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Essentials on Project Financing

Prof. Avv. Matteo De Poli

School of Law of the University of Padua

Studio De Poli – Venice

www.studiodepoli.it

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Definition and Nature of Project Finance

- P. F. is the financing of an industrial (or infrastructure) project with several capital needs, usually based on limited recourse structures, where project debt and equity used to finance the project are paid back from the cash flow generated by the project, with the project's assets, rights and interests held as collateral. In other words, it's an incredibly flexible and comprehensive financing solution.
- It is a specialist field of funding for the purpose of financing the development or exploitation of a right, natural resource or asset.
- It is based upon the projected cash flows of the project and its ability to service and repay debt funding. E.g.:, p. f. may involve issuing a bond to pay for the construction of a museum and repaying it from ticket sales for that museum
- It involves the creation of a legally independent project company (SPC) financed with equity and non-recourse debt
- The main characteristic of project finance is that projects are incorporated as separate companies

The Project: an example of a contractual clause

Definition: "The construction, equipment and placing into operation of, and the provision of working capital for, the plant of the Borrower to be located in *, in the region of *, for the production of *"

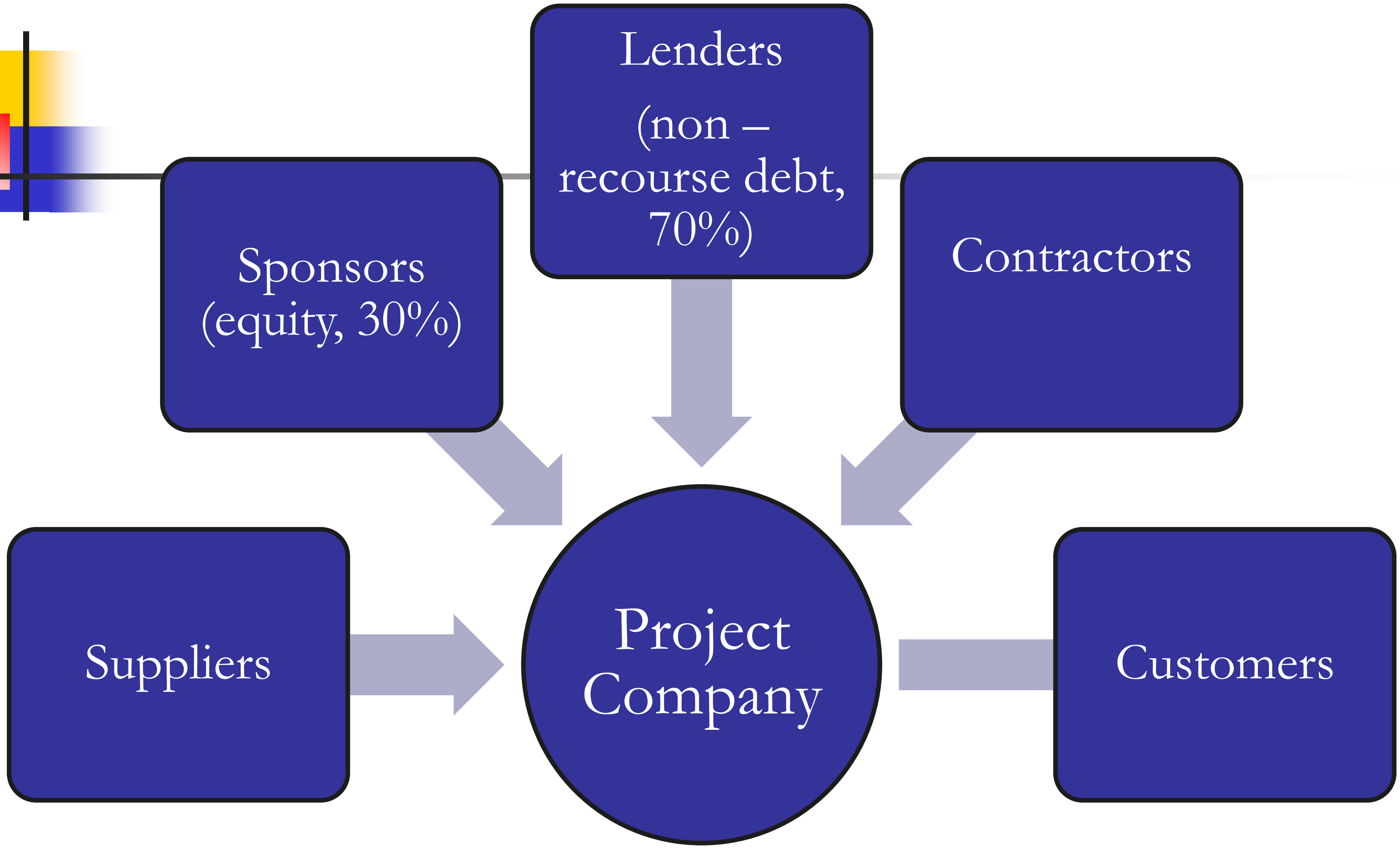
A key concept: the limited recourse finance…

- "Recourse" is the right to demand payment;
- Non recourse finance is the financing arrangement where the lenders will have no remedy against the borrower and are unable to sue the borrower
- Limited **recourse finance** is the financing arrangement where the lender can require the borrower to repay only in special conditions that are spelled out in the **Loan Agreement** itself (if it fails to comply with its specific obligations as to the development and operation of the project). Borrowers may have to pay more for **limited recourse financing.** I

Key Elements

The key elements are:

- Participants (sponsors, project vehicle, lenders, suppliers, purchasers)
- Contracts
- Concession
- Feasibility
- Risks


Lenders
(non –
recourse debt,
70%)
Sponsors
(equity, 30%)
Contractors
Suppliers
Project
Company
Customers

Participants

Sponsors

- The sponsors will became the parties in a Joint Venture, the partners in the Partnership, the investors in the SPC
- They may be private (construction contractors, suppliers, operator and product purchasers) or public (the government of the country in which the project is located.
- **Let's imagine, a corporation importing coal and another supplying energy. They can decide to build a power plant to accòmplish their respective goals. As a result of the project, the importer will supply the plant with coal and the other sponsor will purchase energy from the power plant**

Project Vehicle… (1)

It can be

- an unincorporated joint venture. It is the most flexible form for sponsors cooperation for management purposes but lacks of separate legal personality;

or

- a partnership comprising of the sponsors. In English law it does not have legal personality;

or

- a single purpose project company. Given its legal personality, an SPC provides insulation for the sponsors from project risk and liability. The sponsors participate to the SPC dividing the shares between them according to their contributions

Project Vehicle … (2)

- The use of a separate project company provides *de facto* (not full but) limited recourse for the sponsors

Lenders

- The lenders are all the persons (usually: banks and other international public institutions) who provide financing. Construction of a project is usually financed by a syndicate of banks on a secured basis
- There may be more than one set of lenders

  a) an international syndicate may provide foreign currency lending

  b) a domestic syndicate may lend domestic currency
- The project's rights and assets provide the security for its loan facilities

Suppliers

- Two categories:

  a) those providing equipment, goods or services required for the construction of the project

  b) the providers of services, goods and equipment for the operation of the project once its construction has been completed

Purchasers

- Some purchasers of the project’s product or services may seek to secure their supply by entering into long term purchase contracts
- The may not always be long term purchasers and the project may rely on the spot and retail markets to sell its products

Contracts

Construction contracts

- It's entered into with the construction contractor and deals with the construction of the project. **Often, the construction contractor is an affiliate of one of the sponsors**
- It may take the form of a comprehensive 'turnkey' contract to construct and commission all the projects facilities

  The construction contractor's obligations may be the subject and enters into sub-contracts as required.
- The construction contractor's obligations may be the subject of a guarantee in the form of a bank or surety bond
- Lenders may require sponsors to provide a completion guarantee

Supply contracts

- Supplies fall into 2 categories:

  (a) Construction phase supplies: equipment, materials, services

  (b) Post construction phase supplies: goods, equipment or services needed to operate the projects, such as power
- The lender's concern is to ensure that the project has all the appropriate sources of supplies to enable it to carry on its operations and generate its projected cash flow

Sales contracts

- The need for sales contracts will depend on the nature of the project's product.
- Not all the projects enter into a long term contracts

Operating contracts

- If the project vehicle is a finance vehicle rather than the operator of the project, a contract will be required with an operator to operate and maintain the project
- The operator may be a sponsor

Concession

- Some projects may require a licence (oil and gas production), concession (mining) or permit (power plants or pipelines) in order for the project to be carried out
- The construction of a project may require planning and environmental permissions

Feasibility

- To attract finance for the project it will be necessary for there to be feasibility studies by relevant experts
- These studies are a crucial part to the credit risk assessment of the project
- It is necessary to acquire all the relevant information relating to the project necessary for evaluating: a) the project; b) its risk; c) the return; d) the country profile; its infrastructure profile
- The feasibility studies enable the lenders to assess the extent of the risks associated with a project: pre and post completion risks, political risk, operating risk

Risks

- Risk identification and allocation is a component of project finance. A project may be subject to a number of risks, such as: a) completion r.; b) permit r.; c) price r.; d) resource r.; e)operating r.; f) casualty r.; g) technology r.; h) currency r.; i) interest r.; l) political r.; m) insolvency r.) n) environmental r.
- Environmental risk is the risk of pollution and liability for clean-up costs. Reliance is placed on an initial environmental audit and on insurance