INFRASTRUCTURE & FINANCE REPORT 2010: THE WAITING GAME – TIME FOR A NEW PROJECT FINANCE MODEL?

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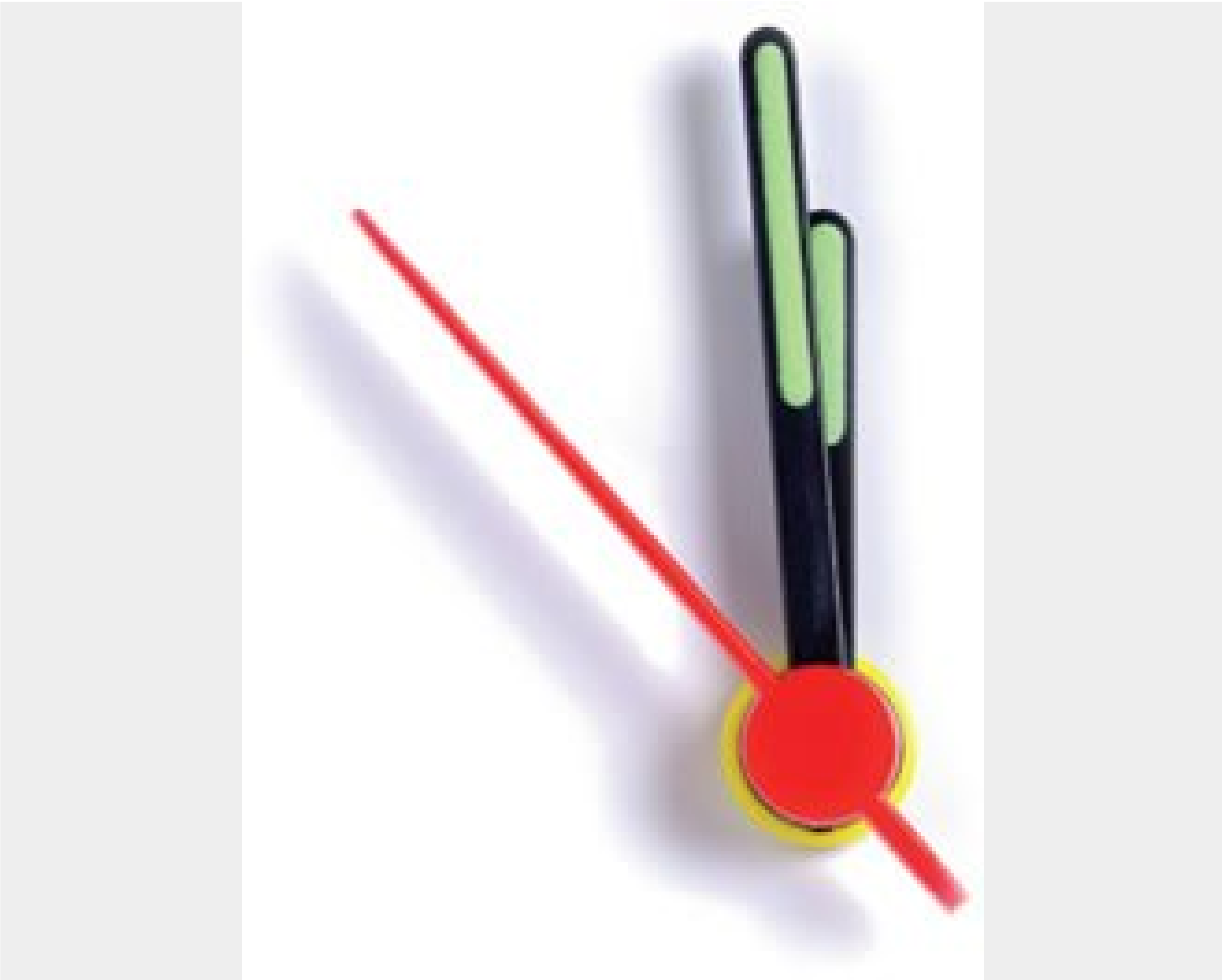

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Among the initial responses to the financial crisis in Portugal and Spain was a strong emphasis on project and construction schemes, intended to inject liquidity and momentum into the national economies. New or long-awaited project and construction schemes were announced, or

brought forward.

In Portugal this included a new Lisbon airport and third bridge across the River Tagus, connecting to an emerging high speed rail network radiating from the capital and to the border with Spain, which itself would see continuing investment in its own transport infrastructure, including fast-rail services connecting the major cities. The Spanish Government's Plan E, urban regeneration scheme, has seen literally millions of tonnes of concrete poured into newly dug holes. But the economic rationale and financial viability of many of these landmark schemes are now in doubt. Banks' unwillingness to make long-term loan commitments has been complicated by wider concerns over the ability of the Portuguese and Spanish states to finance their debt piles, and by fears of economic contagion in the eurozone after the collapse and bailout of Greece – Spain and Portugal have both now announced austerity measures intended to reduce public spending, as their credit ratings have also been downgraded. The result is that in many respects the Iberian projects market is in a state of hiatus, say experts. National and regional projects are on hold, as a result of the hardening of financing terms and conditions – shorter terms, much higher margins and harder sponsors commitments and guarantees – while many schemes already underway are subject to renegotiation, delays and the potential for further cancellation.

"We have seen significant changes in the market as a result of the crisis, but also in Spain as a result of the maturity of the projects market," says José Guardo, projects partner at Garrigues in Madrid. "There is now much less investor interest in infrastructure projects and a growing emphasis in areas such as renewable energies, as the size and scale of project increase."

Practical impact

In May the Spanish Government approved a €15bn plan to reduce a deficit of 11% of GDP to 6% by 2011. The Portuguese government has likewise brought forward the implementation of a four-year stability and growth plan aimed at cutting the budget deficit from 9.4% of GDP to 2.8% in 2013.

The practical impact of this in the short-term means that the delay or postponement of major infrastructure projects will continue because the money is simply not there. Likewise, the banks no longer want to make long-term loans because the security is not there.

"Given the current market conditions, closing an infrastructure project right now may be uneconomical. Although the country clearly needs some projects it is probably wise to postpone until market conditions improve," says Pedro Siza Vieira, Managing Partner of Linklaters in Lisbon.

A number of road projects in Portugal have been cancelled, as has the €1bn high speed rail connection between Lisbon and Porto, and Porto-Vigo, as well as the proposed new €3.3bn Lisbon airport south of the city at Alcochete. The final stages of the high speed rail connection from Lisbon to the border with Spain will go ahead, with some delays, while a connecting bridge across the River Tagus has been postponed – although a new tender process is expected within the year. "The economic crisis, the public debt and the fierce attack on southern European economies is placing a very heavy burden on infrastructure projects, most of them highly dependent on public investment," says Lino Torgal, public law partner with Sérvulo in Lisbon.

Some going ahead

There are now no schemes that are immune to the financial crisis, say lawyers, although many report that smaller projects are still going ahead, notably relating to the development of social and welfare infrastructure. "We are seeing some types of projects come to a natural end, while others are stumbling because of a lack of finance – either on the part of private investors, or the willingness of the state or administrations to carry through with them," says Javier Menchén Calvo, partner with

Ramón & Cajal in Madrid.

The Portuguese government has however committed to develop and support several smaller infrastructural projects – such as the modernisation of schools, urban rehabilitation programs, IT investments and renewable energy projects. In addition, a new public contracting regime was approved in early 2009, intended to allow public entities to award contracts directly to private contractors and suppliers without the need for public tenders.

"Although these were emergency measures, some fear they may stay in force for more than required and prejudice the competition principles upon which the EU directives on public contracting and the Portuguese Public Contracts Code are based," says Miguel Lorena Brito, of F Castelo Branco in Lisbon.

As a result of the wider concerns impacting on the financial markets we have seen that a number of deals are on hold due to funding difficulties, says Rita Roque de Pinho, partner with Cuatrecasas Gonçalves Pereira in Lisbon. "Even those projects already underway are facing liquidity issues.

The banks are changing the way they look at projects and the types of deals they now want to get involved with. "Gone are the days of 25-30 year financings, drawing on heavily leveraged, and widely syndicated loans. Many lenders are now looking at finance windows of only seven or eight years," says Fernando Bernad, projects partner at Cuatrecasas Gonçalves Pereira in Madrid.

Nonetheless, for some it remains too soon to see what will be the outcome of the current economic crisis on Government's wider infrastructure and projects plans. "I cannot see Europe's governments simply stopping their investment in new schemes. In any event, projects such as new fast-rail networks (AVE) are simply too expensive to leave to the private sector," adds Bernad. Spain continues to progress its world leading AVE network, including a connection with France.

Questioning the model

The current situation is though prompting some to question the legal and financial frameworks that have underpinned public finance initiative (PFI) and public-private partnership (PPP) structures, which have to date defined projects structures in Spain and Portugal.

"Nobody really knows what is going to happen next. There is a lot of uncertainty in the financial markets, concern around Portugal's finances and the weakness of the euro. Investors and banks are looking for a kind of comfort that is simply not out there," agrees Manuel Santos Vitor, partner with PLMJ.

> "A fundamental issue is, who is the financier of last resort – public projects ultimately rely on the *Responsabilidad Proteccíon de la Administracíon* (RPL). This has been the *leitmotiv* of project finance in Spain. The Government is there to step in but may not now be able to do so if required."
>
> José Guardo, Garrigues

The preferred model in many schemes has been for the "demand risk" model, utilising long-term finance based on projected returns from user generated revenues, notably toll roads. But in the transport sector, concerns have emerged over the validity of traffic volumes and revenue projections, which have proved overly optimistic.

A lack of trust is the recurring issue affecting current and planned infrastructure projects across

Spain, says Antonio Navarro, finance partner with Broseta in Madrid. “Before the onset of the crisis we were living in very good times, but the predicted continued growth in traffic has proved false and lenders are unwilling now to make decisions based on what the surveys tell them.”

Ultimately the issue is who is willing or able to finance new projects? Reduced levels of available public finance may mean greater demand for higher levels of private finance in projects, but banks and financiers are now looking to global models and solutions and want more certain returns and less risky options, say many.

The downgrading of the credit rating of Portugal and Spain is also making it increasingly more expensive to raise funds in the international markets to service the countries’ existing debts, let alone build new ones. But such issues are also being replicated regionally, with Catalonia recently downgraded by Standard & Poor’s to A+.

Large national projects are inevitably underwritten by central government, but even regional projects – such as those undertaken by Spain’ Autonomous Regions – are guaranteed by the government in Madrid but it no longer has the liquidity to cover all of its liabilities.

“Ultimately the entire financial system is guaranteed by the national authority – which has been demonstrated through the nationalisation of banks, or the launching of rescue and refinancing frameworks over the last two years – and there is still pressure for them to lend more money,” says Guardo.

Previously there was relatively little concern about the strength of the ultimate finance guarantees but this is now a central concern, say lawyers. An issue also is the size of the pool of banks now willing to invest in major projects.

> “What is required to encourage wider finance participation is new ways of sharing the benefit of projects. If the aim is to get a stronger grip on the equity then infrastructure projects are not yet so attractive. The benefit traditionally has been in favour of the constructor and not who controls the end product.”
>
> Fernando Bernad, Cuatrecasas Gonçalves Pereira

“In the past, long-term financing has been achieved with loans syndicated to perhaps dozens of banks. Now many of these same banks have disappeared, and syndication is very much harder. Banks have much less appetite for risk, and want much less exposure to individual projects,” says Alberto Manzanares, partner with Clifford Chance in Madrid. Situations in which the government may not be able to finance ongoing construction schemes are now being seen in Spain, say lawyers. A number of major Spanish construction and concession companies have conditioned their participation in the Spanish government's latest €17bn spending stimulus plan on the resolution of, at least, four operational toll roads - Radiales de Madrid, Cartagena – Vera, Madrid- Toledo and Eje Aeropuerto M- 12 – which are experiencing 50% to 80% lower traffic than initially predicted.

“The 2010 infrastructure spending stimulus plan could go off the rails even before its details are revealed if problems on the country's current infrastructure schemes remain unresolved. The government is pinning its hopes on utilising private finance for the plan. But the contractors and banks are already nursing big potential losses on existing schemes,” says Israel Gómez-Caro, finance partner at Gold Abogados in Madrid.

The financing banks are in a strange situation, they are almost at the point of handing the keys to projects back unless they are able to renegotiate or refinance projects already underway, says

Guardo. “A fundamental issue is, who is the financier of last resort – public projects ultimately rely on the Responsabilidad Protección de la Administracíon (RPL). This has been the leitmotiv of project finance in Spain. The government is there to step in but may not now afford to do so if required,” says Guardo at Garrigues.

Ultimately if the project finance model in Spain, which relies on the strength of the RPL, is losing its attraction what else do we have, lawyers ask.

“But contractors at the end of the day do not want to stop working, because the Administration is their best, and often only, client. People have been happy to date to support and progress new projects because the RPL provided a final safety net,” says Javier López Antón, partner with DLA Piper in Madrid.

Creating a new model

If there is a demand for a new way of doing things, there is little doubt among Iberia’s legal community that the expertise does already exist in the market to create new structures and models.

“The Spanish market in many senses has been the most sophisticated project finance market in the world, and there is relatively very little – in terms of know how or finance models – that has been imported. It has in fact, been the other way round, we have exported our know-how,” says López Antón at DLA Piper. Notable has been the success of Spanish and Portuguese models across Latin America, where lawyers report virtually identical legal and finance structures now routinely being used.

But for some, this first means tackling challenges such as the ability of investors to realise participatory loans and the enforceability of RPLs. Others disagree however that the basic model is broken and believe that a more structured system is simply required.

“Who has to pay the extra cost, the administration. Yes there are expectations and in many cases a need to recalibrate the equilibrium, but there is already the ability to make modifications, including giving concessionaires a larger stake, or longer tenures,” says Manzanares at Clifford Chance Also significant is tackling the rise in liabilities that emerge as projects progress. Spain’s 1954 Indemnification Act bases the ultimate value of a project on its end use, not simply the value of the land on which it sits. In some respects costs have spiralled simply because there is no incentive to have tighter financial controls, say some.

“There is a sense in some instances that projects were perhaps being underbid in the tender stage with the tacit acknowledgement that costs would inevitably rise, and that they would be met largely without question,” says Menchén Calvo of Ramón & Cajal in Madrid.

But political issues also come into play, say others. “Spanish banks have often been under tremendous pressure from the government to agree to extend financing. But this is not something the international banks have been obliged to do, and increasingly we are seeing them take a much more calculated look at the technical viability and risk associated with projects – again bringing the finance into question,” says Manzanares at Clifford Chance.

Alternative finance

Banks are now seeking to “bullet-proof” refinancing schemes, but there is also now a trend towards finding new or alternative financial models, believe many. There is increasing interest in the use of the capital markets and the issuance of bonds, while investment funds are also now beginning to assess market opportunities.

“What is required to encourage wider finance participation are new ways of sharing the benefit of projects. If the aim is to get a stronger grip on the equity then infrastructure projects are not yet so attractive. The benefit traditionally has been in favour of the lenders on one side and sponsor as equity holder and constructor on the other, now it will be split among other players," says Bernad at Cuatrecasas Gonçalves Pereira.

"It is clear that any project going forward will have lower leverage, in terms of the available financing, and there will be a demand for a greater equity input. What is however already evident is a clear turn away from demand-risk type projects as opposed to pure availability deals."

Manuel Protásio, Vieira de Almeida

But new means are already emerging to overcome the funding and pricing issues that commercial banks have been facing, says Pedro Melo, partner at PLMJ. "We have seen in the Portuguese market entities such as the European Investment Bank (EIB) assuming the part of a traditional financing entity, by taking some of the project risk, in situations where, up until two years ago, it only accepted to finance projects against guarantees provided by commercial banks," agrees Ines Pinto da Costa also of PLMJ. It is a situation that Luis Branco, partner at MLGTS also recognises, adding: "An additional feature has been the State guaranteeing of some of the debt through an 'aval'. It is notable that the Pinhal Interior road concession, which was agreed in April relies exclusively on commercial banks and EIB facilities in the region €1.2bn."

Others are seeing a new emphasis on asset repackaging, including the securitisation of real estate, as well as the emergence of new finance players. "The incorporation of assets in real estate investment funds underwritten by private investors has opened a way to seek eurostat compliant funding, entailing no governmental indebtedness. This is clearly a strong trend. In certain given conditions these structures can also assure access to Islamic finance, which has never really gone away" says Miguel Castro Pereira, Head of the Banking and Finance at Abreu Advogados. Others point out the success Iberian construction and infrastructure companies are having abroad, as a "hedge" against a worsening domestic market. "This is a way of avoiding risks of stalling or decreasing their performance and activity," says Manuel Esteves de Albuquerque at Raposo Bernardo. Gervasio Martínez-Villaseñor, partner at Garayar Asociados in Madrid agrees, "Iberian companies have a long experience building and operating infrastructure in other countries, and not only in Latin America but worldwide."

Still more to do

There is an acceptance that for as long as the financial crisis lasts, and the potential exists for further seismic shocks in the currency and sovereign debt markets, projects work (particularly as regards major infrastructure) will remain an area of relative uncertainty.

"In terms of roads, some projects are progressing but no new projects are planned. Even though the timing does not seem the best right now the proposed rail and the airport projects need to be built as they are of relevance to the country" believes Vanda Cascão, partner with Vieira de Almeida (VdA).

The onset of the crises has clearly prompted a reduction in deals numbers and in the scale of those that are going ahead. A large number of tender processes are started but not finished, or proceed at a much slower pace. In any event, some believe that the boom years of projects might have already been over in Spain and Portugal, even without the onset of the global financial crisis.

“The last couple of years have seen the number of projects drastically reduced but the number of big deals would have fallen anyway,” says Manzanares, Clifford Chance. “The administration is being much slower in progressing plans, while the banks are much more risk averse and there are in any event fewer finance players in the market – some banks have simply disappeared.”

There may also be questions surrounding the traditional PFI and PPP models but there are currently no other ways of doing things – there is not yet an alternative model out there, says Manuel Protásio, infrastructure partner with VdA.

“It is clear that any project going forward will have lower leverage, in terms of the available financing, and there will be a demand for a greater equity input. What is however already evident is a clear turn away from demand-risk type projects as opposed to pure availability deals.”

Major infrastructure projects are proving increasingly difficult to progress both because of a lack of financing options and political will as Governments look to reduce debts. But commercial and compliance issues are also causing problems. As financing costs have risen, successful bidders have been seen to increase their prices, say lawyers.

“The Portuguese Audit Court has shown no tolerance in this regard and thus several contracts concluded with higher costs than those initially admitted are now under tough scrutiny,“ says Bernardo Diniz de Ayala, public law partner with Uría Menéndez in Lisbon

In the current economic environment, both private and public parties are proving more resilient in assuming risks and showing less flexibility in negotiations.

“One of the main concerns of the Administration should be, when designing infrastructure PPPs, to establish tender rules and specifications which the bidders may realistically comply with, namely project funding. And for bidding companies to structure their bids in realistic terms and in accordance with the tender documents,” says Diogo Perestrelo, with Cuatrecasas Gonçalves Pereira in Lisbon. With a lack of public funding, and if greater emphasis is now to be placed on private finance, then some key elements of the PPP and PFI model will need to be altered, believe many experts. “In general, the state and regional governments have boosted infrastructure programmes through PPP models. But what was before an opportunity is now a necessity if the intention is to continue building infrastructure,” says Juan Martínez Calvo, partner with Deloitte.

Big infrastructure gaps do still need to be filled, in Portugal and Spain. Seventy percent of the €17bn infrastructure stimulus plan announced by the Spanish Government in April is intended to go towards upgrading Spain's railway network.

“The growth of Spain requires the Government to invest in productive infrastructures and not merely to think of the forthcoming elections. The sector is also now ready to target international investment, so long as repayment is guaranteed,” says Fransec Segura, partner with Roca Junyent. Traditional long-term project finance structures may no longer be viable if now there is only short-term financing available. But there are no magic solutions, projects need to have political backing and to make profits for those involved, say lawyers.

“An example is the new Lisbon airport, which is still required but how do we structure its development? The Government no longer wants to finance major works from its own balance sheet, so the onus appears to be shifting back towards ANA – the airport operator – to finance its own projects. In a sense we are waiting to see if we need to return to the old way of doing things”, says one.

For Guardo at Garrigues in Madrid, what is fundamentally needed is the emergence of a common way of doing things, to create a national framework for use both at the regional and national level.

“We have the tools in the market to create such a framework. The projects we have all seen are based on principles and models far beyond what the law stipulates. But what is required is the will to move things even further, particularly when it comes to the role of the Administrations – how we structure issues, allocate risk, and deal with contingencies, these are now very big questions."

To date, national and regional governments have often not thought in a commercial way, in terms of moving project plans forward, say others. In the current economic scenario, this is now no longer possible.

It must be remembered that there are inevitably three major parties in a project: the administration, the concessionaires and the banks, and each has to see a benefit, says Mariano Magide, partner with Uría Menéndez in Madrid.

"But we are perhaps now seeing a more flexible attitude, the public administrations are now more willing to include all sides from the outset. The market has changed and the only way they will carry projects forward is to be more open and flexible."