Port projects in Latin America: Risk analysis and mitigation

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Recent years have witnessed tremendous growth in infrastructure transactions world-wide fuelled by a confluence of favourable factors, including high levels of available liquidity provided by investment funds, banks and other investors, increased willingness on the part of governmental officials to involve private entities in the ownership and operation of traditionally public-sector-only assets, and commercial parties with renewed enthusiasm regarding the long-term value proposition offered by investments such as toll roads and airports as well as parking garages, hospitals, and other facilities.

The Latin American boom

A very significant portion of this activity has taken place in Latin America and, of these overall investments, transportation projects have played a very prominent role. Recent events in Mexico involving the successful FARAC concession bidding and other examples have confirmed the deep interest which the global investing community has demonstrated in Latin American transportation opportunities.

Among the fastest growing sub-sectors of activity have been port and related maritime infrastructure projects. Recent reports confirm the steady upward surge of interest across the region, with greenfield or expansion projects announced in recent months in Brazil, Chile, Colombia, El Salvador, Guatemala, Mexico, Peru and Uruguay, to name just a few of the involved countries.

Public service; private capital

The emphasis on the development of port and related infrastructure assets in Latin America is part of a larger trend to turn to the private sector to address urgent capital needs of these economies. The reason for this is apparent from even a casual glance at the history of economic development in the region: inability of central governments to fund public sector entities in deep need of capital resources resulted in poor service and inefficiencies, with resulting limiting effects on sectoral and macroeconomic development and adverse socio-economic consequences. Private sector capital and know-how is perceived as a solution to these problems, as well as a means to increase national competitiveness and deliver more efficient infrastructure enterprises with wider reach and deeper penetration in national economies.

A variety of schemes have been used to implement increased private participation in Latin American economies, many of which have been employed in the port sector. These approaches include BOO and BOT structures, as well as concession-based arrangements awarding to a private party the right to long-term operation of a port or port terminal in exchange for capital investment and service standard obligations (among others). Ports are often perceived as key national assets which are legally or culturally constrained from outright privatisation.

In addition, ports attract high levels of domestic political interest due to sensitivity regarding factors such as tariff costs, labour issues and environmental concerns. Such considerations often result in combined public-private structures to ensure continued public sector functional oversight. That said, there are a rising number

of fully privately-owned ports under development or consideration across the region and investors and financiers thus need to be capable of effectively addressing both structures for proposed port transactions.

Risk management in a different environment

Globally, the development of port projects has been financed by all of the traditional means of financing large-scale infrastructure developments: balance sheet funding by major corporates, joint venture investment, and the range of limited-recourse financing techniques commonly employed from the arsenal of classic project finance.

Recent studies show a significant increase in the last 15 years or so in port projects in Latin America which have been implemented through concession-based financing or as greenfield projects (some projects, of course, are both). These types of infrastructure development are often conducted through limited-recourse structures and this article focuses on issues related to port projects which are implemented using limited-recourse project finance techniques.

It is axiomatic in project finance that risk mitigation is the cornerstone of a successful project development and financing exercise. In this respect, port projects, whether in Latin America or elsewhere, are no different than parallel investments and financings in other sectors, be it power, oil and gas, transport or telecom. As most readers will be aware, the typical list generally includes the following risks requiring structuring to ensure adequate risk mitigation:

- Design risk
- Construction/completion risk
- Operating risk
- Change of law/regulatory risk (including permits and environmental)
- Market risk (or, if committed users are involved, offtaker risk)
- Foreign exchange risk (availability; convertibility; transferability)
- Financial risk (local/foreign currency mismatches; interest rate risk)
- Political risk

Risk mitigation in the port sector requires the involved parties to address these familiar risks. In addition, successful financings will require attention, *inter alia*, to the following issues:

Legal/regulatory risk

As noted, the legal environment and potential changes in law are always risks that must be addressed for a successful project financing. Like all public service-related investments, ports also face potential change in law risks that may arise as a result of changed agendas of successive governments and political parties.

Overlayed in the port area are unique concerns such as the relative precision and definition of regulatory and jurisdictional roles of transport ministries, maritime agencies, environmental authorities, and naval and military authorities. Often an extensive array of host government agencies can assert legitimate – and sometimes conflicting – jurisdictional oversight of port-related issues. Transaction parties are well-advised, therefore, to invest sufficient time in diligence of these critical regulatory functions and even to seek face-to-face meetings with such bodies to ascertain whether conflicts, and therefore potential problems, may arise in the course of operations.

Construction/completion risk

In addition to the usual issues, port developments often require the precise integration of land-based and maritime construction activities. Frequently, specialised engineering services may be sought to address needs as diverse as channel dredging, the laying of pier supports and proper turning basin and quay design. Conversely, there are many straightforward civil engineering activities required for construction of many land-based port facilities, such as access roads, terminal buildings, storage facilities and others. Sponsors/owners may wish to engage local (and local currency-paid) constructors for the latter activities, while retaining highly-skilled (and more expensive) foreign parties and their large capital equipment for the more complex tasks. Construction "wraps" may not be feasible because of the lack of relationship of the parties involved, or the prohibitive cost of including turnkey exposure (and associated credit support) in contract pricing. Highly structured solutions – involving financial, legal and technical components – may be required to provide adequate assurance of timely project completion.

Market risk

Successful transportation project structuring generally requires solid market analysis to ensure that adequate demand, whether toll road usage, aviation passenger loads, or other relevant throughput, will exist to support the service to be provided. Port projects, particularly in a

hemisphere with as many countries in close proximity as can be found in Central and South America, multiply the challenges of defining and analysing market risk. Shipping traffic can be diverted to alternate locations relatively quickly to take advantage of more favorable tariffs, better intermodal connections or synergistic opportunities which become available as a result of competing projects "right next door." In these circumstances, financiers uncomfortable with solely relying on macroeconomic analyses and projected container loads, tonnage or TEUs may seek to bolster project economics with some level of user commitments in the form of terminal use agreements, throughput guarantees, or other contractual support for their credit exposure.

Labour and related issues

Many investment projects are owned by a special-purpose company required to comply with local laws, but are left free in large measure to determine employment policies and procedures. This is often not the case in the maritime sector, where key components of the work force may enjoy special protection or may in fact be supplied by parties other than the terminal operator or concessionaire. For example, dock workers and seamen may have special protections, key land and naval security forces may be mandatorily provided by federal or state governments, piloting and tug services may be reserved for a separate concessionaire, channel marking may be approved only if performed by designated officials, and customs and cargo clearing operations most likely will be performed only by national authorities.

Contracts to ensure the provision of many of these services may not be available, and service obligations may be contained solely in relevant domestic laws or agreements to which the subject port or project company is not party. These are key issues affecting the successful operation and efficiency of the port and,

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unless adequately diligenced and competently managed, can result in complex operational risk being transferred from the project to the lenders. At minimum, lenders will need to understand the allocation of responsibility for each of these operational components and how critical services will be provided on a long-term, uninterrupted basis.

Concession issues

Much has been written about the use of concessions to implement infrastructure services, and this summary article cannot do justice to the topic. However, given that port projects in this region often are implemented through concession structures, highlighting a few of the associated issues is warranted. Concessions awarded on the basis of minimum tariff bids are often re-negotiated due to subsequent government views that the original tariff levels were too generous, or owners who underestimated the capital investment required to meet service standard obligations. Similarly, artificial investment obligations, disconnected from performance criteria, often present severe financial challenges to concessionaires with resulting instability in the project.

Concessions awarded ahead of the establishment of a detailed regulatory scheme for the activities in question can lead to discontinuity between the assumed terms of operation as compared with the later reality of regulatory implementation. Unclear dispute resolution provisions, or ambiguity in termination provisions, which are accepted at the bid (and even financing) phase often due to assumptions about "the way it's always done there," can result in lengthy and expensive re-negotiations and restructurings.

Conclusion

The port sector in Latin America continues to provide robust opportunities for infrastructure investment and finance. This discussion has merely sampled the range of issues needing consideration to ensure a successful port project, and, as is always the case, each transaction will present new challenges to overcome. Careful navigation is required to ensure a successful voyage in these waters, but for host countries, equity investors and debt providers alike, the promise of the destinations involved makes such journeys worthwhile.

Note:

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