The financing of an infrastructure project (capital investment project)

PRELIMINARY CONSIDERATIONS

Both the sponsors/promoters/investors and the financiers/lenders of the project have to first make the all-important investment decision: whether to invest in/finance the project or not?

It should be recalled that today’s capital investments generate future returns

If a project’s value is greater than its required investment, then the project is financially attractive

Project finance is all about placing a value on the uncertain future cash inflows generated by a capital investment project. This value should account for the amounts, timing and risk of the future cash flow

The cost of capital is the minimum acceptable rate of return for capital investment (as set in relation to investment opportunities in financial markets). Investment projects offering rates of return higher than the cost of capital add value. Projects offering rates of return less than the cost of capital actually subtract value and should not be undertaken (irrespective of security issues)

By calculating present values (through discounting of cash flows) we see how much cash must be set aside today to pay future expenditure

The difference between a project’s value and its cost is referred to as its net present value (or NPV). The higher a positive NPV, the more attractive the project [Alternatively, comparing the expected rate of return from investing in a project with the return that shareholders could earn on equivalent-risk investments in the capital market]

Projects that earn a good rate of return for a long time often have higher NPVs than those that offer high percentage rates of return (IRR) but expire after a shorter period of time. Subject to sensitivity analysis, scenario analysis, break-even analysis, operating leverage
The expected rates of return demanded by investors and lenders depend on two things: (1) compensation for the time value of money (risk-free rate); and (2) a risk premium (which depends on the sensitivity of the sensitivity of a project’s returns to fluctuations in returns on the market and the market risk premium).

The security market line provides a standard for project acceptance. If the project’s returns lie above the security market line, then the return is higher than investors (and lenders) could expect to get by investing their funds in the capital market and therefore is an attractive investment opportunity.

These considerations apply independently of available security rights!

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REAL SECURITY RIGHTS OVER IMMOVABLE PROPERTY

If an infrastructure project entails ownership of land/immovable property and rights thereto, it is customary for investors and, or lenders to request real security rights over such property, usually in the form of hypothecs or mortgages.

The advantages of such security rights: (1) the property remains in the possession of the owner/operator of the infrastructure who may put it to the economic use for which it is destined; (2) the lender however has a real security right over the property which remains attached to the property and follows it in the event of a transfer to third parties and confers preferential enforcement rights in the event of a default by the borrower.

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WHERE REAL SECURITY RIGHTS OVER IMMOVABLE PROPERTY MAY NOT BE OBTAINED

However in certain situations the creation of real security rights over land/immovable property is not possible, for instance when the land is res extra commercium as in the case of the foreshore, ports, harbours and the related super-structure and infrastructure (for instance, Article 3(2) of the Act of Ownership and other Real Rights and Articles 3 and 5(2) of the Maritime Domain and Seaports Act of Croatia).

Rights over such property would usually have to be conferred by way of concession.
PROJECT FINANCE – GENERAL

The fundamental consideration is that the project’s NPV is positive and high enough to justify the ‘investment’

A related consideration would be the duration of the concession, as well as the estimated cost of the investment and other obligations imposed upon the concessionaire.

Whether or not the concessionaire would become entitled at the end of the concession at the end of the concession to compensation for the ‘investment’ made throughout the life of the concession, or at least some form of right of first refusal in extending the concession, ought to be irrelevant.

In these cases the greater part of the financing of long-term infrastructure projects on such property may be performed (on a non-recourse or limited recourse basis) by debt that is to be repaid principally out of the assets being financed and their revenues (say, the marina itself) – the repayment of the loan is essentially limited to the assets of the project being financed.

Key characteristics of the model: (1) the sponsors/investors would be the shareholders of a special purpose vehicle (the SPV) that would be the concessionaire/project company; (2) the SPV (generally, a joint venture limited liability structure) would be the borrower [if the borrower is not a SPV there its project-related assets and activities would have to be ring-fenced from its other assets and activities]; (3) the SPV’s only assets are likely to be those related to the project; (4) the lender(s) would have limited recourse against the SPV’s project assets, and against sponsors/investors (through guarantees, letters of undertaking, letters of comfort etc); (5) the main security would be in the form of assignment of rights arising from the related project documents (contracts and other transaction documents), including the possibility of ‘taking over’ the project; and (6) more complex and more expensive than traditional corporate financing.

The lender’s claim would be an unliquidated claim in damages against the SPV (or against a guarantor) for breach of any undertaking, representation or warranty as opposed to a claim for the recovery of a debt.

Apart from the expense, all this could be very attractive to the project sponsors/investors.
From the host government’s perspective a project finance could have the following benefits/attractions: (a) a source of foreign investment; (b) reduction of public sector borrowing requirements for infrastructure investments, by relying on private funding of such projects; (c) possibility of developing what might otherwise be non-priority projects.

Typical example would be a DBOT (design, build, operate, transfer) ... usually the lending would be performed by a syndicate of lenders (because of ticket size and for other practical reasons, including the need to have banks in the host country to act as facility agent, security trustee etc).

A project based on the granting of a concession by a principal, usually a government or an agency thereof, to a promoter (concessionaire) who is responsible for the construction, financing, operation, and maintenance of a facility over the period of the concession before finally transferring to the principal, at no cost to the principal, a fully operational facility. During the concession period, the promoter owns and operates the facility and collects revenues in order to repay the financing and investment costs, maintains and operates the facility and makes a margin of profit.

From the lenders’ and from the principal’s perspective the project is ‘off the balance sheet’ for the duration of the concession.

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THE PRINCIPAL PARTIES INVOLVED IN A DBOT ARRANGEMENT

The SPV would hold the project assets (through the concession agreement) and be the borrower for the project and the central party that will enter into most of the project documents. It usually may delegate one or more of the duties assigned to it under the DBOT.

The sponsors/investors could include diverse interests, subject to the approval of the lender(s).

They would usually be expected to furnish the ‘equity’ part of the project cost through cash injection commitments, both before and after completion. This would be achieved through shareholders’ agreements (generally as financial guarantees or indemnity obligations in favour of the SPV). Sponsors would normally also furnish management and technical assistance to the SPV and, possibly, guarantees (performance or otherwise) in favour of the lenders.

If the SPV delegates the design and construction duties to a third party, this will usually be done on a ‘turnkey’ basis, possibly for a lump-sum fee, through a construction contract.
(frequently, the ‘Orange Book’ published by FIDIC). The contractor would have to be approved by the lenders.

If the SPV also delegates the obligation of operation and maintenance of the project (once completed) to a third party this will be covered in an operating and maintenance agreement containing appropriate service levels. The operator would have to be approved by the lenders.

Insurers

The host government – involved in issuing the necessary permits and consents ... usually also the transferee of the project (and related infrastructure) at the end of the concession

The SPV’s customers/off-takers

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LENDERS’ CONCERNS AND THE MITIGATION THEREOF

Financial feasibility of the project

The creditworthiness and the ability of the parties involved, principally the SPV, but also the sponsors/investors, the contractor, the operator etc, to fulfil obligations assumed

The legal validity and enforceability of the project documents. This is critical especially because of the multi-jurisdictional nature of such projects

The proper management of all risks related to the project, including the mitigation and assumption thereof by respective parties – the essence of project financing is the apportionment of project and other risks amongst the various parties having an interest in the project. This risk allocation is managed through a matrix of contractual relations between the various project parties embodied in the project documentation (which are therefore the instruments by which the project risks are shared among the project parties)

The main contracts will be:

- the Concession Agreement/Licence;
- the Construction Contract;
- the Operation and Maintenance Agreement;
- Insurance Contracts;
- Off-Take/Sale/Supply Agreements;
- the Loan Facility Agreement;
- the Security Documents; including Assignments of rights under the Concession Agreement/Licence, Construction Contract, Operation and Maintenance Agreement, Insurance Contracts and Off-Take/Sale/Supply Agreements, Direct Agreements

Governing law

Restrictions on allowing the SPV to be involved in activities other than those strictly related to the project

Restrictions on distribution/payment of dividends by the SPV to its shareholders

Restrictions on sale of shares in the capital of the SPV, exclusion of pre-emptions rights

Limiting the circumstances under which the Concession Agreement/Licence may be terminated/revoked or the rights thereunder forfeited by the SPV in their entirety or partially (withering clauses)

Ensuring that the rights under the various project documents may be validly assigned

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RISK

Detailed risk analysis at the outset; risk allocation determined; each particular risk should be assumed by the party best able to manage and control that risk; risks should not be ‘parked’ with the project company

Political (country) risks (including political and, or economic instability and change of laws) – host government assurances, multilateral financing (where possible) + insurances

Legal and regulatory risks (relating to permits, consents and concession agreement) – host government – contractual provisions + due diligence and legal and expert opinions

Construction (delays in completion, price, technical and performance) and operational risks (technical and performance, related liabilities) (relating to the construction agreement and to the operating and maintenance agreement) – the contractor and the operator respectively – contractual provisions, performance guarantees + expert opinions + insurances

Financial risks (relating to the shareholder agreement and to the credit agreement and security documents) – the sponsors/investors and the lenders respectively – hedging, credit enhancement + insurances
Market/revenue risks (relating to off-take/sale/supply agreements) – off-takers/customers – very difficult to ensure coverage in this regard

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OTHER FORMS OF PROJECT FINANCE

Bonds

Leasing

Equity – rights governed mainly by company law and by agreement; a key issue is ‘control’

Mezzanine finance – exercise of call options

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COMPARATIVE LEGAL ISSUES IN RELATION TO PROJECT FINANCE STRUCTURES

Floating charges covering all the property and assets of the SPV in common law jurisdictions ... confer preferential rights and a higher position in the queue for the net proceeds of a borrower’s assets in the event of the latter’s insolvency, although the borrower is allowed to dispose of the said assets until the creditor exercises its rights of enforcement; the creditor is only entitled to the proceeds of the (forced) sale of such assets after the claims of higher-ranked preferential creditors, those of a certain percentage of unsecured liabilities and expenses of administration and liquidation are duly satisfied; moreover a floating charge may be set aside in the period running up to the debtor’s insolvency (within a year prior to the start of the insolvency proceedings) if the debtor was insolvent when the floating charge was created or if the debtor became insolvent as a result of the floating charge, except to the extent that new money was provided at the time

– viz. general hypothecs in some civil law jurisdictions, a right created over all the property present and future of the debtor (or of a third party for the benefit of the creditor) as security for the fulfilment of an obligation; it attached to the property affected thereby only so long
as such property does not pass into the hands of a third party; in some jurisdictions, the creditor of a debt secured by a general hypothec and whose rights are not otherwise already adequately secured may cause to be registered as a further security for the same debt a special hypothec over property (usually immovable) belonging to the debtor; must be created by public deed which must state the sum for which the hypothec is agreed upon; must be registered in the Public Registry; crystallized upon the filing of enforcement proceedings; only privileged claims and prior hypothecary debts will rank higher

*Right to appoint a receiver/administrator* in common law jurisdictions

– viz. no direct equivalent remedy in civil law jurisdictions

*Doctrine of frustration* in common law jurisdictions, narrower, when without the fault of a party a contractual obligation becomes incapable of being performed because the circumstances in which performance is called for would render it a thing totally different from that which was contemplated by the contract. The parties are therefore discharged from all their future obligations under the contract and the loss as a result of such termination will lie where it falls. This *lacuna* is filled in by *force majeure* clauses inserted in project documents

– viz. the doctrine of *force majeure* in civil law jurisdictions exempts the parties from contractual performance in the event of unforeseen events beyond their control; the event must be external, irresistible, make performance of the obligations impossible and the party affected must have done everything in its power to perform the obligations