venture, the predominant project structure in Australia over the last 20 or so years. However project financings have also been undertaken where either the type of vehicle has changed such as the trust structure utilised in CSR's Delhi transaction, or where the role of the sponsor's vehicle and its legal relationship with the actual project fundamentally change. This may have been done to achieve off-balance sheet treatment (though this has become harder with new concepts of control introduced to the corporations law by the *Corporations Legislation Amendment Act 1991* and by the implementation of new accounting standards⁵); to obtain economic advantages (for example, optimisation of tax benefits) or to obtain the involvement of parties whose credit-worthiness or expertise and know-how were critical to the transaction. A good example is a tolling arrangement with one of its earliest applications in Australia being the processing of Weipa bauxite in the early 1960s.

Queensland Alumina Limited (QAL) was formed to toll process bauxite from Weipa and convert it to alumina for use in each of QAL's shareholder's own smelters.

Each project participant owned a percentage of the share capital of QAL equal to its percentage interest in the project and was obliged to purchase from Comalco Limited sufficient bauxite to produce its project percentage of total alumina plant output. A service charge was paid by each participant to QAL to cover the costs of processing bauxite under a "take or pay" contract, that is, the charge must be paid whether or not their project percentage of production was taken. An adjustment was, of course, made for variable costs not incurred.

The standing of the shareholders—companies like Kaiser Aluminium and Chemical Corporation of America—both financially and in their respective industries, assured the project of access to markets (and insulation from the growing competition of new African and South American sources at the time), access to technology (of the shareholders themselves) and better access to finance. Financiers were attracted not

5. E.g. Australian Accounting Standards Board (ASRB) Standard 1024: Consolidated Financial Statements (effective 31 December 1992).

only by the standing of the shareholders in that capacity but also by the “take or pay” obligations which they had assumed as customers. From the shareholders’ perspective, assumption of these contractual obligations allowed a stand-alone financing to be undertaken without requiring the full impact of the support to be incorporated in their accounts in contrast to the situation if they had been required to provide a guarantee of the debt.⁶

Similarly, the relationship between the sponsor’s vehicle and the project radically changed where sale and leasebacks or leveraged leases were used. Leveraged leases often saw critical pieces of equipment (if not the entire project) owned by third parties (often financiers) and leased to the project entities. The effect of these transactions was to lower the overall financing cost to the project entity by passing on to another party tax benefits which the project entity could not utilise, such as depreciation, usually because the project entity was unlikely to pay tax for some time. The lessor, in contrast, would be a taxpayer and would utilise the depreciation to minimise its tax bill. This benefit would be shared with the lessee, the project entity, by a lowering of the overall financing cost implicit in the lease payments.

Sometimes, but not always, the same financiers owned the leased assets and lent money for the project financing. Where the same parties were not involved, the potential existed for considerable tensions in times of project difficulties. The Barrack Silicon Project (1988), now known as Simcoa, was initially the subject of a leveraged lease where the assets were owned by one financier, leased to the project entity and the debt portion of the lease was funded by a syndicate of banks under a project financing. When the project encountered difficulties during its start-up phase, it became evident that the lessor and the banking syndicate held different and often conflicting perspectives on the situation that ultimately required the termination of the lease. Thus, while the lenders initially had been flexible in accommodating the sponsor’s desire to use a leveraged lease to lower the overall financing costs, the additional structural complexity, and particularly the involvement of a third party lessor, ultimately proved too inflexible in times of project difficulty.

Support arrangements

In projects which produce a commodity for which no established forward sales market exists or where the project is structured around one specific end user (such as a water or electric utility), lenders usually require product offtake arrangements to be in place with credit-worthy entities so as to ensure a stream of future cashflow which will be adequate to service the debt. These arrangements have taken a number of forms over the years ranging from relatively straightforward offtake contracts—in the strictest form as “take or pay” agreements or the less

6. K. Wightman, “Financing a Major Mining Project”, Swinburne Technical School presentation (1976).

restrictive “take and pay” contracts—to throughput agreements or forward purchase arrangements.⁷

The range of offtake arrangements which have been accepted by lenders is, once again, an indication of banks’ preparedness to consider, indeed actively structure, new approaches to risk mitigation.

This type of contractual underpinning has been important to the success of projects in Australia since the 1960s. The early Hamersley and Mt Newman iron ore developments were developed on the back of long-term sales contracts with a number of Japanese steel mills and trading companies. In those projects, the contractual underpinning was never really tested. The Japanese steel mills often did not take their required minimum annual contractual tonnage, but because of the inherent economic strength of the operations, the projects still prospered.⁸

Initially, lenders firmly believed that buyers under long-term contracts would continue to perform their obligations even if their need for the product substantially diminished or the market price significantly declined in comparison with the contracted price.

By the early 1980s, however, reality had set in. Lenders were forced to recognise that sales contracts can come under pressure when a buyer no longer wants the product at the contract price or quantity⁹ and that, at best, the contracts provided a framework for future dealings.

It is worth recalling that not only overseas buyers under long-term contracts have failed to perform their obligations as originally contemplated. Woodside Petroleum Ltd’s contract with the State Electricity Commission of Western Australia (SECWA) for the sale of North West Shelf gas underpinned its original financing in the early 1980s. The Western Australian domestic gas demand forecasts, which were the basis of the contract, proved to be considerably overestimated and the prices and quantities specified under that contract ultimately became, at least in SECWA’s eyes, unrealistic. Long negotiations followed resulting, ultimately, in new contractual terms.

It was quite startling when, some months ago, in the midst of negotiations between SECWA with the then preferred tenderer for the proposed new A\$2 billion Collie power station in Western Australia, comments started to emerge in the press¹⁰ that SECWA and the Western Australian State government were once again wanting to re-open discussions on the North West Shelf gas contracts. The attention of the world’s bankers was focused on the power station project at the time and the proposed financing would need to rely on a long-term contract with SECWA. It was a timely indication of the fragility of such long-term contracts when underlying circumstances change.

7. E.g. McCormick, *op. cit.* at 43; M. R. Davison and C. M. Brown, “Critical Legal Aspects for Lenders and Borrowers—Allocation of Risk and Responsibility”, *Project Finance in Australia IRR Conference* (1983).
8. CRA Limited Presentation to the Institute of International Research, Tokyo (1983), p. 5.
9. Santow, *op. cit.* at 87; for a discussion of the history of performance under such contracts, refer P. Bobeff, “Commodity Sales Contracts” AMPLA Conference (1991).
10. *Australian Financial Review*, 19 February 1992.

In the late 1970s and 1980s, one reaction of banks and sponsors to the lessened confidence in long-term sales contracts was to push for customers to become more directly involved in equity ownership or in providing debt to the project. The strategy did have some success in coal and base metals projects but also brought its own additional difficulties to which I will return later.

Particularly in the case of government sponsored infrastructure developments, long-term offtake commitments by government entities have enabled projects to be undertaken and financed by the private sector and beyond the restrictions of Australian Loan Council limitations. In more recent times these structures have attracted exotic labels such as “build/own/operate” or “BOO” constructions, “build/own/operate/transfer” or “BOOT” and so on. The concepts however are certainly not new. The early 1980s saw such an arrangement implemented for the \$1.4 billion development of the Eraring Power Station. With the original financing structure proposed for this development ruled out by new legislation at the time, Eraring was ultimately owned by a nominee company representing a consortium of financial institutions and banks and was funded by a combination of equity and debt raised through a syndicated eurocurrency loan. Loan repayments were serviced by receipts under a “take or pay” contract with the Electricity Commission of New South Wales (ELCOM). The structure was covered in some detail in a paper published in the 1983 *AMPLA Yearbook*.¹¹ As an aside it is interesting to note that the author of that paper concluded at the time that the real significance of Eraring was “to highlight the out of date structure of the Loan Council in coping with the realities—political, financial and economic—of States’ power and other infrastructure needs”.¹² For the many financiers, lawyers and commercial people involved in the current spate of infrastructure projects (most notably the Collie and Loy Yang B power stations), it goes without saying that the issues present in 1981 are still relevant today and relatively little progress has been made in addressing them.

Lenders have also been flexible in looking at contractual alternatives to provide the type of completion support normally expected of project sponsors. Again, the classic formulation of limited recourse financings could be expressed as that where the sponsors provide a guarantee of the debt until completion of the project is achieved (however defined in the particular case) and thereafter lenders must rely on the project cashflows for debt repayment and project assets for security. In some cases, this “classic formulation” has been unacceptable to the sponsors—for balance sheet reasons, board policy reasons or a view that the company was simply unable to bear the risk. Lenders have accepted a number of different approaches to accommodate this position. In some cases, though relatively few, completion risk has actually been fully borne by the lenders (for example, MIM Holdings Limited’s (MIM) Oaky Creek coal project financing (1981) and Aberfoyle Limited’s Hellyer base metals mine financing (1988)). More conventional approaches have included the

11. Santow, *op. cit.* at 109.

12. *Ibid.* at 111.

sponsor's obligation being categorised as a guarantee to achieve completion. Under this approach, the debt was not guaranteed but the sponsors were committed to do all that was necessary, including further contribution of funds, to ensure that the completion tests, as defined, were met. Ultimately, if the sponsors were not able to achieve completion or were not prepared to continue to invest funds in the project, the solution was to repay the debt. Legally, the lender's position may not have been as strong as if the debt were fully guaranteed but many banks felt sufficiently comfortable to lend on this basis. In other cases the sponsor support was limited to a finite amount and lenders accepted the risk that completion could not be achieved for this amount of investment.

Completion support has also been obtained through key project contracts, such as turnkey construction contracts. In these cases, provided a contractor is of adequate financial strength or, alternatively, provides satisfactory security for its obligations (for example, liquidated damages bank bonds, etc.), completion risk can be shifted to other than the project sponsors.

Sometimes lenders require sponsor support to continue beyond completion. This may occur where the sponsors wish to borrow more than the lenders believe the forecast project cashflows will support or where the sponsors wish to retain greater flexibility in relation to future marketing arrangements than that with which the lenders may be comfortable: for example, where rather than lock into long-term contracts, the sponsors insist on retaining a significant amount of product for spot sales. This type of support may take the form of solvency guarantees for the project vehicle or "recapture" or "clawback" provisions which allow for past distributions of surplus funds from the project to the sponsors to be reclaimed for debt servicing. Minimum product purchase obligations may also be underwritten by sponsors. Such a device has been utilised in a number of major coal projects undertaken in this region in recent years.¹³

Deal-specific features

It is in the area of deal-specific features that the greatest ongoing flexibility, as well as lateral thinking, is apparent.

I will touch on eight examples of such features: (i) drawdown requirements; (ii) funding options; (iii) hedging aspects; (iv) forms of bank remuneration; (v) repayment formulae; (vi) security; (vii) covenants, representations and warranties; and (viii) default provisions.

Drawdown

Drawdown structures can often provide valuable flexibility in the transaction. A borrowing base concept, most commonly utilised in oil and gas transactions, is a good example. This approach applies a debt

13. E.g. North Goonyella Coal Project—*Project Finance Asia/Pacific Newsletter*, Issue 52, 1 May 1992.

service cover ratio test to an agreed financial model. Funds are available to the borrower provided it can satisfy the lenders that, under the model, forecast project cashflows will cover debt service obligations by an agreed factor. This type of approach will be useful in a number of situations: where an active programme is underway to prove up additional reserves or where the borrowers believe that the project will perform considerably better than the lenders' advice indicates and therefore will be able to support a higher level of debt. Examples of Australasian borrowing base financings include the Cooper Basin financing of the South Australian Oil and Gas Corporation Pty Ltd's interest in the Natural Gas Liquids Project in 1982 and the 1991 financing of Oil Search Limited and, to a more limited extent, Ampol Exploration Limited's shares in the Kutubu Project in Papua New Guinea.

Another type of drawdown flexibility has been the willingness of lenders to accommodate long drawdown schedules in financing structures. This is particularly useful for staged developments. For example, CRA Limited's (CRA) Tarong project financing of 1982 involved a two-stage construction programme. Finance for both stages was committed at the outset and detailed terms were negotiated in respect of the Stage 1 funding with the Stage 2 funding terms subject to later negotiation.

Funding options

Funding options under project financing facilities have expanded significantly over recent years to include a range of currencies, bullion loans and letter of credit or other types of credit support facilities.

Multi-currency options and bullion loans have provided hedging mechanisms under the umbrella of the credit facility and these are discussed further below.

Credit support facilities were originally incorporated to take advantage of subsidised export or import credit facilities provided by governmental agencies which were not prepared to take direct project risk. Letters of credit enabled the funding to be obtained, often for longer terms and at subsidised interest rates, from such authorities while the credit risk was still assumed by the project lenders.

Such mechanisms are no longer as necessary as many export credit agencies have begun to accept project risk. The U.S.\$120 million facility recently provided by the Australian Trade Commission, trading as Export Finance and Insurance Corporation, to Highlands Gold Ltd in respect of its interest in the Porgera Gold Mine, Papua New Guinea is a good example. While the first phase of the facility is on a full recourse basis to Highlands Gold Ltd, the second phase, presently under negotiation, will be undertaken on a limited recourse, project financing basis.¹⁴

Credit support facilities however were later utilised in order to access capital market funding or to enable tax-based funding arrangements to be

14. *Australian Financial Review*, 13 June 1991; Highlands Gold Limited Annual Report (1991).

incorporated under the umbrella of such facilities.¹⁵ Project financings such as MIM's Newlands Collinsville project (1983), CRA's financing of its share of the Argyle project (1984) and The Broken Hill Proprietary Co. Ltd's (BHP) acquisition of the Utah coal assets (1984) all incorporated letters of credit to support capital market issues. The Barrack Silicon Project referred to earlier utilised letters of credit to support a leveraged lease.

Utilisation of these options enabled borrowers to achieve lower funding costs, arrange withholding tax-exempt funding and access amounts of funding which would not have been possible had they been limited to domestic markets. Provision of such letters of credit now involve costs which under the Reserve Bank of Australia's capital adequacy guidelines tend to make some of these arrangements less attractive.

Hedging

The importance of hedging has really only been recently recognised by borrowers and lenders alike. Project financings as early as the 1960s provided for the debt to be denominated in the same currency as that of the project sales proceeds. The success of export projects, however, is dependent on the ability to lock in a comparative advantage over competitor projects worldwide. The project must first secure for itself a low position on the cost curve in its commodity. This will signify that, as a low cost producer, it will be able to withstand the price cycles of the industry and the effect of economic downturns on its customers. However, new technology and improvements in productivity have generally led to more producers moving down the cost curve. As this occurs it becomes even more important to capture that "extra edge" of competitive advantage. Particularly where the product proceeds are denominated in a currency other than that in which the costs are denominated, an extremely cost-competitive project can find itself adversely affected due to currency movements. For such projects, it may become increasingly important to either ensure that the relativity of its proceeds currency and cost currency is maintained or, alternatively, even to take a position in the main competitor's currency.¹⁶

Hedging may also enable a producer to eliminate vulnerability related to the pricing of key raw material inputs. Instruments used in recent years such as "oil swaps" can help avoid (or at least mitigate) the effects of events such as the oil shocks of the 1970s. Energy-intensive projects, such as the Greenvale lateritic nickel project in Queensland, were severely affected at the time due to significant resulting increases in operating costs.

15. R. F. McDonnell, "Comment on Recent Developments in Debt and Equity Financing for Resource Projects" [1987] *AMPLA Yearbook* 255 at 261-262; C. Emerson, "Project Financing" (1983 Master File—The Financial Times Business Enterprises Ltd), pp. 14-20.
16. E. L. Robinson, "Finance for a Cyclical Industry" (1991) *Resources Policy* 17 (No. 2) 124 at 131; R. G. Adams, "Managing Cyclical Businesses" (1991) *Resources Policy* 17 (No. 2) 100 at 104.

Other types of hedging have also been incorporated both in the financing agreement and other key project contracts. A typical example is the linkage of power and alumina costs to aluminium prices in supply contracts for aluminium smelter projects such as the Portland Smelter in Victoria. More novel was the recently announced aluminium indexed debt being provided for VAW Australia Ltd's share of the A\$600 million expansion of the Tomago aluminium smelter in New South Wales. Interest rates under the U.S.\$31 million facility will be tied to the average price for high-grade aluminium prevailing on the London Metals Exchange for the three months before each repayment.¹⁷

Hedging may however cause a certain degree of conflict for a borrower/producer. Project financings are often characterised by the bringing together of parties in unusual relationships. Sometimes parties perform roles not normally adopted by them—a sponsor may also be a customer—and these multiple roles may give rise to conflicting objectives. Sometimes a party performing only one role may still have conflicting objectives depending on “which hat” it is wearing or which master it is serving. For example, a borrower may be under pressure from a lender to undertake hedging to give greater certainty to projected cashflows and may itself wish to undertake it in order to lock in its comparative advantage. However hedging often conflicts with shareholder expectations. A classic argument is that shareholders want exposure to a particular metal market such as the gold market and therefore the cyclical component should not be eliminated from the shares. It is interesting to note that, in recent years, some gold producers, who steadfastly held this view in the past, are starting to take a slightly different tack. Their argument now runs that the “upside” for shareholders lies in exploration, that is, the chance of the “new big discovery”. Given this perspective, it becomes quite justifiable to lock in an operating margin on existing operations and so assure the company of sufficient funds to fund its exploration efforts.

As indicated above, funding options have also enabled “in-built hedging” to be provided within the umbrella of overall facilities. Currency options have been available in such financings for some time. The development of the gold loan in the mid 1980s together with the development of increasingly more sophisticated gold price hedging techniques encouraged development of what had previously been marginal projects. It is certainly true that these developments were also helped by the tax-free status of gold mining, strong gold prices and technical advances in ore mining and processing which resulted in a new generation of low-cost, open-cut gold mines becoming viable.

The gold loan provided a natural hedge against the product's price movements and increased the debt-servicing capacity of the project. The low nominal level of gold loan interest (as opposed to cash interest) assisted project economics in the early start-up years by reducing the interest burden.

17. *Project Finance Asia/Pacific Newsletter*, Issue 47, 21 February 1992, 10.

As lenders became more aware of the importance of hedging, hedging lines began to be offered as part of overall financing arrangements. Hedging was specifically contemplated, encouraged and, indeed, sometimes required as a condition of the financing. Hedging provided good ancillary business for the lender as well as improving the credit of the project. Until recently, however, little thought was given to what happened to those hedges in times of project difficulties. More often than not, the hedge counterparties' exposure was not secured and, even if the project financiers took security over the benefit of the hedges, the lenders had no ability to ensure that those hedges remained in place when problems arose.

Assuming a situation where a hedge counterparty is not also a lender to the project, it is easy to understand that the hedge counterparty has a relatively short-term perspective when compared to the much longer-term perspective of the project lender. If, in addition, the hedge counterparty is unsecured while most of the company's assets, if not all, are secured to a project financing syndicate, it is not hard to understand why such a party would act swiftly to close out its position at the earliest signs of difficulty. If the hedge counterparty is also a lender under the facility, the situation becomes more blurred but no less strained given that one lender out of the banking syndicate is effectively providing a benefit to the rest of the lenders while potentially running the risk of its unsecured exposure increasing even further. Similar situations were faced by lenders in a number of projects in recent years. Sometimes the hedge counterparties (particularly if they are also project lenders) have been prepared not to close out their positions provided they are offered *pari passu* security over the project assets. As these types of conflicts only come to light when a project encounters problems, the banking syndicates are faced with some pretty hard decisions: the project has an uncertain future and the likelihood of the banks being fully repaid is certainly in doubt. Do the banks allow their only source of repayment and security to be diluted in order to retain the benefit of hedging contracts which will, after all, only be of value if the project continues to operate and produce?

Over recent months, a number of projects have been discussed in the market where lenders are trying to put in place a security sharing regime with hedge counterparties from the outset so that these "knife-edge" decisions in times of difficulty can be avoided. Lenders have shown a preparedness to share their security on a *pari passu* basis with such hedge counterparties but only on certain conditions. For example, hedge counterparties must be prepared to give up their right to call a "sudden death" default. A minimum grace period must be agreed during which the lenders are given an opportunity to cure the default if they consider it in their interest to do so. If, at the end of the grace period, the default is not cured, the hedge counterparties would be able to terminate the contracts and therefore crystallise their loss (or even gain) but would not, generally, in their own right be able to enforce the security. Whether hedge counterparties are yet prepared to make these concessions in exchange for obtaining *pari passu* project security remains to be seen.

Bank remuneration

Bank remuneration is an area of some sensitivity to all parties involved in these deals. Borrowers still think it exorbitant; the bankers think it totally inadequate and the advisers and lawyers probably think it laughable in comparison to theirs. The topic deserves some comment though and again developments in this area certainly reflect a degree of flexibility on the part of lenders.

Remuneration for project financing is still generally higher than that paid for conventional corporate financing. Given the complexity, depth of analysis and time involved in implementing and monitoring these deals, such increased remuneration is certainly justified. However, it is also often stated that, in project financing, lenders take more risks and, indeed, risks which are equity in nature and yet their return is still only a debt return.

In conventional project financings, this is certainly not, or should not be, the case. While if a project does not proceed according to plan the lenders may ultimately find themselves the "proud owners" of a mine or processing plant, lenders still ultimately are risk sharers¹⁸ and not providers of high risk funds. On the contrary, the type of analysis involved is generally far more in-depth than that undertaken for normal corporate lending and therefore may result in better credit decisions.

However, in some cases both bankers and borrowers recognise that, in that particular circumstance, the bankers' involvement may have an equity flavour and, in such cases, devices can and should be included which provide bankers with a return akin to an equity return—an "equity kicker". Over the years, for example, remuneration formulae have been devised tied to fluctuations in product prices or, alternatively, if project proceeds exceed a certain level, bankers may receive royalties or even actual equity in the project.

As mentioned earlier,¹⁹ recent deals have even featured interest rates tied to commodity prices.

Other types of remuneration flexibility have been evident in transactions from time to time. For example, in situations of a long drawdown schedule, banks have, in the past, been prepared to nominate part of the lending commitment as "unavailable" and therefore charge a lower commitment fee on that portion of the funding. These types of concessions are harder to achieve now given the costs to banks associated with the Reserve Bank of Australia's capital adequacy guidelines.

Repayment

Basic types of flexibility incorporated in project financing repayment formulae are well known. The concept of tying repayments to project cashflows has been fairly pervasive throughout project financings in the

18. The First Boston Corporation, "*Limited Recourse Financing for Canadian Mining Projects*" (1983) 4.

19. *Project Finance Asia/Pacific Newsletter*, Issue 47, 21 February 1992, 10.

last 20 or so years. Normally, the repayment formula will require the higher of a minimum repayment or a stipulated percentage of project cashflow for the relevant period to be dedicated to amortise the loan facility. The minimum repayment will be such as to ensure that, on lenders' downside case assumptions, such repayments are sufficient to ensure that the loan is fully repaid within the maximum term. The alternative repayment formula—a stipulated percentage of project cashflow—should be set at a level where, under a base case scenario, final repayment is achieved with a slight acceleration, such as one year ahead of final maturity in a six- or seven-year facility. This type of repayment approach reflects the “partnership” nature of the lending arrangement, that is, the bankers will agree to accept minimum repayments in project “bad times” but expect to have some benefit—a slightly accelerated repayment—in project “good times”. This approach assists in smoothing the effects of cyclicity and will often be implemented together with a reserve account (that is, one in which a buffer of surplus funds builds up in periods of strong cashflow prior to distributions being made available to sponsors) which can be used to assist in meeting debt payments in project downturns. It is through the use of such devices that it can be said that finance provides “additional weapons in the arsenal for *coping with cyclicity*”.²⁰

Variations on this basic theme can include one or two payment deferrals in the event of severe project downturns after any reserve account balance or other support (such as clawback rights) has been exhausted.

Further repayment flexibility has been structured around borrowers' preferences for servicing debt from either before- or after-tax cashflows. For example, the Blair Athol project financing (1982) and CRA's Argyle financing incorporated repayment rules based on pre-tax cashflows. The Tarong project financing used after-tax cashflows for repayment calculations.

If the before-tax cashflow is used, the percentage of cashflow dedicated to repayments in the repayment formula can be set at a lower level than if the after-tax cashflow is used. If the before-tax cashflow is used, the sponsors are often required to support the borrower's obligation to make tax payments as and when due.

Another aspect of flexibility is usually found in the initial repayment holiday or grace period provided for in the facility before repayments commence. This is usually sufficient to ensure that the project is not put under undue stress when still in the start-up phase.

Security

The traditional approach to security in project financing is to take security over everything! There are, however, a number of aspects that merit comment. First of all “security”, in its broadest sense, is often provided other than through strictly legal means. I refer here to the type of support arrangements discussed earlier. Similarly, an element of

20. Robinson, op. cit. at 132.

security is obtained through the representations and warranties and covenants contained in the facility documentation. I will elaborate further on these below.

There have been some project financings in the last half-decade or so which adopted a very pragmatic approach to security taking. The argument ran like this: assuming the lender has absolute faith in the qualifications of the borrower as, say, a mining house and project operator, the lender could take the view that, if the particular borrower in question cannot "make this project work", then no one can. In such a scenario, it could be argued that the cost of taking security—documentation, stamp duty and so on—is not justified because at the time the lender is forced to exercise its security rights, the project will be a disaster and assuming the cause is not borrower-related, the assets are unlikely to have any value other than perhaps as scrap metal.

Such an approach may have an attractive simplicity, particularly for the borrower. However, given the long-term nature of these projects and their associated financings, it is certainly not unusual for a borrower, in which a lender may have total faith and confidence at the outset of the transaction, to experience a change in circumstances some years down the track and perhaps not continue to justify such an approach for the full life of the loan. Even though negative pledge provisions would usually be incorporated in respect of the project assets in such arrangements, the existence of other unsecured creditors may adversely affect the lenders' position. Similarly secured creditors of the sponsor, which may still have obligations towards the project, will rank ahead of the project lenders. It is therefore only in the most exceptional cases today that lenders will accept anything other than full security for project financings.

Covenants, representations and warranties

I would like to briefly comment on these types of provisions, particularly in relation to those required of sponsors. It is true that banks are prepared to take a very large allocation of project risk post-completion but only on the basis that they understand the nature of the project that they are "inheriting" at that time. It is therefore a fairly standard requirement of bankers that, at the outset of the transaction and, often at completion, the sponsors must make representations and warranties about a number of aspects of the project. These representations and warranties are essentially the basis on which lenders advance credit and are used to allocate project risks.²¹

Classic areas of conflict here will be the lenders' desire to have an absolutely clean "bill of health" for the project at the time they assume responsibility for it and the sponsors' desire to qualify their statements in respect of knowledge, reasonableness and so on.

The covenants under the facility agreement are designed to preserve the project as represented by the sponsors for the life of the loan and

21. Davison and Brown, op. cit., pp. 2-4.

require the borrower, and in some cases the sponsor, to either do or refrain from doing certain things. The scope of the covenants will depend on the credit standing and nature of the borrower, security and the degree of risk assumed by the lender.²²

For example, the covenants may be quite different depending on whether the borrower is a single purpose company or also undertakes other non-project activities. In the former case, the lender will require fairly strict controls over the borrower's activities and, provided the borrower has the freedom required to undertake the project, this should not overly concern the sponsor. The latter case will obviously require greater scope for the borrower to undertake the other activities but, from the project lender's viewpoint, may require, for example, financial ratio tests to be incorporated, to assist in monitoring the ongoing health of the borrower, or ongoing sponsor support for the non-project activities may be necessary.

While there should be relatively few, there will be some sponsor covenants which will be required by the banks to continue during the whole life of the facility. For example, ownership and project management commitments will usually be required for the term of the facility, though these will inevitably be the subject of tense negotiation.

While it is true that sponsors will usually try very hard to eliminate all ongoing obligations, particularly post-completion, it is important to bear in mind the very significant benefits which lenders do offer to sponsors as part of project financing arrangements. Lenders will, for example, often fully take market risk (commodity price fluctuations, reduced demand), economic risk (increased inflation, adverse currency movements) and operating risk (increased cost of raw material inputs or less than expected power consumption efficiency) but these risks are assumed in the context of the banks "knowing" the party with which they are dealing, that is, that the company has a proven track record of operating successfully, that its philosophy of management and operation is one in keeping with that of the banks and so on. It is certainly, at least from the lenders' perspective, totally unreasonable for a borrower to expect lenders to assume such risks if they have no assurance that the party with which they have originally contracted will continue to perform its envisaged roles for the term of the facility, unless the lenders agree to an alternative arrangement.

The types of representations, warranties and covenants usually embodied in project financing agreements will seem extraordinarily restrictive to many borrowers, particularly those who have not been previously involved in project financings. Where lenders are asked to assume project risk post-completion, in the absence of any other source of repayment or security, the lenders not only have the right but also the obligation to be intimately involved with all aspects of the project and its operation and any change to the fundamental elements, which made up the basis of the credit decision, can only reasonably be made with the lenders' prior agreement.

22. *Ibid.*, p. 11.

Default

Events of default are an area which generally borrowers see offering relatively little flexibility but, again, I would suggest that, in the context of project financings, significant concessions have been made to borrowers in this area.

While nowadays it is certainly not unusual, particularly in corporate borrowings, for defaults in project financings to be excluded from the ambit of cross default provisions, this was certainly not always the case. Lenders in project financings assisted borrowers by introducing concepts such as special pre-payment events which allowed project defaults to be dealt with without triggering cross defaults in other corporate arrangements. The Tarong project financing is an early example of where such a mechanism was used. Similarly, devices such as self-receivership (used in CRA's Argyle project financing) and special shares were utilised to facilitate the assumption of control by lenders (to the extent that such procedures can ever be made easy).

Special shares were first used in North Sea financings. The articles of association of the borrower provided for the issue of a special share to which rights were attached designed to meet financiers' requirements in the event of default. Complete control of the borrower could be assumed by the holder of the special share and the company run as if the holder of this special share were the sole shareholder.

Theoretically the benefit of such a mechanism was that it could avoid the need to alert other creditors or to trigger cross default provisions in other loan documentation.

The ability to circumvent cross default provisions is undoubtedly real. Whether such a mechanism could realistically avoid alerting others of the project's difficulty is more debatable in a market as small as ours and the mechanism brings its own complexities such as issues of conflict in directors' duties, that is, how to balance the interests of the company as a whole and the interests of the special shareholder.²³

The nature of default events has also changed over the years, providing the borrower with increasing room to manoeuvre before the "final curtain call". For example, the traditional approach to completion was that the relevant tests were to be achieved by a set date and failure to do so automatically constituted an event of default. In many of these projects, the debt was guaranteed by the sponsors until completion was achieved. Borrowers therefore found it difficult to understand why, while the guarantees remained in place, lenders insisted on the right to take such action.

From a lender's perspective, the situation was certainly not that simple. The decision to lend had been made on the assumption that the project, not the sponsors, would repay the debt over the maximum loan term. A sponsor, considered good for a pre-completion debt guarantee,

23. R. A. Ladbury, P. Fox & G. A. A. Nettle, "Current Legal Problems in Project Finance" (1981) 3 *AMPLJ* 139 at 156; R. A. Ladbury, "Joint Venture Financing—Lender's Requirements Introductory Paper" *Energy Law Conference, Banff* (1981) Vol. II, p. 269.

may not have been considered equally strong in respect of an exposure for the full loan term. Therefore, the continuation of the sponsor's guarantee, of itself, was not sufficient to stop a lender accelerating the loan. However some lenders were prepared to go along with the borrower's view to the extent that, if the project failed to achieve completion for whatever reason (usually a technicality), but the borrower was able to show that the project (not the sponsor) would nonetheless be able to generate sufficient cashflows to repay the debt over the agreed maximum term, a default would not occur. The facility would remain in place though, usually, the sponsor guarantee was required to continue and the interest margin increased.

Similarly, project abandonment was traditionally a "sudden death" event of default. In recent times, the concept of force majeure has been accepted by lenders to the extent of allowing project closures for up to agreed maximum periods of time without triggering a default though debt service obligations are usually not excused during such force majeure periods. Indeed, formal abandonment procedures have sometimes been incorporated in project financing documentation, again to facilitate lenders' ability to deal with the project when the sponsors and borrowers have essentially "given up".

So, in sum, lenders have long recognised the variability of project performance and significant innovation and concessions have been incorporated into project financings to accommodate such fluctuations.

"THE NOT SO POSITIVE"

The lenders' record is not however unblemished. That is not to say that all projects, the subject of project financings, which have failed or all project financings in which lenders did not recover their funds are an indication that the project financing itself failed.

A history of CSR was written some years ago in which the following quote appears:

"Businessmen cannot afford to try to be right in every respect every time—too conscious a concern in that regard would mean delays, which are the enemy of action, and too little would get done. One of their functions is to take risks—calculated risk. Their art is to be right most times, wrong seldom and where it least matters."²⁴

Bankers are also businessmen and the cost of doing business must inevitably be that, sometimes, loans are not repaid.

However, there are certainly a number of examples in Australia's history of project financing where no one should have been surprised, at the end of the day, if the loans were not repaid. It is, of course, always easy to be wise about specific instances with the benefit of hindsight so

24. The passage, taken from A. G. Lowndes (ed.) "*South Pacific Enterprise—The Colonial Sugar Refining Company Limited*" appeared in P. Angly, "Funding the Transformation of CSR" *Asian Banking*, May 1982, 34 at 41.

I will restrict my comments to more general statements rather than deal with specific examples.

In most cases the criticism can be categorised in terms of flexibility—sometimes too little but also at times too much.

Starting with the “too much flexibility” category, as indicated earlier, bankers are fundamentally providers of debt, not high risk equity funds—at least not if they are only receiving a debt return for the risks assumed.

At the start of a transaction, a project lender will construct a financial model into which all project data will be programmed. Price and economic assumptions (exchange and inflation rates and so on) will be made and the project's ability to repay the loan will be tested under a range of scenarios. If loan repayment must rely on circumstances beyond what can be analysed in such cashflows, and there is no credit-worthy party assuming that risk, it is likely that the bank is assuming an equity risk. The type of circumstances which could fit this description includes making a loan which depends on additional reserves being proved up during the loan term to ensure full repayment; open-ended completion risk; lack of control over fundamental changes in project agreements or project scope, absence of protection from force majeure situations or repayments not scheduled to match project cashflows.²⁵ In such cases, it could be argued that the flexibility provided to a borrower goes beyond the fundamental lending and credit requirements for this type of financing.

More often than not, these types of concessions are made where the lender pays lip service to the concept of project financing but, fundamentally, places undue reliance on the project sponsors. Now, while I previously stated that a lender's basic requirements included an assurance that a project sponsor or operator, known and acceptable to it, would remain in place for the life of the loan, this is certainly a different concept from an expectation that a sponsor, which is in no way legally obliged to do so, will in any way support repayment of the debt.

It is certainly true that project financings represent a type of partnership or common enterprise between lender and borrower. The fundamental objective for both is to ensure that the project is completed and becomes independently viable and this is evident often in the forbearance which lenders show to sponsors during the pre-completion period; for example, by agreeing to extensions of time in which to achieve completion, agreeing not to call a sudden death event of default if the project fails to achieve completion, advancing a share of overrun funding and so on. Equally, lenders do expect that sponsors will make genuine efforts post-completion to salvage a project in difficulty. After all, the sponsors have an equity investment in the project and, if the project is successful, the sponsors stand to gain far more from it than any lender ever will. But beyond such genuine efforts, lenders must not have any expectations that a sponsor, which is not only not legally obliged to

25. W. P. Stengel, “Identifying and Minimising Project Risks” *Project Finance in Australia IRR Conference* (1983), p. 8.

meet debt service but which has actually paid a significant premium to achieve limited recourse, will provide financial assistance in times of project difficulty.

While some very experienced project financing banks have probably been guilty of this attitudinal crime to some extent, the trend is certainly more often found among banks which are clearly not qualified to adequately analyse the types of risks involved in project financings.

The type of analysis required usually involves technical assessments as well as in-depth industry knowledge. Clearly not all banks will have access to this type of expertise in-house and yet the funding requirements for many projects have been, and continue to be, so large that a large number of banks must be approached to meet the total funding requirement. This necessarily means that some of these banks enter the transaction either on reliance on the arranging bank's analysis or a misguided reliance on the commitment of the sponsor. Further, these problems are often exacerbated by the involvement of banks with no physical presence in Australia. Long-distance management of loans, which were probably not well understood by the organisation in the first place, at a time when the project encounters difficulty, is usually a recipe for disaster.

What is certainly critical in these situations is at least the involvement of an experienced project financier as agent bank for the bank syndicate. An unfortunate consequence of the series of loan defaults experienced in the late 1980s and early 1990s has been the change in attitude of some agent banks. Apparently based on legal advice, some agent banks have now started to adopt a "post box" role purely acting as a conduit between the borrower and the bank syndicate without providing guidance or leadership for the syndicate. While it is easy to understand that the potential liability which may flow to an agent bank from such "leadership" may well deter it from adopting such a role, lack of leadership in times of difficulty can often doom the project (and its associated financing) to inevitable failure.

The problems which have beset projects which have suffered from too little flexibility often arise from the very complex and often restrictive nature of project financing documentation. It can certainly be argued that, without such complexity and control, lenders could be far more exposed and the likelihood of things going wrong would be far greater. Conversely, however, the restrictiveness of many financing provisions and the requirements often for a majority of, or all, banks to consent to changes in project scope or project agreements may involve too much time delay when swift action is required. Further extensive reporting requirements or high levels of monitoring by banks under a project facility may distract project management from the main business of running the project, with adverse consequences all round.

The banking industry is also one of considerable staff mobility. The officer responsible within a bank for monitoring its involvement in a project financing may change several times during the life of the loan. New account officers, who have no history of the transaction, are likely to find project documentation fairly daunting and, due to a lack of

knowledge of the project and the financing structure, may become unduly cautious in their management of the account.

The right level of flexibility is, of course, ultimately a subjective judgment. It is important to remember that, while all parties to a project financing share a strong common objective, that is, to see the project up and running as originally envisaged and successfully operating, the banks and the borrowers do expect to get very different things out of it. For a start, the time horizons are different. Almost always the sponsors will be involved in the project for a much longer term than the lenders and perhaps, therefore, they can afford to be a little more patient than the banks. Secondly, and very importantly, the best the banks can ever hope to do out of the deal is to get their money back plus interest and fees. The best the sponsors hope to get is potentially unlimited—the much talked about “blue sky”.

Therefore, when things do not go according to plan, perspectives on what is the right course of action may differ. A few examples may help to illustrate the point:

- (a) Gold Mine produces a commodity (gold) which is the subject of an established forward market. As the project commences production, the gold price plummets. Everyone expects this to be part of a price cycle which will ultimately reverse but no one is quite sure when. If the price continues to fall, the project will not be able to even meet operating costs, let alone debt service. The lenders begin to put pressure on the project sponsors to undertake forward selling to at least guarantee that future revenues will cover operating costs and, perhaps, debt service. From the sponsor/borrower's perspective, the lender is asking the borrower to lock in to prices at the worst possible time, eliminating future profit potential.
- (b) Nickel Mine produces a commodity (nickel) which does not have the benefit of an established forward selling market. Again, as the mine begins to produce, the price of nickel collapses. Operations worldwide begin to close—many simply because they are losing vast amounts of money; others, free of debt, decide it is better to stockpile and so withhold supply with a view to pushing the price back up. The sponsor/borrower of Nickel Mine also believes the latter course to be the correct one. However cessation or even reduction of production will clearly affect the ability of the project to service debt.

If, in addition, one of the lenders is also a consumer of the project product, the situation becomes even more complex. In the case of the Greenvale Nickel Project, for example, Japanese companies were customers of the project under long-term sales contracts and also lent money to the project. The sales contracts provided for floor prices so that, as the nickel market price fell, the Greenvale customers continued to pay well in excess of market price. The theory was that when the nickel price subsequently picked up, the buyers would continue to pay the floor price until they “caught up”. The Japanese companies recognised that without the higher than market prices, their debt could not be serviced. But, as buyers, they had a longer-

term perspective. Their loan moneys had essentially been provided to assist in establishing a long-term nickel supply source. The project however had to be independently viable and could not simply continue in existence because of artificially high prices under the sales contracts. In order to achieve a rise in the market price, supply had to be restricted and therefore production reduced. Ultimately this was the course adopted. The other project lenders simply had to accept the reduced ability of the project to service debt in the interim.

- (c) Similar dilemmas can arise even in the absence of severe price downturns. The metal grades in a mineral deposit vary throughout the ore reserves. The mine plan can be drawn up to process the ore on a "flat grade" approach, that is, smooth out production over the mine life or, alternatively, higher-grade material can be selectively mined at chosen times. If high-grade material is processed when prices are high this may maximise profits for the operation as a whole but will probably result in significant losses in low price periods and an inability to service any debt during that time.²⁶

CONCLUSION

There are no easy answers but perhaps I can leave you with a few thoughts.

Despite a not always perfect history, the market continues to have an appetite for project financing. Most recently this has been seen in the wave of infrastructure projects currently under consideration around the country as part of the government privatisation efforts. Borrowers, in choosing their banks, and banks, in choosing their deals, must recognise that project financing requires a genuine capability to assess relevant risks. Having this capability will not always guarantee success, given the unknown and unforeseen factors that can and will arise, but it must, nonetheless, be a prerequisite.

Banks must clearly not expect sponsors who have paid for limited or non-recourse debt to bail them out post-completion if things go wrong, particularly after prolonged attempts to make a fundamentally uneconomic project work. This, of course, ignores situations of sponsor default or misrepresentation.

Equally, sponsors must also bear in mind that, if they expect lenders to act as a co-venturer in the project and show the type of flexibility that they perceive to be so necessary during the course of a project loan, when the "crunch" comes, the sponsors cannot expect to be able to rely on the strict terms of the agreement and say "my responsibility ended at completion".

Borrowers and banks should perhaps give greater recognition to the "equity" nature of bank involvement in some of these deals. The banks

26. Adams, *op. cit.* at 108.

must therefore re-adjust their risk approach in this light and decide whether or not they wish to undertake that type of business and borrowers must be prepared to remunerate accordingly.

It is difficult to see a clear solution for the perceived extensive, and perhaps excessive, legislation of project financings. It has been suggested that, for example, covenants should be written more loosely allowing for flexibility in changed circumstances rather than the type of tight covenants which hold borrowers to strict performance. An argument put forward, for example, is that the more lenders there are who can refuse to waive a default or to renegotiate new terms, the more unrealistic tight covenants are likely to prove when tested.²⁷

The difficulty is that so-called "loose covenants" may not give a borrower sufficient certainty at the outset of the transaction. Further, loose covenants generally contemplate that events may occur "subject to the reasonable consent of the banks". The same lenders which could refuse to waive defaults or other requirements under tight covenants may also prove equally reluctant to consent to the type of flexibility that the loose covenant contemplates.

The following propositions may be trite but perhaps they are still worth stating.

If borrowers essentially believe that the risk sharing that project financing can deliver is important to them, then they must be prepared to pay the costs that the technique brings with it. These are not only financial but also involve a loss of independence and freedom of action. The bank must virtually be treated as a partner in the enterprise with full rights of information and rights of involvement in key decisions which are fundamentally going to change the basis of the bank's credit decision.

The bank, in turn, needs to remember that the sponsors must have flexibility to run the project in accordance with their normal business practice. It is the bank's faith in that ability that underlies the whole credit decision. If the bank were not convinced that the company knew the business of mining or processing or whatever the case may be, it should not be entering into the transaction. Therefore the level of restrictions and control imposed by the bank must not impede normal business practice.

Another issue to bear in mind is that there is little point in inserting obligations in facility documentation which the parties know, at the outset, not to be achievable. Either the bank must accept the necessary amendments to make the conditions achievable (be they aspects of the completion test or simply an obligation to provide accounts within a certain time) or it should reach the view that the risk involved is not acceptable to it and the deal should not proceed. Proceeding with an "unachievable" provision in the facility agreement on a "gentleman's agreement" that the parties really understand that it means something different or that latitude will be allowed perpetuates the myths that have resulted in difficulties in project financings in the past.

27. D. Suratgar (ed.), *Default and Rescheduling—Corporate and Sovereign Borrowers in Difficulty* (1984), p. 27.

Suggestions have also been made about trying to pre-agree ground rules for times of difficulties. For example, it is universally agreed to be desirable (though sometimes hard to achieve if loans are put in place at different times) that all loan documents of a company incorporate the same rules, default events, notice and cure periods, etc. Other equally non-controversial principles must surely include the requirement that any category of default capable of cure should be subject to a cure period.

Other alternatives put forward, for example,²⁸ that lenders be granted a pre-agreed equity interest or that an automatic adjustment of term or interest rate occur in default or pre-default situations, may be more difficult to achieve. Lenders may not want an equity interest in a project progressively encountering more and more problems. The ore reserves at the time may not justify an automatic extension of the loan term. Nor may an automatic adjustment of interest rates reflect the bank's funding costs or the current pricing of risk at that time in the market. Undoubtedly some provision is needed for the deferral of interest payments, at least in final rescue packages. Very few projects can tolerate an accumulation of capitalised interest for any prolonged period of time. Equally, from the lenders' perspective, cessation of interest payments may require the loan to be declared as "non-performing" under bank policy guidelines with resulting provisioning requirements. That option may therefore not be palatable until full loan repayment is genuinely considered to be in doubt.

I have little doubt that such technical aspects will continue to be refined and that the creativity of lawyers in the field will continue to be applied to achieve further advances.

The value of project financing as a risk-sharing technique has been proved by the remarkable string of major developments which would not have been undertaken without similar financing structures. Its continued value is currently being reconfirmed by water, power, transport and telecommunication projects which are only being considered by the private sector on the basis of limited or non-recourse financings. Bankers and industry, and lawyers as advisers to both, can continue to enjoy the benefits of project financing for many years to come, and the technique will no doubt evolve and develop with new applications in new contexts. Fundamental to this all however is a realistic appreciation of what the technique can deliver and where the risk has been allocated.

28. *Ibid.*, p. 30.