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ECAs

New flexibility for ECAs

Changes to the Arrangement on Officially Supported Export Credits will provide increased financing flexibility for project sponsors and other users of official export credits. These revisions relate to project financings, non-standard repayment structures, and renewable energy and water projects. In particular, the modifications include:

- Making permanent the project finance understanding and extending its availability to brownfield projects;
- Increasing the availability of the project finance flexibilities for projects in high income countries;
- Allowing flexible repayment profiles for non-project finance transactions; and
- Extending the maximum repayment terms for certain renewable and water projects to 15 years.

This article describes these changes and their history and looks at the potential implications for project finance and other transactions that utilise official export credit financing.

On July 1 2005, a number of important changes to the Arrangement on Officially Supported Export Credits became effective. By **Peter B Saba**, of counsel in the Washington DC office of **Paul Hastings.**

The OECD Arrangement

The Arrangement is a gentleman's agreement among the major export credit agencies that sets the rules for official export credits. It was developed and is supported by the Organisation for Economic Co-operation and Development (OECD). The Arrangement initially came into effect in 1978 and currently has nine participants: Australia, Canada, the European Community (representing its 25 member countries), Japan, South Korea, New Zealand, Norway, Switzerland, and the United States.

Moreover, through a provision in the Agreement on Subsidies and Countervailing Measures (the Subsidies Code) of the World Trade Organisation (WTO), an export credit practice - whether by a participant or by a non-participant - that conforms to the provisions of the arrangement is not considered a prohibited subsidy under the WTO.

The Arrangement applies to official support provided by or on behalf of a government for the export of goods and services, including financial leases, that have a repayment term of two years or more. Official support can take the form of guarantees, insurance, direct credits, or interest rate support.

With medium and long-term official export credit volumes from G7 governments exceeding US$50bn a year, official export credit support represents an important source of financing for capital goods. Moreover, official export credit agencies play a significant role (well beyond the volume of funds provided) in project financings, particularly in emerging or politically risky markets.

The Arrangement seeks to level the playing field and reduce the subsidy cost of official export credit support. By levelling the playing field for official support, the Arrangement promotes competition among exporters based on price and quality, rather than on the availability of the most favourable government supported financing.

The Arrangement achieves this objective by limiting the financing terms and conditions that export credit agencies can offer, including setting maximum repayment terms and minimum interest rates and exposure fees. As a result of the Arrangement's disciplines, repayment profiles under official export credits have historically consisted of equal, semi-annual principal payments with limited exceptions.

The Arrangement has evolved over its more than 25-year history, but has been undergoing a more intensive review and rewrite over the past few years. This revision process has been driven by a number of factors. These include a desire to reduce the risk of challenge to official export credit financing under the WTO by improving clarity and transparency.

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In addition, some OECD export credit agencies want to provide more flexible terms and increase their participation in financing in less risky markets to balance their portfolios, achieve target rates of return or expand their activities. A significant outcome of this revision process is the increased financing flexibility discussed below.

Project finance understanding

In order to achieve greater flexibility than that which was available under standard Arrangement terms, special guidelines for official support for project financings came into effect on September 1 1998 on a trial basis. These guidelines, known as the Project Finance Understanding, provide flexibility on the timing of the first repayment of principal, the repayment profile and the maximum repayment term, subject to limitations tied to the average life of the credit. Greater flexibility allows export credit agencies to structure a project's repayment obligations to match its revenue stream more closely.

The latest revisions to the Arrangement integrated the project finance flexibilities into the Arrangement on a permanent basis through a new Article 7. This provides greater certainty for project sponsors seeking export credit financing for these long lead time activities and eliminates the administrative burden of repeated extensions of the trial period. As part of these revisions, both minor and more substantial changes to the project finance understanding were made.

The revised project finance flexibilities establish rules relating to maximum term, grace periods, capitalisation of interest and other terms and conditions, as follows:

- Maximum repayment term is 14 years;
- First principal repayment shall be made no later than two years after the starting point of credit and shall not be less than 2% of the principal amount;
- Interest must be paid at least annually, with the first interest payment no later than six months after the starting point of credit;
- No single repayment of principal (or series of principal payments within a six month period) shall exceed 25% of the principal amount;
- Weighted average life of the repayment period shall not exceed 7.25 years; and
- Export credit agency must provide notification at least 10 calendar days prior to issuing any commitment (with an additional 10 calendar days waiting period if any other export credit agency requests further information).

The starting point of the credit is defined by the Arrangement. In the case of a typical project financing where the construction contractor has contractual responsibility for commissioning, the latest starting point that can be used is the date of completion of installation or construction and preliminary testing. Weighted average life of the repayment period is defined as the time it takes to retire one-half of the principal of a credit. This calculation is made by taking the sum of time between the starting point of the credit and each principal repayment, weighted by the portion of principal repaid.

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Brownfield projects

In connection with making the project finance flexibilities permanent, the eligibility criteria for project finance transactions under the Arrangement were revised to eliminate the requirement that limited their use to greenfield projects. Now, brownfield projects, such as major extensions, are eligible for official export credit support on the more flexible project financing terms, as long as they meet the other eligibility criteria.

These eligibility criteria include a legally and economically independent project company, limited or no recourse to the sponsors post-completion, and a non-sovereign borrower with no sovereign repayment guarantee (not including performance guarantees, eg, off-take arrangements).

Projects in High Income OECD countries

Another significant change to the project finance flexibilities increases the availability of these flexibilities for projects in High Income OECD Countries. High Income OECD Countries are those whose per capita GNI has been for at least two consecutive years above the World Bank's threshold (ie, per capita GNI over US$9,386 for 2003 and US$10,066 for 2004). For 2005, 24 countries were classified as High Income OECD Countries for purposes of the Arrangement, including all of the G7 nations (Canada, France, Germany, Italy, Japan, UK and US).

Under the revised Arrangement, official export credit agencies can provide the more flexible project finance repayment terms for projects in High Income OECD Countries if they are a minority participant in the loan syndicate and are offering comparable pricing. Specifically, project finance transactions in High Income OECD Countries must meet the following additional criteria:

- Official support is part of a loan syndication with private financial institutions that do not have export credit agency cover;
- Participant is a minority partner with pari passu status throughout the life of the loan;
- Total export credit agency support is less than 50% of the syndication; and
- Premium rates for any official support do not undercut available private market financing and are commensurate with corresponding rates charged by the private financial institutions in the syndication.

If the official export credit support provided by participants is more than 35% of the syndication for a project in a High Income OECD Country (but in any event less than 50%), the maximum repayment term under the project finance provisions of the Arrangement is reduced to 10 years and the weighted average life of the repayment period may not exceed 5.25 years.

Some OECD export **credit agencies** want to provide more **flexible terms**

Non-standard repayment profiles

The latest revisions to the Arrangement also modified the provisions relating to repayment profiles for non-project finance transactions. Previously, the Arrangement stated that principal should normally be repaid in equal, semi-annual instalments, while the historical understanding and experience meant that exceptions to the standard repayment profile were infrequent. The revisions to the Arrangement deleted the term normally and added a new subsection (Article 14(d)) that permits the use of non-standard repayment profiles in certain circumstances.

Specifically, export credits may now be provided on terms other than equal, semi-annual repayment of principal "on an exceptional and duly justified basis". Such support shall be "explained by an imbalance in the timing of funds available to the obligor and the debt service profile available under an equal, semi-annual repayment schedule."

As a result, structured or non-standard repayment profiles can be used for non-project finance transactions, but the repayment profile must comply with certain specified criteria. These criteria are similar to those that apply to the repayment profile for transactions eligible for the project finance flexibilities except that in the case of non-project finance transactions, the grace period for principal repayment cannot exceed one year, principal payments must be made at least annually and different maximum weighted average lives apply.

While the revised Arrangement now explicitly permits these non-standard repayment profiles where justified for non-project finance transactions, it did not change the allowable maximum total repayment term for such transactions. Similarly, there was no substantive change to the provisions in the Arrangement that permit the use of equal repayments of principal and interest combined (mortgage style repayment) for lease transactions.

Renewable energies and water projects

Another important development in the evolution of the Arrangement was the addition of a new Sector Understanding for Renewable Energies and Water Projects (Annex IV). Pursuant to this sector understanding, export credit agencies may now provide repayment terms for certain renewable energy and water projects of up to 15 years. The maximum repayment term applies irrespective of the country classification.

This sector understanding, however, only provides for standard repayment profiles (ie, equal, semi-annual principal repayments) or, in the case of lease transactions, mortgage-style repayment (ie, equal repayments of principal and interest combined). Accordingly, project sponsors and other users of official export credits for renewable energy and water projects now have a menu of financing options from which to choose.

Such projects could obtain financing under standard Arrangement terms, the non-standard repayment profile, the project financing flexibilities or the special sector understanding depending on which terms and conditions best meet the needs of the project and their ability to meet the eligibility criteria for financing flexibility or extended terms.

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The sectors that are eligible for the financial terms and conditions under the new Sector Understanding for Renewable Energies and Water Projects are: wind energy, geothermal energy, tidal and tidal stream power, wave power, solar photovoltaic power, solar thermal energy, ocean thermal energy and bio-energy. Drinking water and wastewater collection and treatment facilities also are eligible for this sector understanding. Implementation of this sector understanding to hydro power is subject to a decision by the Participants, which is expected to be taken in November 2005.

This special sector understanding was adopted for a two-year trial period effective July 1 2005. At the end of the trial period, the participants will decide whether to discontinue the sector understanding, continue the trial period with any necessary enhancements or modifications, or to make the sector understanding a permanent part of the Arrangement with any necessary enhancements or modifications.

Conclusion

The changes to the Arrangement that became effective on July 1 2005 increase the financing flexibility available for project sponsors and other recipients of official export credit support in both project finance and non-project finance transactions. Depending on how they are implemented by the various export credit agencies, these flexibilities could significantly impact where and how these institutions provide their support.

In particular, we could see an expanding role for export credit agencies in project financings in High Income OECD Countries, greater demand by traditional users of export credit for non-standard repayment terms, and increased economic viability and financing for renewable energy and water projects.

Exporter demand, as well as competition among export credit agencies to support their domestic exporters and to expand their activities, is likely to stimulate both greater and creative use of these flexibilities.

Room for interpretation and the difficulty that may arise in monitoring limitations such as the requirement for commensurate pricing for project financings in High Income OECD Countries may reduce the level playing field for official support. On the other hand, underwriting and credit standards and a focus by a number of export credit agencies on profitability and rates of return may act as limits on the availability of these flexibilities.

It is too early to tell how these new financing flexibilities will be implemented and how widely they will be used. Nevertheless, they are now available and provide an opportunity for increased financing flexibility by export credit agencies in both project finance and non-project finance transactions.