What price freedom?

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Commercial bank lenders frequently complain about the slim margins on project loans, and even though some banks have exited the market, there is little prospect of pricing widening. In fact, a number of developments in the market point to continued downward pressure in the coming years.

First, the Organisation for Economic Co-operation and Development (OECD) rules governing export credit agency (ECA) support for renewable energy and water projects were recently changed, to allow ECAs to offer longer tenors of up to 15 years. Many deals in highly developed countries such as the US, which were the preserve of the commercial banks, will now instead be looking for ECA support, so taking business away from commercial lenders.

Secondly, ECAs from both Europe and Japan are becoming more aggressive in supporting favoured projects with large direct loans, notably in sectors such as oil & gas where there is a global scramble for access to resources.

And third, some ECAs have been slowly evolving and behaving more like commercial banks. Their close contacts with project developers and equipment manufacturers in their home countries, plus their considerable technical and financial expertise, is being used to win mandates on commercial loans.

Perhaps the best example is KfW-IPEX Bank, which is in the process of shedding its state guarantees to become a legally independent bank. KfW used to frequently work hand in hand with Hermes, which provided insurance cover, but now arranges commercial loans on projects with German participants, in addition to covered bank debt.

New renewable rules

In terms of covered bank debt, the European ECAs such as ECGD, Coface, Hermes and Sace, plus Export Development Canada, are likely to be beneficiaries of changes that were made earlier this year to the OECD Arrangement on Officially Supported Export Credits in the renewables and water sectors.

Normally where ECAs are involved, there is a maximum 8.5-year term for countries listed by the World Bank as Category 1 (wealthier countries), and ten years for Category 2 jurisdictions. And there are the usual rules that loans must amortise, with principal payments beginning in the first year. For direct loans, the relevant Commercial Interest Reference Rate (CIRR) must be applied.

But under the final version of the new OECD arrangement for renewable energy and water projects, which was published on 14 September, the rules state that that "the maximum repayment term, irrespective of the country classification, is 15 years."

The eligible sectors are wind energy, geothermal energy, tidal and tidal stream power, wave power, solar photovoltaic power, solar thermal energy, ocean thermal energy, and all types of biomass energy. Projects in the water sector include both drinking water supply infrastructure, and wastewater collection and treatment.

"We may now go out to 15 years for everybody," explains one Paris-based banker, "but if an ECA provides support there come the additional costs of the premium, or the surcharging of the CIRR for direct loans, so there are additional costs, but it is irrespective of the country classification, so it will apply to exports from any country to any country."

For a repayment term of more than 12 years, a surcharge of 20bp above the CIRR will apply for all currencies.

The eligible sectors may be further extended in the future, though at the time Project Finance went to press the main area of discussion was hydro power. The implementation of the special terms and conditions for hydro will be subject to a decision that is expected to be taken at meetings in mid-November, since hydro, particularly on a large scale, while renewable, has perceptible environmental impacts.

A European invasion?

The new rules are in force for a trial period until 30 June 2007, and bankers are curious to see how aggressive the European ECAs (and EDC) are going to be in the US market. "While US Ex-Im might be reluctant to provide support to other rich countries, European agencies, which pushed for the change, will be very eager to push for market share," comments one project finance arranger at a German bank.

European bankers expect strong levels of interest in, and support from the European ECAs for, working on renewables deals in the USA and Canada. Those with a more flexible interpretation of what commercial terms are will be more competitive than commercial banks. An institution such as EDC, known for working alongside commercial arrangers, might be interested in working on US financings. It has not had a strong presence in renewables until now, but that could change as US and European manufacturers set up shop in Canada.

The leading US manufacturer in the renewable energy sector is GE. But such is the level of demand that renewable energy developers cannot get their hands on new GE equipment for a couple of years.

One banker speculates that, since GE has full order books, the US Government does not fear the impact of orders for renewable energy equipment from rival European manufacturers. Thus the US may be happy to let the new arrangement go for a trial period until 30 June 2007. If at that point it is displeased at the results of aggressive support for European equipment exports to the US, it may respond with calls for tighter financing rules.

"The OECD guidelines are only a gentleman's agreement, and if the ECAs do not wish to comply they could just ignore them," comments a banker in New York. "US Ex-Im usually tries to adhere to OECD guidelines on repayments and tenor, and also the way it calculates the premium according to the country rating, but some of the other ECAs have a more relaxed view."

Bulking up in old markets

In fact most European ECAs are more than happy to support exports to rich OECD countries, as is EDC. And the more projects they support, the smaller the pie is for the commercial banks fighting it out for mandates on projects without ECA support.

"EDC is sometimes a competitor to commercial banks by offering direct loans, and this can be problematic for the commercial banks," he adds. "We work very closely with them on guarantees, but their role in the market can be a double-edged sword when we want to extend a direct commercial loan."

Sources close to EDC dispute this assertion, however, saying that, at least in project finance, EDC scrupulously avoids displacing bank capacity, and its direct lending activities serve only to mobilise capacity. "It has not been in competition with banks on any of the 140 deals that it has closed to date." The source adds that EDC's involvement in developed markets deals is rarely at an arranger level, and that banks criticising ECA lending to projects are likely motivated by a desire for ECAs to guarantee commercial bank loans instead.

The EDC would point in particular to its role in stepping up to support the stalled PAK power transaction. EDC acted as one of the arrangers of a Eu226.5 million ($266 million) term facility for the Zespol Elektrowni Patnow-Adamow-Konin SA (PAK) Patnow II power project, which is located in Konin in Poland. The arrangers, WestLB, the EBRD, EDC, Bre Bank and Pekao, provided the loans following a change in EPC contractor and the withdrawal of a commercial lender (for more search "Patnow" on projectfinancemagazine.com).

The project replaces two decommissioned generating units, and EDC is providing part of the senior debt to support PAK's commitment to modernise its group of power plants. The EDC participation will be in the form of direct loans of up to Eu50 million.

And from January 2008 KfW-IPEX Bank will be a legally independent entity within KfW Bankengruppe, without state backing or other institutional guarantees. Since January 2004 it has been run as a legally independent entity within the group.

KfW-IPEX conducts all the market related business in which KfW Bankengruppe competes with other banks in Germany and abroad, including project finance, corporate finance, commodity trade finance and export finance.
At year end 2004 KfW-IPEX had 290 professional staff, 23% more than at the beginning of the year. Its loan commitments were especially large for chemicals and steel projects, electricity generation and transmission, ships, Airbus aircraft, and rail, with a total of Eu6 billion in those sectors.

Loans are typically syndicated alongside and to other commercial banks. In April it was one of three lead arrangers, along with BNP Paribas and Standard Chartered, on a $940 million commercial loan to finance the Taweelah B gas fired power plant in the United Arab Emirates. And in May KfW-IPEX, together with Barclays Capital, arranged and structured a Eu143 million financing, provided by the leads as well as KBC, for the new Antwerp gateway container terminal.

"These days KfW IPEX are doing a lot of commercial lending," comments a London based lawyer who has worked with them for many years on aircraft and other deals. "In the old days KfW were always there on every ECA deal – but that is not the case any more – today from my perspective they are just another commercial bank," he says.

Capacity and opacity

And KfW-IPEX is also playing an important role in the development of PPP in Germany. It devised an innovative PPP structure that was used for the Kreishaus Unna, an administration building in the city of Unna.

"KFW has always been aggressive, and from our perspective as a German bank we see it as one of our main competitors, so we expect them maintain their high share of the export finance business," says one German banker. So project finance banks face a lending environment that remains highly competitive, and will have to fight hard on pricing, fees, and free additional advisory services in order to win mandates.

Some banks are turning to the capital markets to securitise their 100% ECA-guaranteed loans, in order to lower their funding costs, and so make themselves more competitive. In October ABN Amro launched SovRisc, a three-year $1 billion deal backed by a renewable pool of ECA loans originated at the bank.

Calyon already has a single seller asset-backed commercial paper (ABCP) programme, known as European Sovereign Funding, with which it funds ECA-guaranteed aircraft loans. And since 1998 Citibank has used its Govco ABCP conduit to fund ECA backed loans in a variety of markets. For example in 2001 the Citibank loans to the Bajio power project in Mexico were funded via GovCo, and the same structure was used in 2004 for the Transelectrica project in Romania.

"We are seeing a growing number of banks funding themselves through conduit structures, because to win these mandates the banks have to offer extremely tight pricing, which of course depends on their own cost of funding," comments a lawyer. "They are selling short term paper which is backed by sovereign risk, and this is sub-Libor paper."