

Project Finance Revisited
(or You can teach an old dog new tricks)

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New tricks

- tax consolidation
- role of insurance
- uninsurable risk
- consent deeds
- intercreditor issues
- market flex
- MAC/MAE

Tax consolidation

- **Two key issues for project lenders**

1. Joint and several liability for tax of the consolidated group
 - Project structures that fall outside consolidation rules
 - Parent/group enter into valid Tax Sharing Agreement with tax funding/contribution arrangements between subsidiaries
2. SPV (lenders) retaining “value” for tax deductions used
 - Method of “value” retention
 - Indemnity/undertaking from Parent and/or group
 - Question then is value of the indemnity
 - cash cover?
 - credit enhancement?
 - limited to undertaking?

- **How far should lenders push these issues?**

- TSA to mitigate joint & several liability for SPV
 - Non-negotiable, with all the protections discussed in Peter Doyle’s conference paper
- Retention of “value” for losses
 - Lenders will negotiate to maximise position
 - cash cover, credit enhancement achievable?
 - undertaking for value raises issue of Parent/group creditworthiness
 - Catch 22
 - creditworthy parents will not provide enhancement
 - enhancement only required when parent does not pay tax
- No consistent approach by lenders to issue of “value” for losses
 - analysis of impact on debt coverage of acceleration of tax profile
 - projects likely to be considered on a case-by-case basis

Insurance in project financings

- Global events and impact on insurance market have had sobering impact on lenders
 - standard insurances
 - insurance of specific risk
 - uninsurable risk
- Insurance provides critical path for mitigating number of risks
 - changes in insurance market have not reduced lenders' objectives in insurance coverage
 - but lenders have been forced by reality to reluctantly accept more commercial insurance programs
- in some project financings, specific or one-off risks, in some cases arguably credit risks, have been covered through insurance markets
 - covered at financial close
 - subsequently, insurance availability has changed, leaving risk uncovered and borrowers/lenders exposed
- As a consequence, lenders are refocussing on clearer distinction between insurance risks (market standard) and uninsurable risks

Uninsurable risk

- Uninsurable risk – the cause more than any other of substantial increase in complexity of concession based project documentation
- Terrorism Insurance Act – sensible safety net scheme – terrorism cover more relevant to some projects than others, but risk that needs to be addressed in all projects
- Comparing the 1990s versus 2000s Sydney tollroad documentation, the change in uninsurable risk allocation regimes is instructive of the increased sophistication of government and responses of equity and debt
 - Material adverse effects regimes
 - remedies more project related
 - government contributions as last resort
 - Substantially increased onus and risk placed in concessionaires (and lenders)
 - One transaction gave birth to new refinement on MAE – “substantial adverse effect”
 - Uninsurable risk now a key competitive element of any bid

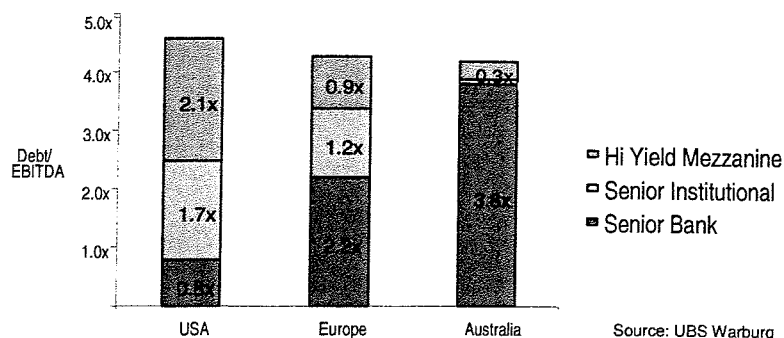
Consent deeds

- Consent deeds have always been fundamental component of project lenders' security package
- Increasing trend for project sponsors to distance themselves from projects and increasing institutional/financial investor led projects will reinforce need for consent deeds
- Consent deeds are not panacea for flawed core contracts
 - the core contract must be financeable
 - lenders will always have views on core contract
- From lenders' perspective, cure periods in core contract must be realistic
 - trend of project sponsors/advisers to seek to put artificial gloss on concession deed by expanding cure periods in consent deed

Intercreditor issues

- Australian project lenders experience with mezzanine debt based largely on utility privatisations using shareholder subordinated debt
 - led to senior lender mantra
 - “deeply subordinated”
 - “first slice of equity not last slice of debt”
- Result was Australian subordination terms, overly restrictive intercreditor terms – senior lenders seeking to be in total and eternal control as first ranking creditors – little differentiation between subordination terms for shareholder debt and third party mezzanine
- Australian market has matured - FLIERS, CARS, use of mezzanine in growing Australian leveraged finance market – mezzanine as true slice of capital structure
- As Australian mezzanine market develops opportunity for Australian senior lenders to benefit through reduced leverage, improved LVR

Bank Vs Institutional Participation in Mezzanine Debt – Leveraged Finance Market



Market flex

- The context
 - US banks – late 1990s+
 - European banks – 2001+
 - Australian banks – specific transactions
 - bank underwritings versus ECM/DCM issues
- Use in Australia
 - longer dated project finance tenders/bids
 - large M&A financings
 - larger leveraged financings
- Application of flex
 - price flex – upfronts, then margins
 - structure flex – limited
 - volume – only through MAC
 - view of counterparties (eg government agencies)
- Current market
 - highly competitive bank market
 - limited to longer date tenders/bids
 - push by borrowers to “buy-out” flex
- The future?
 - is Australia heading down US/European path?
 - or will Australian market, once again, go its unique way?

MAC/MAE

- MAC clauses for underwriting commitments (or extreme flex)
 - lenders focused on financial markets meltdown scenario
 - in borrower’s interest to work with underwriters to manage process to achieve positive outcome for both sides
- MAE event of default clauses
 - catch-all EoD – only one payment EoD, balance of EoDs in document to protect value of asset for lenders – lenders see MAE EoD as fundamental catch-all protection
- Structure of MAE EoD
 - objectivity versus “in the [reasonable] opinion of [the Agent]”
- MAE definition – eg. material adverse effect on
 - value of secured property
 - enforceability of project document
 - business or future cashflows of the project
 - the ability of borrower to carry on project
- MAE definition in the context of MAE EoD
- From lender’s perspective, “in the opinion of the Agent...” is important

- Irrespective of the difficulty and danger in lenders acting on MAE EoD, the clause will remain in every first draft