

PROJECT FINANCE IN ASIA

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Introduction

The rapidly developing economies in Asia are experiencing unprecedented growth. This explosive development has placed unprecedented demands on the existing infrastructure in many countries, most noticeably in the energy fields. In fact, many commentators believe that the underdevelopment of the infrastructure in several countries in the region is one of the principal contributors to a lower economic performance than might otherwise have been expected. Given the quite startling performance of these economies in the last 2-3 years, it is not surprising that numerous people see the development of infrastructure as a unique opportunity, particularly as it is clear that the demand for the development of these projects will far outstrip the availability of traditional sources of financing from the public sector.

As a result, a significant amount of new capacity is likely to come from privately financed projects using project financing techniques adapted to the particular markets in which the projects will be built and operated. This point has not been lost on the vast numbers of developers, construction companies, financial advisers, equipment producers and their professional advisers, who are now based in the region.

Nevertheless, with the pace of development and activity in the region there often appears to be a lack of understanding about, or knowledge of, certain financing structures and their appropriateness for particular projects.

This paper will outline one structure, the Build Operate Transfer (BOT) structure, as it is often considered to be a structure which is particularly suited to large scale infrastructure projects and is a structure on which we currently receive frequent requests for advice and explanation. For those who are familiar with the concepts involved, this paper will highlight some considerations which need to be borne in mind when implementing a BOT in this region.

BOT - General

In short, under a BOT structure, a government typically grants a concession to a project company under which the project company has the right to build and operate a facility, for instance, an oil refinery, power station or water treatment plant; or, to construct new roads and bridges - an area that would previously have seen direct funding. The project company (the employer under the construction contract) borrows from the lending institutions in order to finance the construction of the facility. The loans are repaid from "tariffs" paid by the government under the offtake agreement during the life of the concession. At the end of the concession period the facility is usually transferred back to the government, hopefully after the project company has obtained a return for its equity investors. This type of structure is popular with governments in the region as it enables them to develop infrastructure projects without committing their limited resources to particular projects.

Nevertheless, strictly speaking, a BOT structure is, in itself, a structure that involves non-recourse financing. That is, financing where lenders are repaid solely from the cash flow generated by the project and whose only security is in that revenue and the assets of the project. However, pure non-recourse financing is rare as lenders are seldom willing to commit the large amounts needed for today's international projects solely on the basis of a project's expected cash flow or assets. In fact, even limited recourse financing is very rare in this region (i.e. where there is recourse to the project company if it does not comply with its obligations to the lenders in relation to the development and operation of the project in question).

Accordingly, most international project financings, especially in the emerging markets of Asia, tend to be financed on a basis which, while relying primarily on the project company's cash flow to service the debt and security provided over the assets of the project company, also minimises the lender's risks by incorporating a number of back-up or secondary means of credit support provided by the host government, sponsors, purchasers or other interested third parties.

The Contractual Framework

A BOT is a very complex structure with a large number of elements which need to be combined and integrated. It requires an extensive network of inter-related and often inter-conditional contracts.

A BOT will usually include all or at least a majority of the followings agreements

- (i) A concession agreement, licence or mineral lease between the government authority and the project company. This is the cornerstone of the structure as it effectively gives the project company the right to carry out the project. Concession agreements in this region vary enormously. In some cases, the right to carry out the project is sourced in special legislation enacted by the relevant government. For example, Hong Kong has passed such legislation, including the Tate's Cairns Tunnel Ordinance, 1 July, 1988 and the Eastern Harbour Crossing Ordinance, 1 August, 1986. In other countries the concession agreement will be a very loosely drafted document where parties will rely more on the goodwill of the host government (and its need to develop projects in the future) than on the contractual terms of the concession agreement. As a consequence, sponsors and lenders are often faced with concession documentation which is not as comprehensive as they might like.

The position taken by sponsors and/or lenders in this situation varies. Nevertheless, even where the sponsors and/or lenders are of the view that a concession agreement requires amendment, they should bear in mind that there are often sensitive political matters which need to be considered when requesting changes. Hence, it is not unusual for lenders and/or project sponsors in this region to find themselves in a position where they must determine whether what they perceive as a deficiency in the concession agreement is, or can be, dealt with other than through amendment of the document. For example, should the deficiency simply be considered as another manifestation of any political risk associated with the project?

- (ii) An offtake agreement/take or pay sales agreement between the government authority and the project company. If, for example, the project is a gas or electricity generation project, sales would not be made on a spot or retail market and long term contracts such as these would normally be entered into. Although the structure of these agreements does not generally cause a problem under English law, this is not always the case in countries in this region, particularly those which do not have an English law background. In a number of jurisdictions in the region, the adequacy of consideration in a contract is of great importance. For example, while an English court will generally not be interested if a utility ends up paying ten times the market price for gas because of its take-or-pay obligations, this can be of great importance elsewhere. Therefore, proper advice should be taken regarding proposed offtake agreements, not only in relation to their enforceability but also in relation to their structure. Another consideration which may arise in some of the more regulated economies in the region is whether an adequate offtake agreement can be negotiated. For example, if, as in China, electricity prices are subject to central controls, it may not be possible to simply "pass through" costs to the offtaker.
- (iii) A construction contract between the project company and the construction company. This will usually be in the form of a comprehensive turnkey contract which provides for the project to be handed over and to be ready for immediate operation. Nevertheless, participants in projects in this region should be prepared to consider variants to a contractual structure with which they may be familiar. For example, it is possible in Thailand and Indonesia for a project company to avail itself of certain tax savings if the construction contracts are structured so that there is a clear division between work which is carried out onshore and that which is carried out offshore. Furthermore, licensing restrictions in Vietnam may also necessitate splitting the turnkey contract. Accordingly, some participants in such a project will need to review any preconceptions they might have as to how the construction documentation should be structured.
- (iv) A fuel supply agreement between the project company and the fuel supplier. This would not be necessary where the project company provides its own raw materials or the project is the actual extraction of natural resources.
- (v) An equipment supply agreement(s) with a supplier(s).
- (vi) An operating and maintenance agreement between the project company and the operator. This would not be necessary if the project company is able to operate and maintain the facility itself.
- (vii) A credit agreement between the banks and the project company in which the banks will advance funds to the project company together with any associated security documents (as to which see below). Some of the issues parties will need to consider are: the currency of the loans (should they be denominated in the principal currency of expenditure or the currency of the projected revenues); are the drawdown and reporting requirements manageable from the project company's point of view and do any control amount requirements reflect local legal

requirements? For example, any instance of a rigid onshore account/offshore account structure will not be appropriate if exchange control consent is required for each transfer of foreign currency offshore.

- (viii) A shareholders' agreement between the sponsors which sets out the respective rights and obligations of the sponsors with respect to each other and the project company.
- (ix) Direct agreements between the banks and the construction company, operator and/or consultants which protect the economic interests of the banks as third parties.

It is of vital importance that these agreements are properly structured and the balance of risk appropriately allocated within the contractual framework.

Risk Sharing

BOTs are generally structured on a basis that requires all parties to share the risks of the project. Project risk sharing is necessary because the project company will usually have a limited value being substantially less than the aggregate net worth of its equity parties.

Each project has its own unique set of risks. In identifying the risks, parties generally look at the project in three stages:

- (i) development/financing;
- (ii) construction; and
- (iii) operation.

Within each of these stages multiple sources of risk exist. It is generally perceived that a higher degree of risk exists during the construction phase of a project, as funds have been advanced and the revenue stream on which the lenders and investors are relying upon for repayment has not yet commenced.

Once the project's risks are identified, the likelihood of their occurrence assessed and their impact on the project determined, the risks are allocated to the appropriate parties. Therefore, the primary consideration at the outset in analysing risk sharing, is that the risk must be placed with a party to the BOT structure which is able and willing to accept that risk.

The participating parties may include:

- (a) Government/Government Authority

Infrastructure projects in this region will normally involve the local government either acting through its ministries or an appropriate government authority. It is normally the pivotal player. It will initiate the project, conduct the tendering process and evaluation of tenders and will grant the project company the concession. It will also either grant a long term lease of, or sell the site for, the project to the project company and will often acquire most or all of the service provided by the facility.

A critical issue to consider here is whether the government authority has the appropriate statutory power to enter into each of the project documents to which it is a party and perform its obligations thereunder. If the authority does not have the requisite powers, its actions will be ultra vires and, therefore, void. To determine whether a government authority's actions are intra vires or ultra vires, it is necessary to examine the legislation under which the authority is constituted. If the legislation does not give the authority the power to enter into and carry out the project, the legislation will need to be amended by the government so that the project can be carried out. Furthermore, many of the projects proposed in this region, for example in China, involve government authorities committing assets, such as land, to the project company as opposed to actually subscribing for shares. Care must be taken, especially in controlled economies, to ensure that the authority involved actually has title to the assets being transferred to the project company. If not, the appropriate government agencies will have to be approached.

(b) Project Company

The project company will usually be a company, partnership, a limited partnership, a joint venture or a combination of them. This will be influenced by the legal and regulatory framework of the host government. For example, foreign participation in large scale projects in China is usually through a joint venture arrangement with the government or the state owned enterprise responsible for the development of the particular industry. The tax regimes and foreign exchange rules may also affect the ownership structure.

As mentioned previously, many BOT projects are structured deliberately to insulate the project company from as many risks as possible. In these cases, the project company is intended to be a mere financing vehicle and risks will be passed through it.

(c) Sponsors/Shareholders

The project sponsors are those companies, agencies or individuals who promote the project and bring together the various parties and consents necessary to get it under way. They are usually involved in some aspect of the work, for example, the construction, the operation, the purchase of the services or the ownership of the land. They are invariably investors in the equity of the project company and may be debt providers or guarantors of aspects of the project company's performance.

The support provided by project sponsors varies from project to project and includes the giving of comfort letters (which is not particularly common in projects in this region), cash injection undertakings, both pre- and post-completion, as well as the provision of completion support through letters of credit.

(d) Lenders/Banks

The financing for a BOT will usually involve, due to the sheer scale of the project, a syndicate of banks and, from within that syndicate, an arranging bank or banks which will take the lead role in negotiating the project and finance documents. The syndicate will most likely include banks from the host country, particularly if there are restrictions on foreign banks taking security over project assets.

The syndicate will necessarily undertake a review of all core project documents to assess the allocation of risks and how that allocation impacts upon their credit approval. These will often be evaluated in conjunction with an experienced engineering firm which will assess the design of the project and the technical aspects of the contracts. It is imperative that the promoters of the project understand that this review of the documentation is an essential part of the credit process for nearly all lending institutions and that the comments/requirements of the lending institutions will not be dealt with by insisting that the documentation reflects the agreement reached by the various non-lending parties and, therefore, cannot be changed. In fact, the most prudent approach would seem to be that the documentation should be developed in consultation with the lending institutions, if at all possible, particularly as issues such as their assignability and the underlying rights of termination will be of importance to the lenders.

One of the principal concerns the lenders will have, apart from satisfying themselves as to the general apportionment of risk, will be to ensure that they can take effective security over all or the principal assets of the project.

(e) Multilateral and Export Credit Agencies

Numerous projects in the emerging markets of Asia are co-financed by the World Bank or its private sector lending arm, the International Finance Corporation, or by regional development agencies, for instance, the Asian Development Bank. Export Credit Agencies also play a very important role in the financing of infrastructure projects in the region.

The involvement of Export Credit Agencies may affect the transaction as they have their own policies and requirements. However, our most recent experience in this region has been that a number of these agencies are becoming more flexible in their approach to the way projects such as these are documented. In particular, a number of the agencies have begun to recognise that there is a need for some form of intercreditor agreement between themselves and other commercial lenders when the agency is participating in financing as just one of a number of groups of lenders. Notwithstanding, the participation of these agencies may alleviate some of the concerns about the inherent political risks in the host country.

(f) Construction Company

Often the conceptual design of the infrastructure is dictated by the experienced utility. Nevertheless, the construction company will usually assume responsibility for designing the facility and taking it through all stages of construction until it is mechanically complete. Further, depending upon the nature of the infrastructure, the commissioning risk (that is, the risk that the technology will work and that the infrastructure will operate to predetermined performance standards), is often allocated to the construction company.

The project company will aim to require the construction company to enter into a fixed price, fixed time, turnkey construction contract. This is rarely fully achieved, as there are normally some cost or timing risks which are not taken by the construction company, which can lead to variations in price or timing.

(g) Operator

There has not been a shortage of private operators for proposed infrastructure projects. This probably has a lot to do with the fact that operators tend to accept little risk in the form of up-front capital or expenditure. A private operator simply anticipates making a profit from operating the infrastructure more efficiently than an equivalent government operator.

The other parties usually involved in an infrastructure project include equity providers, insurers, equipment suppliers, fuel suppliers and, of course, various consultants. Most of these parties will also involve their lawyers and financial and tax advisers. The presence of a multitude of parties and their differing interests will, therefore, lead to an increase in the complexity of the project.

Risk Analysis

At its most basic allocation, risk in a BOT will be apportioned as follows: market risk will be borne by the sponsors; detailed design, construction and commissioning risk will, to a large extent, be taken by the construction company; operating risk will be taken by the operator; and all residual risks, including those risks arising as a result of the mismatching of risks among participants will be taken by the project company.

However, the government and the lenders may also bear a significant proportion of these risks, albeit indirectly. For example, if the project company is responsible for providing fuel and the fuel is below the specified quality, a power station might not be able to perform to the required specification. To alleviate this problem, the project company must back to back its obligations to the construction company under the construction contract with its entitlements under the offtake agreement with the government. The risk would, therefore, ultimately end up in the hands of the government and/or the lenders, which is not a position they set out to achieve.

To give a definitive list of risks which will form part of the risk evaluation process is beyond the scope of paper. Each particular country has its own inherent risks. Some of those which have particular relevance to the energy field in the emerging markets of Asia include:

(a) Country and Political

Most developing countries in Asia have, in the past, lacked clearly defined policies for the role of private infrastructure projects, particularly in politically sensitive fields like energy generation. However, as a matter of necessity, there is evidence of a general move in these countries towards establishing appropriate structures for investment in privately financed infrastructure projects. An example is the partial privatisation of Tenaga Nasional and the subsequent award of four licences for independent power projects in Malaysia.

Nevertheless, it is usually not enough to establish the mechanism for private investment without also establishing a regime which provides indirect support. The necessary requirements to convince the parties, and indeed the banks, of the long term viability of these projects include a legal and regulatory framework which addresses issues such as tax, import controls, conversion and repatriation of profits, and commercially based tariffs which permit a reasonable return on

investment. Without these the project may have to be financed with direct government guarantees.

Given the difficulty of structuring privately financed infrastructure projects without a clear regulatory regime, it should be no surprise that there may be long and complex negotiations to get to the stage where there is a "bankable" proposition in terms of the project documents.

For example, in China, extremely lengthy negotiations are usually necessary and it is a common mistake to believe that signing a letter of intent with the provincial authorities will obtem was addressed by using foreign currency, previously earmarked to pay for power purchases from Hong Kong, to pay for 50% of the power purchased from Shajiao "C". Otherwise, assurances may be required from the government that exchange controls will not apply or, alternatively, that the local currency will be readily converted into a major international currency.

(d) Change of Law

Dramatic changes of law through nationalisation or expropriation are a part of the sovereign risk of doing business in emerging markets. However, as stated above, much more subtle changes of law, or regulations may have a significant impact upon project economics. For example, the host government may impose additional tariffs on imports of plant and machinery or materials, or the health and safety requirements may change during the course of construction leading to design changes, both of which may increase the cost of construction of the facility.

(e) Security

In some countries, for example, China and Vietnam, the legal framework for taking the level of security commonly required in Western project financings is still evolving. In other countries, such as Malaysia and Thailand, legal structures are more developed. However, even in these countries there may be difficulties associated with taking security. For example, in Malaysia, there are restrictions with holding foreign currency earnings in offshore accounts, thereby limiting the ability to take security over those accounts without accepting country/ political risk on those moneys. Furthermore, in Thailand the nature of the security which is available is very limited. For example, there is no concept of a general floating charge, a concept frequently used in UK based project financings.

So far as possible, all government consents and approvals should, right from the beginning, contemplate a security structure consistent with project financing practice.

(f) Environmental Issues

Western investors will be well aware of the need to meet certain environmental standards on infrastructure projects. It would be wrong to assume that this is a lower priority in Asian countries with undeveloped environmental policies. For example, both Malaysia and Thailand will require environmental impact studies to be completed before environmental approvals can be obtained. The relevant authorities will often be unfamiliar with the environmental issues raised by the technology used in modern infrastructure projects and significant time may have to be spent satisfying the authorities on the issues involved.

Planning for environmental approvals should start from the beginning of the project, particularly if the project is looking for support from multi-lateral agencies, such as the World Bank and Asian Development Bank, which require environmental standards to be met as a condition of their involvement.

Conclusion

Project finance has become, and will continue to be, an important method of raising funds for the infrastructure necessary to support the developing economics in Asia. In addition, it has the added benefit of reducing the particular country's exposure to the international capital markets.

Nevertheless, the practical aspects, rather than the conceptual aspects, are the backbone of a successful project. Success not only depends on the ability of the project participants to identify, allocate and manage the risks they have accepted but also on the ability of the participants to adopt structures they have used in the past to meet the challenges thrown up in this region. Participants must cast a critical eye over the structures they use and resist the impulse to insist on the inclusion of relevant structures simply on the basis that it worked well in the past. This is particularly important in the emerging markets of Asia where the regional, contractual and financing aspects of projects, including projects structured around the BOT model, are considerably more complicated than in Europe, UK or the USA.

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