

“Natural” project funding: Refinancing risk explored

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In my most recent article^[1], I suggested that one of the reasons for greater concern regarding bond financing as an alternative to the likely constrained bank funding for projects was refinancing risk raised by this so-called “natural” project funding (construction funding by banks with a long term take-out financing by institutional investors or the capital markets).

This article seeks to explore this refinancing risk and examine some of the usual “mitigants” thereof and concludes that these mitigants are unlikely to substantially reduce the refinancing risk that arises if banks just fund construction and, due to required regulatory capital (or, for that matter, other reasons), do not provide a term commitment.

1. Pre-Funding

Of course, the most conservative mitigant of refinancing risk is to pre-fund the long term take-out refinancing; however, this is usually economically unattractive due to the significant “negative arbitrage” (the negative basis between the cost of funds raised over the yield that these funds earn through investment until deployed for their intended primary purpose) and, at least traditionally, the relative short term tolerance for pre-funding bondholders for these arrangements - while pre-funding is used in the municipal debt markets, this is usually for financial “optics” and, when used in a corporate context, pre-funding is usually limited to reasonably predictable and binary events like consummation of a merger or divestiture of a business.

In addition, there is a need to define the condition for the release of funds raised with precision (a point which will be revisited several times in this article) to avoid ambiguity and uncertainty regarding an effective refunding. These conditions would have to effectively balance the competing interests of the project sponsor in an assured refinancing if the conditions are met, but provide sufficient flexibility to accommodate minor and immaterial changes that should not affect the pre-funding bondholders (and the corollary interests of the pre-funding bondholders). This presents a substantial challenge and, even assuming that

negative arbitrage was not an issue, might prevent this option as a practical matter for most projects with significant construction.

Obviously, a change in related construction cost or schedule or the manner of construction completion and related project condition and resulting/likely future project performance might (or might not) be material to the pre-funding bondholders, but defining which change is (or is not) presents a genuinely difficult task.

2. Committed Take-Out

A more efficient economic option is to have a committed take-out/refinancing that would provide funds to repay the bank financing upon satisfaction of specified conditions. These conditions raise the same issues as just discussed and would, in addition, entail further accounting and regulatory capital questions.

Would the commitment be recorded as a liability? When? At issuance or when the conditions are likely to be met? When would the conditions to funding be likely enough to be met that the commitment provider, if a regulated entity, should hold capital against the related obligation? What happens if it is or becomes unlikely that the conditions to funding will be met? Do related recorded liabilities and/or capital requirements disappear? If a company is an active provider of these take-out commitments, does this possible financial statement and capital volatility raise issues with investors? With regulators?

3. "Soft" Economic Incentives

A more market-based mitigant is to effectively encourage refinancing by specific economic incentives that are designed to make the bank funding more expensive relative to other alternatives and to result in the desired long term take-out refinancing. Of course, even assuming that these incentives work as desired, the timing of the take-out refinancing may be less predictable than the bank might want. Incentives commonly used include:

- interest rate/spread increases (or "step-ups")
- intrusive covenant restrictions (ability to incur additional debt, make distributions to owners, to require consent to business changes, etc.)
- available cash "sweeps" to reduce outstanding debt (leaving a smaller balance to be refinanced) and
- as recently suggested by one of the major rating agencies, front-end loaded contracts for outputs or services provided by the project (to provide greater revenue to the project which, when coupled with a "sweep", retires debt faster and leaves a smaller balance that must be refinanced) or
- some combination of the foregoing.

The suggestion for front-end loaded contracts to generate "excess" cash flow that can be used to reduce debt is worth further examination since, at least in theory, it may present the most attractive option to mitigate refinancing risk. Other things being equal, a purchaser of

an output or service may be less sensitive to the "timing" of the related cost of this refinancing mitigant than other alternatives and may be able to afford this flexibility to the project for only modest compensation (if indeed any compensation is required – it is, of course, possible to "embed" this "compensation" in a price adjustment that the purchaser obtains over time).

Several significant issues have arisen with these front-end cash flow arrangements, which while simple in concept are difficult to implement and have some negative "history". This history includes the unfortunate experience of several US electric utilities that were required under applicable US law (PURPA or the Public Utilities Regulatory Policies Act of 1978) to buy output of certain so-called qualifying facilities (QFs).

One such utility was Niagara Mohawk, which was forced to buy such output from a large number of QFs at a pre-determined long term avoided cost (LTAC) that was substantially in excess of then prevailing market prices (or actual avoided cost) and, over time, to restructure its contracts with the related qualifying facilities in order to avoid bankruptcy or the otherwise required substantial rate increases (that were not likely to be allowed as a political matter).

The Niagara Mohawk experience is instructive regarding the issues of front-end contracts. These issues include:

- in the absence of specific contract provisions, there are usually only relatively weak legal remedies for protection (under US law, this is the ability to obtain so-called "adequate assurance" of contract performance) when a counterparty's relative economic position changes (attributable to the law's typical deference to the ability of the parties to have foreseen such events and to address them in the related contract)
- while contracts can (and do) include so-called "tracking" accounts to track the difference between the contract price and then prevailing market price and the resulting amount of the "excess" purchases paid by the purchaser for which it is entitled to a make-up "credit" this assumes that there is a referent "market price" for the project output or service (when, in fact, there may be no such "market" for a significant number and types of infrastructure outputs and services)
- when the tracking account shows a material balance owed by either the project or the purchaser it inevitably raises the question of this evident counterparty risk and the usual requirement for collateral or other credit protection to be provided by the deficit party to the other
- while the market has developed precedents for a "sharing" of project collateral (and related voting controls) between bank facilities and bondholders, these are usually structured to leave "control" with the banks (given the difficulties and related expense of getting effective bondholder action) for all but "major" decisions; however, there are materially different issues if "control" is to be "shared" with the project's major contract counterparty and, in the case of governmental counterparties, no real experience regarding how these entities will behave when faced with questions/issues that arise to the level that requires their decision or other action.

As the foregoing attempts to show, refinancing risk for “natural” project funding is a complex matter with no convincing solution. Nevertheless, there is a compelling need to explore these (and other) mitigants to craft workable solutions to enable projects to proceed for the attendant economic and other benefits to be obtained going forward.

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NOTES:

[1] *The future of infra funding: playing Cassandra*, By Paul Forrester, Mayer Brown LLP, *Infrastructure Journal* 19/10/11, available [here](#).

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