

KEY POINTS

- Lenders should pay particular attention to, and address, certain unique risks inherent in lending to public utilities and infrastructure projects.
- Ironically, infrastructure financing projects with greater project risk tend to have less market risk and vice versa.
- Where collateral is necessary, utilities offer strong options.

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Reaping benefits and managing risks from lending to public utilities

Public utilities are among the most blue chip issuers of equities on the capital markets – offering shareholders both capital appreciation and income. In emerging markets, alongside banks and major industries, public utilities typically make up the lion's share of listed issuers. Investor-owned utilities in the electricity, water, natural gas, transport and telecom sectors also frequently comprise some of the safest bets on major stock markets.

Public utility borrowers also play a major role in the capital markets for debt. Whether for new infrastructure, acquisitions, licenses or refunding debt, utilities typically enter the capital markets in need of tremendous amounts of debt funding.

This article discusses some benefits and risks of lending to regulated public utilities.

BENEFITS OF LENDING TO REGULATED PUBLIC UTILITIES

Loans to utilities typically benefit from economies of scale. The amount of debt required by a utility in a single debt financing round can be quite large. While transaction costs are also quite large, they represent a smaller portion of total debt, commitment fees and interest rate spreads than transaction costs for lending to other types of borrowers.

Loans to utilities also frequently involve stable borrowers with predictable revenues and earnings. Utilities frequently have a monopoly or face limited competition, and demand for their services is usually predictable and relatively inelastic. The essential nature of their services means regular cash flow, reducing default risk, even in difficult economic times. Where debt will fund the needs of a mature utility, strong cash flow may reduce the required interest spread and/or obviate the need for other security or collateral, streamlining the lending process and documentation.

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Where collateral is necessary, utilities offer strong options. One is project finance, where the project (eg a power plant or toll road) can be ring-fenced in a special purpose vehicle and pledged as security on a non-recourse basis. This allows utilities to avoid encumbering later projects with debt from earlier projects. Pledged assets can include property, plant and equipment, licences (but see below on regulatory risk), and receivables.

Another benefit, for public-private projects, is the potential for government guarantees of repayment obligations or of the revenue stream securing repayment. Examples include transport projects such as roads, bridges, tunnels, airports, subways, railways, stadiums and arenas. They also include electric power plants where the primary customer is government-owned. Power plants might also obtain private sector revenue guarantees where they have a single customer, such as a manufacturing plant, enlisting the customer's credit to enhance the project entity's credit.

Infrastructure projects in developing countries also present opportunities to invest alongside international development banks. In some cases, such public lenders may provide a subordinated layer of debt to facilitate the project, and permit the senior private sector project finance debt to have priority on collateral and repayment. Development bank guarantees may also be available.

IDENTIFYING AND MANAGING THE UNIQUE RISKS INHERENT IN LENDING TO PUBLIC UTILITIES

In addition to risks inherent in all, lenders should pay particular attention to, and address, certain unique risks inherent in lending to public utilities and infrastructure projects. Significant examples include project risk, market risk, regulatory risk, political

risk, and exchange rate and interest rate risk.

Infrastructure projects and licence fees typically involve significant upfront capital with long periods before cumulative cash flow becomes positive – sometimes running for ten to 20 years or more. Although a borrower may voluntarily refund debt at an earlier stage, loan repayment terms for such projects typically must mirror projected cash flows. Various techniques are available for public-private partnerships to address this issue, such as having the government partner delay or subordinate repayment of its loans until private sector lenders have been repaid.

Project risk is a significant issue lenders must consider in due diligence and adequately address in loan terms and documentation. While all construction projects pose some risk of delay and cost overruns, some projects have an inherently higher level of such risk. Examples include controversial and publicly sensitive projects such as nuclear power plants or wind farms as well as challenging 'never-been-done-before' projects like the Channel tunnel.

Market risk is also a significant issue for certain types of utility financing and infrastructure projects. This is particularly the case where the borrower is entering a competitive market, increasing capacity to meet anticipated demand growth or deploying new technology to provide new services. Examples include purchasing additional radio spectrum rights to provide new or enhanced telecom services – carrying the risks of overpayment for the licence and/or investing in infrastructure for which demand is unproven – or construction of a mass transit line with limited geographic coverage to compete with existing roads, buses and other modes of transit.

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Biog box

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less market risk and vice versa. For example, a proposed nuclear power plant that will generate electricity to meet the increased generating capacity needs of a rapidly growing population centre may face low market risk, but faces high project risk. Alternatively, a proposed new entrant to provide mobile telecom services (say a third or fourth licensee in a market) will face significant market risk, particularly where existing market penetration rates are already high, but will face low project risk.

Some regulatory risk is present in all utility and project finance loans, but more so in some than in others. Lenders must understand the regulatory environment of the borrower in order to evaluate and address

borrower may, for example, need to obtain regulatory consent to incur debt or pledge assets. In some cases, a licence may be non-transferable, meaning that the borrower's assets would have little value to a purchaser in a foreclosure sale unless the purchaser can obtain its own licence. In the case of landline telecom facilities where the regulator does not arbitrarily limit market entry, a purchaser might be expected to obtain its own licence quite readily. On the other hand, in the case of wireless telecom facilities where the borrower's assigned radio spectrum is essential to the operation of the facilities, then a purchaser of its assets would not be able to use these facilities without also acquiring the right to use the relevant radio spectrum. In virtually

of lenders or be coupled with consents of the guarantor allowing lenders to rely on the guarantor's obligations and seek direct recourse in the circumstances provided in the financing documents.

Exchange and interest rate risk must also be considered and addressed where appropriate. Many public utility and infrastructure debt financings are cross-border with a borrower located in a developing market, while the source of capital is frequently from more mature capital markets. It is therefore likely that the currency in which the funds for the loan originate will not match the currency in which the borrower operates and in which the borrower will generate the revenues needed to repay the loan. Lenders can denominate loans in local currency and undertake their own hedging and offsetting transactions, or they can denominate loans in a benchmark currency such as US dollars or euros, and require the borrower to enter into its own hedging transactions.

Similarly, lenders can structure fixed or capped interest rate loans to reduce the risk of borrower default arising from interest rate increases and, if funding for the loans is obtained at a floating rate, lenders can enter into their own hedging or offset transactions. Alternatively, where the funds borrowed are made available on a floating interest rate, but the borrower is depending on stability of its debt service to ensure its ability to meet its obligations, the lender can require the borrower to enter into its own interest rate hedging transactions. In the case of both currency and interest rate risk, available hedging instruments include swaps, caps and collars.

CONCLUSION

Lending to regulated public utilities has long been a staple crop of the world's capital markets that brings many benefits to lenders while presenting certain inherent risks that can usually be identified and managed. As weakened capital markets work their way back to normalcy, lenders and their advisers faced with new demands for loans to public utilities will want to refresh their understanding of the relevant risks and the tools for mitigating them, which will vary based on the borrower's business sector and the specific project to be financed. ■

"Dramatic shifts in consumer behaviour ... can undermine the effectiveness of regulatory protections."

regulatory risk. If the borrower relies on a license or concession to provide services, how strategic is the licence and the existing regulatory bargain to the borrower's business? Does the borrower's business plan rely on the regulator to prohibit, delay or otherwise restrict entry into the market? This may be the case, for example, where someone constructs an essential facility and relies on commitments from the regulator (express or implied) not to allow further entry for some specified period of time. This is typical with the issuance of mobile telecom licenses, power plants and certain transport projects. Even where the regulator has undertaken to protect the borrower's market position by limiting further market entry, disruptive technologies and unanticipated dramatic shifts in consumer behaviour and habits can undermine the effectiveness of the regulatory protections. An example is the inroads made by voice over Internet services into the demand for landline phones and the market share of voice calls held by traditional local and long-distance telephony.

Another aspect of regulatory risk is the regulator's role in approving or conditioning the incurrence of debt or any exercise by the lender of its rights in the collateral. The

every case, the regulator will retain the right to approve the transferee based on such objective criteria as having the financial and technical qualifications to assume and carry on the borrower's business.

Political risk is another factor to be considered, particularly with respect to large public-private infrastructure projects that rely heavily on government guarantees or a government owned or operated base for financial viability. Political risk is also present where the borrower is wholly or partly government-owned, even if it has independent management. In other cases, even fully private sector projects face political risk if they are in an industry with government limitations on foreign ownership (such as a golden share) or in which government might be expected to intervene with foreign ownership for populist or other political reasons. A case in point is the controversy in 2006 over Dubai-based DP World's proposed indirect takeover of the management contracts for certain US ports through its acquisition of British-based P&O. In any case, government guarantees and other contractual obligations by public authorities need to include appropriate waivers of sovereign immunity and need to run directly in favour