Great Project, Primitive Country: Testing the Sovereign Ceiling

A Case Study in Financing Natural Resource Export Projects in the Project Bond Market

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Abstract

The development of a project bond market in the 1990's added a very attractive funding option for sponsors considering project financing. The project bond market makes use of SEC Rule 144-A which permits bonds to be sold to sophisticated investors without the burdensome retail registration requirements; borrowers whose projects gain access to this market often secure terms that are difficult to obtain from banks, e.g. tenors of 15 years or longer, fixed interest rates and limited covenant restrictions. Such terms are especially well suited for energy projects characterized by high capital intensity and extended payback periods.

Access to the project bond market typically requires obtaining an investment grade rating (BBB- or better) from two nationally recognized Rating Agencies. Bond buyers rely on the Agencies to perform the due diligence and analysis which banks do for themselves. Over the past two decades the Rating Agencies have developed their methodologies for rating project bonds. Sponsors seeking entry to the bond market can expect the Agencies to perform a credit assessment every bit as thorough as the leading project finance banks.

One guideline the Agencies usually follow is that the highest rating available to a project will be the sovereign debt rating of the country where the project resides. This limitation is known as the "Sovereign Ceiling." It implies, for example, that if Spain's sovereign debt rating is AA-, no project bond in Spain can have a rating higher than that.

There have been cases where specific projects have pierced this Sovereign Ceiling. Two cases in point were the first two Venezuelan heavy oil projects, Petrozueta and Cerro Negro. Both secured investment grade bond ratings even though Venezuela's sovereign debt was rated as "junk." These project bonds were later downgraded to junk as Venezuela's credit deteriorated further.

This case presents the situation of an excellent project located in a risky country. The project has strong pro forma cash flows, promising markets, secure sales contracts and strong sponsors. However, the host country, New Heberville, enjoys only a B-1 rating on its sovereign debt. Is there any way for the sponsors to "pierce the Sovereign Ceiling" and gain entry into the project bond market? What arguments might be made to persuade the Rating Agencies to grant an investment grade rating? Or is this objective so unlikely to be achieved that the sponsors should concentrate their efforts elsewhere?

This case is based upon financing plans developed for a major Asian LNG export project in 2007-08.