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Dealing with currency exchange risk in project financings

Briefing

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On many international project financings, the main cash flow generated by the project is denominated in the local currency which does not match the currency (e.g. US Dollars) which is used to pay debt service or perhaps to calculate the equity commitment for any foreign sponsors. Developers and financiers therefore seek to ensure that the finance documents provide a mechanism by which the project company periodically converts the local currency into the relevant debt service currency and transfers to an offshore account to ensure sufficient hard currency is available to meet the debt service obligations of the project company. In addition, lenders often impose a limit on the maximum balance in the project company's onshore accounts to what is strictly necessary in order to keep the project operational. This means, at any given time, the project company will usually only have sufficient local currency funds to meet its projected local currency denominated expenses for a fixed period of time, say up to a few months.

During the life of the project, despite having included the mechanisms under the finance documents described above, the project may encounter certain unforeseen issues which can restrict or hinder the ability of the project company and/or its local account bank to convert local currency into the relevant debt service currency and/or to make any transfers to the project company's offshore accounts in accordance with the finance documents.

For example, the host country may seek to introduce currency exchange controls by limiting the extent to which local currency can be converted into foreign currency or prohibiting any transactions to be carried out in foreign currency between domestic entities with a view to strengthening the demand for the local currency and to build up the capacity of the host country's financial sector. Also, regional political instability can influence a host country's decision to tighten foreign exchange controls. Recent examples include Turkey and Argentina in the summer and autumn of 2018.

There is also the risk of quasi foreign exchange restrictions, which arise where governments or central banks take action which does not amount to a change in law, but has the practical effect of restricting access to foreign currency and/or transferring funds offshore.

We set out below some of the options which may be available to the project company and the lenders when they are faced with currency exchange and transferability issues.

Working capital facility

If the project company is facing delays in accessing hard currency (but there are no formal exchange controls in place), one option would be for the project company to obtain a working capital loan in hard currency.

Working capital facilities are often envisaged under the finance documents. If so, the parties should consider if the relevant provisions permit a working capital facility to be drawn down in the debt service currency. If however, no working capital facility is envisaged in the finance documents, it is important to check whether the finance documents permit the project company to incur additional financial indebtedness to meet the relevant debt service obligations and if so, whether the total amount required will not exceed any applicable threshold in respect of permitted indebtedness.

If permitted, a working capital facility is potentially a relatively quick and simple option for the project company to obtain funds. However, it is only a short term solution given that working capital facilities typically do not have a long maturity. Consequently, if the project company is facing difficulties accessing foreign currency, drawing down a working capital facility will only delay, but not remedy, the issue and the project company will soon be facing the same problem when it comes to repaying the working facility loan.

Replace or add a new account bank

The project company may consider replacing the existing account bank or adding a new local account bank.

Our experience of advising on these issues has shown that sometimes certain banks have easier access to foreign currency than others and therefore may be given preferential treatment when it comes to transferability of local currency into foreign currency.

The finance documents will govern the process for replacing an account bank (such as meeting a minimum credit rating threshold and the entry into relevant accession documents) and there may also be local law issues concerning whether the existing security documents will extend to the new accounts and how to release security over the existing accounts if the account bank is replaced.

Although it may be possible to remove an existing account bank contrary to its wishes, it will be preferable to obtain the support of the existing account bank to such replacement. In addition, the consent of the lenders in accordance with the intercreditor provisions is also likely to be required. Consequently such approach will need the active involvement and support of the existing finance parties as a solution to the debt service shortfall.

Another alternative is the addition of a new onshore account bank which can be used to the extent required to resolve the currency shortfall. This has an advantage that the existing account bank can remain involved as a finance party. However the finance documents are unlikely to provide for multiple onshore account banks and consequently amendments will need to be agreed between the finance parties which deal with all intercreditor and security issues arising from multiple onshore account banks.

Permitted investments

Finance documents in respect of project financings typically allow the project company some flexibility to invest the balance of certain project accounts in certain investments during the term of the loan. The finance documents will strictly control which funds can be used to invest and in which investments such funds can be invested. It is worth reviewing these provisions to ascertain whether the documents allow the project company to make certain permitted investments in local currency but to receive funds in the debt service currency when the permitted investments are liquidated. This could enable a project company to source sufficient hard currency. However, this is not necessarily without its challenges, particularly if any currency exchange controls still restrict conversion or finance documents require the proceeds of investments to be repaid into the original account in the same currency.

Renegotiation of offtake contracts

The project company can attempt to re-negotiate with its offtaker(s) to change the currency of its payments under the relevant offtake contract(s). In many cases, this may be difficult as the offtaker may not be in a position to pay in foreign currency especially if its focus is primarily domestic. There may also be other political or economic factors which may prevent it from paying in hard currency.

In any event, if the project company manages to negotiate successfully a change in currency with the offtaker, this is likely to require amendments to the relevant offtake contracts which will be defined as a project document under the finance documents. The finance documents typically prevent the project company from amending or agreeing to amend any material part of a project document without first obtaining the consent of the lenders.

The project company will also need to consider any associated effects of such change such as: (i) whether the project company will have sufficient local currency to cover its local currency expenses; and (ii) whether any consequential amendments will need to be made across the suite of finance documents.

Investment agreements

Project developers and financiers may seek to obtain special rights and/or exemptions from the government to ensure they are protected from any existing and/or potential restrictions relating to foreign currency controls being imposed on the project by entering into an investment agreement with the host government. Under such an investment agreement, the host government will undertake to ensure that the project developers and/or the financiers will continuously benefit from preferential treatment throughout the life of the project and provide certain protections such as setting out a mechanism for the parties to make a change of law claim against the government. There may even be an indemnity whereby the government undertakes to indemnify and hold harmless the project company and/or the financiers for any loss in connection with the breach by the government of its obligations under such investment agreement.

When negotiating such agreements, careful consideration must be given to ensure the contract can be enforced against the government, for instance by ensuring the government has waived any immunity and agreed to resolve disputes in an appropriate forum.

In the current economic environment, these issues are particularly relevant as the recent devaluations in Turkey and Argentina demonstrate. We have recently advised on a number of projects where project companies have encountered foreign exchange issues and the observations set out in this client briefing reflect only some of the potential solutions. Each project will have its own way of resolving these issues in a manner that works best for both the developers and the lenders.

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NORTON ROSE FULBRIGHT

Contacts

If you would like further information please contact:

Charles Whitney
Partner and head of energy for EMEA
Tel +44 20 7444 3171
charles.whitney@nortonrosefulbright.com

Jamie Munro
Senior associate
Tel +44 20 7444 5007
jamie.munro@nortonrosefulbright.com

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