Practitioner's perpective

Financing mining

The financing of mining infrastructure can be tricky. Jo Daniels at Baker & McKenzie explains

BAKER & McKENZIE

Brisbane

T: +61 3 9617 4354
F: +61 2 9225 1595

Email: Jo.Daniels@bakermckenzie.com

Jo Daniels

New mining projects, often located in remote regions, need infrastructure to transport commodities from mines to ports to sell to export markets. This "pit to port" infrastructure, which is usually rail, tends to be the most costly part of the ancilliary infrastructure such as power and water treatment plants, airports, mining camps and roads, that a project requires.

Examples of projects with such infrastructure include that in the Galilee Basin in Australia, where the project proponents include the Adani Group, and the Benga coal mine in Mozambique, which an Indian investment company, International Coal Ventures, recently purchased from Rio Tinto.

Debt is essential for pit to port projects. As appetite for risk has reduced since the financial crisis, banks tend to contribute less to the project cost and have reduced loan terms from 20 years to around five to seven years thus placing the refinancing risk on the project sponsor. Debt may take the form of loans sourced from domestic and international debt markets, secondary (mezzanine) finance from parties seeking to secure offtake or by issuing bonds on a stock exchange.

Project sponsors also require equity financing. This could take the form of private investment into the project (for example, a party seeking to secure offtake), sovereign wealth funds, equity from major contractors, listing on the relevant stock exchange, or from export credit agencies.

To secure finance, project sponsors must show that project risks are manageable. Financiers who have different risk appetites will consider the risks against the prospective return. The required return will vary greatly between projects and financiers.

Some of the key risks and considerations of financiers in assessing pit to port projects are set out below.

Separate financings: Private projects more commonly have separate financings of the mine and infrastructure (as in the Simandou iron ore project in Guinea), or of the mine, rail and port projects. This involves particular challenges.

The first challenge is the natural tension between the financings as to where the returns are made. For example, an increase in return on the railway means a decrease in the profit available to the mine. Therefore, debt and equity financiers will have strong views on the structure and amount of the tariffs to be paid for rail and port services.

Separate financings also heighten the focus on structuring contractual agreements to ensure the seamless operation of the entire supply chain for maximization of throughput. Where there is only one project, supply chain issues are internalized. However, where there are separate financings there can be an incentive for the rail operator, port operator or the mine to make decisions that may not necessarily be in the whole supply chain's interests.

Common user infrastructure: A project proponent typically builds infrastructure almost solely for its use, as in the BHP Billiton and Rio Tinto railways in the Pilbara region of Australia. However, the economics of railways prompt most new projects to have in place a number of foundation customers. While this generally diversifies risks for the financiers, having a number of different users of the railway and port leads to issues of discrimination among users, such as who gets priority when there is a shortfall of capacity and who pays for any expansion required.

Legislation that mandates third party access to infrastructure can increase risks. For example, in Australia any third party may seek to have an asset that has been built "declared" to be subject to third party access. Once declared a regulator can decide the key terms and conditions for third party access, including the price. Such regulation can be avoided by putting in place contractual arrangements that allow for open access.

Sovereign risk: Financiers routinely assess the sovereign risks of a project. These include changes in law or government, the risk of regulation, resource or infrastructure nationalism and, in some instances, war. Governments may impose tax or seek increases in royalty, restrict foreign ownership, and impose unreasonable environmental and employment obligations. In cross-border projects, inter-governmental relationships and revenue sharing arrangements are considered.

Security: Financiers require safeguards to secure their return on investment. Construction will be secured by security over the assets of a project. Special purpose vehicles are ring-fenced to prevent liability passing to the parent company, which is typically hesitant to guarantee the obligations of the project vehicle. This is a key issue for financiers. Revenue may be secured through offtake arrangements with bankable offtakers, usually in the form of take-or-pay obligations.

The separate financing of aspects of new mining projects and associated infrastructure has benefits but also challenges. Project proponents and financiers need to carefully consider the extent of separate financings and where there is separate financing, understand the challenges of ensuring the supply chain operates as a whole.

Jo Daniels is a partner in the Brisbane office of Baker & McKenzie.