Didn't You Used to Be Project Financing?

A Case Study in Energy Project Financing's Evolution 1980-Present

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Abstract

This case explores how energy project financing has evolved in terms of risks accepted by lenders. Borrowers who employ project financing usually are attracted by the loan being "non-recourse" to project sponsors. This means that the sponsors, who provide the equity financing for a venture, can expect the project loan to be repaid solely from the project's cash flows and/or assets. Such "fully non-recourse" loans enable sponsors to limit their financial exposure to a project; they also allow sponsors to evaluate project economics on a Return on Equity basis rather than using Return on Total Capital.

Over time the clarity of this financing model has become less clear. Originally, sponsors of upstream oil &gas projects were able to secure fully non-recourse loans by pledging only their reserves and a portion of anticipated production. Increasingly lenders have insisted that energy projects need to be secured by additional elements. This added security can include pledged contracts where customers guarantee minimum levels of purchases and/or prices. Lenders have also become adept at securing partial guarantees from sponsors. Thus, today's energy project financing typically includes "limited recourse" to sponsors and other project stakeholders.

At times the extent of this limited recourse can call into question whether much, if any, risk shift to borrowers has been achieved. The case explores this question by contrasting an upstream "Production Payment" financing of 1970-80's vintage with a more complex cotemporary power plant financing. The case asks whether the more recent financing model accomplishes any material risk shift to lenders. It also probes whether there is some risk shift, and is it sufficient to justify paying lenders a premium interest rate? Finally, it poses the question of whether project sponsors have allowed lenders to demand too much contractual protection, and whether they should push lenders to accept more price, production and market risk going forward.