Corporate governance

1.16 If a project company is organized under local law, which is frequently a requirement of host governments, the investors and lenders will need to assess the governance flexibility afforded to them by that law. Of key relevance to investors is to ensure that the ability of the company to distribute profits to shareholders is not unduly constrained by corporate law and local accounting practices. If it is, they may find it preferable to fund the company with debt instruments rather than equity.

1.17 Among the other issues to be considered are whether shareholders benefit from limitations on their individual liability for the obligations of the project company, whether the rights of minority shareholders will be respected, and whether agreed voting, share transfer restrictions, or pre-emption rights, and the like, set out in an agreement among the shareholders will be given effect under local law. It will also be important to the investors that their appointed directors retain the right to direct the company and its management on key issues. This is of particular concern where international investors are in joint venture with local investors or an entity affiliated with the host government.

Industrial regulation

1.18 Many projects operate in regulated industries. The vast majority of countries, whatever their level of economic and political development, impose regulatory oversight on their public utilities (power, water, and telecommunications), transportation and other infrastructure sectors.[6] Many also view their resource extraction industries to be of material importance and extend regulation to them as well. Regulation can encompass a licensing regime, under which permission to operate is granted to specified companies or classes of companies. Licences or concessions (being in effect a more complicated licence, often including undertakings by the host state) may be granted on an application basis, following individual negotiations or on the basis of a competitive tender involving pre-qualified bidders. Regulation may (and often does) extend further to specify the manner in which a project company is to operate and, in many cases, the price it may charge for its services or output.

1.19 Regulation is thus not unusual, but the manner in which it is imposed can vary significantly. For most projects, the analysis of the regulatory environment encompasses two inquiries: (i) what rights are granted to, and what obligations are imposed on, the project company; and (ii) what risk is there that the regulatory regime will change over time to the detriment of the project company or its investors and lenders.

[6] For a discussion of how lenders to the early independent power projects in the United States assessed regulatory risk, see P. Fletcher and J. Worenklein, 'Regulatory Considerations in the Project Financing of an Independent Power Production Facility' 8(4) *Journal of Energy & Natural Resources Law* (1990).

1.20 Where the regulatory regime is established as a matter of statutory law, project finance lawyers must review the relevant legislation and regulations carefully, in close consultation with local lawyers. Where those laws are comprehensive and clear, certainty as to the scope of the regulatory regime can be achieved, but there will remain the risk that the regime may evolve over time; it is an accepted prerogative of sovereign states to change their domestic laws.

1.21 In circumstances where there is an absence of regulation of general application, or where there is significant uncertainty as to the stability of the regulatory regime, it may be appropriate for the host state to enter into direct undertakings with the project company and, in some cases, its principal investors, to set out specific investor protections. The scope of these will vary significantly depending on the extent of investor and lender concern as to the reliability of the host state's investment regime.[7] The nature of the governmental commitment may vary from providing legally binding undertakings, a breach of which may entitle the investor or lender to specific damages, to mere 'comfort letters', which may afford little, if any, certainty of remedy.

1.22 The host government might also seek reciprocal undertakings from the project company, including commitments to provide adequate service during the term of the agreement; observe relevant safety and environmental standards; sell its output at reasonable prices; and, particularly where the project company is under an obligation to transfer its assets to the host state at the conclusion of the concession period, to carry out prudent maintenance and repairs so that at the end of the term the government or state-owned entity will acquire a fully operational project. There may be specific penalties or termination rights arising by reason of breach of these undertakings. These agreements also often include a recognition of the role of lenders, including express notice, cure, and 'step-in' rights.

1.23 The commitments of host governments are often implemented into national law through some form of enabling legislation, allowing greater certainty that the relevant undertakings will take precedence over competing, and often inconsistent, laws and regulations. In other cases they are entered into in the form of bilateral contracts that may, again, take precedence over competing legislation. In both cases, it is important to ensure that they were validly entered into and were within the legal competence of the granting authority. Although on its face there is much to suggest that a bespoke, bilateral contract is more likely to be certain and reliable than unilateral legislation of general application, this may not always be the case.

[7] For a discussion of the scope and nature of host government undertakings, see P. Fletcher and J. Welch, 'State Support in International Project Finance', *Butterworth's Journal of International Banking and Financial Law*, September, 1993.

Permitting

1.24 The construction and operation of a project generally requires the project company to secure a broad range of permits and consents. The subject matter of these range from environmental and social considerations, to land use, to health and safety, to, as noted above, industrial regulation.

1.25 The analysis of the risk arising from the need to secure permits turns, in the first instance, on identifying the consents that will be required and ensuring that they have been issued or will be issued in the ordinary course without undue expense, delay, or conditionality. The risk of permit revocation is also important, as well as a determination as to whether a secured lender, or its transferee, would be entitled to the benefit of the permits were the lender to exercise its remedies under the security documents. In many instances, the granting authority will wish to retain discretion to assess the identity and competence of the transferee, and unless the granting authority provides guidance as to what criteria it will apply in making that assessment, the lenders may be left with a degree of uncertainty.

Taxation

1.26 Virtually all projects are subject to some form of taxation, and the tax regime will generally have a significant impact on the project's economics. Most sponsors assess their return on investment on an after-tax basis, and thus consider clarity and certainty of the tax regime to be a key consideration.

1.27 In assessing the tax treatment of the project company in its host state, the following is usually considered.

Corporate taxes

1.28 The project company is likely to be subject to corporate taxes, often calculated on the basis of the profits arising to it. Occasionally, however, the tax may be calculated by reference to other factors, such as the value of the project company's assets. In some cases, as an inducement to attract foreign investment, the host government may afford the project company with a tax 'holiday' or rate concessions for at least a specified period.

1.29 Where corporate taxes are calculated by reference to profits, the project company will need to be able to deduct expenditure from the payments it receives so that it is liable to tax on its residual profit only. A significant proportion of the project company's expenditure is likely to be interest payments, which as a general rule would usually be deductible. Where the project company is excessively leveraged, however, there may be restrictions on the deductibility of interest payments under thin capitalization and transfer pricing rules.

1.30 As an additional category of deductible expenditure, the project company may be able to claim depreciation allowances for certain forms of capital outlay—for example, some or all of the cost of the relevant project's plant and machinery.

Other taxes

1.31 The project company may be required to account for value added or sales taxes on supplies of goods and services it makes. In some cases, it may be obliged to pay royalties to the host government calculated on the gross value of its sales. Stamp taxes, registration taxes, and notaries fees may also be payable on certain transaction documents. Where such taxes and fees are imposed on lending and security documents, the amount payable will often depend upon the amount borrowed or secured. In such circumstances, lenders may be asked to under-secure their loans so as to reduce the cost of the relevant tax or fee.

1.32 Subject to relief under an applicable double taxation treaty, certain jurisdictions impose taxes on overseas residents who dispose of shares in a company which is incorporated in that jurisdiction. This may be relevant to equity investors in the project company.

Withholding tax

1.33 As a general principle, the laws of the host state may require the project company to withhold tax on interest and dividend payments it makes to overseas lenders and shareholders, but relief from the withholding may be available under an applicable double taxation treaty. Where withholding tax is due on interest payments a project company makes to its lenders, the project company will usually be required to gross up those payments and compensate the lenders for the withholding.

Customs and immigration law

1.34 Whenever goods or individuals cross a border, they become subject to the laws of both the country they are leaving and the country they are entering. For projects, the concern is generally focused on the ability of the project to import into the host state key goods and equipment and to employ qualified expatriate managers, engineers, and labour. Customs restrictions may be limited to an import duty, but in some cases may extend to an absolute prohibition on imports. Immigration law may permit some limited employment of expatriates, but may also require the training and employment of local nationals. In some cases, the project company is able to negotiate exceptions to both import and immigration restrictions, but these may be subject to conditions. The other concern that may arise is that the project's revenues may be adversely affected if the target export markets impose customs duties or import restrictions on the project's production or if the host state restricts exports.

Reliability of local law and courts

1.35 Countries with well-developed laws and an established and independent judiciary are often more attractive jurisdictions for investment than countries with little clarity as to their laws or certainty as to their application.

1.36 Countries that achieved independence—and thus a distinct body of law—only recently, or who are unable to afford the cost of an extensive court system, may be at a disadvantage in attracting foreign investment. Emerging economies, in particular, may seek to address this through regional integration and the harmonization of disparate legal systems as an means of attracting foreign direct investment, eliminating barriers to cross-border trade and providing a platform to improve their chances of competing more effectively on the world stage. Integration is perhaps best developed in Europe through the European Union (EU) and European Economic Area (EEA) and is gaining momentum in other regions such as the Middle East through the Gulf Co-Operation Council (GCC) and in Eastern Africa through the East African Community (EAC). However, arguably the most ambitious legal harmonization outside of Europe is the '*Organisation pour l'Harmonisation du Droit des Affaires en Afrique*', better known through its French acronym 'OHADA'. The OHADA Treaty is not new. In fact, it will soon be entering its third decade, having been brought into force on 17 October 1993 in Port Louis, Mauritius. However, its laws have only been in effect from 1998, and it is only recently that investors have begun to take this legal harmonization seriously.

1.37 The OHADA Treaty regime establishes the supremacy and the direct effect of OHADA uniform laws. That it is ambitious is therefore obvious. Whether it is the trigger for any increase in foreign direct investment remains to be seen. However, it is at least not unattractive that a sponsor in Guinea can expect to encounter the same business laws in Benin and seek justice in the same appellate courts. This does not guarantee legal certainty, but at least it brings with it a degree of legal familiarity that can only be good for business confidence.[8]

1.38 Legal certainty will be of concern to all parties, but lenders will focus particular concern on whether local law recognizes the rights of secured creditors and whether their claims will be respected were the project company to become insolvent. Not all countries have express insolvency regimes, and the ones that do vary significantly as to the rights and preferences that they afford to secured lenders.

Changes in law

1.39 Project finance loans are generally repaid over years if not decades. Notwithstanding the initial certainty that may be achieved in assessing the host country's laws, these

[8] See also para. 12.182 et seq.

may (and in fact are likely to) change during the life of the project. Public policy evolves in virtually every country as their governments change; where regime change is frequent and policy objectives vary widely, those changes can be volatile. For example, tax rates can be subject to substantial increase as governments manage the competing demands of their spending aspirations and of their budgetary constraints. Governments have tended in recent years to impose increased environmental compliance requirements on companies subject to their jurisdiction in order to comply with new treaty and similar obligations. As their economies develop, host governments are often able to extract more favourable terms from new investors, and agreements reached at an earlier time may begin to appear unreasonable over time. Host governments may be tempted to try to bring older, less favourable, terms in line with current market standards.

1.40 In some instances, the risk of changes in law and policy can be addressed through the underlying concession agreement, where the host government agrees to freeze the application of laws to the project company or to provide compensation if those laws change. In other cases, the project's off-takers may be prepared to compensate the project company through tariff adjustments to cover increased costs arising from changes in law. At an extreme, changes in law can result in actual or 'creeping' expropriation. In some cases, investors can rely on the protections afforded by bilateral investment treaties entered into by their home jurisdictions and the host state.

Environmental and Social Considerations

1.41 The construction and operation of a project invariably have environmental and social impacts on the locality of the project. Managing these impacts may help assure the long-term acceptance of the project by affected parties. Lenders will generally require, at a minimum, the project company to undertake to comply with all environmental and social laws and regulations binding on it. They will also likely require the development of, and compliance with, an agreed environmental and social risk management plan. This is both to insulate the project company, and the lenders, from legal risk, but also to preserve the lenders' reputation as responsible parties.

1.42 Even in the absence of environmental legislation in a particular jurisdiction, national or multinational credit institutions financing a project may require compliance with World Bank or similar standards. The International Finance Corporation, for example, has implemented detailed standards defining a borrower's environmental and social responsibilities in managing its project. Areas of focus include: labour and working conditions; pollution prevention and abatement; community health, safety, and security; biodiversity conservation and sustainable natural resource management; and protection of indigenous peoples and cultural heritage. Standards such as these seek to achieve comprehensive mitigation of environmental impacts and management of the project's impact on local populations.

1.43 A large range of other financial institutions have adopted a voluntary set of guidelines, known as the Equator Principles, that call for such organizations to require compliance with guidelines similar to those of multinational lenders. As a result, virtually every large-scale project seeking access to the financial markets must evidence a high level of environmental and social compliance.[9]

Governing Law Considerations

1.44 Contracts are often quite clear in describing the terms of a transaction, but the manner in which contracts will be interpreted or enforced may differ significantly from those terms. The relevant considerations involve an analysis of: (i) the choice of law to govern the contracts; (ii) the enforceability of contracts under that law; and (iii) the choice of forum for disputes arising from the transaction, including whether judgments or awards from that forum will be enforced in each relevant jurisdiction.

Choice of law

1.45 The knowledge that the transaction is governed by the law of a familiar jurisdiction can be a source of significant comfort to investors and lenders. Choice of law questions inevitably arise in the context of negotiating finance documents and frequently involve an election between English law and New York law.[10] Because the law of each of these jurisdictions relevant to the enforceability of customary finance documents is broadly similar, any preference between the two is perhaps not as substantive as it might appear. Each has well publicized case law precedents that provide clarity as to how the law will likely be applied in specific circumstances. However, lenders may nonetheless have strong views based on familiarity with customary forms and terminology or based on a preference for submission to the courts of one or the other jurisdiction. It is worth noting that both English and New York courts will accept (subject to limited exceptions) jurisdiction to hear disputes governed by English or New York law, respectively, even where there is little connection to either jurisdiction other than the election of the parties.[11]

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[9] See also para. 4.71 et seq.

[10] For a discussion of the differences between New York and English law governed finance documentation, see R. Gray, S. Mehta, and D. East, 'Debt Repurchases: Easier with the LMA', *International Financial Law Review*, March 2010; R. Gray, S. Mehta, and D. East, 'Similar Objectives, Subtle Differences', *International Financial Law Review*, December 2009/January 2010; R. Gray, S. Mehta, and D. East, 'US and UK Compared: Fundamental Differences Remain Between the Markets', *International Financial Law Review*, October 2009; R. Gray and S. Mehta, 'The Market Disruption Clause', *International Financial Law Review*, December 2008/January 2009.

[11] In respect of New York law, see New York General Obligations Law, sections 5-1401 (*Choice of Law*) and 5-1402 (*Choice of Forum*); in respect of how an English court would treat this issue, see Article 3 of the Rome Regulation on the Law Applicable to contractual Obligations (EC 593/2008).

1.46 In relation to a range of commercial contracts, the choice of law can have particular significance. For example, parties may find attractive the ability under Article 2 of the Uniform Commercial Code as in effect in the State of New York to leave open for resolution by agreement among the parties (or absent agreement between them, through resolution by a court) key price terms in contracts for the sale of goods and certain commodities. English law, by contrast, may (subject to various exceptions) find that the contract fails for uncertainty in such circumstances.

1.47 In some circumstances, there is no real choice of law. Conflict of law principles, such as the doctrine of *lex situs* (i.e. the rule that the law applicable to proprietary aspects of an asset is the law of the jurisdiction where the asset is located), may dictate which law is to be applied in relation to certain contracts. For instance, under English conflicts of law rules, ownership of land is determined under the law of the jurisdiction where the land is located, so a contract transferring title to land in (say) France that is invalid because it does not satisfy a particular requirement of domestic French law, will not be valid even if the contract is expressed to be governed by English law and would have been perfectly valid if the land had been in England. Likewise, many governments may require the use of domestic law to govern contracts with national agencies, and in many cases may require that those contracts be written in the domestic language.

Enforceability

1.48 Not all contracts are enforceable in accordance with their terms. There may be mandatory provisions of law that override the terms of the contract. Many countries have civil or similar codes whose provisions will apply to a contract notwithstanding its terms.[12] Legal uncertainty may be pronounced when the country in which the project is located has no tradition of reported case law (making it more difficult to establish how the rules are applied by the domestic courts in practice) or where domestic law prohibits fundamental aspects of the transaction (for instance, *Sharia'a* principles preventing the enforcement of interest payments). In some cases, mandatory provisions of law will be applied by the courts even if not applicable under the express law stated to govern the contract. Thus, parties need to assess not only the terms of the relevant agreements, but also their consistency with applicable law.

Forum

1.49 The selection of a forum for any disputes heard in connection with the project has important implications such as:

(1) Will the forum be neutral in its decision-making?

[12] For analysis of the application of civil law to project financings, please see Chapter 12.

(2) What law will the chosen forum apply and will the outcome differ as a result?
(3) Which evidential or procedural rules will apply in the forum?
(4) Will judgments or awards be enforced in the home jurisdiction of the borrower or the other project parties?[13]

1.50 One important factor, when considering the choice of forum, is whether the dispute should be litigated or arbitrated. There are advantages to using the courts, particularly in jurisdictions such as England and New York, where long histories of case law precedent, established procedural laws, and unbiased judicial oversight provide comfort for sponsors and lenders that their claims will be duly upheld. In many jurisdictions, courts can compel parties to disclose facts or documents and may be able to order interim relief, such as an injunction. Further, as arbitration is a product of contract, only parties that have consented to arbitration through the contract can be compelled to proceed in that forum. Litigation may thus be necessary in a multi-party dispute in order to join an interested party that is not party to the original contract.

1.51 On the other hand, the speed and privacy of an arbitral process is a benefit, and a specially designated arbitrator may be better equipped to address complex technical issues than a more generalist judge. The parties may view an arbitral forum in a neutral foreign venue as providing certainty of an efficient and reasonable result. Moreover, an arbitral award may, in some cases, be more likely to be recognized and enforced in the relevant party's home jurisdiction without review on the merits than a foreign court judgment. International treaty arrangements, such as the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention), and regional treaty arrangements, such as the Convention on the Enforcement of Judgments, Disputes and Judicial Summonses in the Arab Gulf Co-Operation Council States (the GCC Convention), call for member states to give effect to arbitral awards made in other member states. Nonetheless, there are often sufficient exceptions to even treaty-based rules to leave open the possibility that the award may be re-opened on enforcement.

1.52 As a practical matter, lenders prefer to use the courts as they typically view arbitration as a less attractive option for disputes under finance documents. This is in part due to the perceived tendency of arbitrators to arrive at compromise positions (so-called 'rough justice'), although lenders may wish to reserve the option of arbitration to address technical issues or where arbitration may have procedural benefits in relation to enforcement of awards. Commercial contracts, on the other hand, far more frequently contemplate arbitration.

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[13] For a more detailed description of dispute settlement procedures, see Chapter 14.

Sovereign immunity

1.53 The host government and its instrumentalities may be immune from being brought before the courts of either the host state or of other sovereign countries. In addition, they may be immune from enforcement of judgments, so that even if a court or arbitral panel were to rule against them, it may not be possible to execute that judgment against their assets. This immunity is widely acknowledged as a matter of international law, but there may be exceptions to its application. For example, a state entity acting in a commercial capacity may not benefit from immunity in all circumstances, and it may be possible for a state entity to waive its rights to immunity. Many courts have sought in recent years to subject to their jurisdiction sovereigns for violation of international norms of conduct, but the scope of these decisions remain somewhat narrow and controversial.

Credit Documentation

1.54 Once the overall risk of the project has been properly profiled, the parties will need to reach agreement on the most appropriate financial structure for the deal. There are some very obvious rules at play: lower risk projects tend to have greater flexibility in their funding sources than projects facing greater risk and are thus able to secure less stringent financing terms; projects with a larger capital cost will need to integrate a broader range of lenders into their finance plan than smaller projects, with the consequent need to satisfy a broader range of credit requirements.

1.55 Project finance credit documentation is generally replete with conditions precedent to lending, representations, undertakings, and remedies designed to allow lenders to manage the underlying risks of the transaction. As those risks vary significantly across transactions, so does the manner in which they are addressed in credit agreements.

1.56 Although most lenders value the comfort provided by relying on precedent transactions, particularly given the guidance they provide as to what will be accepted in the syndication markets, there is no broad consensus on what model of credit document should be used in the industry. Neither the Loan Market Association (LMA) in London, nor the Loan Syndications and Trading Association (LSTA) in New York, the two leading inter-bank associations charged with developing standard credit documents, has sought to prescribe standard documentation for project finance transactions.

1.57 Various categories of lenders have specific and unique requirements. For example, export credit agencies may in most circumstances only lend if and to the extent that their funding is expressly applied to finance exports from their home jurisdiction. Capital markets debt can only be accessed if the project company satisfies the

requirements of rating agencies and the disclosure and other requirements of listing authorities or other security regulators. *Sharia'a*-compliant transactions must be structured to avoid any of the prohibitions imposed by Islam, including most notably the prohibition on the charging of interest on loans. These disparate and specific requirements must often be blended into a unified set of documents governing the overall transaction.

Security Packages

1.58 Project financings are in essence complex secured lending transactions. The willingness of lenders to extend long-term credit to a project may depend on the degree of comfort they take in the viability of the underlying security 'package'.

1.59 The structuring of security packages across jurisdictions and diverse assets can present numerous and unique challenges.[14] The purpose of a lender's collateral package is to enable it to deprive the borrower of the pledged assets when the loan is in default and to provide the lender with the means to defeat claims that the borrower's other creditors may seek to assert against its assets. Whether a security interest has been validly created and whether it has priority over competing interests are questions of law. As noted above, under English conflicts of law rules, proprietary aspects of an asset are determined by reference to the location of the asset on the basis of the doctrine of *lex situs*. The validity and priority of the security is thus, in most instances, governed by the law in which the charged assets are, or are deemed to be, located. Whilst the bulk of a project company's assets will for these purposes be located in the jurisdiction where its physical plant lies, its bank accounts and receivables may be (or be deemed to be) located elsewhere, as may its shares, which will, in most instances, be the jurisdiction of its incorporation.

1.60 Difficulties arise when dealing with security in jurisdictions where clear procedures for creation or perfection of security (such as registration or filing) are absent or where the enforceability of step-in rights granted to the lenders is uncertain. This may arise in, for example, Saudi Arabia, where the application of *Sharia'a* principles may adversely affect the perfection and/or enforceability of common forms of security. Similarly, lack of clarity as to which country has jurisdiction may adversely affect the certainty of security sought to be taken over satellites in space or cables laid under the sea. Lack of clarity may also arise where the domestic law lacks uniformity. In many countries, the government agency responsible for the registration of security interests varies with the type of asset (e.g. security interests over land use rights may be registered with the local land bureau, and equipment may be

[14] For a more detailed description of security packages generally, see Chapter 11.

registered with the commerce and industry bureau). The substantive and procedural requirements for creation and perfection of security interests may be far from uniform as a result of differing local government agency practices.

1.61 In other cases, the cost of filing or registering security may be significant, which sponsors may see as unduly burdensome and resist having to bear. Sponsors may argue that the practical value of security does not warrant the expense, particularly in jurisdictions with little experience of complex financings. In some cases, it may be possible to negotiate reductions in or exemptions from such costs in the underlying concession agreement or enabling legislation.

1.62 The efficacy of security interests may be overridden by the relevant insolvency regime, whether this is a court-supervised 'debtor-in-possession' regime (as in the US) or one whose primary objective is the liquidation of the insolvent debtor. Whether the court or administrator (or the equivalent) is bound by a grant of security must thus be assessed in light of the applicable insolvency law (or, where the charged assets are located in a number of jurisdictions, the insolvency laws of all those jurisdictions). However, many jurisdictions simply do not have an insolvency law to apply at all, leaving uncertainty as to how security may, as a practical matter, be enforced.

Process Management

1.63 Closing a project finance transaction is often as much about process management as it is legal analysis and drafting. The project finance lawyer is required not only to analyse the project risks and assess the negotiating leverage of each party, but also to organize the documentation process and ensure that each of the parties understands fully the issues in question. With projects often being located in remote parts of the world, and with sponsors and lenders often being based in a broad range of countries and time-zones, the challenge of organizing a financing can be significant. Managing the logistics of complex negotiations across the globe requires a mastery of both languages and communications technology. Fortunately, technology is advancing at a pace that allows ever more ambitious financings to be undertaken. Web based document 'deal rooms' allow parties to access current drafts of reports, documents and update communications at their discretion. Although in many respects English is the dominant language of project finance, it is a significant hindrance to closing deals if the project finance lawyers are not conversant in at least some of the native languages of the key project participants.

1.64 Of key importance is the ability of the lead project finance lawyer to communicate with local counsel in a broad range of jurisdictions. Local lawyers who have trained

at international firms will often be adept at conveying legal issues in terms that are readily understood by their international counterparts. However, the role of guides in the nature of this book cannot be understated in ensuring that all of the lawyers on all sides of the deal have a common view as to the key legal issues that must be considered by the parties.

2

PROJECT PARTICIPANTS AND STRUCTURES

Cathy Marsh and Andrew Pendleton, Milbank, Tweed, Hadley & McCloy LLP

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General Overview

2.01 In broad terms, a project financing is characterized by lawyers assisting their clients to allocate rights and obligations between the project participants, spreading risks and responsibilities, to create a bankable project. In so doing, complex structures evolve. In the case of the vast majority of project financings, however, such structures are likely to be complex without necessarily being complicated: i.e. though there is likely to be a detailed web of interconnections and relationships between

parties (see, for example, figure 2.3), the constituent elements in isolation, or in smaller pieces, rarely fall outside the boundaries of a relatively standard framework. To the inexperienced (and, we should note, on many occasions, to those with much more experience) the complexity of project structures can still be intimidating or, at least, confusing. It is enlightening, therefore, to take a reductionist approach and break-down such structures by examining their most fundamental components: the key project participants.

2.02 An understanding of the objectives and goals of the key project participants is absolutely critical to the successful negotiation of a project financing. The challenge of structuring a transaction lies in reconciling the different objectives of those interested parties to ensure that each stands to benefit from the project and is therefore committed to its success.

2.03 The first part of this chapter will examine the key project participants by addressing the following simple questions: (i) who are they, (ii) what are their roles, and (iii) to a lesser extent, what are their key motivations? The second part of the chapter will give an overview of typical structures employed for a project, in terms of both the ownership structure employed by the sponsors of a project and also the underlying structure of the project as a whole.

2.04 There are, of course, many different types of project so the identity and roles of their respective participants can vary, as can the structures employed, with often great variation even within the same industry sector. However, by considering key project participants in the context of the life cycle of a project, from its origination, through its financing and construction, to its operational phase, and also examining the underlying structures used by these participants in (hopefully) achieving their goal, this chapter aims to provide an accessible and general overview of project financing.

Project Participants: Stage One (Project Origination)

An introduction to project origination

2.05 There is, of course, no single project finance model that is applicable across the entire market. Different models are applicable to each sector, and even within the same sector. While elements of commonality are always identifiable, project finance remains an innovative area wherein bespoke solutions are required on a regular basis. However, the main protagonist in the origination of a project is almost always either a host government or a private sponsor, and both will, normally, have key roles.

2.06 As reflected in figure 2.1, a breakdown of which types of projects are originated primarily by a host government and which by a private sponsors can generally be made on a sector by sector basis.

Figure 2.1 Breakdown of key project originators by sector

Project Sector	Likely Project Originator
Ports	Government
Rail	Government
Roads/tunnels/bridges	Government
Hospitals	Government
Schools	Government
Water/waste water	Government
Power	Government/private sponsors
Leisure amenities	Government/private sponsors
Oil and gas	Private sponsors
LNG	Private sponsors
Mining	Private sponsors
Petrochemicals	Private sponsors
Telecoms/satellites	Private sponsors

2.07 A broader theme can also be recognized in figure 2.1: governments are key players in encouraging the development of projects to meet the core needs of their communities within the infrastructure sector particularly in less developed countries, while private sponsors are more likely to demonstrate their initiative where there is an opportunity to utilize or exploit resources, as in, for example, the mining sector.

2.08 There are, of course, overlaps and exceptions. The power sector is dominated by giant utilities companies like GDF Suez and the EDF Group, but many such companies have their origins in state ownership and some continue to be owned, at least in part, publically. The end of the last century and the turn of the millennium were marked, in Europe in particular, by widespread privatization of public utilities and other infrastructure-related entities. Arguably, this reflects that, while governments continue to be good at recognizing developmental needs, the private sector can be better placed to turn ideas into operational projects. An appreciation of some of the same concerns that drove the march of privatization is helpful for the purposes of understanding the roles and actions of host governments and private sponsors during the origination phase of project financings.

The role of host governments

2.09 Traditionally, in Europe and beyond, central governments were responsible for the planning, financing, construction, and operation of major projects with limited input from the private sector. This approach places a huge weight on the balance sheet of a government. Where developed solely within the public sector, the scale of a major project also weighs heavily in other areas: a wide array of skills and experience is required in spheres such as finance, engineering techniques, and labour.

It is rarely practical, from a cost or logistical perspective, for governments to develop or retain such skills and experience internally. Most countries therefore require a credible alternative to public sector project development.

2.10 The reluctance or inability of host governments to increase their borrowing, together with emerging political will to involve the private sector (including foreign investors), therefore underlie very visible efforts to find ways to involve private capital and private initiative in the promotion of public interest objectives, such as the development of infrastructure.

2.11 Once it decides to involve the private sector in project development, the host government will have at least some of the following objectives.

Objective one: Minimizing costs

2.12 Private participation in the development of infrastructure and other projects can lower overall costs. For example, effectively structured and transparent bidding procedures in respect of projects being proposed by host governments are designed to heighten competition among private sector sponsors and suppliers, thereby encouraging efficiency with a view to lowering overall costs.

2.13 Private participation can facilitate the fulfilment of certain infrastructure needs, such as electricity and water supply, with little or no capital expenditure by host governments. In periods of economic uncertainty, such as that following the 'credit crunch' of 2008, widespread doubts over the serviceability of sovereign debts only increase the desirability of development without substantial capital expenditure funded from the public purse.

Objective two: Risk transfer

2.14 Host governments will, generally, seek to transfer the risk of infrastructure development from the public sector to the private sector. Successfully accomplishing this goal is likely to involve:

(1) no liability for the project;
(2) retaining control over the project; and
(3) limiting the government's undertakings and retaining flexibility.

2.15 A host government will seek to insulate itself from responsibility for the design, construction, development, testing, and commissioning of any project. Fundamentally, it will not wish to be liable to any third parties for cost overruns or accidents in relation thereto.

2.16 Government utilities entities often feature in projects as the purchasers (i.e. off-takers) of project product, particularly in respect of power and water. Under the terms of the off-take agreements governing such purchasing, which are more commonly agreed before the project is developed, a government entity will, often, guarantee payment in respect of a certain level of product output regardless of

whether the actual off-taker ultimately takes the relevant output and sells it on to end users.

2.17 A guaranteed market acts as credit support inducing private sponsors to develop projects to meet the government demand and reassuring lenders that the project will receive income, which can be used to service the repayment of project debt. However, it is then entirely the responsibility of the privately owned company to supply the agreed product. Any technical and financial obstacles to that supply are hurdles for the private sponsors to clear.

2.18 Notably, under the terms of, for example, a power purchase agreement, the entity controlled by the private sponsors is actually likely to be liable to pay liquidated damages to the government entity purchasing the relevant product in the event that the project does not perform its supply obligations.

2.19 Should the original private sponsors fail to provide the required level of service or the project runs into insurmountable difficulties, host governments may also want the ability to take control of the project. As a last resort, it may bring the project into public ownership or, more likely, it will offer the ownership or operation of the project to other private sector entities.

2.20 Once private sector investors have received an acceptable return on their equity investment in a project (and once the project debt has been repaid), a host government may also have an interest in bringing successful projects back into public ownership. A fully operational, efficient project can deliver a healthy revenue stream without the likelihood of significant liability for unforeseen costs, which are much more likely during the construction phase of a project. Ownership and project structures providing for differing levels of ongoing host government involvement, such as 'build-own-transfer' schemes, are discussed in greater detail at 2.142 below).

2.21 A host government will seek to limit its own commitments as far as possible. However, some undertakings may be essential. For example, certain projects may require the building of access roads and other types of infrastructure, which private sponsors may be unwilling to support. Where the economics of a project are not sufficiently strong to induce private sponsors to participate, particularly in marginal instances, a host government may take more responsibility for peripheral costs that facilitate project development (by, for example, funding new access roads and related infrastructure publically).

2.22 Frequently, governments will also be required to exercise powers to purchase compulsorily land required in connection with a project, while cooperation will normally be required to provide the project with various permits and licenses. Private sponsors may also request further assurances in other areas, such as an agreement not to compete directly or facilitate direct competition with the business of their project.

2.23 As a general rule, a host government will wish to retain as much discretion as possible in passing new laws and regulations dealing with, for instance, taxation, health, safety, and the environment. Sponsors will either wish to constrain this flexibility or include a premium in their pricing to reflect the risk that their return may be subject to changes in law or policy.

Objective three: Demanding a safe, efficiently run project

2.24 A host government will demand that the project be completed to the government's specifications as quickly as possible and seek adequate safeguards and assurances that the project will be operated in accordance with good industry practice and in line with the public's interests.

2.25 Terms relating to, for example, health and safety, the environment, and employment may be set out explicitly in contractual arrangements between a host government and private sponsors, but it is more likely that these matters will be governed by existing laws, rules, and regulations. In certain less economically developed countries, applicable laws, rules, and regulations may also be underdeveloped and major international projects can provide excellent opportunities (and impetus) to address such deficiencies: this process is actively encouraged and assisted by certain international multilateral finance institutions, as further discussed in paragraphs 2.71 and 2.73 below.

Objective four: Attracting new capital

2.26 It is a major goal of all governments to attract new capital investment to their territories from beyond their borders.

2.27 Project financings of new infrastructure facilities, to the extent funded by loans from overseas lenders and equity capital provided by foreign investors, can increase the flow of capital into the host countries substantially. The sums involved will typically amount to many millions, and often billions, of dollars.

2.28 In addition to the creation of new jobs and infrastructure related directly to the relevant project, knock-on benefits are likely to be achieved with potential industrial development in related sectors. For instance, the off-take product of a mining project may be processed at a related project site in the vicinity of the mine. Moreover, it is to be hoped that any project will result in a trickle-down effect involving increased spending in, for example, the shops and bars of local communities.

2.29 The host government will also retain a percentage of the profits generated by a project by way of taxation and various licensing and permitting fees and charges. In less economically developed countries where first-in-country major international projects are proposed, it may actually be necessary for host governments to legislate in respect of areas such as taxation to give private equity and debt investors the necessary comfort to participate. Again, as further discussed in paragraphs 2.71

and 2.73 below, certain international financial institutions will also actively encourage and assist with this process. Promoting such development is the raison d'être of certain publically funded international finance institutions.

Objective five: Technology development and training

2.30 Host governments will expect the development of major projects in a variety of sectors to promote the innovation and/or introduction of state of the art technology and the creation of a skilled, well-trained body of professionals and personnel in the host country. To advance these objectives, the government may require minimum levels of domestic procurement and employment as conditions of tenders, licences, and/or permits.

Objective six: Competitive advantage

2.31 Looking at project finance from a broader perspective, it may also be hoped that the establishment of private infrastructure facilities by local and foreign investors will help to generate a more reliable, efficient, and cost effective industrial sector. Such developments may enhance a country's overall competitive position and promote economic growth and social development.

Starting a bidding process

2.32 Where a host government wishes to procure the development of a project by a private sponsor, it is likely to publish a request for proposals soliciting bids on particular terms. Ideally, those terms will be sufficiently detailed and fixed to:

(1) ease comparison of bids; and
(2) with, as discussed above, a key aim of the host government being to encourage competition and thereby push down prices, force bidders to compete with transparent pricing structures.

However, once a preferred bidder has been selected, there may be further bilateral negotiations between the host government and the private sponsors to refine the relevant terms.

2.33 The procurement of certain goods and services by public bodies is governed by a variety of supranational rules and regulations, which typically apply to the bidding process for a major international project. The key international agreement is: the World Trade Organization's plurilateral Agreement on Government Procurement, which is known as the GPA and came into force on 1 January 1996.

2.34 The parties to the GPA include the EU Member States, the US, Canada, Chinese Taipei, Hong Kong, Iceland, Israel, Japan, Korea, Liechtenstein, Norway, Singapore, and Switzerland. Other countries that have subsequently become observers of the GPA include Albania, Argentina, Armenia, Australia, Bahrain, Cameroon, Chile, China, Colombia, Croatia, Georgia, India, Jordan, the Kyrgyz Republic, Moldova, Mongolia, New Zealand, Oman, Panama, Saudi Arabia, Sri Lanka, Turkey, and

Ukraine, and, of these countries, Albania, Armenia, China, Georgia, Jordan, the Kyrgyz Republic, Moldova, Oman, and Panama are in the process of negotiating accession to the GPA.

2.35 The key provision of the GPA, Article III, provides that international products, services, and suppliers shall be treated no less favourably than their domestic equivalents and that domestic suppliers in international ownership or providing international goods or services shall not be discriminated against. Similarly, Article IV restricts the application of rules of origin.

2.36 The GPA also contains rules guiding key details of the bidding process. Article VI encourages required technical specifications to be set by reference to performance in the context of international standards rather than design or descriptive characteristics to the extent that this could be an obstacle to international trade. Article VII requires the bidding process to be conducted in an open, non-discriminatory manner to encourage competition. Other provisions provide for inclusive time periods to facilitate international bids and detailed information to be distributed on a consistent, open, and transparent basis. It should then be possible for the winning bid to be chosen on the basis of, chiefly, price, in addition to certain other clear criteria and essential requirements to the extent that they are set out in the request for proposals.

2.37 In light of the GPA and similar requirements, the detailed and fixed terms set out in the request for proposals are likely to focus on the output of the project. For example, in relation to power and water projects, the bid terms should require a certain capacity of power and water output, while the bid terms for a transport infrastructure project, such as a road or port, are likely to require capacity for a certain number and size of vehicles or vessels over a particular time period.

The roles of advisers and consultants

2.38 Before the terms to be set out in a request for proposals are determined (or a project is otherwise developed), a substantial amount of research and development work is always required. Major international projects are typically researched and developed as concepts long before their financing is arranged or construction begins.

2.39 Feasibility and other studies produced by specialist consultants may be required to establish the viability and desirability of a project. Areas to be considered in such studies vary from sector to sector and project to project, but they are a fundamental stage in the life of any project regardless of whether (a) it is the subject of a bidding process and (b) it originates in the public sector or private sector.

2.40 Consultants, who should bring independent and specialist expertise to a project, may be required to:

(1) establish where a resource, such as a mineral deposit, exists and whether it exists in quantities to justify its exploitation;

(2) consider the viability of exploiting a resource or developing a product or service from a cost and other logistics perspective;
(3) develop ideas to facilitate the exploitation of a resource or the development of a product or service;
(4) measure the demand for a particular resource, product, or service;
(5) evaluate the potential to finance the relevant project and, where relevant, help to structure such financing;
(6) advise on the best practice in respect of project insurance and assist arrangement thereof; and
(7) provide legal advice in relation to legal aspects of each of the matters described above and the project in general.

2.41 Relevant consultants may therefore be experts in one or more of a wide variety of fields such as engineering, the environment, finance, insurance, or law.

The role of private sponsors/equity owners

2.42 The principal objective of private sector sponsors and equity investors is to maximize their profits. However, the appetite for risk and the required investment return of each sponsor will vary. Equity investors may have more compelling economic interests in a project than their equity return. For example, they may have another role in the project as a supply, operations and maintenance or off-take contractor.

2.43 Equity investors typically invest through a project company. The ownership structures applicable to project companies are discussed in greater detail below. The shareholding or other equity interests in the project company may be held by one entity or, as is often the case in large international projects, a consortium of equity investors. Such a consortium may include local participants (often as a condition of bid eligibility), foreign operators and equipment suppliers, and other investors seeking returns sufficient to justify the risks being taken.

2.44 As discussed in relation to host governments above, infrastructure projects typically have significant funding requirements and entail risks, often in excess of those which an individual sponsors or consortium of sponsors may be willing or able to provide or assume themselves. In this context, the typical project finance structure can be appealing to sponsors for the following reasons:

(1) it provides financing that is legally non-recourse to the sponsors (who are likely to be shielded financially by the 'corporate veil', although such a veil offers little protection from a reputational perspective);
(2) it achieves 'off balance sheet' accounting treatment of project debt (as such borrowing for the project does not show among the sponsors's own borrowings in its consolidated accounts);
(3) it allows highly leveraged structures, which often permit a reduction in the cost of capital by way of the substitution of lower cost, tax deductible interest for

higher cost, taxable returns on equity (some projects have been financed on or close to a 100 per cent debt basis, although a level of 60 per cent to 85 per cent is more typical); and

(4) it provides for the allocation of project risks among multiple participants, thereby reducing each participant's individual risk of loss.

2.45 Where participating in project financing, private sponsors are likely to have at least some of the following aims.

Aim one: Maximizing return on equity

2.46 Virtually all sponsors seek opportunities to obtain attractive rates of return on their investment. To attract private foreign investment, host countries may need to afford investors greater returns than are available in other markets internationally. There is, of course, a natural limit to the returns available to investors in that the real cost of a project (manifested in, for example, monthly energy bills) may be a large part of a local consumer's basic cost of living: one can easily imagine the political sensitivity to, for example, increases in domestic retail electricity rates to satisfy the demands of foreign investors. In many cases, host governments, particularly in less economically developed countries, provide more subtly for better equity returns by applying generous taxation regimes to international projects.

Aim two: Strategic expansion

2.47 Sponsors, particularly utilities companies, are very likely to seek to expand into new markets at times when there is limited growth in demand in their domestic markets. As a consequence, national utilities and international private developers may expand into new regions, often by way of successful bids for projects put out to tender by host governments in the manner described in paragraph 2.32 above.

Aim three: The sale of goods

2.48 Certain project participants, such as equipment manufacturers and fuel suppliers, have as one of their principal objectives, securing contracts for the sale of equipment or supplies or for the operation of the relevant facility. Although these parties may be prepared to invest in private projects by way of equity, a significant portion of their profit lies in securing the related supply contracts. They may be willing, therefore, to take risks in relation to their equity investment (which forms only part of their overall return on the project) that other private sponsors may be reluctant to accept.

Aim four: The sale of services

2.49 In addition to selling goods, other project participants, such as utilities companies, may have services and expertise to sell. Again, although these parties may be equity investors, their profits could be supplemented significantly by their fees for the performances of services, such as the operation and maintenance of the project, and

this may be more important to them than their equity investment, which may only constitute a small portion of the overall equity investment by a consortium.

2.50 In addition to making direct equity investments in a project, we have discussed how private sponsors sometimes plan to participate in a project as goods and services contractors. However, their participation is not limited to those matters. They will also typically be involved with all or some of the following.

Credit support

2.51 In addition to injecting equity into the project company by subscribing for share capital or granting shareholder loans, private sponsors are normally required to provide or arrange related credit support. For example, lenders may require as a condition of providing their debt that the sponsors provide completion or cost overrun guarantees.

2.52 To the extent that a relevant sponsor does not have a sufficiently strong long-term credit rating from a reputable ratings agency, such as Standard & Poor's, Moody's, or Fitch Ratings, sponsors may, instead of providing a guarantee, be required to procure other forms of credit support, such as letters of credit, from a third party, normally a bank, with an acceptable long-term credit rating.

2.53 Private sponsors may also be expected to provide credit support in respect of the project company's obligations to pay interest and tax, or in coverage of other shortfalls.

Skills and personnel

2.54 An experienced international sponsors will, of course, typically, assist the project company by utilizing the skills it has developed on other projects. During the origination and financing phases of a project, it will, in fact, normally, be personnel employed directly by the sponsors who plan and agree the scope of the project and how it is to be financed. The relevant personnel may then move onto assist with other projects in respect of which the relevant sponsors is a participant. Alternatively, they may be transferred to work for the project company directly during the construction and/or operations phases.

2.55 Large private sponsors in, for example, the oil, petrochemicals, and power and water sectors are also likely to have substantial experience in areas of ongoing relevance to a project such as insurance and marketing.

2.56 Specialist insurance teams (who will in most cases be employed directly by a sponsor) use their experience to assist the project company in obtaining appropriate cover. Moreover, economies of scale can mean that private sponsors can obtain excellent value when negotiating project insurances for both the construction and operations phases of their multiple projects. Insurance matters are discussed in more detail in Chapter 6.

2.57 Sponsors with long-standing interests in various projects within a sector are also likely to be able to assist with matters such as the international marketing of the project product. In certain cases, care (and legal advice) must be taken to ensure that competition laws and regulations are not breached by such arrangements. There may be relatively small or niche markets for particular products and certain large international sponsors may be dominant players in those markets.

Connected projects

2.58 In many cases, a project will produce a product that is simply purchased on an *ad hoc* basis by a third party who is otherwise unrelated to the project participants. However, other projects are more interconnected. For example, the off-take product of one project may be the feedstock of another. Alternatively, multiple projects, often producing the same off-take product, may be based at the same site or at nearby sites. These projects sometimes share certain facilities, which are often related to the processing, packaging, or transportation of the project product.

2.59 Where a private sponsor has an interest in one project that is closely connected to other projects, it is naturally likely to be involved in some capacity with the other project. The reasons for this include the desirability of having control and certainty in respect of key influences on each project. Moreover, if a private sponsor takes the view that the business case for one project is strong or it has expertise in the area of one project, it is likely to view related business positively.

The role of the project company

2.60 The choice of ownership structure applicable to a project company is very important to the relevant sponsor or sponsors, particularly to the extent agreement must be reached between multiple, independent sponsors or where local laws dictate certain structures. Ownership structures are therefore discussed in greater detail below. However, the relevant structure does not impact significantly on the role of the project company.

2.61 To understand the role played by the project company, it may be helpful to compare a project to a painting: the sponsors are the artists crafting their design onto a blank canvas, which is the project company. The key feature of the project company is that it does not, normally, have any obligations or business beyond the scope of the relevant project. Where a project company is kept 'clean' in this way, investors can best assess the risks involved with their lending: all of the project company's rights and obligations are clearly and exclusively set out in finance documents and commercial contracts, which are each entered into solely for the purpose of developing and operating the one project (and which will each be reviewed by the project company's lenders and their advisers).

2.62 Commercial contracts are analysed in greater detail in Chapter 5 and finance documents are discussed in greater detail in Chapter 7 and the chapters which follow.

Taken together, these contracts should constitute the 'whole world' of the project absent only the various laws and regulations applied to the project by relevant governmental entities. Subject to those laws and regulations, the project company contracts to receive funds from debt and equity investors, which it, in turn, contracts with construction contractors to, primarily, apply to the construction of the project. Because the various investors are repaid from the revenues generated once the relevant project is operational, the project company may also contract from the outset, again subject to applicable laws and regulations, for the operation and maintenance of the project, which is likely to involve arrangements for the purchase of project feedstock, technical equipment and experience, and, often, guaranteed off-take.

Project Participants: Stage Two (Financing the Project)

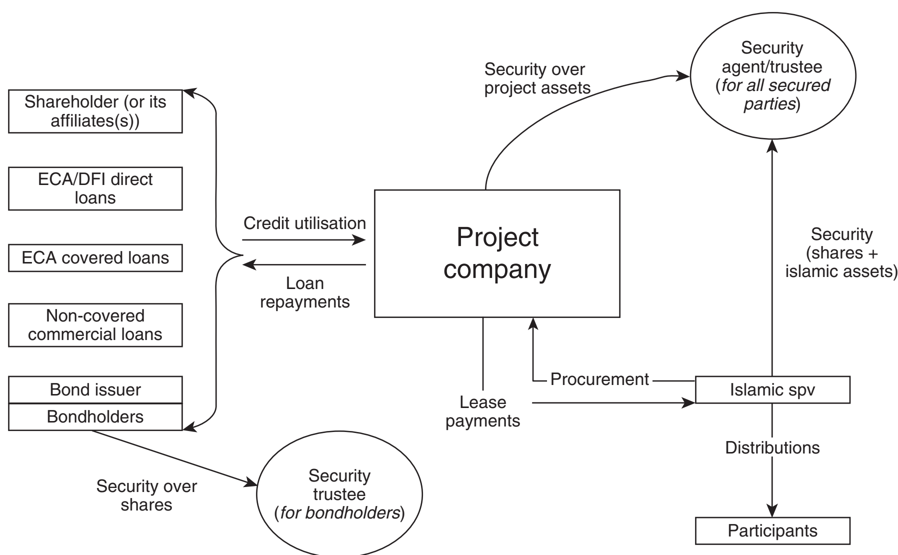

Figure 2.2 Example financing structure

An introduction to the financing stage

2.63 Through the origination phase of a project, financing costs are typically for the account of the project originator, whether such originator is a private sponsor or host government. As discussed above, the origination phase may entail significant research and development in the areas of technical viability and specification, financial and legal planning (including the arrangement of bidding processes), and related matters. The costs involved can be substantial, particularly when you remember that projects are often (and, sometimes, repeatedly) suspended before

they can be financed (and sponsors may have other projects that have had to be abandoned following substantial research and investment). Furthermore, private sponsors will also incur significant costs bidding for the right to develop a project in the context of any competitive process and the nature of such processes dictates, of course, that some bids will be unsuccessful.

2.64 The substantial costs involved with originating a project (whether such project is developed successfully, aborted or lost to another bidder) are most easily absorbed by a powerful private sponsor and/or a wealthy host government with other revenue streams. Where host governments retain the ability to raise taxes, well-established private sponsors are likely to have equity interests in multiple projects and can use the revenues from one project to assist the development of further projects. In fact, certain private sponsors opt to finance their projects fully (right through to the operational phase) by way of balance sheet financing. The main advantage of such corporate financing over project financing is that the borrowing is not tied to a particular project. This provides the sponsors with greater flexibility to take whatever action in respect of a specific project it considers to be best in the context of its overall business. In contrast, project finance lenders are, typically, granted security over a particular project and the success of that project is therefore fundamental to their risk analysis. This is reflected in the detailed covenant and information regimes to which the lenders will bind the relevant project company (which regimes are most suitable for financings transacted conservatively in the context of high risk environments such as politically and economically unstable areas, or where cutting edge technologies are being applied). Risk factors in relation to project financings are discussed in more detail in Chapter 4.

The role of equity financing

2.65 Even where debt is secured on the terms of a project financing, the debt lenders usually require that a substantial proportion of the overall project cost, usually in the region of 20 per cent or more, is funded by way of equity investment. Even where private sponsors have the liquidity to provide such equity financing out of their own pockets, they will normally be reluctant to make such an injection from the outset. Equity may be contributed by way of share capital investment in the project company or, more frequently, it is provided via shareholder loans to the project company. The latter approach establishes a simple mechanic enabling the private sponsors to take their equity return by way of repayment, although the main debt lenders will, in most instances, expect such equity repayment to be contractually subordinated to the repayment of their debt.

2.66 As discussed above in the context of ownership structures, private sponsors specializing in the development of a particular type of project will often co-own a project with another equity investor. Although minority share owners are sometimes other private sponsors specializing in the development of the same type of project, they

are, frequently, entities with limited specialist knowledge who invest discreetly with a view to achieving nothing other than strong equity returns. Examples of such investors include pension funds and hedge funds investing on an international basis. On other occasions, similar entities, such as regional pension funds, invest with a view to achieving strong equity returns, but also with a view to supporting regional development and/or having some influence on the project in question.

2.67 Certain private sponsors prefer to meet their equity funding obligations by way of debt financing. This is known as an equity bridge financing as it is bridging the gap that equity investment is meant to fill. Equity bridge financing may be acceptable to the other lenders in a project provided that it is subordinated adequately to the repayment of any senior debt financing. However, certain lenders may be reluctant to participate in a project that involves little balance sheet financing by the sponsors on the basis that this may be considered to demonstrate an absence of equity commitment to the relevant project. As a legal matter, provided that subordination is effective and a suitable guarantee of equity funding obligations is obtained from an entity of substance (i.e. an entity with sufficient assets to support such a guarantee, or a suitable bank demand letter of credit) it is hard to argue that equity bridge financing is inherently detrimental to the interests of other lenders.

The role of debt financing

Who are the lenders?

2.68 A variety of commercial banks, export credit agencies, insurance companies, pension funds, and other finance entities may participate in a project financing through public or private debt placements. Multilateral and development finance institutions, some of which are global in reach and others regional, may also act as lenders. The identity of the lenders to a particular project will depend on a variety of factors, which will include the extent of any existing commercial relations between a particular sponsor and bank, the political and/or economic/social developmental importance of the relevant project, its location, and its commercial risks.

2.69 The Glossary contains a list of export credit agencies as well as national development finance institutions of various countries, and also lists the major multilateral development institutions.

Why do the lenders participate?

2.70 In assessing the objectives of lenders, one must bear in mind that debt is priced with a fixed or index-linked rate of return. There is little, if any, 'up side' to debt-holders if the project performs beyond expectations. However, with no recourse other than to the assets of the project, the lenders face the full risk of loss if the project fails. Their tolerance for risk, given this skewed risk/reward relationship, will thus be substantially lower than that of equity investors, who can justify accepting risk to achieve the possibility of higher returns. Moreover, notwithstanding the breadth of

covenants required by lenders in project finance credit documentation, lenders have only limited practical ability to control their borrower and manage risks. The common question asked in the context of project finance, 'is this risk bankable', reflects the need to assess risk through the eyes of the party least able and willing to assume risk, the debt-holders. However, if all lenders were motivated by purely mercenary values imposed from a short-term perspective, projects would not be bankable and project finance would, frequently, not be practical.

2.71 In a project financing, different types of lenders may have different objectives or, at least, different priorities. For example, export credit agencies may be motivated not only by profit considerations, but also by the aim of promoting the supply of goods and services from the country of origin. Alternatively, multilateral lenders and development finance institutions may have as one of their key missions promoting economic and social development in the host country. A variety of these institutions provide support in the form of loans, political or commercial risk insurance, guarantees or indemnities, or any combination of these, for project financings. Although export credit agencies, development finance institutions and multilateral lenders do not, typically, operate on a charitable basis, the terms on which they lend, insure, guarantee, or otherwise support a project are more favourable than those that may be obtained from purely commercial institutions. Such favourable terms may be absolutely critical to the bankability of more 'risky' projects or, as has been seen in times of international economic downturn, the bankability of any major project when many commercial banks have indicated that they are, even temporarily, closed to new business.

2.72 Co-financing or complimentary financing arrangements among commercial banks and official credit agencies may increase the level of comfort (and debt participation) of commercial banks in project financings. The quasi-governmental nature of official credit agencies and other multilateral institutions may provide some, normally informal and typically political, protection against government expropriation of, or interference with, a project. Moreover, there is also a perception that, again on an informal and political basis, these types of institutions are particularly unlikely to abandon a project to fail and enforce security so they may take action that protects or supports a project to the benefit of the commercial participants without any, or with limited, additional cost to such commercial participants.

2.73 When export credit agencies and multilateral development institutions participate in a project it will be subject to a high level of environmental, employment, and other social standards, which can be expensive to meet. The application of these standards is very important to these institutions from a policy perspective and a key objective is to encourage the use of best practice in the implementation of infrastructure and their projects. A number of leading private sponsors and commercial lenders have begun to incorporate many of these standards such as the 'Equator Principles' and other environmental requirements into project documentation and

covenants to have been introduced into finance documentation to ensure compliance during the life of the loans.

The role of alternative financing

2.74 As discussed in Chapter 9, additional debt financing for a project may be obtained in the bond market. The motivations of bondholders are likely to be, effectively, indistinguishable from commercial banks and financings involving them will be structured as such. The significant documentation and regulatory requirements involved with bond issues is, of course, a not insignificant additional cost to a project. This means that a bond issue is only likely to be undertaken where the margins available are considered advantageous or where a shortage of alternative finance solutions necessitates that the investment net is cast widely.

2.75 The Islamic finance market is also becoming increasingly popular as a source of project finance. Although the structures used to incorporate *Sharia'a* principles are unique and different from classic debt financing, Islamic finance is, typically, used as a substitute for debt financing. Such structures and the motivations of Islamic finance institutions are analysed in greater detail in Chapter 10.

2.76 Hedging products are not an alternative to other sources of project financing, but they can complement debt financing. Relatively simple interest rate and exchange rate swaps are undertaken by most project companies in relation to major international projects. The banks involved will, on most occasions, be existing international or local lenders to the project. The terms of the swaps are likely to be negotiated on a purely commercial basis.

The role of other financing participants

2.77 As discussed above, various advisers and consultants play a vital role in a project. This is particularly true when a financing is being structured and agreed. Experienced commercial banks and financial advisers may be required to help introduce private sponsors to potential equity and debt investors. Moreover, often before such introductions are made or, at least, before commitments are offered, they will participate in the negotiation of documentation, using their market experience to help to structure a deal that is likely to be bankable (i.e. viable for debt investors).

2.78 Once a deal is being structured, lawyers for all parties will, of course, be at the centre of negotiations, acting as facilitators and recorders of any deal. Although private sponsors are likely to have taken, for example, full technical, engineering, and insurance advice prior to the financing stage, the lenders to a project will require their own advisers to verify that the terms being proposed by the sponsors are consistent with market practice or otherwise appropriate. Around the time of financing, the sponsors' own insurance advisers, typically insurance brokers, are then likely to negotiate actively and independently with insurers and, often, offshore reinsurers

for appropriate coverage in advance of construction or amended coverage to facilitate the project financing. Insurance matters are discussed in greater detail in Chapter 6.

2.79 Around the time of financing or commencement of project construction, sponsors are also likely to be formalizing arrangements for various authorizations, consents, permits, and related matters with host governments. This can be a difficult, bureaucratic process requiring significant input from local lawyers. Lenders will expect these matters to be resolved before they make any funds available to the relevant project company.

2.80 Finally, as discussed further below in the context of the operational phase of the project, it can be crucial that off-take arrangements, under which the product of the project may be subject to certain guaranteed purchase terms, are entered into before the financing of the project can be agreed. Where there is no open and developed market for the applicable project product, lenders will need to be able to satisfy themselves that off-take arrangements are in place generating revenues sufficient to cover all, or a portion if there is a limited open market for the surplus product, of the proposed repayments.

Project Participants: Stage Three (Constructing the Project)

An introduction to the construction stage

2.81 The construction phase of a project will, in many instances, commence before the financing for the project is fully agreed. This may be necessary to enable the project to be constructed to a schedule imposed as a condition of a bidding process run by the host government. A shortage of qualified construction contractors may also necessitate that action be taken to secure the services of an appropriate contractor at an early stage. Alternatively, a confident, experienced, and well-resourced sponsor may, simply, opt to proceed with construction as soon as possible on the basis that the project is then likely to become operational, such that it is generating revenues, sooner. In any circumstances where the contracts relating to the construction of a project are agreed before it is financed, there is of course a risk to the project company (quantifiable by reference to its full obligations and liabilities under the relevant contracts), which is typically backed by a payment guarantee from the sponsors or sponsors, who are, therefore, also 'on risk', in the event that financing cannot be obtained on the terms anticipated. In the event of, for example, disruption in global markets in the intervening period, this risk could easily jeopardize the life of the project or, more notably at this stage, the solvency (or, at a minimum, the equity returns) of the relevant guarantor or guarantors.

2.82 Although construction arrangements are, typically, negotiated between the sponsors of a project and the relevant contractor or contractors, and then presented to

the project company's lenders as a *fait accompli*, lenders will review the terms of any material contracts that the project company entered into before the financing has been agreed and amendments, usually of a minor nature, may be necessary to ensure bankability.

The role of the construction contractor

2.83 Once a project site and purpose has been identified at the origination stage, technical advisers will help to identify the specifications of the project and the work required to construct a project capable of producing the relevant product in the quantities and of the quality required to make the project bankable. The sponsors, in consultation with such technical advisers, will then approach the market to negotiate terms with a contractor or contractors for the construction of the project to such specifications. The main construction contract is a key contract because it governs the main costs being financed.

2.84 The construction contractor designs and builds the project, often on the basis of a 'turnkey' fixed-price contract. The construction contract is generally awarded on the basis of a competitive tendering process, where pricing is likely to be the key consideration. The objective of the contractor will be to complete the construction of the project at a cost that allows it to preserve its anticipated profit margin. The contractor is, usually, liable for delay damages for late completion and may earn an early completion bonus to the extent that the project is completed ahead of schedule. Contractors are also, often, called upon to pay damages in the event that the project does not pass certain performance tests.

2.85 The construction contractor generally enters into subcontracts for equipment procurement, civil works, and design and engineering services pursuant to which it seeks to pass on many of the risks it is asked to assume under the construction contract entered into with the project company. A contractor will, of course, seek generally to avoid assuming risk (for example, assuming sole responsibility for completing the project) for which it is not compensated adequately or which it is unable to pass through to subcontractors.

2.86 Construction contractors and even subcontractors operating on the project site, in addition to interacting with each other and the project company's representatives, may also have to join the project company and sponsors in liaising with the host government in respect of licences, consents and approvals.

The role of energy and other infrastructure

2.87 Major international projects are constructed in a variety of locations, some of which are lacking in every kind of infrastructure. Before a project can, therefore, be constructed, appropriate infrastructure must be developed. Although this may be arranged independently by the host government or other private sector

sources as a separate project or projects, the development of appropriate infrastructure may, instead, be fully incorporated within the terms of the project being supported.

2.88 Infrastructure needs of a project are likely to include the following:

Access needs

2.89 Unless the project site is at sea or similar, road and/or rail infrastructure sufficient to support traffic accessing the site for construction and operation of the project is almost certain to be required.

Power and water needs

2.90 The construction contractors and subcontractors are likely to require significant amounts of electricity and water for the construction of a major international project. Appropriate pipelines and cables will be necessary, and must be arranged in coordination with local public or private utilities providers. However, where projects are being constructed in less developed countries, pipelines and cables may not be enough. Additional investment in power generation and clean water supply may be necessary such that there is sufficient supply to guarantee that the needs of the project are met. Where supply is insufficient, arrangements may be made with host governments and/or the private sector to favour supply to the project over alternative end users. This is likely to be a sensitive political issue for certain project participants, such as development finance institutions, who may require that infrastructure is developed to enhance rather than detract from the service being offered to the rest of the local community.

Housing and other social development requirements

2.91 Once work commences on the construction of a project, huge workforces may descend on areas or existing communities without the infrastructure to support them. Their most basic needs will be food and shelter. These may be addressed by the construction of housing and related infrastructure such as restaurants and shops. Over time, these basic needs are likely to be supplemented by a market for entertainment and, if more permanent communities are developing in anticipation of employment being generated by the project during its operational phase, other services relating to health and education needs.

Ongoing roles

2.92 Various advisers and consultants assisting both the project company and its lenders will be involved with monitoring the progress of construction in the context of compliance with the transaction documentation. Expenditure, equity investment, technical specifications, environmental standards, insurance matters, and legal compliance are all likely to be under high levels of supervision through the construction phase.

2.93 Certain actions will also be necessary in preparation for the operations phase of a project. For example, different insurances will be required for the operation of the project and the lenders will expect that these are in place in anticipation of the commencement of operations.

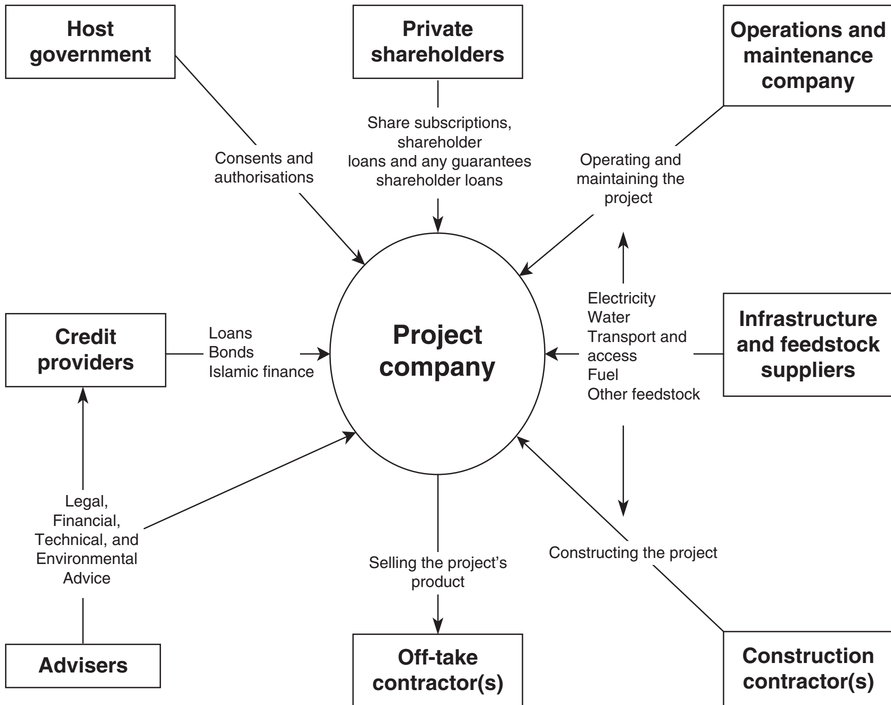

Figure 2.3 Example Construction and Operations Phase Structure

Project Participants: Stage Four (Operating the Project)

An introduction to the operations stage

2.94 As in relation to the commencement of construction, there is likely to be a timing overlap between the completion of construction and the commencement of the operational phase of any project. Early generation revenues may be available if a project can be operated before its scheduled commercial operations commencement date. There may, therefore, be an incentive for a project company to develop operational capability while the construction contractors and/or subcontractors, as applicable, are finishing the building or, more likely, the testing of the project facilities.

The role of the operator

2.95 Manufacturing and other facilities are complex and their operation and maintenance often requires significant skills that a single purpose project company may

not have within its own workforce or intellectual property resources. In such circumstances, an independent contractor is often charged with operating and maintaining the project for an extended term. In some cases, separate arrangements, often with an affiliated entity (where a sponsor has industry expertise within its group of companies), will be made to manage ordinary day-to-day operations. To supplement this, major equipment maintenance may be contracted out to an experienced equipment vendor under the terms of a technical support agreement.

2.96 Although operation and maintenance agreements are not always entered into at the time that the financing of the relevant project is agreed, lenders are likely to require comfort that appropriate arrangements have been planned. For example, in the power sector, lenders may want contractual assurances that the operator will be a controlled affiliate of a sponsor where such sponsor is an experienced power developer.

2.97 Strong operating warranties and commitments may mitigate lender concerns as to technology risks. For example, in projects whose economics have been underpinned with assumptions as to the plant's high efficiency or availability, the operator may be called upon to warrant the plant's performance over an extended period to provide assurance as to the attainability of the projected operating standards. However, the fees payable to an operator will often not provide adequate compensation for assuming the significant financial risk posed by impaired operating margins. The debate thus, generally, hinges on structuring the risk/reward relationship to ensure that the operator is properly incentivized.

The role of the operation and maintenance guarantor

2.98 As discussed above, the operator is, often, either the project company or an affiliate of the project company on the basis that there is relevant expertise contained within the relevant group of companies. Neither the project company when acting as the operator of a project nor a separate operating company is likely to be an entity of substance. Lenders will therefore seek additional comfort from an entity of substance, often the senior company within the group or another group company with an acceptable long-term credit rating, in the form of a guarantee of the operator's obligations under the operation and maintenance agreement. Alternatively, a letter of credit may be substituted for such guarantees.

The role of feedstock, fuel, and other suppliers

2.99 Suppliers are critical in providing an assured source of feedstock, fuel, and other raw materials to the project. These inputs will be crucial to the ability of the project to produce its product and, by selling that product, generate revenues with which to

repay the project's debt financing. To provide assurance of supply, the project company may enter into long-term supply and transportation arrangements. This arrangement is likely to be mutually beneficial as the supplier thereby also secures an assured market for its resource.

2.100 A supplier may be asked to provide warranties of supply and price over a long period, which could expose it to substantial risks. The terms of *force majeure* and similar relief provisions, and opportunities for price 'reopeners', will be of significant concern to any supplier.

The role of off-takers

2.101 If all the participants discussed above are well chosen and contractually bound to perform, a project should be able to produce its target product and offer it for sale. The identity and creditworthiness of any entity that purchases all or any significant proportion of the output from the project and the terms of the purchase or off-take contract are central to most project financings. Only where there is a well developed and reliable open market for a project's off-take product might this not be the most important commercial contract to the credit risk evaluation made by the lenders. Such evaluation of a project will depend upon an assessment of the financial condition of the off-taker or off-takers, since the project's cashflow will be directly dependent upon their ability to perform their obligations.

2.102 The objective of the off-taker is generally to secure assured access to the output of the project. In most cases, it will be prepared to commit to buy all or a significant portion of the project's output, and in many (if not most) cases it will offer a degree of revenue assurance through a fixed or floor price. The off-taker may have undertakings to others to sell-on the project's output, generally at a price that will afford a margin on those sales. The off-taker will wish to avoid circumstances where there is any price or other mismatch between the primary off-take commitment and its on-sales arrangements. In many cases, such as the distribution of electrical energy, there may be an element of subsidy in those on-sales. The circumstances in which revenues may be curtailed or terminated or, alternatively, increased must be carefully defined. Allocating the risk of *force majeure* events affecting either party, and determining when the obligations of either party may be terminated, are of particular importance.

2.103 The off-taker's commitment may be less crucial in mature markets where access to purchasers may be certain and price volatility limited or at least predictable. For example, in some countries, regulatory reform has made possible the emergence of 'merchant' power plants. A broad range of energy, natural resource, and petrochemical projects sell their products into mature and liquid markets. In these cases, off-take undertakings may be limited to assurance of access to these markets, sometimes at an indexed price, but not to any specific 'floor' price. In such cases, as in the case of 'merchant' power projects, the underlying economics

must be sufficiently robust to withstand cyclical, or even just volatile, price and revenue projections.

Ongoing roles

2.104 As in relation to the construction of a project, various advisers and consultants assisting both the project company and its lenders will be involved with monitoring the ongoing performance of the operational project in the context of compliance with the transaction documentation. Financial covenants, technical specifications, environmental standards, insurance matters, and legal compliance are all likely to be under high levels of supervision throughout the operations phase, although perhaps less than during the construction phase as the inputs and outputs of any mature project should be relatively stable.

Project reincarnation

2.105 Because the inputs and outputs of a project are more stable during the operations phase than before, the risks associated with the project are likely to be commensurately lower. As markets also change, the terms of any financing agreed much earlier in the project's life cycle are unlikely to reflect the terms that might be available to an operational project. The sponsors may therefore consider attempting to refinance the project on improved terms (possibly with the same or many of the same lenders). Alternatively, they may consider whether an agreeable return could be generated by selling some or even all of their equity stake in the project company. The same kind of financial and legal advisers involved with the original financing are likely to be involved in any refinancing or sale.

2.106 As discussed in greater detail below, certain project structures provide for operational projects to be transferred into alternative ownership, possibly by host governments, once operational. Further, in less stable parts of the world, a fully operational and profitable project may be a target for expropriation by a host government, although this is relatively unlikely given the disincentive to further private investment unless fair expropriation compensation is paid.

2.107 In many cases, sponsors will retain their ownership interest in a project company until after the debt financing its construction has been repaid on the basis that it is during this period that it is most straightforward to generate a return on the product. Revenues that were being used to repay lenders can then be used to repay equity loans and pay dividends.

2.108 Where there are, for example, significant mineral deposits in a particular area or there is further demand for power or water, a project that is addressing, but not fulfilling, such demand may be extended, supplemented, or renovated in some way with a view to increasing output and revenues. It is possible that the revenues from

the first project will be used to help finance equity investment in further projects or that the first project will be refinanced to provide for debt financing of such parallel projects. Alternatively, where a project is failing, it may still be renovated, extended, or refinanced with a view to generating increased revenues to turn the project's fortunes around.

2.109 Wherever a project is reincarnated in any of the ways introduced above, the range of project participants is unlikely to include classes of participants fundamentally different from those already introduced in this chapter, even if the individual lenders and contractors will, probably, change. It is to be hoped, therefore, that the first part of this chapter has given the reader a comprehensive introduction to the various players involved in the life of a project.

Ownership and Project Structures

An introduction to ownership and project structures

2.110 The premise of a non-recourse or limited recourse project financing is inextricably linked to the ability of lenders to assess and, to an extent, control the operations of the borrowing entity. This is most effectively achieved through the use of a single purpose vehicle whose only asset is the project. The first part of this section explores the various considerations that influence, or dictate, the choices made by sponsors in establishing the entity that will implement the project.

2.111 All project finance transactions have some level of interaction with their host government. At one end of the spectrum this is solely in respect of permitting requirements and at the other may involve a significant degree of government ownership. The second part of this section reviews the most common project structures.

Selecting an ownership structure

General considerations

2.112 Although a single sponsors may decide to carry out a project alone, as a matter of practice most large projects are jointly owned or jointly controlled. The reasons for selecting a joint structure include: spreading the project risk among a number of participants; maximizing the benefits of a combination of skills, technology, and resources; and allowing participants to act in a project that would otherwise be beyond the capabilities of any of the individual sponsors.

2.113 The ownership structure of a project is influenced by the particular financial, legal, accounting, and taxation objectives and concerns of the sponsors. Flexibility of management structure, the ease with which profits can be distributed, minimizing tax burdens, achieving off-balance sheet treatment, the scope of minority

protection, and considerations regarding dissolution are among the issues that guide decisions about the proper project vehicle.

Particular considerations include:

2.114 **Will the host government be a shareholder?** Generally, any project company that is to be part-owned by the host government will have to be incorporated in the project country. The requirement for government ownership varies across different sectors and host countries and is dependent on the balance between the relevant host government's appetite for risk, its obligation or desire to provide social infrastructure, and its requirement to benefit financially from the project.

2.115 Mining and oil and gas projects often have a minority government stake, paid for by the international shareholders. As a 'carried' interest, the host government bears little financial risk and since such projects do not fall squarely within the category of 'infrastructure', they are not generally within a government's mandate to provide infrastructure. However, they do bring incidental benefits of an infrastructure nature (by way of the construction of roads, railways, and electricity and water networks) and the potential to create significant revenues. The host government typically also requires a royalty under the relevant permitting regime.

2.116 In the United Arab Emirates, the ongoing programme of independent water and power projects is structured so that each project is majority owned by the Abu Dhabi Water and Electricity Authority. The procurement of power and desalinated water is generally considered to be the responsibility of a host government is therefore subject to government regulation. The Abu Dhabi approach to ownership is not the general approach in the power and water sector, within the Middle East or elsewhere. However, it gives the host government considerable control over the provision of a significant segment of infrastructure, augmented by the fact that the power and water is also purchased by the host government. In other countries, such as Oman which is going through a process of privatization of its power and water sectors, no government ownership is required and although the purchaser is currently government-owned, there is the potential for further privatization so that future power and water projects in Oman may, as in the UK and the US, become subject to industry regulation and permitting, but not otherwise be owned by or contract with the host government.

2.117 In the UK and the US, project financing is now most commonly seen in sectors extensively regulated by government and falling within category of infrastructure, such as schools, hospitals, power generation, water and waste projects and roads. Some of these are wholly within the private sector (meaning that they are developed, operated, and financed by independent companies and lenders and their product is bought by an independent purchaser), such as power generation and others, such as schools and hospitals, are financed using the public/private partnerships, in which the government contracts with the developer for the provision of

the relevant building and associated services (i.e. teaching or healthcare) but does not take an ownership interest until the expiry (or earlier termination) of the concession arrangement under which the particular facility was developed and built by the private sector.

2.118 **Will there be more than one shareholder/partner?** Project financing offers developers the opportunity to consolidate resources and expertise to implement a project that none, acting alone, could achieve. This may be a question of finance, technical expertise, or managerial skills. It also enables the shareholders or partners to spread the risk across a broader pool of investors.

2.119 **What are the requirements of local law?** In some jurisdictions, it may not be possible for a non-local entity to do business, or there may be a requirement for at least one shareholder or partner to be a local entity. Further, it may be that the nature of the project company's business or ownership restricts the types of entity available to the shareholders (for example, a company as opposed to a limited liability partnership).

2.120 **Are there any relevant lender considerations?** If the financing is to include export credit agencies or development finance institutions, these may have requirements as to the jurisdiction in which the borrowing entity is incorporated.

2.121 **What are the fiscal implications?** Tax and accounting regulations may significantly influence the choice of vehicle and jurisdiction for the project company, as may the ability to withdraw shareholder profits.

2.122 **What are the management implications?** In many cases, the bringing together of several different project shareholders introduces, for example, money from one and experience from another. The potential for an imbalance in ownership proportions means that the ability to have flexible management arrangements that are independent of ownership interest and to have appropriate protections for minority shareholders.

Types of ownership vehicle

2.123 In determining the most appropriate type of vehicle for a given enterprise, as discussed above, the laws of the jurisdiction of organization of the vehicle must be taken into account. Applicable law, or the requirements laid down by the authority that is procuring the project in question, may require incorporation in the country where the project is located and/or dictate the type of vehicle that must be used. Where flexibility is afforded, however, tax and other considerations may lead to the selection of a vehicle organized in another country.

2.124 Typically, one of three generic types of vehicle is used as project entities, wherever that particular entity is established: a special purpose company, an unincorporated joint venture, or a partnership.

Special purpose company

2.125 Special purpose companies are often used where the flow-through of tax benefits to the joint venture partners is not critical and where the centralized management control available through a corporate structure is deemed desirable.

2.126 The following are the main advantages of special purpose companies:

(1) they have a separate legal identity, and thus have the ability to enter into contracts and litigate legal proceedings in their own name;
(2) there is generally little restriction on the transferability of interests;
(3) the liability of shareholders will be limited; and
(4) corporations have continuity of life.

2.127 The major disadvantages of special purpose companies are:

(1) equity investors may effectively be exposed to double taxation (at the corporate and shareholder level);
(2) they may be subject to greater administrative complexity; and
(3) a corporate structure may have less operational flexibility than the alternatives.

2.128 There are wide variances in the rules governing companies across jurisdictions and, although it may appear sensible to organize the company in the country where the project is located, investors often wish to organize the company in a jurisdiction that allows flexibility in the management and capitalization of the company (subject to any applicable local law requirements, as discussed above).

Unincorporated joint venture

2.129 An unincorporated joint venture is a form of association between entities that wish to carry out a project together for a particular commercial purpose. This is probably the most flexible form of cooperation between entities in terms of management and has long been used in major oil and gas development projects.

2.130 The following are certain important features of the unincorporated joint venture:

(1) it is an association of persons engaging in a limited common undertaking;
(2) the entitlement of each joint venturer is expressed as a share of the assets not a share of the revenue or profits;
(3) an operator may manage the venture, subject to the direction of an operating committee, which often comprises representatives of each joint venturer (usually voting in accordance with their proportional interests); and
(4) each joint venturer may (depending on the applicable law) owe fiduciary obligations to the others.

2.131 The use of an unincorporated joint venture may pose complexities that render its use impracticable. These include:

(1) because it is not a separate legal entity, it may not be able to borrow or enter into contracts in its own name; and

(2) financing is often more complex to obtain if the joint venturers seek separate, rather than joint, financing as the lenders' security will be limited to an undivided interest in the assets.

Partnership

2.132 The partnership is a common form of enterprise in many (but certainly not all) jurisdictions because it:

(1) allows tax benefits to flow through directly to the partners;
(2) allows maximum flexibility for the allocation of profits and losses between partners;
(3) affords flexibility for the resolution of management and other business issues; and
(4) has legal personality, allowing it to borrow and enter into contracts in its own name.

2.133 The partnership has the following general features:

(1) although it may be a separate legal entity, the partners are nonetheless jointly and severally responsible for all liabilities of the partnership;
(2) the liability of each partner to the creditors of the partnership may be unlimited (although recourse to the sponsors can effectively be limited by the use of special purpose corporate partners);
(3) in certain jurisdictions, the number of partners may be restricted; and
(4) transfer restrictions may prevent partners from transferring their partnership interests without the prior consent of the other partners.

2.134 Some jurisdictions have constituted hybrid entities, such as a limited liability partnership, that may offer the benefits of partnership tax treatment with the limitation of liability and other attributes of a corporation.

Relationship among equity investors

2.135 Whatever the form of the project vehicle, there is often an agreement among equity holders that governs their relationship. This may take the form of a development agreement, a joint venture agreement, a partnership agreement, or a shareholders' agreement. Often, depending on the corporate ownership chain, there may be two or more such agreements—the sponsors may invest through a chain of corporate entities, one or more of which may be jointly owned in some manner by two or more sponsors. If that is the case, then one would expect to see a shareholders' agreement or similar between the legal entities that are the direct owners of/investors in the actual project company or other vehicle, together with similar arrangements further 'up the chain' of ownership until such point in the chain as there is no common interest or ownership.

2.136 Whatever 'label' is given to the documentation that ultimately governs the relationship between the various equity investors, the following terms, and the manner in which risks are allocated, must be considered (the terms 'joint venturer' and 'venturer' below are used generically to refer to the various parties that have come together to promote the project, via whatever particular vehicle is selected, rather than being used in a restrictive sense):

(1) the nature of the financial obligations to be imposed on the joint venturers;
(2) the allocation of responsibilities, management and voting rights;
(3) the conditions under which distributions may be made;
(4) the restrictions on competition among the joint venturers;
(5) the consequences of default (specifically, whether the venturer will find its ownership share diluted or terminated);
(6) the nature of any restrictions on the assignment or transfer of interests; and
(7) the circumstances under which the venture will be terminated.

2.137 An overview of key provisions of a joint venture, partnership, or shareholders' agreement is set out in Appendix 3.

Dilution and cross-charge mechanisms

2.138 Sponsors will generally wish to address the risk that another equity participant fails to meet its equity funding obligations or otherwise breaches its obligations under the joint venture, partnership or shareholders' agreement. Dilution provisions provide a mechanism to allow the non-defaulting equity participant to reduce the defaulting equity participant's interest by assuming its portion of the funding obligation and thereby acquiring a pro rata portion of that equity participant's interest in the project vehicle.

2.139 Many project vehicles also put into place a cross-charge or similar mechanism whereby each of the equity participants grants a charge in favour of the other equity participants over its interest in the project vehicle or the project assets to secure its performance under the joint venture/partnership/shareholders' agreement (including payment of cash calls). Lenders are frequently asked to permit dilution to occur and to allow such cross-charges to be implemented.

Project structures

2.140 The essential elements of a project financing are the construction or acquisition of a facility by a private sector entity and the sale of the output of that facility to an off-taker or onto the market. There is a wide variety of ways to structure that basic transaction to meet the particular requirements of the parties. The various types of project structures in the international marketplace include the following.

Build, own, operate (BOO)

2.141 Under a typical BOO structure, a utility or state entity enters into an off-take agreement with a project company that agrees to build and operate a new manufacturing (or other) plant for a given product. This structure may also be applied to the development of a 'merchant' plant which has no formal off-take contracts. BOO projects often involve a consortium consisting of, among other possibilities, a local developer that brings in local contacts, an equipment vendor interested in selling its product, and a company interested in operating the facility.

Build, own, transfer (BOT)

2.142 Under a BOT structure, the project company absorbs the risk of completion and then transfers the asset to a public sector entity after repayment of the project debt. A BOT structure is often based on a concession or development agreement between a government or a government agency and the project company. The obligation to transfer the asset back to public ownership may arise at the end of a specified period of time or, if earlier, upon the occurrence of specified conditions (e.g. material default by the project company).

Build, lease, transfer (BLT)

2.143 In this case, the project company assumes the construction risk. The completed facility is then leased to the government, which assumes the operating risks. Lease payments, made by the government to the private sector lessor, are structured to amortise the construction debt and provide a fixed rate of return on the equity. At the end of the lease term, ownership of the asset is transferred to the government. This structure allows the government to shift the construction and financing risks to the private sector whilst retaining operating control over the facility.

Build, transfer, operate (BTO)

2.144 Under this structure, the project company completes the project and transfers it back to the host government for a specified consideration. The government then contracts with a private company (often related to the project company) to operate the facility and either pays the operator a fee or receives royalty payments from the operator during the contract term.

Transfer of operating rights (TOR)

2.145 The divesting entity (often, an arm of the government) in this structure transfers the right to use existing assets and, in return, enters into an agreement with the acquiring entity for the purchase of the capacity or output of those assets. Often, the acquirer must invest significant capital to repair or expand the assets and, in some

cases, must deal with complex issues concerning relations with existing facility employees.

'Within the fence' projects

2.146 In emerging markets, large industrial consumers must often go to considerable lengths to ensure the availability of reliable, cost-effective power or other utilities, even if it means that the consumer must self-generate its requirements. As an alternative to building their own power stations, industrial customers may enter into power purchase agreements with independent power producers. In addition to industrial sales, the independent power producer may sell a portion of its output to a local utility.

Forward sale structures

2.147 In this case, a project company or joint venture will finance the construction of its facilities with, in addition to equity invested by the sponsors, proceeds from selling all or a portion of its anticipated production (oil or gas, for example) during a specified period to an unaffiliated purchaser, often a special purpose company organized offshore and owned by a charitable trust. The sale may be for a lump sum prepayment or for staged payments, timed to meet construction cost liabilities. The special purpose company finances the purchase price payments mainly by borrowing from third party lenders. It on-sells the product in the spot market or pursuant to long-term off-take agreements, often with affiliates of the sponsors, and uses the revenue from the off-take sales to pay the debt service on its borrowings. The primary recourse of the lenders is through security over the special purpose company's purchase agreement with the project company and its off-take sales agreements. By characterizing the structure as a sale of product, rather than as a form of security over project company assets, and ensuring that the debt of the special purpose company is not consolidated as debt of the project company, the forward sale technique is designed to structure around limitations on the ability of the project company to grant liens or to borrow. The key legal and accounting issue with this type of structure is whether the forward sale arrangement is, in fact, effective to transfer title to the future production (generally referred to as a 'true sale') or is merely a disguised loan to the project company, secured by future production.

Privatizations

2.148 Governments often seek to raise capital by selling all or a part of their assets to the private sector. A government may in some instances 'corporatize' the entity that holds the asset and then sell down all or a portion of the equity in that entity. Alternatively, it may 'divisionalize' an entity by selling one or more discrete businesses while maintaining public ownership of others.

2.149 Clearly, the above discussion gives only an overview of the considerations that may be involved in the selection of both the underlying structure of any particular

individual project and the nature of the entity that is used as the key project vehicle to pursue a particular project. Hopefully this part of the chapter has provided an overview of the various decisions that may be involved when considering each of these questions, and a flavour of the factors that may underlie the decision to pursue any particular structural direction.

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3

SOURCES OF FUNDING

Mark Plenderleith, Milbank, Tweed, Hadley & McCloy LLP

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Introduction

3.01 From the inception of the development process, sponsors will be minded continually to assess the availability and constitution of the likely sources of project capital. A common goal of sponsors is to minimize and delay the funding of the highest cost of capital, the sponsors' equity, and to leverage the project with the cheapest source of external financing which, depending on market conditions and the project, is likely to be long-tenor senior debt from the commercial bank market, eligible financing from public sector funding institutions, or the capital markets.

3.02 As has been the case in the wider financial markets, the recent dearth of liquidity in the project debt and capital markets has been one of the key factors affecting the achievability of the ambitions of sponsors in terms of transaction scale, pricing, tenor, and gearing of projects.

3.03 The project finance market between 2000 and 2010 illustrates the extremes that sponsors may face when they approach the capital and loan markets to raise project funds. The dramatic growth in the project finance sector in the years preceding the

collapse of the US housing market and the events leading to the September 2008 bankruptcy of Lehman Brothers was in part fuelled by a wealth of options for traditional originating project finance lenders to distribute their exposure, whether through syndication, secondary market sales, or, to a lesser extent, securitization. In the project finance loan market, the traditional model of a commercial lender originating a loan and holding that exposure was replaced with a model which saw the originating lender quickly distributing the booked loan, and thereby creating space on the originator's balance sheet to participate in further financings.

3.04 Primarily in developed countries, the use of credit ratings on loans, in addition to bonds and other securities, expanded the reach of potential investors and allowed the market to move beyond the capacity constraints of the traditional project finance lenders. In the project bond market, the highly developed US and Western European domestic projects' markets were fuelled by the activities of the monoline insurance companies providing guarantees (or 'wraps') of the timely payment of project bond principal and interest for investors wishing to look only to the 'AAA' credit ratings of the monolines, without conducting an in-depth due diligence of the issuer.

3.05 The infrastructure development programmes of both mature and emerging economies and the race for secure access to natural resources generated a highly competitive market for the world's leading export credit agency debt providers. Competition in regional markets was heightened by the rapid deployment of capital in the energy and infrastructure sectors and the boom seen in the Middle Eastern projects market fuelled the development of Islamic financing structures which could be incorporated into more traditional project financing templates in the region. The result of the 'perfect storm' was tremendous competition among lenders and other finance providers and a plethora of competing financing options.

3.06 The global recession, fully felt in 2009 and early 2010, left a firm imprint on deal-flow in its immediate aftermath as the capital markets and project finance debt markets dramatically contracted. Public sector lending provided life support to a limited number of deals, however, the focus of spending was directed at massive governmental intervention through wide ranging stimulus packages in 2009/2010 which strained budgets and the resources of the implementation bodies. During this period sponsors found great challenges in securing sources of project financing as the avenues for arrangers to distribute exposure either tightened or became unavailable and the appetite to originate and hold was at a record low.

3.07 The cycle of the funding market has once again acutely focused participants on the fundamentals of having a well-structured project based on early identification of risks and appropriate allocation and mitigation of such risks. Part of this process, and the subject of this chapter, is the constitution and implementation of the funding structure. This chapter illustrates a variety of sources potentially available to sponsors pursuing a project finance funding plan. The chapter concludes with an

overview of the reasons for entering into, and a description of the role of term sheets, letters of interest, commitment letters, and mandate letters. Chapters 8 through 10 discuss three particular funding sources in greater detail, the participation of export credit agencies (ECAs) and multilateral agencies, the use of the international bond markets, and the application of Islamic financing, which has provided additional liquidity predominantly in the Middle East region, Malaysia, and Pakistan.

Sources

3.08 Equity capital is the highest risk category in the capital structure. As described in Chapter 2, project finance equity providers are willing to accept more risk than debt providers and focus on the return on money invested, the 'up-side'. Debt providers do not share in the up-side. Returns are fixed and relatively low. Debt providers therefore expect to be protected from the 'down-side', and the risks need to be structured such that repayment is, to the maximum extent possible, assured. As discussed further in Chapter 4, re-pricing of the debt alone will not be an acceptable solution to financing a project which has failed to identify, allocate, and mitigate risk correctly.

3.09 Sophisticated sponsors dedicate substantial efforts to assessing the financial markets in order to identify the optimal sources of funding for a project. A principal determinant of the attractiveness of a project to the financial markets is the robustness of its financial projections. In assessing access to the debt markets, key financial ratios will be considered, including:

(1) the debt-to-equity ratio, which is the ratio of aggregate project debt to the aggregate amount of equity invested in the project;
(2) the average and minimum debt service coverage ratio, which is the ratio of (i) the aggregate net cashflow generated by the project to (ii) the aggregate debt service obligations of the project company for any relevant period; and
(3) the loan life coverage ratio, which is the ratio of (i) the net present value of the projected net operating revenues generated by the project over the term of the project debt to (ii) the principal amount of that project debt.

3.10 The sensitivity of the coverage ratios, which are tested through financial modelling, to the technical, legal, and political risks associated with the project need to be considered. The outcome of this analysis will be weighed against current financial market conditions to determine the optimal financing plan. The more robust the outcome of this analysis, the greater the project's access will be to deeper and lower cost sources of financing. Sophisticated sponsors will leave their options open until financial close and, even thereafter, will regularly review refinancing options.

3.11 The principal sources of finance will change according to the existing state of the debt and capital markets. Deal specific factors, such as its geographical location,