Project Finance: Current Strength And Future Trends

*The Editor interviews **Barry N. Machlin**, co-head of the Global Projects Group and Partner at Mayer Brown LLP.*

Editor: Please tell our readers about the evolution of the Global Projects Group at Mayer Brown. What disciplines are required to round out the practice group?

Machlin: The Global Projects Group has been in existence in its current form for about ten years. Prior to its formation the specialties involved were long-time practices of the firm but not previously organized in as much of a focused effort. Our group was established in part to better speak to the market and to our clients about the abilities of the group and in part to meet the competition from other firms with similarly constituted groups.

Project finance generally involves the creation of a new special-purpose entity with a singular business goal, such as developing and operating a power plant or constructing and operating a petrochemical facility. The disciplines involved often are broad. On a transaction-by-transaction basis different specialties are required to deliver the necessary scope of service to the client. However, the core disciplines are finance and project development. The finance area entails representing lenders or other providers of debt capital to projects. Project development consists essentially of corporate work, representing companies that are developing these projects. There are a range of other practices which supplement those primary practices, such as environmental, energy and transportation regulation, government contracts, tax, litigation, and arbitration. At Mayer Brown, we pride ourselves on being able to deliver a "one-stop shop" where clients can have access to all of the disciplines necessary to efficiently and effectively serve the needs of the particular transaction.

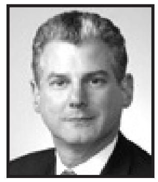
Editor: Are the deals normally structured along the lines of the classic project finance deal where the asset alone provides the credit-support behind the financing?

Machlin: Certainly the preponderance of the credit support comes from the enterprise itself but typically the sponsoring equity players will be providing at least limited support during the construction period to address significant risks that may not be otherwise covered by the enterprise before it is operationally viable.

After the enterprise is up and running, it is generally a limited recourse, stand-alone operation to which debt and equity are looking for their respective repayment and profit.

Editor: Why has there been an upsurge in project finance and development work, particularly in the Midwest?

Machlin: There are several principal reasons for the upsurge in project finance and development work recently. As long as such projects are economically viable, the rating agencies and most lenders view limited recourse projects as being especially credit worthy owing to the fact that such projects are isolated (i.e., "ring fenced") from the credit exposure of the sponsoring corporate parties. Another reason is that it is very hard and risky to do some of the novel, large transactions on company balance sheets. For instance, there is a significant upsurge in interest in nuclear power generation in America now after a twenty or thirty year hiatus. Nuclear power developments require enormous amounts of time – maybe up to ten years for permitting and development – and enormous amounts of capital – in the billions. The credit needs of one such nuclear project may be too large for the sponsoring utility or company to use their general corporate credit/balance sheet for support. A second example is the need to develop clean coal, a requirement for meeting power generation requirements well into the future. The technology to deal with developing environmentally friendly coal is very expensive, and these can be multibillion dollar plants. Again, such projects are simply too large and too risky to be done on the balance sheet of most companies, and, as they may not be successful, should they fail, the financial consequences need to be isolated from the rest of the company. In sum, there is a combination of credit-protection needs by the sponsoring companies, and credit-quality requirements of lenders, as well as the need to isolate the risks and consequences of these enterprises. All of these factors contribute to the general view that they are better handled on a stand-alone basis.



Barry N. Machlin

As to the Midwest, this region is benefiting from a number of converging trends: as many people are aware, there has been a very large boom in ethanol production projects in this region. Second, there has been a lot of power plant development in the Midwest, many of which have been coal-fired plants and some which are new technology "clean-coal" developments. Third, the wind energy sector is very strong in the Midwest. Fourth, the infrastructure privatization sector has been very strong here, with landmark deals involving transportation assets such as roads and airports in Illinois and Indiana. Our Global Projects Group has been among the leaders in doing these types of transactions, and we see a great amount of future activity here in the Midwest, but also in doing international projects that originate with parties in the Midwest.

Editor: Were all of these stand-alone projects or did some of them have insurance policies, guarantees or other support from third parties?

Machlin: Many of these domestic projects have some form of external financial assistance or benefit from tax incentives. For example, the Energy Policy Act of 2005 had a series of incentives, credits and benefits in the area of nuclear, "clean" coal, renewable and other kinds of new technologies. There also are a number of tax incentives to benefit many of these projects.

Our experience is that these external supports are very important to project economics, but they do not do the whole job. Long-term, solid projects must be well structured, in that the project must make sense in the market that it competes in. Successful project developers realize that they need more than just tax advantages or government guarantees to be successful.

Editor: In your project finance deals overseas have you secured financial support from either the U.S. government, for example an OPIC loan, or from the government where the project is being built?

Machlin: My practice is approximately eighty percent international and twenty percent domestic. In my international practice I am most frequently involved in transactions which have official support of some kind from either the host government, or the U.S. or another developed nation's government, or both. This support may be in the form of a concession with certain benefits to the company that has the contract to operate a port or an airport; it may be in the form of special land rights or usage permissions as in the case of designating a particular area as a site for power plant development. The support may also be in the form of actual government guarantees to a purchaser who will buy the product of the project; such is the case with local utilities that agree to purchase electricity from projects. These are examples of so-called host government support.

In the case of the U.S. or other developed nation support, a typical project that I am involved in would have a government agency involved in providing a guarantee, a direct loan or an insurance policy as credit support for an overseas project. There are three such entities with which our firm has had considerable experience. The first are the so-called export credit agencies whose mission it is to facilitate exports of national goods and services. One of our large clients is the Export-Import Bank of the United States, which is our nation's export credit agency. For example, I've been involved for the last five years in a transaction in Egypt where there is an Ex-Im Bank guarantee supporting a group of banks that are lending money to a special-purpose company that is developing a $600 million ammonia plant in Egypt. The U.S. government guarantee of that debt is very important to the project's success because Egypt is not a place where limited recourse project financing has been frequently done. I have been involved in transactions that use the support of other government's export credit agencies, for example, Germany, France, England and Japan. The other clients that are frequently in the transactions we are involved in are multilateral agencies such as the affiliated agencies of the World Bank. The agency we have represented most often is the Inter-American Development Bank or IDB, which provides lending and other support to projects in Latin America. I'm currently representing that institution in the first privately owned port to be financed in Brazil.

Editor: Mayer Brown has been accorded many accolades for its work in the form of "Deal of the Year" recognition. Please give a few examples of different types of financings.

Machlin: Highlighting a few is a challenge since we have been involved in about 15 such deals in just the last 7 or 8 years. Here are a handful of recent examples that demonstrate the range of our practice: We had leading roles in two landmark infrastructure Deals of the Year: the Chicago Skyway and Indiana Toll Road public-private partnership transactions. We do a significant amount of groundbreaking work in the Mexican energy sector and were involved in a power transaction, known as the Bajio Power Project, that was a Latin American power Deal of the Year. Lastly, we have a very substantial mining and metals practice, which is headed by my London partner and Projects Group co-head, Ian Coles. We have been involved in several major mining deals that have won Deal of the Year awards, Julietta and Kupol, which were gold and silver developments in Russia, and Vokshod, a chromium mine in Kazakhstan.

Editor: How do you advise your clients to protect themselves against risk of project failure, especially when the main credit support for the project is inherent in the asset being financed?

Machlin: I think this boils down to the analysis of the various risks which are present in the project, assisting the clients to honestly face them and address them through "risk mitigation strategies." The strategy you use depends on the risk. Project finance and development essentially consists of building an enterprise on the foundation of a number of inter-related contracts. Risk mitigation in project work is done through the terms of those contracts, making sure that the contracts anticipate what may happen and provide a solution for that contingency. In these risk anticipation and management tasks, we view ourselves as counselors as much as legal advisors. And we find our most successful client relationships are the ones where we are working with and facilitating the client's development of a project from its inception through successful completion in order to better help the client anticipate and resolve issues along the way.

Editor: How do you see the future of global project finance evolving both in the U.S. and overseas?

Machlin: I see it as a function of "the world is flat" phenomenon. I think we are seeing everywhere enormous cross-investment streams. One thing that is going to characterize project finance in the future is going to be an increasing array of investors coming from new and different locations and investing in new and different locations. Clearly there will be continued growth in the power sector in the United States and globally. This will be increasingly coupled with the need to develop power in an environmentally responsible manner. We are likely to see more and better technology for handling coal, more wind, solar and bio-fuel technologies. Our wind energy practice, headquartered in Chicago and led by another partner, Tim Callahan, is very prominent in the U.S. wind market and continues to see an amazing increase in activity with many more wind projects planned. We also will see more attempts at nuclear power plant development as many see that technology as providing a path for low-emissions power generation.

Overseas, the risk of answering this question is that there is so much going on all over the word that it is easy to leave developments off the list. There will be an increasing stream of investment in the so-called BRICs – Brazil, Russia, India and China– as well as other major users of project finance, such as Mexico. Oil and natural gas developments, and all of the associated types of projects, such as drilling rig platforms, LNG facilities and petrochem plants, will remain robust and accelerate in certain areas. This trend will continue to fuel project development in OPEC and other oil and gas-rich countries, including in the Middle East, Africa, Mexico, Latin America and elsewhere. The incredible demand for minerals and metals, much of which is driven by China and other Asian countries' industrial demand, will support mining and natural resource projects in Africa, Russia, certain Latin countries and others worldwide. Finally, across the world, there will be an increase in all types of infrastructure transactions. The Panama Canal expansion, in which our firm has a leading role, is going to create in this hemisphere an ability to vastly increase the volumes of trade traffic, resulting in a significant increase in port-related projects, and we are doing several of these projects right now. We are also using our transport experience to help clients who are bidding for airport, roads, bridges and similar projects in Latin America and elsewhere in the world. We feel Mayer Brown is very well positioned to help our clients take advantage of these trends – as we like to say, we deliver "Global Projects Excellence."

Please email the interviewee at bmachlin@mayerbrown.com with questions about this interview.