Phillip Cornwell

PROJECT FINANCE IN AUSTRALIA

Phillip Cornwell is the head of Allens' project finance group, one of the 10 'most highly regarded individuals' in *Who's Who Legal: Project Finance*, and recognised in *Chambers Asia-Pacific 2014* as a 'leading lawyer'. His experience includes the financing of the North West Rail Link PPP, the US$6 billion QCLNG pipeline acquisition, the A$14.5 billion WestConnex transport project, the Sydney Airport acquisition, the Alice Springs to Darwin Railway, the A$2.4 billion NCIG Newcastle Coal Loader, the A$8.5 billion Australia Pacific LNG project, the A$3.4 billion Wiggins Island Coal Export Terminal, and Pan Australia's Phu Kham project, Laos.

Richard Gordon is recognised in *Chambers Asia-Pacific 2014* as a 'leading lawyer' in project and acquisition finance. His experience includes Queensland Investment Corporation's A$7 billion divestment of Queensland Motorways, the Port of Brisbane acquisition, AGL's acquisition of the Macquarie Generation business, the acquisition and restructure of Alinta Energy, the BrisConnections toll road, the Alice Springs to Darwin Railway and numerous PPPs and wind farms.

Ben Farnsworth has extensive experience acting on Australian and offshore project financings across a wide range of industries. His recent work includes the financings of the US$20 billion Ichthys LNG project, the A$8.5 billion Australia Pacific LNG project, Otto Energy's Galoc oil field project in the Philippines, Fortescue Metals Group's ECA-backed Pilbara expansion as well as numerous PPP transactions.

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"Australia remains among the world's busiest jurisdictions for project financings."

GTDT: What have been the trends over the past year or so in terms of deal activity in the project finance sector in your jurisdiction?

Phillip Cornwell, Richard Gordon & Ben Farnsworth: The attention of the world's project financiers has been drawn to Australia over the past few years because of the capital expenditure boom in Australia's resources sector. A succession of resources mega-projects has seen the title of the biggest ever project financing pass first to the Australia Pacific LNG project in Queensland and then to the Ichthys LNG project in Western Australia.

As the commodity cycle turns, climbing construction costs and weakening commodity prices have seen the tailing off of project financing for resources mega-projects in Australia.

Despite the resources downturn, enormous spending on Australian infrastructure projects through government and private sector asset divestments, as well as another big year for public private partnerships, has seen Australia remain among the world's busiest jurisdictions for project financings. The continued high level of activity is underpinned by a sophisticated and well-tested domestic project financing market and very strong international appetite for exposure to Australian regulated returns.

The fact that Allens, an Australian-based law firm, has topped the global league tables for infrastructure project finance, gives an indication as to how strong the Australian infrastructure spending boom has been, and this trend looks set to continue (or indeed increase) over the coming years.

GTDT: In terms of project finance transactions, which industry sectors have been the most active and what have been the most significant deals to close in your jurisdiction?

PC, RG & BF: The Australian infrastructure sector produced a string of multibillion-dollar project financing transactions in 2014.

Driving this activity are government settings towards asset recycling. The current Commonwealth government was elected in September 2013 with a mandate to invest in infrastructure, particularly in the transport sector. Similar policy platforms have been adopted by state and territory governments. The last year has also seen significant private sector infrastructure asset sales seeking to take advantage of strong domestic and international interest. Given this context, it is unsurprising that the infrastructure sector was home to most of the leading Australian project financing deals of 2014, resulting from both asset sales and new investment in transport infrastructure.

Examples of large-scale government-prompted infrastructure financing are numerous. The A$1.75 billion Port of Newcastle project financing was carried out under the Commonwealth government's asset recycling programme [*this is discussed in further detail below*]. This was the first time a Chinese government company (China Merchants investing in consortium with Hastings Funds Management) bid for and won an Australian government-owned asset.

The A$3.7 billion North West Rail PPP illustrates the renewed focus upon the transportation sector, as well as the availability of significant government funding assistance. This was Australia's largest public transport infrastructure project and the New South Wales government contributed monthly construction payments during the delivery phase that totalled 50 per cent of the total construction costs – a groundbreaking model for government funding assistance for a project of this size. Another significant transport project was the A$2.9 billion NorthConnex project in Sydney. This was the first major infrastructure project to be approved under the New South Wales unsolicited bids process. Again the project involved a significant state and federal government contribution.

In the private sector, recent asset divestments such as Queensland Motorways and Royal North Shore Hospital have come with headline infrastructure financings. Similarly, the highly competitive sale of BG's liquefied natural gas (LNG) pipeline in Queensland is expected to lead to copycat deals for the other Gladstone coal seam gas to LNG projects as the owners look to take advantage of the strong demand for these assets.


Richard Gordon

The exception to the succession of mega-infrastructure projects is the closing of the US$7.2 billion financing for the Roy Hill iron ore mining project. Roy Hill represents a unique financing structure for a multi-sourced project financing. While the absence of completion guarantees is the norm for Australian project financing, this is not the case for export credit agency-led resources deals and in this regard Roy Hill is an outlier. Sponsors were able to secure the financing without a completion guarantee from five export credit agencies (from Korea, Japan and the United States) as well as 19 domestic and foreign banks. Of assistance was a fully wrapped EPC package from Samsung CT, significant equity-funded construction already completed and a relatively short timetable for first shipment. These somewhat unique circumstances raise the question of whether the absence of a completion guarantee represents a permanent shift from what was previously considered an absolute requirement for multi-sourced financings or whether this financing structure will remain a one-off.

GTDT: Which project sponsors have been most active in driving activity? Which banks have been most active in providing debt finance?

PC, RG & BF: The infrastructure sector in Australia is highly competitive for both sponsor and financier investors. Both domestic and offshore pension funds (particularly North American funds) have been active in pursuing Australian infrastructure assets.

Chinese state-owned entities (SOEs) have been active investors in Australian resources projects for many years but more recently have become bidders for Australian infrastructure. Chinese SOEs join non-pension fund domestic players, strong regional infrastructure investors (particularly from Japan and Singapore) and other international infrastructure specialists in a congested sponsor landscape.

Given the very large equity contributions required to fund the succession of Australian mega-infrastructure projects, most competitive bidding processes – both from government and private sector divestments and greenfield PPPs – have seen international investors partner with local players. Besides access to deeper capital pools, such partnering also allows international investors insights into the domestic government and financial markets through long-standing local player relationships. The strategy has proven a successful one.

On the lending side, the big four Australian banks continue to dominate the Australian project finance market but are facing increased competition from their international competitors.

The Japanese mega-banks continue to be well represented in significant Australian project financings with BTMU and SMBC in particular increasing their local headcount and exposure to the Australian market. The past year has also seen the robust return of many European banks who were traditionally strong participants in the Australian market but retreated to varying degrees following the global financial crisis.

Very strong liquidity in the Australian banking market is rounded out by a large number of regional financial institutions as well as smaller Australian banks. Regional players are increasingly competing strongly for significant Australian infrastructure project financings, often going beyond merely supporting international sponsors with whom they have strong relationships in their home markets.

GTDT: What are the biggest challenges that your clients face when implementing projects in your jurisdiction?

PC, RG & BF: In the infrastructure sector the biggest challenges have resulted from instability in government policy, which has caused losses in respect of projects that have been delayed or abandoned altogether, and which has also contributed to high bid costs. The cancellation of Victoria's contracted A$6.8 billion East West Link tollway project following a change of state government represents a case in point.

In addition, Australia's relatively immature domestic bond market constrains debt capital markets financing, subjecting projects to greater refinancing risk. Generally bank loan tenors range between one and five years. Longer tenors are available but limited, and are priced to reflect the regulatory factors and asset and liability management by banks that drive shorter tenors. Also, there is a general aversion to acceptance of patronage risk in light of the large-scale greenfield projects that have failed dramatically over the past five or so years, particularly in the toll roads sector. The New South Wales government, though, will test the appetite for patronage risk later this year with the roll-out of Stage 2 of the Westconnex toll road project.

The energy and resources sector is facing difficult times in the key commodities areas of iron ore, coal and oil and gas, although the gold price remains strong for the moment. The woes of the commodity sector will make significant greenfield project financings in this sector challenging but have boosted M&A activity and equity raisings.


Ben Farnsworth

The recent decline in the Australian dollar has also made Australian resources projects more attractive to international investors and acquisitions financed on a cash flow basis are likely to increase.

The Australian power sector is currently challenging. Falling electricity demand has limited investment opportunities in new generation capacity. This and political pressure to curb rising electricity costs has increased pressure on network regulation at a time when many state and territory governments are considering privatisation of government-owned transmission and distribution networks (some requiring new capital investment), as well as existing generation capacity.

Uncertainty around government policy has hampered investment in renewables. Investment in the renewable energy sector in 2014 plummeted to around a tenth of that in the previous year largely as a result of inconsistent government policy, which saw the repeal of the 'carbon tax' and a proposed review of existing renewable energy targets.

THE INSIDE TRACK

What three things should a client consider when choosing counsel for a complex project financing?

1. Track record is important. Nothing succeeds like success.
2. Commercial understanding. Our teams have a 'deal mentality' to get things done with a minimum of fuss.
3. Depth of talent is going to be important given the volume of work in Australia. Clients need to know that the firm can deliver, from senior partner to junior associate.

What are the most important factors for a client to consider and address to successfully implement a project in your country?

A good understanding of the various project financing structures that have been successful in this market. Particularly in infrastructure financing, risk allocation between sponsors, financiers and government is constantly shifting. Understanding what the Australian bank market will accept will be crucial.

What was the most noteworthy deal that you have worked on recently and what features were of key interest?

North West Rail PPP. This is Australia's largest ever project in what will be the key area of new infrastructure investment – public transport. The state government delivery phase contribution totalled 50 per cent of the construction costs, representing a new model of Australian government funding for a project of this size.

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GTDT: Are there any proposed legal or regulatory changes that may give rise to new opportunities in project development and finance? Do you believe these changes will open the market up to a broader range of participants?

PC, RG & BF: Australian governments have acknowledged that there is an 'infrastructure deficit' and they recognise the need to facilitate private investment in infrastructure.

This policy setting has seen infrastructure investment as a key theme of recent Australian government budgets, at both the Commonwealth and state and territory level.

Leading the way was the federal government, which announced in its 2014–2015 budget a A$39 billion Infrastructure Investment Programme and an A$11.6 billion Infrastructure Growth Package. The latter package included a proposed Asset Recycling Initiative: a A$6 billion pool of funds to give the state and territory governments incentive payments of 15 per cent of the value of any government-owned asset they propose to sell. This initiative was widely expected to prompt a race among the states and territories to recycle assets. Incentive payments were only available if sale proceeds were reinvested in new infrastructure and the limited Commonwealth funds would be allocated on a first come, first served basis. Despite agreement between the Commonwealth and each state and territory, enabling legislation has been stalled in the Senate (the federal government's upper house, which has power to block legislation), where the incumbent Commonwealth government does not hold the balance of power.

Despite these political headwinds, at the beginning of this year, the majority of state and territory government budgets for 2014–2015 had committed to infrastructure spending in the key areas of roads, rail and social infrastructure. The divestment of a range of existing state-owned infrastructure assets was also signalled. Among the biggest ticket items marked for sale were the port, industrial water pipeline and electricity transmission and distribution assets in Queensland as well as electricity transmission and distribution assets in New South Wales and the Port of Melbourne in Victoria. The infrastructure spending pipeline appeared among the world's strongest, expected to result in over A$100 billion in privatisation deals alone.

However this pipeline was dealt a significant reverse by the Queensland state elections in February 2015, which saw the defeat of the Liberal and National Party, who campaigned on a A$37 billion privatisation platform. The scale of the reverse against the incumbent Queensland LNP government, which had held a significant majority, was unexpected and the defeat has been seen as a rejection of the privatisation agenda, which has now been dropped in Queensland.

With the New South Wales state government going to the polls in March, it should quickly become clear whether this political reversal to the current privatisation round will mark a more general about-face against sales of government-owned assets.

GTDT: What trends you have been seeing in terms of range of project participants? What factors have influenced negotiations on commercial terms and risk allocation? Are there any particularly innovative features?

PC, RG & BF: Investment into Australian projects has become hotly competitive, particularly in the infrastructure sector. On the equity side, domestic and offshore pension funds and other infrastructure investment specialists compete strongly with new players such as Chinese SOEs and other sovereign wealth investors (including by buying into the equity of local infrastructure players).

Similarly, bank debt liquidity remains very strong from both domestic and international banks. While export credit agencies have been crucial to the headline project financings in the Australian resources sector over the past years, they are unlikely to play such a significant role in infrastructure investment, although we expect that export credit agencies supporting home country sponsors investing into Australian infrastructure will continue to be active.

The trend of non-bank debt providers including pension funds looks set to continue, although it may be that the enormous volume of equity investment opportunities coming through the infrastructure project pipeline will mean that pension funds will be more selective with their debt participations.

As in many other countries the viability of creating a bonds framework to assist greenfield infrastructure projects to access the debt capital markets has been much debated, but to date remains unsolved. Nonetheless most infrastructure financings are structured to permit domestic and international debt capital markets participation post-construction or acquisition.

GTDT: What are the major changes in activity levels or new trends you anticipate over the next year or so?

PC, RG & BF: Government (and private sector) asset sales will remain the primary focus of the Australian project finance market over the next year. The Australian electorate's appetite for privatisations should become clearer following the New South Wales state elections in March. If the New South Wales government receives a mandate to pursue their planned big ticket privatisations, it seems likely that the pipeline of large-scale asset sales and reinvestment in new infrastructure spending will continue despite the recent Queensland polls.

The pipeline of project financings for PPPs and infrastructure will continue to be strong. In Queensland, the new government has already committed to rolling out more PPPs and the Victorian government has recently announced the acceleration of the Melbourne Metro project (estimated to cost between A$9 billion and A$11 billion). This is assisted by Australian governments' willingness to adopt new government funding models to reduce borrowing costs. Upfront capital funding and buy-back of debt after construction completion by government has become a common feature of Australian PPPs. Efforts to curb high bid costs (and their restraint on competition) provide another potential fillip to investment. Unsolicited proposals have grown in popularity, in part because of reduced procurement costs, and there has been much discussion of relaxing the requirement for bids to be fully financed at the time of tendering.

We are waiting to see if there is a recovery in the commodities market to support more greenfield work in energy and resources. In the greenfield resources project financing space Australian market participants will closely watch Baosteel's iron ore investment in the Pilbara as well as a number of mega-coal projects in the Galilee and Surat basins in Queensland.

Meanwhile, there is significant M&A activity in those sectors, often financed on a cash flow basis. In the oil and gas sector, Apache looks set to continue its efforts to sell the rest of its Australian business after Woodside's purchase of its US$3.75 billion stake in the Wheatstone LNG project and other LNG interests. Similarly, many in the market expect Shell's Australian LNG portfolio to make up part of its current global divestment programme. In the pipeline space, further activity is expected as other Queensland assets come on to the market and smaller greenfield projects are pursued.

Fuelling activity in resources is the recent slide in the Australian dollar, which may support activity in both M&A and greenfield resources development by improving the relative cost competitiveness of Australian resources projects.

Australian project financing looks set for another very strong year.

> "Government (and private sector) asset sales will remain the primary focus."