



Project Bonds and Energy Transition: A proven financing solution

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Content

[Introduction](#)

[Legal considerations](#)

[Commerical/structural considerations](#)

[Transaction management considerations](#)

[Conclusion](#)

Introduction

The stricter monitoring/disclosure and liquidity requirements faced by banks in the wake of the global financial crisis mean that projects can often no longer be funded by traditional bank debt alone. The debt capital markets have stepped up to the challenge and project bonds are on the rise, particularly amidst the green finance boom. Whilst the specific challenges that project bonds pose when used in a project financing arrangement are complex, they are by no means insurmountable and with the help of experienced professionals, project bond financings can be structured in a way that offers a viable alternative solution.

Concrete steps to establish, develop and encourage energy transition have been embraced by governments and the wider public sector, financial institutions and investors. Global investment in energy transition totalled US\$755bn in 2021, an increase of 27% when compared to 2020, and renewable energy achieved a record US\$366bn of investment in 2021. These already impressive numbers will continue to grow as the world moves towards the goal of achieving net-zero emissions by 2050, as pledged in the Paris Agreement.

Traditional project finance loan arrangements are already being stretched thinly to cover the increasing capital deployment demand for the development of renewable energy projects against this backdrop, as banks' funding sourcing and loan diversification needs – exacerbated by the implementation of Basel III regulations – make it difficult for traditional loan financing to keep pace with energy transition projects.

In response, many banks have already started to increase their use of so-called “mini-perm” structures. These short-term debt financing solutions incentivise refinancing following project completion, either by exposing the project company to a risk of default should a refinancing not be possible prior to maturity (a “hard” mini-perm) or through “soft” means, such as periodically increasing the margin on the loan (a “soft” mini-perm). The use of both hard and soft mini-perm structures increases the need for additional capital, since long-term projects not only need to secure initial funding, but also refinancing as part of their long-term funding strategy.

Thankfully, the capital markets have a solution to offer. Project bonds – an attractive and now well-established alternative or complimentary financing method to traditional bank loans – could be the answer. This is even more so in the renewables space as a result of the recent boom in the use of green bonds. But, what is a project bond? What are the requirements for a bond to be labelled as “green”, and what are the main issues to be considered by potential issuers and sponsors intending to raise debt through the international capital markets?

What is a project bond?

A project bond is not a distinct “type” of bond (as the name may suggest) at all, but rather an umbrella term that covers a wide array of bond products that are categorised by their repayment source being limited to the cash flows of a particular project. Project bonds are generally issued by a special purpose vehicle (ProjectCo or the Issuer) to finance or refinance either the whole or part of a project.

Historically, project bonds have most commonly been used to refinance an existing project *after* its construction phase has been completed, as investors have not traditionally been prepared to assume the construction risk of a project.

However, in recent years, the use of project bonds to fund the construction phase of greenfield projects has become more commonplace where ProjectCo can show that it meets specified rating requirements and/or the project bonds include appropriate credit enhancement features.

The green bonds boom

“Green bond” is a label used for bonds which proceeds are earmarked for the financing of green initiatives. Demand for green bonds has been on the rise ever since the World Bank issued the first green bond in 2008. While in 2012 the green bond market amounted to only US\$2.6bn, in 2021 green bond issuances reached US\$517.4bn and they are expected to reach approximately US\$2.5trn by 2025.

Work among regulators is ongoing, but there is currently no established definition as to what constitutes a green initiative for these purposes. It might range from a renewable energy project such as a wind farm to energy-efficient buildings.

However, in order to give assurance about the “green characteristics” of green bonds, issuers customarily align with the International Capital Markets Association Green Bond Principles (ICMA GBP), which have become the market standard for the labelling of a bond as “green”. Under the ICMA GBP, an issuer should have a “Green Bond Framework” in place for the issuance of green bonds.

This framework should cover at least the following characteristics of any instrument issued with a “green” label:

- use of proceeds
- the process for evaluating and selecting the projects or assets to be financed under such instruments (including the environmental objectives thereof);
- the management of proceeds; and
- reporting, at least annually, on the use of proceeds.

The use of project bonds as a source of funding for renewable energy projects is the perfect candidate for the ICMA GBP “green” label, as there is limited scope to challenge a renewable energy project’s environmental impact. In addition, once bond proceeds are applied to the project, additional management or impact reporting requirements should be minimal or not required at all.

Issues of particular importance when issuing a project bond

Globally, the project bond market has grown at a 10% compound annual growth rate over the past 10 years. Against the backdrop of this global shift from traditional bank financing to capital markets-based funding, now is an opportune time for sponsors and stakeholders to potentially reduce their project funding costs and broaden their investor base by accessing the institutional bond markets.

There are, however, a number of particular issues involved that Issuers and sponsors should consider when funding a project through the use of project bonds.

Legal considerations

Due diligence, disclosure and liability issues under US securities laws

The issuance of a project bond will typically require the preparation of an offering memorandum or other offering document in accordance with applicable securities laws and/ or stock exchange listing rules. Accordingly, both the Issuer and the project will be subject to an in-depth review by several parties.

This is a necessary process, but it can be time intensive, as it typically includes:

- the preparation of a third-party technical review report to opine on the operational conditions of the project and its past performance;
- the preparation of an independent model auditor's report to certify that the project's financial model is based on reasonable assumptions; and
- the evaluation by legal counsel of the Issuer's credit, structural, financial and cash flow risk profile in order to prepare the offering document.

Under securities regulations in several jurisdictions, both the Issuer and any underwriting banks will be liable for any incorrect statement of a material fact or omission of material information in the offering documents (though the standard varies from jurisdiction to jurisdiction). As a result, underwriters and advisors are particularly meticulous in conducting the disclosure exercise.

Additionally, disclosure requirements involved in issuing project bonds in the US markets may give rise to particular liability issues in the US where Rule 10b-5 of the Exchange Act (which prohibits any person from making "an untrue statement of material fact" in connection with the purchase or sale of securities) applies, in particular given the class action route for litigation available in the US.

Additional materials and documents required to be disclosed and vetting processes to be complied with vary depending on the nature of the underlying project and its particular conditions, but will customarily include:

- **a negative assurance letter from ProjectCo's legal counsel and the underwriters' counsel:** counsels will conduct a thorough review of all aspects of the project and the offering documents to issue this negative assurance letter and will seek back-up evidence for each material statement made in the offering documents; and
- **a comfort letter from ProjectCo's auditors:** auditors will extract each figure contained in the offering document that has been extracted from the financial statements of ProjectCo and issue one or more market standard comfort letters addressed to the underwriters confirming that such numbers match those observed in their audit of year-end financial statements (or review, in the case of interim financial statements) and providing negative assurance as to any material changes in certain balance sheet line items (to be negotiated on a case by case basis) at the time of pricing and issuance.

Project sponsors may not want to disclose commercially sensitive information such as contractual terms of offtake or credit enhancement arrangements. This commercial reality can be hard to reconcile with the stringent disclosure requirements involved in a bond issuance. Nonetheless, it is worth noting that the scope of contractual disclosure required is well defined.

Covenants

Covenant packages for project bonds – as a general rule – are usually *less* restrictive for the Issuer as compared to those in traditional bank financings. However, it is nonetheless expected that the covenant package for a project bond should include certain covenants, such as:

- to maintain all security in full force and effect;

- not to dispose of the project assets or amend any of the project documents, including the offtake agreement, EPC agreement and/or O&M agreement, as the case may be;
- to repurchase the bonds in case of a change of control;
- to comply with certain environmental standards;
- to maintain a debt service reserve account with a balance of at least the next interest and principal repayment amounts;
- to restrict the incurrence of additional financial indebtedness;
- to restrict dividend distributions;
- to limit the operating and maintenance expenses; and
- to maintain the rating of the bonds.

The covenants for project bonds will be primarily “incurrence based”, ie triggered by specific action on the Issuer’s part or the occurrence of a specific event. They will usually be intrinsically linked to high thresholds and various qualifiers (eg a covenant will not be breached unless it causes a “material adverse effect”) in order to ensure flexibility for the Issuer and the project, while still allowing the bondholders a remedy should the thresholds imposed be exceeded.

Commerical/structural considerations

Negative carry

The nature of a typical project means that, though the proceeds of a project bond issuance are received all at once, they will be deployed over a period of several years as and when the project requires funding. Until the funds are deployed, they will generally be either deposited in a bank account or invested in low risk, low return liquid assests. This exposes the project sponsors to the risk of “negative carry” – a situation whereby the bond coupon exceeds the return on the bond proceeds.

There are options available to ProjectCo in order to mitigate against negative carry. For instance, ProjectCo could retain some/ all of the bonds at closing and sell them at a later date to investors who have provided upfront commitments – in exchange for a commitment fee from ProjectCo – to purchase them at a stated price.

Certainty of pricing

In the context of a traditional bank loan, lenders are generally able to provide certainty on the interest rate early in the financing process. In contrast, in bond transactions the coupon will only be formally confirmed a few days before the issuance of the bonds.

The issue price, coupon and yield are dependent on the economic and market conditions at the time of issuance which will vary as a result of the effect of inflation, benchmark rates and other macroeconomic variables which have an effect on the actual yield of a bond. Sponsors should bear in mind that market conditions could easily shift between the moment they make the decision to issue a project bond and the moment it is actually issued, putting pressure on the project’s financial model.

“Make-whole amounts”

Bondholders have a particular aversion to an issuer making prepayments prior to maturity. This primarily stems from the fact that most investors in bonds will be institutional investors such as pension funds or insurance companies needing to offset their long-term liabilities arising as a result of the nature of their businesses with predictable, long-term investments. As a result, ProjectCo will generally have to pay a “make-whole amount” if it wishes to make a prepayment of the bonds, which will essentially comprise the net present value of the remaining payments of principal and interest on the bonds.

Intercreditor issues

When project bonds comprise part of the funding structure of a project, they will usually only represent one of several tranches of financing, in particular in larger projects (noting that many renewable projects require several tranches of financing). The participation of different lenders of different classes in a project funding structure gives rise to some complex intercreditor issues that must be considered, for instance:

- which decisions will require the consent of a majority of lenders;
- which decisions will require the unanimous consent of the lenders;

- which decisions will require the consent of bondholders as opposed to traditional bank lenders or export credit agency lenders; and
- which lender or class of lenders can call an event of default or accelerate the facilities/ bonds.

An intercreditor agreement will be necessary to govern the decision-making process and enforcement mechanics between different layers of a project funding structure. It will regulate, most crucially, provisions outlining how votes are to be allocated between the different creditor groups and on which issues each of the creditor groups should “get a vote”.

A particular point to consider when allocating voting rights between different creditors is the issue of timing. The decision-making process for bondholders may be particularly time consuming due to quorum requirements and bondholder approval thresholds.

The precise principles of the intercreditor arrangements will vary greatly depending on whether the different classes of creditors are providing their funding on common terms or not.

- If the funding *is* being provided on common terms, the intercreditor agreement will play a more important role than if funding were not provided on common terms as it will need to regulate the decision-making process on all issues (including who can call an event of default).
- On the other hand, if funding *is not* being provided on common terms, the underlying documents for each different source of funding will separately govern the decision-making process and enforcement mechanics for each of the different sources.

Credit enhancement

In order to make project bonds more attractive to investors, sponsors must be prepared to add credit-enhancing features to the overall financing structure. While the exact structure of such credit enhancement will vary from project to project, sponsors will regularly be required to deliver letters of credit, to be called by the bondholders in the case of project costs overruns, a shortage in the debt repayment reserve account or the occurrence of an event of default.

In addition, investors may expect that in government-sponsored projects, a direct or indirect sovereign guarantee is granted (although in the case of renewable energy projects, government involvement might be limited to the role of offtaker, in which case it is common for the government to provide for a guarantee of its obligations under the power purchase agreement).

Transaction management considerations

Timing of security release

When project bonds are issued for the purpose of refinancing, the interests of existing lenders in the structure will often not be aligned with the interests of the future bondholders. This issue is particularly evident when considering how and when security in favour of incoming creditors will be created and perfected.

While existing lenders will wish to have received their repayment prior to the release of the security that is to be re-taken on behalf of bondholders, the bondholders will likely wish to take the security from the moment their money is disbursed to ProjectCo. Consequently, the influx of bond proceeds, the repayment of existing lenders, the termination of interest rate swaps (where relevant) and the release and re-taking of security must occur almost simultaneously. This adds an extra layer of complexity to the process.

In addition, certain security that is subject to registration before public authorities, such as mortgages and share pledges (though this may vary from jurisdiction to jurisdiction) may not be released and re-taken at the same time. If the project bond structure includes such security, the underwriters must get comfortable with such security being perfected as a condition subsequent, with appropriate disclosure included in the offering documents. This point usually leads to lengthy and complex negotiations between all parties and sponsors must be prepared to mediate among them.

Re-running of the financial model

As a result of the uncertainty of pricing issue, as explained above, and the nature of project bonds – whose repayment source is the project cash flows – the marketing of the bonds and the financial model included in the preliminary offering document will refer to *indicative* financial model information only. Once the bonds are priced and the cost of financing determined accordingly, the financial model of the project and its description within the offering documents will then need to be updated.

Rating agencies vetting the structure

Project bonds offered to the public will need to undergo a rating process. This process is normally conducted by one or more of the principal rating agencies (Standard & Poor, Fitch or Moody's). Credit rating agencies conduct a thorough review of the project and its financial model in accordance with their approved internal guidelines for project finance, the requirements of which may differ depending on the type of project, its credit enhancement features and parties involved.

The rating agencies will generally perform an initial structural review followed by a review of all legal documentation – including the preliminary disclosure – and will then issue an indicative rating before the launch. Sponsors should approach credit agencies early in the transaction process to fully understand their timelines and requirements for their particular project. Obtaining credit ratings is customarily a condition precedent to bond closings.

Financial statements

Generally, the disclosure package of a bond transaction will include the last two years' full year audited financial statements of the Issuer. In addition, depending on the time of year in which the bond issuance is expected to occur, quarterly financial statements might be required.

The usual rule, though the particular situation of each Issuer has to be analysed separately, is that if more than 134 days have passed since the year end, first quarter financial statements – which will be valid for another 134 days from their cut-off date – will be required. This general rule applies equally to each quarter, so if more than 134 days have passed since the first quarter cut-off date, half-year financial statements are needed (and so on for each quarter).

For project bonds issued in the US markets, while quarterly financial statements do not need to be audited, they will have to be reviewed in accordance with US Accounting Standards 6101, Letters for Underwriters and Certain Other Requesting Parties (AS 6101) issued by the Public Company Accounting Oversight Board (PCAOB). Accordingly, sponsors should be aware that ProjectCo might need to prepare interim financial statements and such statements will need to be reviewed by the auditors to avoid any potential delays in finalising disclosure.

Conclusion

Project bonds are a useful and increasingly popular alternative to traditional project finance loan arrangements, particularly when it comes to renewable energy projects, which can also benefit from a green bonds framework. As a result, there has recently been a steep increase in the use of project bonds to fund projects. However, project bonds carry with them different legal, commercial and transaction management issues to traditional bank loans, which must be considered at an early stage and with the help of experienced and knowledgeable advisors, in order to determine whether the debt capital markets are available for a project.

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