Power financing

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1. Introduction

Delivery of a successful power project invariably requires a substantial financial investment on the part of sponsors and developers. Following the global financial crisis, more and more sponsors and developers are not able to fund the sizeable development costs involved in constructing a major power project. Those sponsors and developers that are active in the sector are also under increasing pressure to reduce the cost of their capital. These pressures, in addition to the need to remain competitive in a changing financial environment, are steering project sponsors and developers towards the deep pockets of third party investors or debt providers. Typically the financial investment required to finance a well-structured project will consist of a combination of equity contributions and debt advances. The debt amounts will exceed the equity contributions due to the desire to optimise the cost efficiencies of the project and, of course, to take advantage of competitive debt funding terms available from financial institutions providing debt.

Those looking for debt finance from third party financial institutions will have a number of financing options available to them depending on their particular circumstances and liquidity. Sponsors or developers with a substantial balance sheet might have no concern with raising the finance by way of a corporate loan, whilst others looking for shorter term loans to finance particular assets may consider asset financing as an option. Where debt is advanced on the basis of on balance sheet lending, the focus is on full recourse to the assets of the sponsor. Due to the costs involved in the construction of large power projects this funding approach is not always viable. The most popular method of commercial debt financing of independent power projects remains project financing. Without revisiting all of the various descriptions and definitions that exist, suffice to say that project finance is essentially a financing method used to finance large infrastructure projects based on the ultimate projected revenue of the project once completed, rather than the cashflows or finance available to the sponsors or developers themselves.

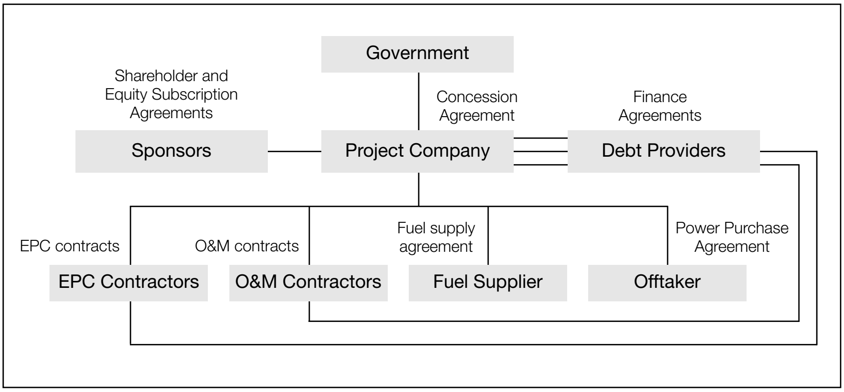
The main benefit of a project financing is that it offers financing that is not on balance sheet for a sponsor or developer and in practice with very limited recourse to the sponsor or developer but rather recourse to the particular project and its cashflows. Project financing, more so than other financing mechanisms for power projects, is influenced by the particular project risks and the risks associated with the country where the project is located. This contrasts with corporate lending where the actual size of the balance sheet of the borrower and access to the assets on that balance sheet in the event of a default are of key importance. Whilst the benefits of project finance for sponsors and developers are clear, due to the fact that it is essentially all about financing a proposal (and not a completed power project), certainty for funders can be a challenge. Financial models, projected revenues and project costs as well as fixed and variable assumptions regarding revenues and costs all play a role in attempting to provide elements of certainty to the funder of a proposed power project. Project finance, notwithstanding all its benefits, is also a complex and document-heavy funding mechanism. It is a more costly way of financing compared to traditional corporate funding and it takes longer to achieve financial close in a project finance deal, due to the complexities involved, and in particular also the detailed due diligence that is required.

2. What does a power financing structure look like?

Power financing implemented through the use of a project finance mechanism is typically structured by way of long term senior debt advances to a thinly-capitalised special purpose vehicle set up for the particular project. Sponsors invest by way of joint venture structures in the special purpose vehicle which is ultimately the entity responsible for delivering the project and also the borrower of the long term debt.

Figure 1 sets out a typical contractual structure for a project financed power project where a government concession is involved.

Figure 1: Project finance contractual structure



The special purpose vehicle or project company is at the core of the financing structure. It is the contractor under a concession or project agreement, the recipient of debt funding, the counterparty (employer) in respect of construction and maintenance contracts as well as the purchaser of fuel and the generator of electricity. One might think that these responsibilities are all substantive and not something you would trust a thinly-capitalised special purpose vehicle (typically taking the form of a limited company) to perform. The vehicle is however essentially just a conduit for a complex array of contractual rights and revenues and project finance as a funding mechanism brings with it established due diligence and risk management processes that analyse and assess the risks involved in contracting to deliver a power project on a project finance basis.

3. The players

We have mentioned the role of the project company but in practice, who are the key participants in this complex financing structure necessary to enable the construction and subsequent operation of a power project?

Firstly, there are the sponsors. The sponsors are entities or individuals who 'own' the project/invest equity in the project, typically expecting an ultimate return or profit from the operation of the project. The sponsors are typically privately owned entities or can be private individuals acting through incorporated ventures or indeed entities owned by the relevant government to further its political and economic policies in the power sector. The sponsors usually invest in a project using a combination of equity (share subscription) and debt (equity loans). The treatment of equity and debt returns from a tax, legal and accounting perspective in the relevant jurisdiction of the project and the treatment of equity and debt returns in the jurisdiction of the sponsor (if different) can play a major role in determining the level of equity and debt investment by sponsors.

Another key instigator of a power project is the government or quasi-governmental body of the country where the project is located. Governments are typically involved in affording concessions to sponsors for the construction and operation of projects through the use of concessions evidenced in a concession agreement or a project agreement. Their presence is however not always a requirement, for example in the case of merchant power plants where the project sells electricity directly to a stable and relatively predictable wholesale market.

The next key party is the funder. The funder provides the required substantial amount of debt funding to ensure the sponsors can commence work on the project confident that there will be sufficient funding to build and operate the project. The senior debt funding can come from a variety of sources, including multilateral financiers such as the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC). They can also include governmental entities, or agencies set up to assist in the procurement of power projects for the relevant government. The commercial funders make up the balance. Traditionally the commercial funders consist of well capitalised banks and financial institutions, local as well as international. However, due to the financial crisis and the capital crisis experienced by banks and financial institutions generally, there has been a shake up in the market and in a number of jurisdictions we have seen the emergence of dedicated infrastructure and energy debt funds prepared to advance long term commercial debt to power projects.

The project company, as a special purpose vehicle, requires the expertise and resources of various construction, engineering, maintenance and other sub-contractors. As a result there will typically be a raft of sub-contractors, engineers and technical experts involved in a power project to enable the project company to deliver the project. The key sub-contractors are usually the construction company (operating on a turnkey contract basis or using an EPC model) and the operator who will operate and maintain the project once construction is completed, although there can be a split between the role of maintenance provider and operator.

In traditional project financed power projects, the offtaker also plays a key role. Where the project is not a merchant power plant, the project company will enter into a power purchase agreement with an offtaker in respect of the electricity generated by the project (ideally a long term offtake agreement from the perspective of the funders).

There are of course other parties involved in a power project financing, such as professional advisers, insurers, suppliers of fuel, administrative services providers and asset management services providers but the above entities are those constituting the core contracted pillars required to enable the project financing of a power project.

4. Financing agreements

Whilst sponsors typically seek financing from a variety of debt providers including financing by way of senior debt loans, subordinated equity loans and bonds, the principal financing documents involved in the project financing of a power project include:

- facility (loan) agreement;
- common terms agreement
- intercreditor agreement;
- hedging agreements;
- accounts agreements;
- security documents; and
- direct agreements.

The key financing document in a project financed power project is the facility agreement. This is the document containing the details regarding the credit facilities made available to the project company by the debt funders. The facility agreement is usually drafted on a syndicated basis allowing for more than one debt funder and for specific funder roles such as agent, arranger, security trustee and/or account bank, depending on the precise nature of the debt funding provided.

The facility agreement will contain provisions governing the mechanisms of providing credit such as drawdown conditions and mechanisms, repayment formulae and tables. It will however also contain various complex provisions based on the principle that the funding is ultimately based on a sound project generating revenues to produce a cashflow sufficient to service a long term debt facility. These provisions include detailed obligations regarding the production and maintenance of a financial model as well as detailed construction and operation budgets. Due to the nature of a project financing there are numerous financial covenants testing the performance of the project at regular intervals and considering the project cashflows compared to project costs and the project revenues compared to the debt obligations of the project company on a forward looking as well as a backward looking basis. The facility agreement will also contain extensive project specific covenants and a comprehensive 'belt and braces' events of default package to ensure maximum protection to funders.

In the event that there are different sources of credit available to a project, such as debt facilities provided by commercial banks and debt facilities provided by multilateral banks or governmental bodies, it is not unusual for funders to make use of a common terms agreement. As the name suggests the common terms agreement is a document that 'houses' provisions that are common to all of the debt advanced in respect of a project. These provisions include not only common definitions but also general representations and project covenants (including common events of default and/or trigger events) in favour of all the debt funders of the project.

The different funders to a project may have different legal interests due to the nature of their funding and as a result there will be a need to regulate the legal relationship between the various funders (including any priority of claim arrangements). The funders will enter into an intercreditor agreement for this very purpose. This document will also ensure that the claims of sponsors and equity providers are subordinated in all respects to those funders providing junior and/or senior debt finance.

Where the debt financing for a project attracts interest calculated on a floating interest rate basis which is subject to movement over the life of the loan, the funders will require that the project company enters into a hedging agreement to ensure that the risk of an adverse fluctuation in the applicable interest rate over the life of the loan is hedged against a fixed interest rate. Similarly where the debt currency is different to the currency of the project revenue and project costs, the funders will require that the project company enters into further hedging agreements to hedge against the currency risk. Depending on the precise circumstances of the project there might also be other hedging agreements (for example to address increases in pricing linked to indexation).

As mentioned earlier, the project financing of a power project is primarily concerned with the cashflows of the project. To this end the funders will usually require an array of bank accounts to be held in the name of the project company with an account bank (normally one of the senior debt funders to the project). The project company will be required to enter into an account agreement with the account bank and the funders. The funders typically require bank accounts: (i) to hold all proceeds and revenues of the project; (ii) to hold insurance proceeds; (iii) to set aside reserves required by the funders to service debt; (iv) to set aside reserves required by the funders to cover lifecycle or maintenance costs; and (v) to set aside reserves required by the funders to address particular project specific gaps or contingencies identified by the funders as part of their due diligence exercise or credit assessment of the project. Where funders are of the view that such reserves may not be sufficient on their own to cover the identified or perceived gaps, they might require the implementation of a mandatory prepayment mechanism or a so-called 'cash sweep' mechanism where, in certain pre-agreed circumstances, the cash generated by or held for the project is applied in payment of the debt should the identified or perceived gap or set of circumstances arise.

Power project finance is secured finance. The funders will require a comprehensive security package for the period that all and any funds remain due to them under the debt documents. This security consists of full asset security in respect of the assets of the project company wherever such assets are located. The funders will typically not only take security over the assets of the project company but also over the ownership in the project company by way of share security. Where the debt is syndicated or there is a club of funders the security is usually granted in favour of a security trustee who holds the benefit of the security on trust for the funders.

As the real value of the project lies in the revenue generating contracts, funders will take special care to ensure that they have unfettered access rights by way of security to the key project contracts should a default arise.

In addition to obtaining comprehensive security over the rights of the project company under its key project contracts, the funders will want to ensure that there is continuity in the event that the project company does not perform its obligations under such key project contracts. In order to avoid the termination of key project contracts by the counterparties to such contracts, the funders require that the counterparties enter into direct agreements (also known as 'step-in agreements') with the funders. The direct agreements require that the contract counterparties, prior to exercising any rights they may have to terminate the relevant contracts, grant a right to the funders or their representative to 'step into' the position of the project company under the relevant project contracts. This ensures continuity of contract and safeguards the funding and any losses that might arise due to a termination of a key contract. Direct agreements are typically required for the likes of concession contracts, construction contracts, operation and maintenance agreements, lease agreements, as well as power purchase agreements. They are however not limited to these contracts and will be required by funders in respect of any contracts regarded as key for the continuation of the project. Unlike the position in respect of traditional project financed infrastructure projects that involve public sector participants, the direct agreements in power projects do not typically follow a prescribed standard form which means there is potential for a whole raft of direct agreements, all in different forms and heavily negotiated to reflect the particular commercial circumstances of the project.

Whilst not a financing document itself, the legal due diligence report is a crucial part of the documentation required by a funder prior to committing any funding to a project. This document, issued to the funders and other key project participants is typically prepared by the legal advisers to the project company due to their proximity to the project and the sponsors, although it can also be provided by the legal advisers to the funders and sometimes the ultimate legal due diligence report can be a combination of due diligence reports from a number of legal advisers. The legal due diligence report is essentially a report on the risks contained in or identified in the transaction documentation for the project and the allocation or management of those identified risks. The legal advisers issuing the due diligence report typically issue a reliance letter in respect of the report, subject to general disclaimers and in certain instances containing limits in liability. This report is accompanied by a separate report issued by technical advisers in respect of the project and the performance of its assets. You can also expect to see reports from the insurance advisers to the funders of the project as well as the financial model auditors who in turn look at the financial model developed for the project. These reports all assist the funders in making a decision as to whether the project is 'bankable' and as such that it is a project that complies with the requirements of the internal credit approvals received by the funders to enable them to proceed towards making a financial commitment available for the project.

This is an extract from the chapter 'Power financing' by Hugo Coetzee in Power: A Practical Handbook*, published by Globe Law and Business.*