GROWING COMPLEXITY OF ECA FINANCING

"LIFE IS REALLY SIMPLE, BUT WE INSIST ON MAKING IT COMPLICATED." CONFUCIUS. BY **OLIVER IRWIN**, PARTNER AND **BENJAMIN PRIDGEON**, ASSOCIATE AT **BRACEWELL**, AND **GEOFF KNOX**, CO-FOUNDER, HEAD OF ENERGY AND MINING AT **PORTLAND ADVISERS**.

Project sponsors seeking to develop large-scale infrastructure projects have faced a variety of challenges over the last decade. Project sponsors have long sought to combine financial products from a diverse pool of private and public sector creditors; over the years export credit agencies (ECAs) have remained reliable and consistent sources of credit for projects with large capital expenditure requirements.

As we will explore in this article, in the last decade ECAs have actively embraced their role at the forefront of bringing complex and innovative financing solutions to the market.

Following on from the aftermath of the 2008 financial crisis, the rise in the regulation of the commercial bank market – in particular, the implementation of Basel III – meant that international commercial banks became subject to stricter requirements to maintain reserve capital and retain liquidity.

These constraints on the international commercial bank market (the traditional source of project finance debt) required project sponsors and their financial advisers to become adept at employing increasingly diverse financing structures to fund their projects. In turn, project finance lawyers became equally adept at drafting complex intercreditor agreements that catered for the various, and sometimes competing, requirements of ECAs, multilaterals and development finance institutions (DFIs), Islamic finance facilities and capital market issuances.

A notable example of a large-scale project financing – with an estimated overall project cost of US$19bn – that successfully utilised ECA, DFI and Islamic finance facilities, and capital market issuances was the Sadara Integrated Chemicals Project in the Kingdom of Saudi Arabia.

A joint venture between Saudi Aramco and Dow Chemical Company, the financing structure for the Sadara project included a US$2bn sukuk (an Islamic bond) issue, commercial bank and Islamic bank facilities, a US$4.7bn direct loan from the Export-Import Bank of the United States (US Ex-Im), and support from several other ECAs including UK Export Finance (UKEF), Euler Hermes, Bpifrance, Export-Import Bank of Korea (KEXIM) and Korea Trade Insurance Corporation (K-Sure).

At the time that the Sadara project achieved financial close in 2013, the average price of Brent crude oil was around US$108 a barrel. Three years later in 2016, the average price had dropped to US$45 a barrel, yet ECAs were still actively participating in similar projects in the Middle East region.

The Liwa Plastic Industries Complex, owned by Oman Oil Refineries and Petroleum Industries Company, achieved financial close in 2016 with a US$6.4bn project financing. The participants in the financing included six ECAs – Atradius Dutch State Business NV, Euler Hermes, KEXIM, K-Sure, SACE and UKEF – three Omani banks, two Asian banks, 10 European banks, two North American banks, and two regional banks.

By the end of 2017, all three major rating agencies, S&P, Fitch Group and Moody's, had downgraded Oman's credit rating. Notwithstanding this downgrade, another huge Omani project financing in the petrochemicals sector, the OmaniDuqm refinery project, a joint venture between Oman Oil Company and Kuwait Petroleum, achieved financial close on a US$4.61bn multi-sourced financing, the largest project financing in Oman's history. The participating ECAs were UKEF, CESCE and KEXIM.

These financings clearly served to send a message to project sponsors that notwithstanding the aftermath of a financial crisis and the ensuing liquidity crunch, a low commodity price environment or a sovereign downgrade for a host government, ECAs remain open for business and at the forefront of participating in well-structured project financings.

Another notable recent example of a successful financing in a jurisdiction with a fiscally challenged host government is the US$4.63bn Coral South FLNG project financing in Mozambique, which achieved financial close in December 2017, making it the largest ever project financing in Africa.

The financing structure included ECA cover provided by five ECAs – consisting of Bpifrance, SACE, KEXIM, K-Sure and Sinosure – funding from 17 commercial banks, and a direct loan from KEXIM. The largest ECA involvement came from Sinosure, which supported the Chinese banks including the Export-Import Bank of China (China EXIM), ICBC and Bank of China.

Coral South FLNG's lenders had to embrace complexity on several levels. The project structure featured the upstream concession being held by a separate joint venture to the borrower that owned the floating LNG vessel. The project structure also included the provision for future projects and operators accessing the gas reserves from the same upstream concession.

The financing structure had to account for oil price risk, since the LNG price is determined by a formula linked to crude oil price benchmarks, some advanced technology being used in an offshore application for the first time, the unique features of the single LNG offtake agreement, and support for the debt service undertaking provided by the local sponsor.

A further challenge was introduced when the Government of Mozambique defaulted on two sovereign bonds, resulting in the suspension of support from the IMF and a downgrade of Mozambique's sovereign credit rating by S&P and Fitch Group to CCC. The sovereign downgrade occurred just a few months before lenders sought their credit approvals. Despite these complexities, signing of the financing documents was achieved within an 18-month period.

The successful financing of the Coral South FLNG project is expected to lead the way for large-scale project financings of two onshore LNG projects in Mozambique, both of which are scheduled to achieve financial close in 2019.

The Anadarko-led Area 1 Mozambique LNG project and the ExxonMobil-led Area 4 Rovuma LNG project have both approached the commercial bank market seeking to raise covered and uncovered loan facilities. It is estimated that the aggregate amount of long-term project finance between the two projects will be the best part of US$30bn and ECA finance is expected to be central to both financing plans.

The Coral South FLNG project demonstrated China's increasing willingness to take exposure to global oil and gas and emerging market risk, which in turn has influenced the financing plans of project sponsors in jurisdictions where sanctions have hindered their ability to access the global capital markets and trade internationally. Sanctions have a long history but over the last few decades have been used increasing frequently, in particular by the USA.

As a result, sponsors of cross-border projects benefiting from diverse funding sources are now adept at operating in a complex sanctions environment as they are required to be aware of both multilateral sanctions imposed by international bodies such as the United Nations (UN) and the European Union (EU), as well as unilateral sanctions imposed by individual countries such as the USA.

The requirement to comply with differing multilateral and unilateral sanctions regimes can lead to conflict between ECAs and the international commercial banks benefiting from their cover, whose policies may be more far-reaching than that of the ECA backstopping the credit risk. Sanctions-related events of default and mandatory prepayment regimes can be of particular focus when negotiating ECA-supported loan documentation.

One recent example of a sanctions issue that has yet to be definitively resolved is the conflict of the USA's sanctions targeting Iranian related activities – imposed following the USA's withdrawal from the Joint Comprehensive Plan of Action – with the EU Blocking Regulations, which prohibit EU entities from complying with the sanctions imposed by the USA in relation to Iran.

Although sanctions have impacted the ability of some project sponsors to raise finance from certain financial institutions, a prominent example of a project that successfully reached financial close in 2016 despite sanctions issues was the US$27bnYamal LNG project in Western Siberia.

Following Russia's annexation of Crimea in 2014, the EU and the USA imposed sanctions on a number of Russian entities and individuals that prevented Russian borrowers from accessing US dollar-denominated capital markets and insurance markets.

While neither lead sponsor Novatek nor its major shareholder were directly targeted by sanctions, many commercial banks declined to be involved in the Yamal LNG project.

Undaunted by the constraints of the sanctions imposed by the European Union and the USA and the sharp fall in crude oil prices in 2016, the ECAs pressed on with a revised financing structure that featured euro and renminbi-denominated loan facilities and structural features that addressed unique foreign exchange, oil price, LNG shipping and insurance risks.

The US$19bn project financing that emerged included a combination of direct loans and ECA support from China Development Bank, China EXIM, Bpifrance, SACE, JBIC, Euler Hermes, EKN and EXIAR. Equity was provided by Novatek (50.1%), Total (20%), China National Petroleum Corporation (20%) and the Silk Road Investment Fund (9.9%).

The anti-bribery and corruption (ABAC) and anti-money laundering (AML) requirements of ECAs and commercial banks is another source of complexity. ECAs have long incorporated ABAC and AML language in their loan and guarantee documentation, while commercial banks have taken this to a new level following several well documented incidents that have resulted in banks incurring multi-billion US dollar fines and penalties.

The requirement to comply with differing multilateral and unilateral sanctions regimes can lead to conflict between ECAs and commercial banks

Political factors in recent years have had a considerable impact on the financing of large-scale infrastructure projects. China's Belt & Road Initiative (BRI) was officially launched in 2013. This development campaign is aimed at boosting trade and stimulating growth across Asia and beyond by investing in shipping routes to the Mediterranean and Africa and overland corridors to the Middle East, Central Asia and Eastern Europe.

Estimates vary as to the cost of the initiative but it is expected that the investment in infrastructure over the initiative's 10-year life will exceed US$1trn. The Chinese policy banks, China Development Bank and China EXIM, and Sinosure have played a prominent role in the initiative by providing support to the Chinese commercial banks. By way of contrast, a government clash over spending priorities has seen US Ex-Im lacking a board quorum since July 2015, meaning that it cannot approve any transaction over US$10m.

This is significant, as prior to the shutdown US Ex-Im was a prominent participant in large-scale project financings – in 2012 US Ex-Im reportedly provided just under US$36bn of finance to support US exporters – and was regarded by many as the trail blazer for ECA involvement in complex project financings in the 1990s. US Ex-Im is reportedly in the process of being restored to its full powers, but the timeline for its restoration phase remains unclear.

The traditional credit enhancement function of an ECA was to provide political risk cover in emerging markets where political instability impaired the ability of project sponsors to attract commercial bank debt. Over the years, the role of an ECA in a large-scale infrastructure project has grown to encompass comprehensive guarantee and insurance coverages, as well as direct lending to project companies.

As the demand for ECA finance has increased, the products offered by ECAs have evolved: by way of example, in 2016 COFACE, France's then ECA, transferred its export credit function to a new agency, Bpifrance, which is able to issue direct guarantees and export credit insurance in the name of and on behalf of the French state, thereby resolving any issues as to whether guarantees issued by the French ECA were sovereign guarantees.

Similarly, in 2014 UKEF announced the establishment of its Direct Lending Facility, a move specifically designed to make its financial support more attractive to the purchasers of UK exports.

One major project financing to have benefited from UKEF's Direct Lending Facility was Vitol's US$1.3bn project financing of its participation in the Offshore Cape Three Points (OCTP) oil and gas project in Ghana, which achieved financial close in March 2017 and included UKEF's first direct loan into Africa.

One of the notable features of this financing was that it was based on a hybrid structure that combined the traditional project finance structure – including long tenors and a comprehensive security package – with elements of the reserve-based lending (RBL) model such as annual borrowing base redeterminations.

The IFC had previously participated in RBL financings, but this hybrid model was a first for both UKEF and the IFC and required careful structuring to ensure that each of the project participants' concerns was adequately addressed.

Many emerging market oil and gas project financings benefit from the direct export of oil or LNG production into global markets, with the proceeds of such exports being held in offshore accounts to be applied towards debt service.

A major component of the OCTP project is the sale of gas under a long-term gas sales agreement to Ghana's natural gas aggregator, Ghana National Petroleum Company (GNPC). The OCTP project featured credit enhancement provided by the World Bank in relation to the purchase obligations of GNPC under the gas sales agreement.

In addition, political risk insurance was provided by MIGA, the insurance arm of the World Bank, in favour of the commercial bank lenders.

The OCTP project was also notably the first project in which all four limbs of the World Bank – IFC, MIGA, IDA and IBRD – have acted together. This project also highlights that, in addition to ECAs, DFIs and multilaterals continue to play a prominent and important role in supporting infrastructure projects in emerging markets.

Certain multilateral development institutions enjoy a preferred creditor status (PCS), meaning that they have preferential access to foreign currency in the event of a foreign exchange crisis.

Although PCS does not confer any legal status, host governments are strongly incentivised to recognise PCS in order to maintain ongoing access to sovereign loans from multilateral lenders.

PCS raises an issue for ECAs as it goes against the general principle of project financing that all lenders should rank pari passu and operate on a level playing-field. ECAs have also put forward the position that they should not be discriminated against by host governments because they have also demonstrated a track record of being supportive of countries whose economies are in financial crisis.

Certain ECAs have taken the position that the benefit of a multilateral's PCS should be shared with the other senior creditors participating in the financing; to-date this position has not been accepted by multilaterals on the basis that this would potentially jeopardise their preferred creditor status.

This issue came to prominence in 2014 when the IFC and the European Bank of Reconstruction & Development (EBRD) withdrew from the financing of Turkey's multi-billion US dollar Star Refinery project.

The PCS issue continues to adversely affect the ability to complete multi-sourced financings involving certain ECAs and multilateral development institutions. However, the view of individual institutions across both sides of the PCS debate varies and the outcome of the intercreditor discussion does depend on the facts and circumstances of the deal in question.

We have recently seen ECAs accept that they will not share the benefit of a multilateral's PCS on the basis that the project was structured in such a way that there was limited local currency and/or the revenue flows were largely offshore, both of which substantially mitigate any incontrovertibility concerns a creditor may have, and thus negate the PCS issue.

Although structuring a financing that includes ECA, DFI and multilateral funding sources can be complex, many of the attendant issues have been solved in prior financings: for example, commercial banks, DFIs and multilaterals will typically readily accept that disbursements of an ECA facility should be exempt from the general rule that different lenders' loans be disbursed on a pro rata basis.

In addition, ECAs, DFIs and multilaterals have consistently demonstrated their willingness to accommodate the tenor constraints of international commercial banks by structuring financings so as to provide flexibility in the manner in which the commercial bank tranches amortise, even if this serves to create structural subordination and/or some residual refinancing risk.

The majority of ECAs adhere to the rules of the OECD consensus (the Arrangement) although there are notable exceptions such as the Chinese ECA and policy banks. The Arrangement is a gentleman's agreement (rather than a legally binding agreement) and one of its functions is to regulate the terms on which ECAs may provide financial support.

Support from an ECA may be tied to a particular contract for goods or services supplied by a contractor from the country in which such ECA is established (tied lending) or the ECA's support may be provided (for example, to secure imports of resource) on a basis that is unconditional on the procurement of goods or services (untied lending).

A prominent example of tied lending in which an ECA was willing to embrace a complex and innovative financing structure was the ground-breaking project financing for the Barakah nuclear power project in Abu Dhabi, which achieved financial close in October 2016.

Nuclear power projects are notoriously difficult to finance, and the support of the government of Abu Dhabi - which provided a US$16.2bn loan towards the estimated US$25bn overall project costs - was crucial in securing the necessary funding for the project.

KEXIM and a number of international and local banks provided both senior debt facilities and equity bridge loans. KEXIM's direct loan of US$2.5bn demonstrated its confidence in the project and its willingness to support Korean Export Power Corporation, a prominent nuclear power developer.

We have also seen an increase in untied support offered by ECAs in recent years. Euler Hermes and SACE both provide for untied support to projects of strategic importance to their respective national economies so as to secure reliable supplies of raw materials upon which their manufacturing industries depend.

Sinosure, JBIC and NEXI all also offer a number of untied loan products. JBIC's Overseas Investment Loans (OIL) are loans to support Japanese foreign direct investments (as opposed to the export of goods or services).

These untied loans help to secure stable supplies of energy and resources for Japan and to finance projects maintaining order in international financing or having significant effects on global environmental preservation. In addition, NEXI also provides overseas untied loan insurance to Japanese lenders providing foreign loans that are untied to exports from Japan.

In recent years project sponsors have also become familiar with the enhanced environmental and social policies of commercial banks as well as ECAs, DFIs and multilaterals. The Equator Principles III (EP III), released in 2013 and adopted by an increasing number of financial institutions, are intended to set the minimum standard for environmental and social due diligence in large-scale infrastructure projects.

In theory, EP III should not lead to intercreditor complexity between multilaterals, ECAs and commercial banks because these principles were developed from and modelled on environmental standards and social policies such as the IFC's Performance Standards, the World Bank Environmental and Social Framework, OECD Environmental and Social Due Diligence and EBRD's Environmental and Social Policy.

That said, ECAs, DFIs and multilaterals still typically require intercreditor veto rights in relation to decisions relating to environmental and social policies, which can lead to challenging discussions with participating commercial banks that may not feel comfortable ceding decision-making to third parties in relation to these policies.

The global push for cleaner and more sustainable energy has ECAs participating in an increasingly diverse range of sectors and jurisdictions. Despite the challenges posed by language, geography and differing objectives, ECAs are increasingly collaborating with each other to enable and facilitate multi-sourced project financings rather than seeking to compete against each other.

This mindset has enabled ECAs to push the boundaries in terms of project size and risk allocation as they harmonise intercreditor protocols, environmental and social requirements and sanctions provisions. ■