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The Impact of the World COVID-19 Pandemic on Project Financing

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Abstract

With the dramatic plunge in oil prices, school and business shutdowns and increased concern around the impact of COVID-19 (coronavirus), the need for project financiers and borrowers to consider the implications under their finance documents has become even more pressing. COVID-19 is spreading fast across the globe. At the time of writing, the WHO reported cases of COVID19 in 206 countries with the tragic deaths of people. Since 31 December 2019 and as of 15 April 2020, 1 948 511 cases of COVID-19 (in accordance with the applied case definitions and testing strategies in the affected countries) have been reported, including 125966 deaths. The primary focus is necessarily on containment, treating the ill and helping communities cope with the epidemic. Our illustrative scenarios indicate that the potential loss of income in affected countries could be significant, with global GDP declining by up to 3.9%, and developing countries hit the hardest (4% on average, but some over 6.5%). Governments will need to offer significant support to affected businesses and households. In the context of a project finance transaction, the interruption of construction or operations can have significant implications. The project company is typically a thinly capitalized special purpose vehicle and lenders have limited or no recourse to sponsors in circumstances where the project is underperforming. In this note we consider some of the issues under the finance documents for typical project finance transactions. Most facility agreements contain information undertakings with which borrowers need to ensure they comply. The scope of the undertakings will vary across different facilities, projects and sectors, but they are likely to be most extensive during the construction phase of a project. Borrowers will need to consider whether any of these undertakings have been triggered by the COVID-19 outbreak and its impact on the project. Many transactions will also give lenders the right to ask for information and so borrowers will need to ensure that they respond to any such requests within appropriate time limits.

Keywords: Project Financing, Project Financial Risk, COVID-19 Pandemic, COVID 19 Public Financial Administration, COVID 19 Economic Impact, Project Development, World Project Problems.

1.0 INTRODUCTION

Coronavirus disease 2019 (COVID-19) is an infectious disease caused by severe acute respiratory syndrome coronavirus 2 (SARS-CoV-2). The disease was first identified in December 2019 in Wuhan, the capital of China's Hubei province, and has since spread globally, resulting in the ongoing 2019–20 coronavirus pandemic. Common symptoms include fever, cough, and shortness of breath. Other symptoms may include fatigue, muscle pain, diarrhea, sore throat, loss of smell, and abdominal pain. The time from exposure to onset of symptoms is typically around five days but may range from two to fourteen days. While the majority of cases result in mild symptoms, some progress to viral pneumonia and multi-organ failure.

As of 15 April 2020, more than 1.99 million cases have been reported across 210 countries and territories, resulting in over 127,000 deaths. More than 500,000 people have recovered. The virus is primarily spread between people during close contact, often via small droplets produced by coughing, sneezing, or talking. While these droplets are produced when breathing out, they usually fall to the ground or onto surfaces rather than being infectious over long distances. People may also become infected by touching a contaminated surface and then their face. The virus can survive on surfaces for up to 72 hours. It is most contagious during the first three days after the onset of symptoms, although spread may be possible before symptoms appear and in later stages of the disease.

The standard method of diagnosis is by real-time reverse transcription polymerase chain reaction (rRT-PCR) from a nasopharyngeal swab. Chest CT imaging may also be helpful for diagnosis in individuals where there is a high suspicion of infection based on symptoms and risk factors; however, it is not recommended for routine screening.

Recommended measures to prevent infection include frequent hand washing, maintaining physical distance from others (especially from those with symptoms), covering coughs and sneezes with a tissue or inner elbow, and keeping unwashed hands away from the face. The use of masks is recommended for those who suspect they have the virus and their caregivers. Recommendations for mask use by the general public vary, with some authorities recommending against their use, some recommending their use, and others requiring their use. Currently, there is no vaccine or specific antiviral treatment for COVID-19. Management involves treatment of symptoms, supportive care, isolation, and experimental measures. The World Health Organization (WHO) declared the 2019–20 coronavirus outbreak a Public Health Emergency of International Concern (PHEIC) on 30 January 2020 and a pandemic on 11 March 2020. Local transmission of the disease has been recorded in many countries across all six WHO regions

2.0 THE WORLD BANK ON COVID 19

Borrowers (World Bank, IFM etc.) may be considering steps to mitigate the impacts of COVID-19, either on the basis of good business practice, or due to an obligation to do so under its project agreement or offtake arrangements. However, lenders often have rights of approval regarding changes to the project budget and expenditure, requiring approvals of spend exceeding a certain threshold. Lenders may also have rights to request the borrower revise budgets in the event there is a change in circumstance which may affect the accuracy of the existing budget. Borrowers will need to keep these budget restrictions in mind when approving any extraordinary expenditure which may be required to mitigate the impacts of the pandemic. If provisions do not allow the requisite flexibility, a borrower may need to request a waiver from lenders of these provisions, to allow an emergency budget to be approved. If the loan is in the construction phase and has not been fully drawn, the parties will need to consider if any events have occurred which would allow the lenders to refuse to fund a utilization. Draw-stop events typically include an event of default (or potential event of default) continuing; misrepresentation; the occurrence of or a forecast funding shortfall; and delays in construction. It is likely that COVID-19 may lead to delays in construction, for example, due to staff shortages or issues with the supply of materials. As well as a right for lenders to draw-stop, this may lead to an event of default for failure to achieve completion by the scheduled longstop date, either on that date or before, if a look-forward completion test has been included. Borrowers need to be careful when repeating representations for the purposes of utilization to avoid misrepresentation, for example, representations relating to project compliance, no breach of law, no default or material adverse change

The World Bank is providing $100 million to Ghana to assist the country in tackling the COVID-19 pandemic. This $100 million will be made available to the government and the people of Ghana as short, medium and long-term support. This financing package includes $35 million in emergency support to help the country provide improved response systems. Under this emergency package the World Bank will support the Government of Ghana to help prevent, detect, and respond to the COVID-19 pandemic through the Ghana Emergency Preparedness and Response Project (EPRP). The EPRP will help strengthen Ghana's National Laboratories by providing robust systems for the early detection of COVID-19 cases and providing real time disease surveillance and reporting systems of outbreaks. It will also improve response systems by providing social and financial support and free health services to COVID-19 patients and families who are isolated or quarantined. Finally, the project will focus on risk communications and community engagement for increased awareness and compliance with prevention measures engaging the Ministry of Health, Ghana Health Service, Ministry of Information and other agencies.

In addition to the emergency facility, a $65 million contingency emergency response component) was triggered from the Greater Accra Resilient and Integrated Development Project (GARID). This contingency financing will support critical activities such as laboratory equipment and chemicals essential medical equipment and supplies including test kits and personal protection equipment. The World Bank Group is rolling out a $14 billion fast-track package to strengthen the COVID-19 response in developing countries and shorten the time to recovery. The immediate response includes financing, policy advice and technical assistance to help countries cope with the health and economic impacts of the pandemic. The

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IFC is providing $8 billion in financing to help private companies affected by the pandemic and preserve jobs. IBRD and IDA are making an initial $6 billion available for the health-response. As countries need broader support, the World Bank Group will deploy up to $160 billion over 15 months to protect the poor and vulnerable, support businesses, and bolster economic recovery.

The World Bank's International Development Association (IDA), established in 1960, helps the world's poorest countries by providing grants and low to zero-interest loans for projects and programs that boost economic growth, reduce poverty, and improve poor people's lives. IDA is one of the largest sources of assistance for the world's 76 poorest countries, 39 of which are in Africa. Resources from IDA bring positive change to the 1.6 billion people who live in IDA countries. Since 1960, IDA has supported development work in 113 countries. Annual commitments have averaged about $21 billion over the last three years, with about 61 percent going to Africa.

On 11 March 2020, the World Health Organisation ("WHO") declared COVID-19 to be a pandemic, with the WHO "deeply concerned by the alarming levels of spread and severity" of the outbreak. In response, the financial markets have plummeted to levels not seen since the 1987 stock market crash. Central banks in the UK and US announced interest rate cuts, along with a string of other support measures to stabilise economies. On 14 March 2020, the United States banned travel from 26 European countries, later extending this to the United Kingdom and Ireland and countries around the world are imposing lockdowns of varying severity. The impact on global economies is only beginning to unfold and we are entering a period of prolonged economic uncertainty. The project development and finance sector is already feeling the effects. Below are some of the issues that we expect to see over the coming weeks and months, on a macro level and with respect to documentation.

2.1 Liquidity constraints

One clear risk for the procurement and financing of greenfield projects is the impact on liquidity (and its knock-on effect on pricing) in the debt markets. The 2008 financial crisis saw a dramatic fall in bank liquidity for project development, with certain banks effectively retreating from the market. With regulatory reform in the intervening years, banks should now be better able to withstand turbulence in the financial markets and governments have been swift to announce stimulus packages with the aim of averting a crisis. The United Kingdom has announced a £30 billion emergency package and the Trump administration has also unveiled a major economic stimulus plan in the United States. In the Middle East, the governments of the UAE and Saudi Arabia have unveiled measures amounting to $40 billion to fight the pandemic-induced crisis.

However, the effectiveness of these measures will largely depend on the duration of the crisis and the extent to which it can be contained within manageable proportions. One possible side-effect of this large-scale diversion of government spending is on the funding made available to export credit agencies, multilaterals and development financing institutions for projects which may, in the current climate, be seen as non-essential. At the same time, should commercial banks scale back their funding for project development, the role of these institutions in supporting the industry will be critical. During the 2008 financial crisis, the World Bank was swift to announce measures to support development in emerging markets and it has already launched a $12 billion initiative to assist developing countries in dealing with COVID-19. Clearly, the immediate priority will be supporting health and financial systems but, as the longer-term economic picture emerges, additional measures to assist project development may be needed.

3.0 EMERGING ECONOMIES

Particular attention needs to be given to the effect of the crisis on emerging economies. Interruptions to supply chains, fluctuations in exchange rates (including the impact on indexation provisions to the USD in project documentation), limited finances of governments to honour support commitments for projects impacted by the spread of COVID-19, suspension of manufacturing/worksites, travel restrictions and less welfare support availability to workers that are unable to work can have a significant effect on the progress of projects, including impacts such as costs overruns and delays. Whilst the spread of COVID-19 is well understood and reported on by health organisations, the day-to-day effect

on projects may be less clear, owing to lack of information and reporting. The availability of insurance to cover "pandemics" in the case of delay in start-up insurance should be checked.
All of these issues need to be considered by lenders and sponsors alike, as well as their counterparties, including EPC contractors, who may be coming under pressure from exposure to multiple projects impacted by the COVID-19.

3.1 Volatility in Commodity Markets

Even before the onset of COVID-19, there was significant uncertainty in the oil markets, due to the shifting balance of supply and demand, as well as regional instability in the Middle East. Added to that now is a rapid slowdown in the global aviation industry, historically one of the largest consumers of oil. In the years since the oil price fell in 2014, oil producing nations in the Gulf, for example, have increasingly focused on the development of a higher margin, downstream petrochemical industry, both at home and abroad. Yet these petrochemical developments are extremely capital intensive and necessitate a large degree of upfront cash. In a climate of prolonged economic uncertainty, investment decisions on large-scale projects of this kind may be deferred in the interests of consolidating the balance sheet.

Even for projects already at the stage of negotiating their financing arrangements, the impact of COVID-19 may shift the economic frame of reference. The price of petrochemical products is linked to the price of oil and the financial models used for the sizing of debt financing on these projects are underpinned by oil price projections and the potential influence of various downside scenarios. As well as potential manufacturing and supply chain issues (see further below), the onset of COVID-19 could result in the price of debt increasing and a reduction in debt to equity ratios. Lenders may require that project sponsors insulate projects from variability in the commodity demand and pricing environment.

3.2 Projects under Construction

As one would expect, COVID-19 has already put pressure on supply chains and the availability of labour worldwide. In China, a major source of supply for projects, the Lunar Year holiday was substantially extended, and some factories shut down at the direction of government. While Chinese businesses are beginning to show signs of "waking up" post the spike in COVID-19 cases throughout China, many plants appear to have been operating at far below their capacity due to shortages in labour force. The supply of certain equipment to projects under construction has already been disrupted and, as the impact of the virus accelerates across Europe (with France, Germany and Italy all playing a significant role in global project finance supply chains), it is possible that the effects will be amplified.

EPC contractors are already seeking to test natural force majeure definitions in construction contracts. This in turn may require borrowers to make back-to-back force majeure claims under concession agreements to avoid breaching milestone completion dates and incurring liability for liquidated damages. Where force majeure is claimed and not contested, parties should document this to avoid potential disputes later on, when anticipated delays in completion (and the associated costs) materialise. Delivery or receipt of force majeure claim notices may also trigger reporting obligations to lenders and, depending on the nature of the required remedial measures, may give rise to questions not only around compliance with completion longstop dates in the finance documents but also around forecast funding shortfalls.

3.3 Operational Projects

In existing projects, borrowers and sponsors should be cognisant of provisions in their financing documentation that might be triggered as the situation evolves. Wherever possible, these issues should be identified ahead of time, to allow an orderly discussion with lenders and waivers to be obtained in advance, so as to avoid default and cross-default issues before they arise. Various aspects of the documentation may be triggered by COVID-19 related circumstances:

Operational impairment: shortages in labour or spare parts may lead to reduced operations or, in a worst-case scenario, outages. Force majeure relief may be available under supply/offtake arrangements but this will not translate into the finance documents, where debt repayment schedules will be fixed. Certain projects, typically those in the commodity-based sectors, may contain limited provision for deferral of debt repayments, which could facilitate relief for one or two repayment dates at

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most. Otherwise, debt service reserve accounts should provide relief for around six months. Borrowers will also need to think about the availability of insurance to mitigate the impact of operational issues.

Financial ratios: projects which are exposed to demand or price risk (especially those with exposure to commodity markets or the transportation sector, which could be heavily affected by social lockdown) may suffer breaches of forward-looking financial ratios as economic projections deteriorate. Utility based projects, with long-term fixed price offtake arrangements should be relatively well insulated from these issues for now, provided their operations are unaffected. Financial ratios in such projects are often structured as historic only, based on actual data, so are not susceptible to negative forward looking projections.

Material adverse effect clauses: for projects which contain stand-alone MAE/MAC clauses, it is possible that these could be triggered by circumstances relating to COVID-19. However, the circumstances in which this could occur should be limited, since these clauses are typically drafted in such a way that they are only triggered by events directly impacting the project, rather than the wider, macro-economic or social environment. To the extent that covenants or events of default are independently triggered, material adverse effect carve-outs and qualifications will need to be reviewed. Again, assuming such provisions are drafted in customary market terms, they should only be triggered to the extent of an identifiable impact on the project.

Information undertakings: borrowers should be mindful of their obligations to notify lenders of material circumstances affecting the project, such as notices from commercial counterparties or any claim of force majeure. Such notification obligations often have very short timeframes and borrowers are at risk of being in breach of their finance documents before they are even aware that they have an obligation.

Rating downgrades: project sponsors may be subject to downgrades in their credit ratings, which could render them ineligible to provide corporate guarantees to backstop obligations in the finance documents or, alternatively, require them to cash collateralise such obligations.

Insurance exclusions: project sponsors, contractors and lenders need to carefully check project insurance policies to assess the impact if any of the COVID-19 being declared a "pandemic".

Whilst the majority of compliance issues will relate to the borrower, there will also be potential pitfalls for lenders, including:

- *Funding:* should the crisis impact on the ability of individual lenders to fund drawdowns, this could lead to defaulting lender provisions being triggered in loan documentation, unless the issue can be characterised as a disruption to the wider financial markets.
- *Voting:* skeleton staffing arrangements or absences due to sickness could lead to delays in response to voting requests, potentially causing banks to fall foul of snooze and lose provisions.
- *Agency functions:* banks which are engaged in agency roles may suffer impairment of their ability to perform administrative functions and to manage communications among the lender group.
- *Rating downgrades:* banks suffering rating downgrades may become ineligible to perform the functions of LC provider, account bank or hedge provider, or otherwise to be an "Approved Bank" for the purposes of the financing.

Due Diligence: lenders will need to consider COVID-19 and its effects as part of their due diligence review, including its effect on host government's ability to honour support commitments across multiple projects, any currency indexation provisions in the project documentation, information covenants, insurance policy exclusions, ability of project counterparties to perform their obligations where multiple projects they may be exposed to are affected by COVID-19 and assessment of levels of sponsor support required to cover potential cost overruns and delays.

The circumstances arising from COVID-19 are unprecedented in modern times and it can be expected that the situation will evolve rapidly. King & Spalding continues to monitor developments and their potential impact on the project financing industry, so as to help our clients in navigating these difficult times. The emergence of the COVID-19 coronavirus is already disrupting the project development and finance market in profound ways. Supply chains have been interrupted as workforces are furloughed, leading to cascading series of delays. This has been most immediately felt in early- and intermediate-stage manufacturing processes of components that are eventually integrated into a wide range of energy, infrastructure, and industrial projects. Disputes will inevitably arise surrounding the interpretation of existing contractual provisions and applicable statutory and equitable principles of law in light of the current outbreak. (For example, see Mayer Brown's recent Legal Update, "Force Majeure With Chinese Characteristics.")

The more lasting impact of COVID-19, however, will be a fundamental rethinking of how project development and finance documents deal with future outbreaks. Indeed, even if the emergence of a coronavirus strain of this severity ends up only being a once-in-a-generation-type event, there are early indications that COVID-19 may be a new type of seasonal malady; the "flu and cold" season may become the "flu and cold and COVID-19 season." If so, the disruptions we are witnessing now may, on some level, become a new normal. This has understandably injected concern throughout the project development and finance market. This Legal Update provides an overview of some of the key contractual considerations in project development and finance documents that are potentially ripe for rethinking in light of COVID-19.

4.0 CURRENT CONTRACTUAL TOOLS IN PROJECT DEVELOPMENT

Project development documents are the full suite of agreements signed between an owner of a project and its counterparties with respect to, inter alia, the design, procurement and equipment supply, construction and operation of a project. Many of these documents do not typically contain detailed provisions relating to pandemics, epidemics, or other disease-related outbreaks. This is particularly true of equipment supply contracts, which are precisely those that are being hardest hit by COVID-19.

The most relevant provisions in such contracts are usually those which relate to "force majeure" and/or "excusable events." These types of clauses generally allow the affected party relief from the performance of its obligations to the extent a specified event occurs and hinders such performance. There are several key considerations in how these clauses work, including (1) what constitutes an excusable event, (2) what impact such event must have on the affected party, (3) what steps the affected party must take to claim such event, (4) what types of relief are offered to the affected party, and (5) the extent to which a party may terminate a contract for an extended occurrence of such event. COVID-19 has the potential to impact each of these areas in fundamental ways.

4.1 Definitions

As mentioned, many project documents contain no express reference to disease-related outbreaks, and those that do often use generic terms like "epidemic" and/or "quarantine" without defining these terms with any specificity. This leaves open several key questions: What defines the occurrence of an epidemic vs. a mere "outbreak"? Do quarantines need to be mandatory declarations by government authorities or do they cover voluntary actions by private parties (or something in between)? Affected parties whose contracts do not expressly reference disease-related outbreaks (or only do so in vague terms) can face a difficult path to making a claim.

The same is true for parties with generic force majeure standards relating to any unforeseeable event outside of the control of the affected party. COVID-19 is likely to lead to some level of claim under such generic standards, but it is not clear exactly what related impacts are seen as direct and material versus incidental. Common law-type doctrines such as frustration of purpose or impossibility offer little additional clarity, as these can often carry very high burdens of proof. The result is that many owners and counterparties alike are struggling in the current environment to understand the contractual impact of COVID-19. We expect that, going forward, both sides may expect and demand that disease-related outbreaks and related actions like quarantine be expressly included and defined in detail.

4.1 Impact

Negotiations on excusable event provisions often focus on the concepts of materiality and direct vs. incidental impact, which we do not expect to change as a result of COVID-19. However, one fundamental feature of current excusable event provisions is that they are overwhelmingly granted to counterparties (e.g., contractors, engineers, consultants, service providers, etc.) and not the owner itself. Owner obligations are typically those of payment, which are usually not excusable for force majeure-type events. As a result, depending on a contract's payment structure, some owner payments may become due during a shutdown caused by COVID-19 even though the counterparty's work may be at a standstill. As outbreaks become their own specified category of excused event, some owner obligations, such as fixed-date payment obligations, may be eliminated or subjected to potential excuse/delay. This type of change may, in turn, have long-term pricing implications for projects.

4.2 Procedures

One early takeaway from the COVID-19 outbreak is that there is a lack of clarity about how to handle related claims. In particular, when should such claims be made and what supporting documentation is valid? Under most current contractual formulations, affected parties typically do not notify others of claims until actual material delay or cost increase has been felt; for many owners and lenders in the COVID-19 outbreak, this has come later than desired. "Early-notice" provisions may be required in future contracts, particularly where outbreaks are known to exist and likely to spread to the affected party. Regarding supporting documentation, COVID-19 has shown that outbreaks may be pervasive but (ironically) difficult to document. This may be especially true where impact is anticipated to occur, or has resulted, from "soft shutdowns" by companies or institutions, generic governmental or quasigovernmental declarations or recommendations, or simple unavailability of needed goods. A related issue is the duty to mitigate: to the extent there are regional differences in the severity of an outbreak, it is unclear how stringently an affected party must seek alternative equipment sourcing, for example. We expect that, in the future, project documents may contain a much more significant amount of detail on what such supporting documentation should look like and how the duty to mitigate should be exercised and evidenced.

4.3 Relief

With some exceptions, most project documents take a very simplistic view of relief for parties affected by excusable events. The traditional approach for force majeure, by and large, has been binary: owners bear schedule risk stemming from such events, and contractors bear the associated costs of delay. For other specified (non-force majeure) excusable events, owners often bear both schedule and cost risk. As COVID-19 spreads and becomes a potential annual occurrence, we expect parties to take a more sophisticated approach to relief. This could be done many ways, such as through sharing of schedule and cost risk. For example, contractors may be able to get relief for only a specified percentage of certain cost and/or schedule claims. Alternatively, the concept of deductibles may become more widely used, whereby owners would bear "X" days and/or "Y" dollars' worth of documented delay above a certain threshold minimum, with contractors bearing the remainder (or vice versa). A desire for greater certainty and limitations on such claims may be driven not only by owners, but by their lenders and investors as well.

4.4 Termination

Voluntary or automatic termination for extended force majeure is often, but not always, included in project documents. While the terms of such termination can vary greatly, the middle of the market for large projects is usually that either party may terminate if there has been an excusable event occurring for six consecutive months. This type of historical precedent is not often tailored for the specifics of a project and is usually an afterthought in most negotiations. In light of COVID-19, these provisions may receive much more scrutiny. Contractors and other counterparties may seek adjustments to these provisions to account for the new reality of outbreaks. Owners (and their project lenders and investors) may want the ability to quickly move to different supplier's/service providers quickly if the contracted counterparty is unable to perform.

5.0 COVID-19 AND PROJECT FINANCE DOCUMENTATION

Project finance documentation is also typically silent on the issue of disease-related outbreaks. Lenders and investors are typically reliant on overall deal structure to capture any residual or unknown risks to the project being financed. However, there are a few key areas in these documents that are likely to receive increased scrutiny.

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5.1 Schedule Analysis, Insurance and Financial Force Majeure Provisions

A major risk element for any project is the time it takes to achieve completion. As such, schedule risk is a key area of focus of lenders, investors, and their advisors (particularly in the financial, legal, tax, technical, and insurance areas). While a certain amount of "float" is always built into project schedules, analyses will need to account for the potential of lingering and recurring COVID-19 impacts and similar outbreaks. Some project finance documents contain force majeure provisions that are relevant in connection with long-stop completion deadlines that can trigger enforcement actions. For markets that use these types of provisions, many of the same considerations discussed above for project document force majeure may also be relevant in finance documents.

A related point for lenders and investors is whether any insurance products can play a role in addressing these schedule risks. While delay in start-up and business interruption insurance policies do not typically extend coverage to disease-based outbreaks, there may be a rise in specialty insurance-like products that cover related types of delay. Whether such new insurance products play a role in future project financings or not, lenders and investors are likely to require modifications to overall deal structure to account for this new type of schedule risk.

5.2 Renewables and US Tax Incentives

Concern over schedule is likely to be particularly salient for not only owners but also lenders and investors to US renewables projects that rely on federal tax incentives, including tax credits. Such tax incentives are a critical component of the economics of the project, and they support tax equity financing that may provide the take-out for construction lenders and or early-stage investors. The full effect of COVID-19 is in some respects uncharted territory, but there are two primary issues with which project participants are already grappling.

The first relates to the IRS requirements that renewables projects start construction by the applicable statutory deadlines. Many projects seek to meet these start-of-construction deadlines under so-called "5% safe harbor" rule, which treats an owner as having started construction of a project if it has paid or incurred at least 5% of the total project costs. A special rule allows an accrual basis owner who pays costs in one year (even though the equipment will not be delivered until the following year) to treat the costs as having incurred if the owner reasonably expects delivery within three and one-half months of the payment.

Equipment supply disruptions from outbreaks such as COVID-19 threaten to delay deliveries beyond the three-and-one-half month period. Whether those disruptions affect the reasonable expectation test is a fact-based inquiry, which may depend in part on what was known about COVID-19 at the time of payment. The expectation of owners who paid costs in December of 2019 (pre-outbreak) was most likely not affected by COVID-19, but it is less clear how owners may be treated going forward in a post COVID-19 world (particularly if future annual outbreaks are anticipated).

A second issue relates to the so-called "continuity" requirement. Once construction has started, the IRS rules require that the owner maintain a continuous program of construction to completion. A "safe harbor" treats a project as satisfying the continuity requirement if the project is placed in service by the end of the fourth year after the year in which construction was started. Stoppages in construction due to COVID-19 are likely to be seen as excusable disruptions beyond the owner's control for purposes of the continuity requirement. However, they will not (under current IRS rules) toll or extend the four-year safe harbor rule, and they will not extend any statutory deadline by when a project must be placed in service. This may put significant pressure on the availability of tax credits for certain projects seeking to achieve completion near the end of the applicable deadlines. For example, a wind project that started construction in 2016 under the 5% safe harbor but has not demonstrated continuity must be placed in service by the end of 2020 to be within the safe harbor. As a result, work stoppages during 2020 could jeopardize the project's eligibility for production tax credits.

As a result of these issues, owners, lenders and investors of projects currently under construction are quite focused on the potential impact of COVID-19 on tax credits. However, it is also an open question as to how comfortable they may be taking risk on these issues in future deals, particularly in light of potential future outbreaks or annual recurrences of COVID-19. Deal structures, project documents, and overall construction timelines may need to be adjusted as a result.

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5.3 Project Covenants and Direct Agreements

By the very nature of project financings, lenders and investors are deeply involved in the details of the project documents underlying a project. Finance documents often contain customized, detailed covenants to account for project document risk areas identified during the diligence phase. In addition, security documents such as direct agreements or consents to collateral assignment often address particular areas of concern directly with the project counterparty.

As the new market for project document provisions emerges (including those on excusable events as mentioned above), these provisions will be analyzed by lenders and investors and will likely result in new covenants and direct agreement requirements. For example, lenders and investors may wish to have heightened reporting requirements relating to outbreaks and/or additional limitations on contractor remedies and termination rights in respect of such outbreaks. They may also wish for owners to have greater flexibility to procure goods and services from alternative providers. Lenders and investors are likely to play a significant role in how project documents are structured in the future to provide clarity and cost and schedule certainty around disease-related events.

5.4 Secondary Effects and the Bottom Line

The net effect of all these considerations is that, absent significant reform to project documents to address outbreak-related issues, lenders and investors may price deals with more risk and/or for longer construction schedules than would have existed but for the COVID-19 outbreak. This is likely to have an impact on base case financial models and the required capital raise for some owners. In some cases, it may determine whether certain tightly scheduled projects, or projects relying on certain safe harbor exceptions under US law, are even viable in the marketplace.

Finally, aside from the documentary issues mentioned here, COVID-19 may cause a number of secondary effects in project finance markets. Over the short term, these can include general price suppression of traditional energy sources (such as oil) that may boost some sectors but make others (such as renewables) less competitive. Labor shortages in certain markets may also impact price and schedule for completion of projects. Import or travel restrictions may hamper the free flow of goods and services. Over the medium term, COVID-19-caused recessions in major economies can also have profound impacts on the level and type of capital that is available to fund projects.

6.0 CONCLUSION

The global rise of COVID-19 is causing immediate repercussions throughout the project development and finance market. The full impact of this outbreak is currently unknown and is likely to vary greatly on a project-by-project and market-by-market basis. However, one thing is certain: the potential for future outbreaks (including potential recurrences of COVID-19) is likely to be a key risk factor for project owners, counterparties, lenders and investors for the foreseeable future. If the loan is in the construction phase and has not been fully drawn, the parties will need to consider if any events have occurred which would allow the lenders to refuse to fund a utilization. Draw-stop events typically include an event of default (or potential event of default) continuing; misrepresentation; the occurrence of or a forecast funding shortfall; and delays in construction. It is likely that COVID-19 may lead to delays in construction, for example, due to staff shortages or issues with the supply of materials. As well as a right for lenders to draw-stop, this may lead to an event of default for failure to achieve completion by the scheduled longstop date, either on that date or before, if a look-forward completion test has been included.

6.1 The Events of Default Trigger

Borrowers need to be careful when repeating representations for the purposes of utilization to avoid misrepresentation, for example, representations relating to project compliance, no breach of law, no default or material adverse change. Aside from the completion delay event of default referred to above, there are a number of other events of default which could be triggered as a result of the COVID-19 outbreak. Many of these events will extend to the “Major Project Parties,” those parties which are fundamental to the successful performance of the project, including the construction contractor, operator, main suppliers and offtakers. These include:

Non-payment: If a project is in the operations phase, principal and interest payments are likely to be due every 3 or 6 months. Revenues for many operating projects are likely to be impacted by COVID-19. Lenders might argue that the likelihood of being unable to meet a payment known in advance is an indicator of insolvency or a potential event of default, but facility agreements typically give borrowers the benefit of the doubt until the payment default actually occurs – there is always the chance of an improvement in liquidity which means that when the time comes, the payment is made. One of the challenges with project financing is that the ability to introduce new money or bring about measures to ease short-term cash flow issues may be constrained by restrictions in the finance documents.

Financial covenants: Project finance documents include financial covenants to assess the ability of the project company to service its debt, often on a backwards-looking and forwards-looking basis. If set correctly, financial covenants will indicate early signs that a project is not performing as planned. A reduction of revenue is likely to negatively affect compliance with financial covenants leading to either an event of default of a distribution lock-up. If there is no specific provision for testing at the request of the agent on unscheduled dates, lenders will need to wait for a scheduled calculation date (coinciding with repayment dates) to assess performance. Some project finance facilities allow for equity cures if financial covenants are breached – this is a contractual right for further equity to be injected into the project to count as additional revenue or to prepay some of the debt.

Cessation or suspension of business: A suspension of all a material part of its business usually constitutes an event of default. This may extend to major project parties.

Project document events: Project finance facility agreements typically include events of default for matters occurring in respect of the project documents, for example, repudiation of project documents or non-compliance by the counterparty to a project document where this is likely to have a material adverse effect (see below).

Breach of laws: If government advice on business conduct during a pandemic or epidemic is mandatory and is not followed, this may trigger an event of default or a misrepresentation. However, where restrictions are imposed on a project as a result in a change in law, borrowers may be entitled to claim compensation or relief under the project concession agreement, which will require careful analysis.

Cross default: The project company is unlikely to have any other financial indebtedness, but Major Project Parties will. Default in respect of that indebtedness may impact on their ability to comply with their obligations under the project documents to which they are party.

Material Adverse Effect (MAE): The outbreak of COVID-19 has brought with it much talk of triggering material adverse change or material adverse effect provisions in loan agreements. Whether a material adverse change event of default will be triggered will depend on the drafting in each case. The fact that a party is located in, or is trading to, an area which is affected by the outbreak would not of itself constitute a material adverse change in its financial condition (although, depending on the surrounding facts, it might have a material adverse change in its prospects). However, if a borrower experiences financial difficulties as a consequence of the outbreak, then that deterioration in financial condition could constitute a material adverse change in its financial condition. It has been held that for an event to be material it must (a) not be temporary and (b) significantly affect the party's ability to perform its obligations under the contract. To establish a material adverse change is inevitably going to be a highly subjective process involving careful consideration of the drafting and surrounding circumstances. It is often much easier to rely upon and enforce the more specific contractual provisions mentioned above than to argue that a material adverse change has occurred.

Insolvency: In a worst case scenario, a borrower may trigger the insolvency events of default

7.0 RECOMMENDATION TO PROJECTIZED ORGANIZATIONS

Project companies should check their finance agreements to ensure that they continue to comply with their obligations. Even if there is no specific requirement to inform the lenders, they should consider opening communication channels early if issues are foreseen or arise. If they have not already done so, project companies should liaise with their project document counterparties to identify potential issues and agree how to deal with them. Parties should consider whether the project insurance covers any delay in construction or business interruption as a result of the outbreak. However, these policies will usually respond in limited circumstances, where there has been physical damage to the project, so policies should be checked carefully, and advice from insurance advisors sought, to ascertain the level of cover these provide.

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