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Australian Government
Productivity Commission

By Email

Dear Sirs

Australia's Export Credit Arrangements - Public Inquiry

Allens Arthur Robinson (***Allens***) is pleased to make this submission to the Australian Productivity Commission (***APC***) for the purposes of the Public Inquiry into Australia's Export Credit Arrangements (***Inquiry***).

In making this submission we have reviewed both the submission made by the Export Finance and Insurance Corporation (***EFIC***) and the draft findings and recommendations made by the APC in respect of the Inquiry.

Background

Allens is a leading international law firm, with more than 800 lawyers, including 189 partners. We have staff on the ground in 15 cities and nine countries across Greater China, South East Asia, Mongolia and Australia. Allens has one of the most extensive legal networks in the Asia Pacific region and we are one of few law firms that offers a comprehensive presence in both Australia and Asia, including through strategic alliances and strong connections with firms in Japan and Korea.

Our project finance team have acted on multiple project and export credit financings both locally and abroad. We have been consistently recognised as the leading Australian firm for project finance (for the seventh consecutive year) by Dealogic, as well as ranking sixth place, worldwide, in Infrastructure Journal's 2010 Top Ten Global Legal Advisers in Project Finance (the only Australian firm to be included in the global top ten). We have acted on a range of landmark projects for a variety of sponsors, project companies, governments and financiers.

Allens is well known for its representation of major financiers and our team also has extensive experience working with export credit agencies (***ECAs***), including Japan Bank for International Cooperation (JBIC), The Export-Import Bank of Korea (KEXIM), Korea Trade Insurance Corporation (K-Sure), The Export-Import Bank of China (China Eximbank) and China Export & Credit Insurance Corporation (Sinosure), Nippon Export and Investment Insurance (NEXI) and EFIC. We also have one of the country's leading banking and finance practices and act for the majority of the leading Australian commercial banks.

Our firm also has a leading global resources practice, based on a long history of working on many of the most significant resource projects and transactions in Australia and the

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Asian region. More recently, our work has taken us to jurisdictions as diverse as India, Mongolia, Brazil and Guinea. Our role as key advisers to many of the world's largest resources groups, such as Rio Tinto, has placed us at the cutting edge of developments in the energy and natural resources sectors in particular.

We believe that this combination of experience in both the project/export finance sector as well as the commercial banking sector and energy and resources sectors, means that we are well placed to understand the difficulties generally faced by borrowers in today's constrained credit environment and the critical role which is increasingly being played by ECAs in general, and EFIC in particular, in major project financings, both locally and overseas.

Our submission

Our submission responds to a number of the draft findings and recommendations made in the APC draft report, as specifically set out below. In making these submissions we have been mindful of the need to comment only on those areas where we believe that our experience is directly relevant, so that we can comment on these issues in an informed and meaningful way.

Draft Finding 3.1 – Most products offered by EFIC are also offered by the private sector. The price and conditions of provision may differ.

In our experience not all of the key products offered by EFIC are not always offered by the private sector. This has increasingly become the case as bank liquidity has tightened in response to increasing global economic uncertainty. The impending Basel III regulatory reforms are also likely to impact this situation further by requiring commercial banks to set aside additional capital for long term maturities which may in turn discourage them from participating in medium to long term project financings and in ECA guaranteed medium to long term export credits.

"Basel III I think is a game changer, what you are seeing now is that banks have to put too much capital against the loans…..Also, you have liquidity issues for the banks themselves, and treasurers are making sure the cost of the liquidity that they raise is passed on to the term lending."[1]

A significant consideration is also complexity and volume. Historically Australia has had large volume transactions and we believe that the large infrastructure and oil and gas projects in the pipeline in Australia, coupled with the ever increasing size of major project financings in general, both in Australia and overseas, may continue to stretch the liquidity of the commercial banking market. For example, we understand that the $US34 billion Ichthys liquefied natural gas project in Western Australia is currently seeking to raise US$20 billion in project financing for a 16 year tenor and the view of the market appears to be that this alone may have a significant impact on bank liquidity, before taking current market conditions into account.

"The debt raising would severely test bank liquidity even under normal market conditions, bankers say.[2]*"*

[1] *Steve Rankine, Executive Director of Infrastructure Debt with Hastings, as quoted in Basis Point Magazine [March Edition 2012]*

[2] *Basis Point Magazine Issue 965 February 2012, p 9*

Another striking example is the Australia Pacific LNG project, which is reported[3] to be seeking to raise US$8.6bn of long term project finance, and was only able to obtain commercial bank commitments in a total of US$2.65bn. The report states that the balance of the debt funds will be provided by two ECAs (US ExImbank and China ExImbank).

A further consideration is the location of projects being financed. As noted below, project financing of large scale projects in emerging countries has become increasingly difficult or impossible to secure without ECA participation, given the accompanying political risks in particular. In our experience, it is extremely rare to find commercial banks or private credit insurers willing to provide loans or political risk coverage to projects in these markets other than on a short term basis and the capacity of local lenders is generally extremely limited. Given that many of the countries concerned are in the Asia Pacific region, ensuring their funding and ongoing development is obviously critical for Australia's continuing economic growth and promotion of Australia's export industries, many of which are already suffering due to the unprecedented strength of the Australian dollar. Obviously one of EFIC's key mandates is, and in our view should continue to be, supporting these exporters (via the provision of export tied funding and political risk coverage) who may otherwise be significantly disadvantaged when competing with market participants from other countries who do have ECA support.

The above issue should also be considered within the context of the many emerging countries in Africa which, due to its extensive and largely untapped natural resources is an increasingly obvious and important destination for Australian investment. Once again however, securing financing for such investment remains difficult due to the political risks associated with investing in many of these countries and the involvement of ECAs, in securing such financing will therefore be critical. To the extent that such projects involve Australian corporate sponsors, EFIC support will in our view remain critical to the overall ability of such projects to attract financing.

As noted above, we have been an active advisor in this market for many years now and can observe that the size and complexity of international project financings has increased quite dramatically in recent years. The result is that the sponsors of these projects are finding it increasingly difficult to source the requisite levels of funding without ECA or other multi lateral agency (***MLA***) or development finance institution (***DFI***) support. Such support can take the form of political risk and other insurance, covered or direct lending however in our experience it is increasingly rare to see large project financings which do not have some or both of these types of support.

Draft Finding 4.1 – There can be sound commercial reasons why private providers do not offer some products or do not cover some types of applicants – in which case there is not a market failure

Whilst this is undoubtedly true in many instances, we have observed that following the global financial crisis it has become more difficult for borrowers to secure project financing of large scale projects, particularly those in emerging countries where the perception of political risk in particular remains high and the willingness of lenders to rely on project revenues for repayment is correspondingly low. This difficulty has compounded following the eurozone crisis which appears to have triggered further reductions in risk appetite and credit availability.

[3] *Project Finance International* 7 March 2012, p25.

In addition to the above, the amount of time and resources generally required to negotiate a complex variety of accompanying commercial issues in concluding financing arrangements for these projects also needs to be taken into account.

In our experience, the combination of these factors has meant that commercial lenders have been less willing to become involved in some of these financings and in many instances not willing to become involved in them at all, without ECA or other MLA or DFI support. In referring to "support" we mean not only the provision of financial support or insurance coverage for a project but also support in assessing the various project and country risks and then determining how such risks may be best accommodated within project financing structures. In our experience, EFIC, like many of its international ECA counterparts, has been a valuable source of such support in many of these project financings, without which such financings may not have been successfully concluded. In our view, the recent and tremendous economic growth of China is an excellent example of the power of ECA and MLA participation. It was not so long ago that many commercial lenders were unwilling to finance projects in China without ECA and MLA support because of the associated political risks. Australia has of course since become a key beneficiary of China's remarkable economic development, which in our view could not have been achieved without the extensive ECA and MLA support it has received.

Finally, we note that we have started to see an increase in the number of major project financings (including in Australia) where the commercial terms are largely agreed with ECAs prior to any commercial bank involvement. We believe that this in itself is evidence of the reliance commercial lenders are increasingly placing on ECA support of the type referred to above, as well as an acknowledgement of the timing and complexity issues also referred to above,

Draft finding 5.2 – The decline in provision of trade finance during the global financial crisis was primarily due to lower demand for traded products. As such, government policy aimed at addressing the decline through the provision of export finance and insurance would not have been successful

This is highly speculative. Certainly in our experience there was a dramatic credit and liquidity squeeze, resulting in higher charges (in turn discouraging new business) and the rationing of credit across the board. We think it would be difficult to rule its impact out.

Draft finding 6.1 – The concept of the market gap can cover circumstances where there is no market failure that would warrant EFIC support.

Please refer to our comments in relation to draft findings 3.1 and 4.1 above. We consider that there is substantial evidence to support the view that there are market gaps which currently warrant EFIC and other ECA support and in relation to which there is a current perception of significant market limitations.

Draft finding 6.2 – EFIC is likely to be crowding out private sector provision of export finance and insurance. At present EFIC's relatively small size limits the economy wide consequences of this. Some transactions are of sufficient size to pose a non trivial financial risk to the Commonwealth

Please refer to our comments in relation to draft findings 3.1 and 4.1 above. We have seen no evidence of crowding out, and the bankers we deal with welcome EFIC's involvement as a co-financier, eg helping export infrastructure projects (such as Wiggins island Coal Export Terminal) obtain finance in these constrained times. We consider that there is substantial evidence to support the view that there are limitations on private sector provision of export finance and insurance which therefore warrant EFIC and other ECA support. While we agree with the finding that EFIC's relatively small size limits the economy wide consequences of any perceived "crowding out" (and refer to our comments made above regarding the extremely large size of many current and projected financings in relation to which EFIC support may be sought) we suggest the limits are too small and hinder EFIC's ability to play a constructive role.

Information Request – The Commission is requesting additional information from participants on evidence of EFIC's cost effectiveness and operational efficiency, with reference where possible to comparable financial institutions

We are unable to comment as to EFIC's cost efficiency on a comparable basis however having worked on various transactions involving EFIC and various other ECAs, MLAs, DFIs and commercial financial institutions we would comment that EFIC has in our experience an operational efficiency which is at least equivalent to similar other institutions and we have observed that its participation in the transactions in which we have been involved has, in general, been regarded as being very worthwhile indeed. The personnel with whom we have dealt have been knowledgeable, experienced and generally of high calibre. Many have a background in banking and have a very strong understanding of how large and complex project financings are put together, and of where the key risks lie.

Draft recommendation 10.1 – EFIC's support for onshore resource projects should cease, as there is no clear market failure affecting access to finance for these projects. A direction to this effect should be issued by the Minister for Trade as soon as possible.

We refer to our comments in relation to draft findings 3.1 and 4.1 above. In view of the size and complexity of many of the onshore resources projects, especially rail and port export infrastructure, currently planned for Australia we consider that the available evidence suggests that the commercial bank market has neither the appetite nor the requisite levels of liquidity to project finance these projects without considerable ECA support.

"But volume is what will put pressure on the margins. Historically Australia has had large volume transactions…..Where we see the challenge is the large project financings being talked about, especially in Australia, which will really stretch the liquidity of the banking market."[4]

In providing such support ECAs may in turn look to ensure that there is sufficient evidence of in country backing for these projects and EFIC involvement is likely to be one of the indicators of such backing that those ECAs will expect to see.

Although we are not suggesting that it will be necessary that EFIC be involved in every one of these projects we do consider that they should remain able to participate in them to the extent that there is a proven need for them to do so and of course that their own internal requirements in doing so are met. The risk caused by placing a blanket prohibition on such involvement is of course that such prohibition may have unintended consequences, including any legitimate need for EFIC involvement being rendered impossible, so negatively impacting the overall ability of the project to

[4] *Kevin Salerno, Head of Institutional Loan Markets, Commonwealth Bank of Australia, as quoted in Basic Point Magazine Issue 965 February 2012*

obtain the necessary financing and sending a negative message to the financing market for these onshore projects in general. In this respect we believe it is critical to understand the role that EFIC inevitably plays, both directly and indirectly, in facilitating the investment of foreign capital in Australia (notably via other ECAs) and the possibility that such ongoing investment may be negatively impacted by any restrictions on EFIC's ability to provide support to both Australian projects or Australian sponsored projects overseas.

A preferable approach to recommending a prohibition on EFIC involvement in onshore projects may be to recommend certain minimum criteria that these projects must meet in order to qualify for EFIC support.

Draft recommendation 10.3 – Amendments to the Export Finance and Insurance Corporation Act 1991 should be made to (inter alia) reorient EFIC's objective to addressing information related market failures in financial markets affecting newly exporting SMEs seeking access to export finance;

This recommendation, by definition, appears to assume that that the commercial market is able to, and will, finance all of the other activities in which EFIC is currently engaged. These activities include a variety of Australian projects which have presumably generated substantial employment and long term export revenue streams for the country as well as significant economic and social improvements for those emerging countries in which many of them have been implemented. For the reasons set out in our submissions regarding findings 3.1 and 4.1 we do not believe that this assumption is supported by current market activity, nor that the situation will improve in the immediate future. We also refer to our comments made in relation to draft recommendation 10.1 above, and note again the impact that any significant curtailing of EFIC participation in non SME projects may have on ECA investment in both Australian major projects and Australian sponsored projects overseas, in particular those taking place in the energy and resources industries.

Conclusion

In our view EFIC is severely constrained in comparison to other major ECAs by:

- its limited mandate;
- its limited ability to engage in direct lending (guarantee support is far less efficient, as capital adequacy costs are high and bank balance sheets tight); and
- the relatively low limit on its ability to support large projects.

If these restrictions were removed or relaxed, Australia's AAA credit rating could be used to help eliminate export bottlenecks and generally provide Australian business with a more level playing field.

To sum up, in our experience EFIC has played, and is continuing to play, an important role in:

- providing finance to large export orientated infrastructure projects, helping to fill the gap left by the exodus of overseas banks and general post GFC liquidity constraints in the Australian finance markets, as well as the overall negative impact of steadily more restrictive capital adequacy and liquidity requirements under the Basel rules; and
- providing reassurance to other ECAs in taking the lead in analysing the risks of export projects in Australia and new projects with substantial Australian involvement in our less developed country neighbours like PNG and Timor Leste.

To our knowledge the banks and financial institutions active in this region do not resent EFIC's activities nor complain of being crowded out; quite the opposite, they welcome EFIC's involvement in helping to get important infrastructure and export infrastructure transactions financed.

Accordingly, we are of the view that rather than winding back its operations, EFIC should be encouraged and empowered to engage in financings which serve the national interest, including by filling market gaps, and be free to structure its participation in the most efficient way to achieve those objectives.

Yours faithfully

Allens Arthur Robinson