1 Western Europe: some current banking issues

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Locations and emphases may have changed but, in overall terms, the healthy appetite for project financing in Western Europe has continued over the past year because the underlying factors giving rise to such appetite have themselves continued.

Privatisation

The privatisation bandwagon rolls on. The UK Government is now running out of industries to privatise but the momentum is shifting to countries which espouse comparable philosophies such as Portugal, Spain, Italy and Greece. The benefits of privatisation are well rehearsed, if not universally endorsed, and where the resulting structure gives rise to individual assets with specifically identifiable revenue streams, then project financing opportunities are spawned. The leading example of this process to date is, of course, the UK electricity supply industry where, up to May 1992 when it came to a temporary halt, £3.3bn was raised from the banking market to finance nine greenfield sites plus one privatisation by way of trade sale.

Sponsor appetite

Similarly, good reasons persist for sponsors to seek limited-recourse financed joint ventures. These offer sponsors the opportunity to:

- pool expertise, which is increasingly important as operators move into previously unfamiliar countries. Having completed their domestic metamorphosis, the newly privatised UK utilities such as National Power and Thames Water are increasingly prominent in this respect;
- share the risks involved in such projects with both other sponsors and the banks;
- keep the associated borrowing off their balance sheets;
- leverage up their equity returns from the project.

Bank appetite

Banks continue to be attracted by:

- their greater control over the borrower's incoming cash flows than they would have with corporate facilities;
- the higher margins that can be earned on project financings as the banks enter their fourth year since the introduction of the Cooke ratios and the resulting constraints on their asset growth;
- the comparative absence of competing sources of funds from other types of financial institution which are not constrained by the Cooke ratios. These institutions tend to not have the resources to undertake the same level of credit assessment on individual transactions as do the banks; so they rely more on the credit agencies. But although ratings for projects in Europe have been mooted recently, particularly where a pattern has been established in transaction structure (such as in the oil and gas and power sectors), these transaction complexities mean that ratings are still some way off.

EC prioritisation

EC initiatives to open up a pan-European energy network are proceeding only slowly with proposals on third party access in particular encountering opposition from member states.

In addition, the EIB is progressing plans for a European Investment Fund. Launched at the Edinburgh Summit in December 1992 and backed by EC, EIB and commercial bank funds, this would issue guarantees in support of privately financed trans-European networks in the fields of energy, telecommunications and transport; and thus supplement the EIB's activities in these sectors.

Environmental considerations

Not so much an impetus to project financing per se, but more an increasingly significant issue that banks must satisfy themselves on for all financing is the impact on the environment. Promulgated at either national government or EC level, environmentally driven regulation acts to both increase projects' operating costs; and increase potential lender liability in the event that the banks are required to take over control of a project.

These, then, are last year's trends which, like all good trends, have continued into 1993. They do not, however, disguise the fact that in individual sectors new opportunities have arisen and old ones faded away and the market has moved on. So let us sketch the issues in these individual sectors:

Power

In the UK, gas duly did its dash and in mid-1992 the spate of greenfield CCGT plants came to a halt. This was due to:

1) British Gas' benchmark LTI3 price represented an increase of some 25% over that originally available to Independent Power Producers (IPPs). Not surprisingly, this seriously dented the economics for the Regional Electricity Companies buying electricity from such plants.
2) Nuclear capacity and IPPs which are committed to long-term take or pay Power Purchase Agreements will by 1995 be able to together meet base load demand in England and Wales. Further new stations could then only lop the peaks of demand, rendering them considerably less attractive to sponsors.
3) Political pressures arising out of the domestic coal industry; there has been much debate and divided opinion, the latest instalment in which being the Government white paper on the subject. At the time of writing, some further gas fired stations look feasible once more but it is too early to assess outcomes save, perhaps, to underline the importance of banks assessing of political risk.

Whatever is resolved in the short-run, in the longer run new capacity will still be required, whether to replace existing old, environmentally dirty, coal fired (or even nuclear) plant or to meet the forecast demand growth of 1% p.a. How much of this is financed on generators' balance sheets and how much via non/limited recourse lending remains to be seen.

On a smaller scale, various plants have been financed using renewable technology burning tyres, municipal, domestic or specialised waste and chicken litter or harnessing windpower. These rely on the first two tranches of Non-Fossil Fuel Obligation (NFFO) orders in England and Wales which permit the projects to sell their electricity at premium prices subsidised by Government levy (most of which, in fact, goes to the nuclear industry).

However, the current tranche runs only until December 31, 1998 giving debt service periods hereon in of little more than four years. The Renewable Energy Advisory Group, reporting in December 1992, recommended an acceleration of the third tranche, longer terms to facilitate financing and expansion of the scheme into Scotland and Northern Ireland. The regulatory obstacles remain considerable, however, and several projects are still mired in the public enquiry process.

The Independent Power model migrated to continental Europe and specifically to Pego in Portugal. Lessons of a pre-built coal fired station being transferred to the private sector, to be at risk from the possible required introduction of emission controls in the future and selling its output to a state-owned utility, itself to be privatised, were learned in the NIGen transaction in Northern Ireland and are now being applied at Pego.

Although gas is to be used at the two next IPPs, Taranto in Italy and Lavrion in Greece, it is not necessarily as plentiful or as secure an energy source in continental Europe as it is in the UK — witness Portugal's difficulty in introducing it — and new stations are as likely to feature coal as they are gas. Coal firing raises two issues:

- how to apportion that country's current envelope of EC-permitted SO_X and NO_X emissions between the new privately owned station and the rest of that country's generating capacity;
- in the event that permitted emission levels are in the future reduced such that further capital expenditure (principally Flue Gas Desulphurisation equipment) is required, then such expenditure needs to be recouped over a reasonable time frame via increased capacity charges payable by the power purchaser; and a lender of last resort established from inception to ensure that such expenditure could be funded.

In terms of other fuels, renewable sources such as hydro-electric (in Spain) and wind power (in the UK) are introducing new risks in that such projects are taking rainfall risk and wind risk respectively.

There are often plans to privatise not just the generators but also the remainder of the utility which will purchase power from the generators. In such instances, the banks need assurances from the government concerned as to the creditworthiness of the utility subsequent to its privatisation.

The nine UK greenfield CCGT transactions featured similar structures and risk profiles even though the means of addressing such risks varied considerably between deals. The banks were thus able to progress a considerable way along a learning curve. Banks' transaction costs in terms of man-hours committed are likely to be greater in continental Europe, however, where the market is much more fragmented.

Firstly, for each country, a new legal system, language and network of contacts need to be addressed. The EC notwithstanding, each country will develop a regulatory system shaped by its own history, topography, fuel mix and political inclination. In particular, the degree to which governments are prepared to relinquish long held controls over such a strategic industry will vary.

Secondly, banks have been increasingly involved in shaping governments' thinking as they develop the pioneer transaction rather than being presented with the finished product on which to bid. And thirdly, most of the markets are considerably smaller than the UK and man-hours thus invested may not be able to be recouped over more than one or two transactions. This greater investment of time is likely to be reflected in higher pricing.

Banks' country limits, and in particular their maturity profiles, could be tested by the sudden demands for considerable amounts of debt in countries where previously only sovereign business had been transacted. Some of the construction costs and all revenue are denominated in local currency. Provision of local currency funding may be limited, however, and the resulting foreign currency denominated borrowings may leave the foreign exchange risk with the local power purchaser.

The considerable tax deductions available at the beginning of operations were in the UK utilised either via leasing or consortium relief. These tax deductions and/or such options to utilise them may not be so available in other countries. But where the tax deductions exist and the mechanisms to accelerate their use do not, the project's cash flows are more insulated against fluctuations in corporate tax rates, even though the sponsors' returns might not be as attractive as if the deductions could have been used earlier.

Increasingly prevalent in project financings is contingent equity, ie equity which is to be injected upon the occurrence of some predesignated adverse event. This represents a compromise between sponsors who wish to maintain their return on funds committed to a project; and the banks, who are not prepared for a highly geared project to bear certain risks. Since such equity may not be needed to be injected for some years into the operating

term, techniques to address sponsor creditworthiness may need to be more imaginative than for actual equity, which tends to be injected during the construction term, ie in the relatively near future, or even up front.

It is not only in western Europe that London-based project finance teams are looking to apply their new found experience in independent power. Asia needs more generating capacity and countries are opening themselves up to European and US promoters. Banks have been focusing increasingly on Malaysia and Australia with untold potential in countries such as India and China.

Transport

Private sector transport financings have generally only been feasible for monopolist locations with an assured traffic supply route such as tunnels or bridges. In this respect, the third Forth bridge in the UK is at the feasibility study stage following in the steps of Dartford and Severn. The Skye bridge, on the other hand, has no pre-existing bridge whose revenues can mitigate the construction costs of the second crossing. As in the power sector, project financing of these bridges has been pioneered in the UK, and in continental Europe the countries following most closely are the Netherlands (the Wijker road tunnel) and Portugal, where road and rail bridges across the Tagus as well as an extension of the Lisbon subway are under consideration.

Otherwise, such projects suffer from the problem that they do not capture all the benefits which they generate. This problem will remain whilst they face state subsidised competition (such as free motorways). The Birmingham North Relief Road (BNRR) will pioneer the taking of competitive traffic risk. But it is noteworthy that light railway systems in Manchester and Croydon in the UK will feature considerable government grants and little, if any, bank lending.

There are hopeful signs, however, that this issue is starting to be addressed. The March 1993 UK budget finally abandoned the Ryrie rules and recognised that to be financially feasible, privately financed transport projects would, after all, need Government funding too. Two major rail projects, the high speed Channel Tunnel Rail Link and the trans London CrossRail, were identified as suitable candidates although it is still early days yet. And on the road side (as it were), a Government Green Paper on road pricing is promised for mid 1993.

The regulatory process in the UK remains convoluted and drawn out. However, there are signs that this is also being recognised. Whilst opportunities may in due course emerge from the privatisation of British Rail, it is patently too early to even plan for such a contingency.

Banks have been reluctant to commit the considerable amounts of time necessary to follow such projects over several years, especially when they are required to commit to one of several competing bidders. More rewarding uses of their time have been available in other sectors, so it is no surprise that enthusiasm for the transport sector has to date been muted; in due course, such caution may no longer be warranted.

Oil and gas

Even though it is the most mature sector of the project finance market, the oil/gas sector needs to respond as promptly as any other to changes in, say, its regulatory framework. This was exemplified by the spate of transactions generated by the recent changes to Norwegian taxation which stopped the deductability of interest on inter-company loans. Interestingly, boundaries between corporate and project lending were blurred when some borrowers took the opportunity to obtain corporate pricing for essentially project risk.

But these boundaries were being blurred anyway for borrowing base facilities, whereby corporate facilities to medium-sized companies are secured over their portfolios of fields; the extent of utilisation of such facilities is governed by discounting future cash flows from proven reserves; and the cash control and gearing covenants correspondingly represent hybrids between levels appropriate to specific fields and those appropriate to the larger multinationals.

Eastern Europe

Eastern Europe and the CIS states remain an area of almost unlimited potential. To hugely varying degrees, however, they also remain sloughed in problems of political and currency instability, inadequate legal and regulatory systems, environmental concerns and unreliable (particularly financial) data.

In eastern Germany, such problems have already, or are being, surmounted and it is here that the first project financings will be effected. PowerGen/NRG Energy's intended purchase of Mibrag's brown coal operations and commitment to build 1600MW of capacity near Leipzig is the current frontrunner. There will also be opportunities as local authorities establish Stadtwerke for autogeneration.

Telecommunications

Most UK cable television financings to date have relied on equity funding but the first project financing is currently being arranged in Leeds. Borrowing concepts from the US as well as the 1990 BSB satellite TV financing, funds can be drip fed into such projects dependent on sales achieved, considerably lessening banks' exposure. Providing phone lines at the same time gives such projects a second revenue stream. With the mainly US-based sponsors unable to efficiently utilise the tax deductions, leasing is likely.

Water

The water industry's needs for huge capital expenditure has given rise to a considerable number of leases in the past and 1992 saw the first project financing syndicated in Madrid, namely the Vigo water concession.

Conclusion

So the appetites which have been fuelling project financing in Western Europe continue to do so: Governmental and private sector appetite for privatisation; sponsor appetite for risk sharing and pooling of expertise; and bank appetite for greater control over borrower cash flows and richer returns. Within the region, however, the opportunities are migrating from the UK into a more fragmented continental Europe so transactions are tending to be more heterogeneous. Nonetheless, prospects for sating those appetites continue to look good.