

Project Finance in Asia's Emerging Markets - A Legal Perspective

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Introduction

By its very nature each project financing is unique. There is unfortunately no textbook approach. Those who have been involved in project finance will be well aware of the enormous time, not to say mountains of pine forests which are consumed in such undertakings.

What are we talking about - what is project finance?

There are probably as many "definitions" of what constitutes project finance as there are projects. The basic characterisation is that there is no recourse, on the part of the lender to the sponsor.

The objective of the sponsor is that the lender should have recourse exclusively to the cashflow of the project and perhaps to the assets of the project.

The objective of the lender will be to maximise recourse to the sponsor. It is all a matter of allocation of risk.

Some risk may also be borne by third parties. Not all of those third parties will be direct participants in the project. They may, for instance be providing insurance or bonding to the project.

There is a natural tension between sponsor and lender. The lender wants to maximise recourse to the sponsor and the balance sheet of the sponsor (and for that matter anybody else having anything to do with the project). The sponsor's objective is to limit recourse to its credit. There is, however, a mutuality of interest in ensuring that the project is feasible. If it is not, not only will the lender not be repaid, but the sponsor and anyone else having an economic interest in the project misses out.

Allocation of risk

The skill or science in structuring a project financing lies in allocating the various risks that inevitably arise. Ideally, as with any financial transaction the degree of risk apportioned to any one party must bear some relationship to their anticipated reward.

As lenders are generally risk averse, their approach will be to minimise risk wherever possible. The starting point for a lender may therefore be to maximise the equity or debt which the sponsor injects into the project.

Generally speaking, lenders will not insist that a sponsor's contribution be by way of equity but will require any debt to be deeply subordinated.

Risk takers

In addition to the sponsor there will be other parties who have an economic interest in the project. Both the lender and the sponsor therefore may seek to lay off risk to these parties who, as mentioned above, will often be participating in the rewards of the project. These may include:

- contractors, suppliers and consultants involved in the project;
- the operator of the project, post completion;
- the suppliers of raw materials to the project post-completion;
- purchasers of products from the project post-completion;
- third parties providing guarantees or other credit enhancement or support.

One of the means of minimising or allocating risk is through insurance. This is a crucial element of any project financing. It requires a comprehensive understanding of what risks can be insured against and where the appetite for the insurance might lie in the international market.

Insurance and bonding

To a greater or lesser extent all projects will utilise insurance and bonding arrangements.

Depending on the type of project, the array of insurable risks consist of:

- damage or destruction of assets;
- delay or cessation of construction;
- delay or cessation of operation post completion;
- environmental risk.

Classically, lenders will require an assignment of any policies or insist on being named as an insured party. The lender will usually also require that any proceeds of a claim

be paid to the lender. Again there is a natural tension between the interest of the sponsor, who will want to apply insurance proceeds towards rebuilding, and the lender who will want to be repaid and walk away.

A number of project risks can be addressed through the use of contractors bonds. The sort of risks which are covered by such instruments are:

- the failure of the winning bidder for the project to proceed (bid bonds);
- failure of a contractor to complete the project (performance bonds);
- failure of the contractor to perform after moneys have been advanced;
- obligation to comply with post completion defect liability periods.

These are all examples of risk of a generic kind and minimisation techniques of a generic kind. There are a multiplicity of specific project risks, some or all of which may occur in any given project.

Completion risk

One of the matters most likely to result in delay or failure to complete is construction risk.

Much will turn on whether the construction contract is of a turn-key variety or whether the contractor is being funded by the sponsor. If the contractor becomes insolvent or is unable to complete the project then, very clearly, problems arise for all interested parties. It is critical therefore that both sponsor (if it is not the same as the contractor) and financier have undertaken an independent review of the capacity of the contractor to perform.

It is also crucial that the contractor has experience in the type of project and also desirable that the contractor has done business in the relevant country before. As will be the case with a number of the risks referred to in this article, there is substantial overlap between some of the issues.

It is usual in this day and age, for construction contracts to be “fixed time - fixed price”. There will also be either one, or other, or both, a parent company guarantee and/or a contractor’s bond.

Supply issues

Any project will require consideration of supply of:

- raw materials;
- transport;
- equipment;
- labour.

Each one of these has the potential to blow out the cost and the term of the project. Once again, some of these can be mitigated against by incorporating “penalties” in contracts for lateness or non-performance.

Delays can amount to more than simply a deferral of completion. They will inevitably increase financing costs, because:

- there is a delay in the generation of revenue; and
- additional interest accrues/is payable.

In some instances construction must reach a certain critical stage in order to take account of weather conditions. In other instances, the project must reach production/operation by a specific time to meet the supply obligations. Purchasers of the product will not commit to unlimited deadlines.

For all of these reasons it is therefore desirable to build in a contingency in the financing structure.

Supply risk

The risk here is that costs will escalate beyond the original projections and/or materials become unavailable. In assessing any given project it is prudent to ascertain:

- whether a supplier(s) has a monopoly;
- is the price of the product subject to fluctuation?
- is the output of the product sold in a different currency from that of the loan (in which case some hedging may be required).

Currency/foreign exchange risk

It is crucial not only that there be adequate cash flow from the project to cover debt servicing but that the cash flow -

- is in the currency of the loan; or
- is easily convertible into the currency of the loan.

A mismatch or mismanagement of exchange rates can undermine the economic viability of a project.

This issue is particularly important in developing countries. As mentioned above, it is important that the pricing of the product or service be tied to the currency fluctuation between the host country currency and the currency of the loan. It is possible to use escalation formulas which are tied in part, to changes in the exchange rate.

The ideal solution, from a lenders point of view, is to have the price or tariff of the product paid in the currency of the loan and the foreign currency payments held in an offshore account.

Even if the escalation formula factors in changes in the exchange rate, if the price or tariff is paid in a foreign currency, there is still a potential convertibility problem. The lender will be at risk unless the local currency can be converted to the currency of the loan immediately and placed in an escrow or trust account and, preferably, offshore.

Some of these problems can be overcome by recourse to currency swaps or similar derivatives. However, there is always a cost to any of these risk minimisation instruments.

A related risk is that in relation to exchange controls. Lenders will usually seek comfort from the host Government to ensure that funds flowing out of the country will not be subject to exchange controls. The alternative is the offshore account, referred to above.

Technology risk

This can be a source of tension between sponsor and financier. Lenders prefer established and tested technology.

The sponsor however, may wish to use more cutting edge technology to overcome potential obsolescence and provide greater efficiencies.

The risk with new technology is that it will take longer and cost more to get into production. There is also the risk that there is no precise base comparison and assessment of forecasts and projections is therefore made more difficult.

One means of addressing this risk is for performance guarantees to be obtained from the technology supplier. In the case of turbines for instance, it is sometimes possible to extract performance guarantees from credit worthy parent companies.

Political risk

Even if they are not a participant, the co-operation of host Governments is always a vital factor in any project financing. Of primary concern is the granting of permits, licences or consents. These are almost universally required in any significant project financing. This issue requires exhaustive due diligence and will inevitably require a high degree of local knowledge from lawyers and other experts.

Ideally, any permits and consents should be unconditional and unambiguous. They should be obtained upfront and not being capable of being revoked. They should, as far as possible, cater for any potential changes in the project.

Host governments can also have significant impact on projects in a number of other ways, namely:

- imposition of taxes and tariffs;
- import or export controls and quotas;
- environmental requirements.

A change in taxes or tariffs has the potential to dramatically change the financial outlook for a project. Accordingly, sponsors should familiarise themselves as much as possible with the regulatory framework for the industry or product involved.

A more fundamental risk is that there will be a change of Government, or a major policy change. This may be a positive or a negative. At worst it may give rise to a risk of expropriation. Again, local knowledge is imperative. Although some political risk can be insured against, usually through export credit agencies, there is, as ever, an attendant cost.

Force majeure

These are risks, beyond the control of the parties. The traditional examples are earthquakes and other natural disasters, wars, strikes and political insurrection.

Some of these risks can be insured against. The issue again, is that of cost. There is, however, the risk that not only the project, but individual parties may be affected by force majeure events. Thus, suppliers of raw materials and purchasers may also be subject to force majeure events. The underlying contracts which those parties have entered into must be reviewed to determine what the force majeure regime is.

Operational risk

After the completion of the project the testing of market

projections will take place. The operator must be capable of operating the project efficiently and in line with the original projections. This requires technical ability, financial stability and an understanding of the environment in which the project is located.

There is a risk that, between conception of the project and the project coming on line, market conditions may have changed significantly. The lead time in major projects is significant. Thus the demand for the product may change, it may become outdated or there may be new competitors on the scene. The market in which it operates may be deregulated.

Some of this risk can be offset by obtaining performance guarantees from the technology suppliers and purchasers of the end product. Care must be taken to ensure all aspects of the project are operating in accordance with the original specifications before any of these guarantees are released.

Sales risk

This is generally not a matter of concern where the end product is being purchased by the sponsor. If however, the product is being sold to third parties then demand for and the cost of the product once operational, is crucial.

The sort of factors which affect price include:

- competition from other suppliers;
- reduction in demand for the product whether because of lower priced or more efficient alternatives or obsolescence;
- deregulation or other Government intervention.

Sales risk should be addressed at the outset. Where there is a take-off by third parties, long term supply contracts will traditionally be entered into with purchasers. There is an underlying issue of the credit standing of the purchaser and where that in turn is an issue then some form of credit enhancement or performance guarantee is often required.

Environmental risk

This is rapidly emerging as a significant issue. Recent developments in Papua New Guinea are but one illustration of the potential for environmental risk to disrupt or delay a project. One of the ways to mitigate this risk is to retain technical experts at the outset, to assess the level of risk and the environmental laws of the host country. There should then be a regime which ensures that operational procedures comply with those laws.

The risk is that a project may:

- be forced to close;
- be required to invest in additional technology and equipment upgrades;
- incur increased monitoring costs;
- incur liabilities for clean up costs or fines;
- have its production costs increased;
- incur liabilities to third parties such as indigenous owners.

The outcome of all of these may be a reduction in cashflow and/or a reduction in the value of the physical assets used as collateral.

Governing law

This will always be an issue in developing countries. Even if there is a developed body of law there is the risk that those laws may be subject to change or that they have been infrequently interpreted.

It is important that there be an independent, timely and accessible dispute resolution mechanism.

Generally speaking both sponsor (if it is not a resident of the host country) and financier will wish to have the documents governed by the laws of a jurisdiction that they are familiar with and which is internationally recognised.

If, however, the sponsor is a resident of the host country, or the government of that host country is a party to the transaction, then there will be pressure for local law to prevail. In some instances, those countries who have adopted the common law system, such as Malaysia, this may not prove to be a problem. In other circumstances, say Vietnam, this matter will be of more concern.

It will not always be possible to avoid the application of local laws in respect of certain issues. This will particularly be the case where security has been taken over tangible property and where local property laws will apply. Once again, sponsor and financier must be intimately familiar with local property and security laws and local legal advisers retained to advise on all of the potential risks.

Conclusion

Project financing is a complex undertaking. It requires a considerable mix of skills. It also involves long lead times. A corporate looking at a project financing of any consequence needs to plan any such undertaking very carefully. That said, care must be taken to ensure that regard is had to the existing balance sheet and capacity of the corporate.

Experience shows that the first form of a project financing structure and in particular the extent of sponsor exposure often bears little resemblance to the final form - which evolves some months/years later! □