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The end of LIBOR: The search for a new benchmark interest rate for Project Agreements

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Often referred to as “the world’s most important number”, the London Interbank Offered Rate (LIBOR) is used as the reference interest rate for a range of commercial and financial contracts worth hundreds of trillions of dollars globally.

Partly as a consequence of the changing nature of financial markets, and partly as a response to high profile rate-rigging scandals, the UK’s Financial Conduct Authority announced in 2017 that it did not expect LIBOR to remain as an acceptable benchmark for the setting of interest rates beyond 2021.

Industry bodies and regulators around the world are now exploring market-wide solutions for a future without LIBOR. Some markets have started to move away from LIBOR. In June 2019, the UK’s biggest port operator ABP used the “sterling overnight interbank average rate” (SONIA), to switch £65 million of debt to a new rate. This was regarded as a significant test case. However, most markets have been more risk-averse and await a broader consensus on a replacement benchmark.

Clearly, LIBOR is a key feature of facility agreements and other finance contracts. Practitioners have for some time been addressing the issue of LIBOR and its imminent demise. However, as participants in the project finance sector will be aware, LIBOR is also used in a wide range of project agreements – concession agreements, construction contracts, operation and maintenance contracts and more. Many of these contracts have a term which will extend long after the anticipated end date of LIBOR. In this briefing, we provide an overview of the use of LIBOR in these project agreements and the extent to which parties can “future-proof” their contracts for life after LIBOR.

What is LIBOR?

LIBOR is an interest rate average calculated from estimates submitted by a panel of leading banks in London. Each bank submits a notional interest rate to reflect the interest rate that it would be charged to borrow from other banks. In reaching a conclusion, each bank will refer to

available transaction data and its own expert judgement. LIBOR was established in 1986 to enable banks to set objective, credible interest rates for corporate loans. Since then, the use of LIBOR as a "base" interest rate has extended to trillions of dollars of financial and commercial contracts around the world.

The credibility of LIBOR has been severely eroded in recent years. The method of calculation has certain highly subjective features: each bank is **estimating** how much it **might** be charged to borrow. In addition, the process for determining LIBOR was not subject to any significant degree of government supervision. As a result, the system was prone to manipulation.

Allegations of widespread rate-rigging first came to light in 2008, when it transpired that banks were falsely inflating or deflating their rates to profit from trades or to give the impression that they were more creditworthy than was actually the case. Over a dozen banks have incurred fines running into billions of dollars. For these reasons, a key feature of any replacement benchmark will be that it will be based on actual trading, rather than hypothetical quotes provided by individual banks.

Use in Project Documents

The primary use of LIBOR in project documents is to provide a rate of interest which applies in the event of late payment. The rate is also used to calculate liability for financing charges payable by one party to another. Although originating from the London market, LIBOR's popularity and resulting widespread use is because it has historically been regarded as "neutral" or objective. As a result, it is often favoured by international participants in cross-border projects (instead of rates linked to local or commercial banks).

Medium or long term project agreements which utilise LIBOR, including concession agreements and operation and maintenance contracts, will therefore be affected by the anticipated end date for LIBOR. However, we are also at a point in time where the replacement of LIBOR may be relevant for shorter-term contracts, such as EPC and other construction contracts. Projects which are now coming to market will have a period to reach financial close and then a construction and defects period of 2 to 3 years and more. All project participants should therefore now be considering how to address the end of LIBOR in their contracts.

New Contracts

There are two inherent difficulties in making provisions in project agreements for the replacement of LIBOR. The first is that it is still far from clear as to what the generally accepted replacement benchmark will be. ABP's decision to use SONIA may gain traction but it is too early to say for sure. The second is that the timing of the replacement is still uncertain. On that basis, any replacement wording for LIBOR necessarily has to be drafted in broad terms.

A fairly straightforward solution is to include a right for the sponsors (or the government, owner etc.) to nominate a suitable alternative rate, at the time that LIBOR is replaced. This

degree of flexibility is helpful given the uncertainties of the nature and the timing of the replacement.

If that position cannot be agreed on (as the counterparty to the contract may not accept the other party having a unilateral right to nominate the replacement rate), the parties could also consider a “tiered” procedure for determining an alternative benchmark. This could include: (i) mutual agreement by the parties (noting that an agreement to agree is unenforceable under English law), (ii) in the absence of agreement, a benchmark rate formally designated or recommended by a successor administration of LIBOR, and (iii) where the first two alternatives have failed, nomination by the sponsors (or the government, owner etc.) of an appropriate rate. Although this “tiered” procedure casts a fairly wide net, it provides a helpful mechanism for the parties to incorporate a replacement benchmark interest rate as the market moves towards a consensus as to the appropriate replacement rate for LIBOR.

Existing Contracts

One additional point to consider is that there are a significant number of project agreements in existence which incorporate LIBOR, but do not contemplate its replacement. For the parties to these agreements, the best course of action for now may be to do nothing at this stage but instead to monitor the approach being taken by the market. The advantage of this approach is that once the preferred replacement rate for LIBOR has been established the parties will be in a position to evaluate more accurately the effect of that replacement rate on the risk profile of their contracts.