

## UNDERSTANDING THE LEGAL FUNDAMENTALS OF PROJECT FINANCE CONTRACTS<sup>1</sup>

### Abstract

*Project finance is an alternative finance mechanism for structural development whereby the funding of a project is dependent on the project itself and not on the sponsors or credit providers. It is an international transaction involving long-term, nonrecourse loans for the financing of heavy, cost intensive projects. Because of this peculiar nature, the risk involvement is higher than what is obtainable in other international transactions. Even more risk-laden is project finance in developing countries. Therefore, it takes a proactive legal draftsman who is well grounded on issues of project finance contracts to pre-emptively circumvent some of these issues which may frustrate the contract by making provisions for foreseeable and other reasonable risks even before they arise. This paper seeks to arm the legal draftsman with the fundamental knowledge of project financing contracts and by extension arm him with the basic tools for a productive career in the drafting and implementation of project finance contracts. To achieve this objective, this article engages in a comprehensive appraisal of the concept of project finance contracts; exploring its nature, merits, demerits and structures. Conclusively, it guides the legal draftsman on the effective requirements for the drafting of a practical, proactive project finance contract.*

**Key words:** *Project Finance, Legal Fundamentals, Contracts*

### 1. Introduction

Simply put, project finance is a method of financing infrastructure project where the means of paying for the project is the project itself. It refers to a range of financing structures where the funding of a project is dependent on the productivity of the project itself and not on the credibility of the Sponsors or credit providers. It is the “financing of long-term infrastructure and industrial projects based upon a complex financing structure where debt and equity are used to finance the project, rather than the balance sheet of Project Sponsors”<sup>2</sup>. It is a term generally used to refer to:

A nonrecourse or limited recourse financing structure in which debt, equity, and credit enhancement are combined for the construction and operation, or the refinancing of a particular facility in a capital-intensive industry in which lenders base credit appraisals on the projected revenues from the operation of the facility, rather than the general assets or the credit of the Sponsor of the facility, and rely on the assets of the facility, including any revenue-producing contracts and other cash flow generated by the facility, as collateral for the debt<sup>3</sup>.

Finnerty defined it as:

The raising of funds to finance an economically separable capital investment project in which the providers of the funds look primarily to the cash flow from the project as the source of funds to service their

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<sup>2</sup>Wikipedia, *Project Finance* Available at: [http://en.wikipedia.org/wiki/Project\\_finance](http://en.wikipedia.org/wiki/Project_finance). Last accessed 31/07/2009

<sup>3</sup>SLA Hoffman, *A Practical Guide to Transnational Project Finance: Basic Concepts, Risk Identification, and Contractual Considerations* (Oakland: 1989) p. 1

loans and provide the returns of and a return on the equity invested in the project.<sup>4</sup>

It is basically a form of loan contract. However, it is peculiar in the sense that the lender looks to the economic value and possible cash flow of the intended project as collateral for loan and the source of loan repayment rather than placing liability on the borrower.

This should not be confused with asset-based finance which is the form of financing usually applied in the purchase of immovable property in Nigerian. Here, financing is based on the value of the asset financed. The value of the property sought to be bought or developed with the desired loan determines the value of funds to be released as loan. It is however secured on the accounts, assets, balance sheet and credit-worthiness of the borrower. However, where the borrower defaults, recourse could be made to the property which is the subject of the loan. Project finance on the contrary is the financing projects with loans which are not based on the value of the project but on the productivity and estimated output of the project.

The features of international project finance contracts include the following:

- i) The distinctive feature is its nonrecourse nature. In other words, it involves a loan where the Lender is only entitled to repayment from the profits of the project which the loan is funding, not from other assets of the borrower. By implication;
  - The Lenders look primarily to the potential output of the project as a source of repayment for the debt.
  - The credit assessment is based on the project itself and not on the creditworthiness of the borrowing entity.
  - The security for loan is the project itself; the Lender has little or no recourse to the assets of the borrower for debt repayment.

A nonrecourse loan is secured by a pledge of collateral for which the borrower is not personally liable. The Lender is only entitled to repayment from the output of the project which the loan is funding, not from other assets of the borrower. If the borrower defaults, the Lender can seize the collateral, but the Lender's recovery right is limited to the collateral. The collateral being the project itself must be able to service the loan. If this collateral is insufficient to settle the outstanding debt (for example where the value of the collateral drops or where it is over-estimated *ab initio*) the difference between the value of the collateral and the loan becomes a loss for the Lender and not the liability of the borrower. The borrower has no legal obligation to repay the loan sum or make interest payments if the cash-flow of the project turns out inadequate to service the debt. This is because the financing is predicated on the merits of the project and not on the credit of the Project Sponsor. Consequently, lenders would in most cases prudently limit the loan sum to a certain percentage of the cost of the project so that the collateral rather over-repays than turn out inadequate.

- ii) Being international in nature, it usually involves two or more countries, governments and/or international organisations. This will therefore demand that the draftsman takes cognisance of the legal and economic background of the various parties and the applicable laws which could govern the contract at hand.

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<sup>4</sup>JD Finnerty, *Project Financing: Asset Based Financial Engineering*, (United States: 1996) p. 2

- iii) It usually involves the construction of long-term, capital intensive projects. These types of projects are characterised by high capital expenditures, long-term loan periods, and uncertain revenue streams<sup>5</sup>.
- iv) Generally, a special purpose entity is created by the Project Sponsor to undertake the project and thus shield the Sponsor's other assets from recourse by the Lender in the face of project failure.
- v) A syndicate of lenders and equity investors is often involved so that sufficient funds are raised and risks are effectively spread.
- vi) Since the financing is basically secured by the project assets and not the Sponsor's assets, the Lender would often assume control by placing a lien on all the project assets to ensure repayment of the loan sum.
- vii) It involves a series of foreseeable and unforeseeable risks and an endless cycle of possible risk-management options thus a high level of precision and proactivity in drafting a potent project finance contract.
- viii) It is a complex transaction. It involves several parties, contracts and processes. If a detailed analysis of project finance is undertaken, we would discover that it encompasses diverse areas of law, business, corporate finance, securitisation, insurance, government and politics *inter alia*.

What is often obtainable in reality is a limited recourse project finance and not the fully nonrecourse finance. The Sponsor is made to contribute a percentage of the project fund while the greater percentage is provided by the Lender. The Sponsor is also required to underwrite certain risks, though this would be to a limited extent. The risks allotted to the Sponsor and the extent to which this is done varies with the peculiarity of each project. Increasing the Sponsor's equity contribution and liability ensures greater involvement by the Sponsor and serves as a further guarantee to the Lenders. In certain cases, the agreement ends up as a structured project where the Project Sponsor assumes some risks in the project in return for a reduction in the risk premium otherwise payable. Risks not allocated to the various contracting parties are retained by the Sponsor. This may imply that the Sponsor has the discretion to infuse additional capital or debt into the Project Company if necessary.

To make for a predictable and feasible contract, all relevant issues must be clearly and specifically addressed. If the contract is porous, trivial issues could lead to frustration or contract failure. The contract must have a clear achievable target and time frame. Time is of essence in every such contract. The quality of goods and services to be provided as well as the scheduled mode and time of the delivery must be provided for. Though it is almost impossible to have all things work out 100% as planned yet the need for predictability is indispensable. It makes the terms of the contract, the obligations of the respective parties and the time frame for the contract ascertainable. It places a high level of responsibility on the parties. Furthermore, the risks and liabilities must be duly apportioned to fortify the contract against frustration. All parties must be committed. For instance, a Sponsor must be committed to the project though he is not *financing* the project in the true sense of the word. Although the cost of the project is not borne by the Sponsor because the project finances itself, he has his own share of equity contributions, responsibilities, risks and liabilities.

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<sup>5</sup>Investopedia, *Non-Recourse Finance* Available at: <http://www.investopedia.com/terms/n/non-recoursefinance.asp>. Last accessed 31/07/2009.

## 2. Project Finance in Developing Countries

Project finance structures vary from contract to contract and from country to country because of the peculiarities of each contract and of the economic and political situation of each country. The project may be subject to a number of technical, environmental, economic and political risks *inter alia*, particularly in developing countries and emerging markets<sup>6</sup>. And this has greatly affected the application and growth of project finance in developing economies.

Project finance in developing countries could be said to be novel compared to its age long usage in developed countries. Prior to the 1970s, Government financing and ownership of infrastructure had been the norm in most developing countries. However, the growing demand for infrastructural development with the limited nature of Government funds made it increasingly difficult for Government to carry out these projects single-handedly. Coupled with the increased emphasis on privatisation and corporate financing, alternative means of financing were explored including equities, bilateral loans, multilateral loans, commercial loans, *inter alia*. But the recourse nature of these alternatives and the high demands it placed on Government made them unsuitable for heavy, cost-intensive projects. The financing of heavy projects became too expensive and burdensome for developing governments and this gave room for project finance as an alternative means of financing heavy infrastructural development.

The surge towards project finance began to grow, reaching a climax in 1996-97. In 1997 the number of project finance deals worldwide exceeded 600, many of them in developing countries, and their value topped US\$2,340 billion. Within this period, project finance transactions in developing countries rose to a peak of 380 projects (summing up to US\$123,169 billion). But by mid-1997 into 1998, a lot of developing markets encountered dramatic economic deterioration which brought project finance on a downward slide to 140 projects (summing up to US\$60,069 billion) in 1998 (of particular notoriety is the East Asian financial crisis of mid-1997)<sup>7</sup>. That period recorded several failed projects while many large projects undertaken in previous years lost economic feasibility. Generally, investors became sceptical about investing in developing countries. A lot of sponsors cancelled or deferred numerous major projects while the ones under execution were severally threatened by frustrating events. The IFC<sup>8</sup> has suggested that majority of these failures were as a result of currency related risks, political interference and corruption<sup>9</sup>.

However, not all project financing in developing countries fail; a high level of success has also been recorded. For instance, a World Bank study has shown that despite the rise and fall of 1996 – 1998; 2,500 projects reached financial closure from 1990 to 2001, representing investment commitments of US\$750 billion. Though some projects were silently frustrated into extinction during this wider period, only 48 projects were formally cancelled for various reasons which include low consumer demand and pricing, unfair competition due to government interference in the market, corruption, etc.<sup>10</sup>

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<sup>6</sup> Wikipedia, *Project Finance*, (n 2)

<sup>7</sup> IFC, *Project Finance in Developing Countries* Available at: <http://rru.worldbank.org/Documents/Toolkits/Highways/pdf/23.pdf>. Last accessed 31/07/2009

<sup>8</sup> International Finance Corporation

<sup>9</sup> IFC, *Project Finance in Developing Countries*, *Op cit*

<sup>10</sup> Harris, C. *et al*, *Infrastructure Projects – A review of cancelled projects*, World Bank Note No. 252, Available at: <http://rru.worldbank.org/Documents/PublicPolicyJournal/252Harri-010303.pdf>. Last accessed 31/07/2009

### 3. The Parties and Procedures

The risks inherent in project development and operation may be too onerous for the Project Sponsor and proposed Lenders. To cope with these risks, several specialist companies and financial institutions are conscripted, forming a contractual network of investors and spreading risks to support financing. This may lead to a transaction involving multiple parties and complicated procedures. This further makes it imperative that the project finance contract effectively and meticulously apportions the risks and liabilities amongst the various parties to avoid disputes and frustration. The parties and procedures explained below comprise the basics of a simple project finance transaction and may not necessarily apply to every project finance transaction.

#### 3.1 The Parties:

**Project Sponsor:** This is the entity that primarily procures the project and sees to its development. He is otherwise known as the developer. In most cases, it is the same party that wants the project to be carried out. He initiates project finance because it is important to him that the project is undertaken, yet he suffers various financial and other limitations which make project finance a necessary financing alternative. He coordinates the development of the project. In some cases, it may be the Government. In some other cases, it may involve more than one sponsor e.g. where there is a joint venture or where the sponsorship involves a group of companies and subsidiaries. Whatever structure the entity takes on, it must be a juristic personality recognised by the governing laws of the transaction and the applicable laws of the host country. In most cases he is also the borrower, but he may also vary from the borrowing entity as the need arises. However, for the purposes of this study, the Project Sponsor is regarded as the borrowing entity.

**Project Company:** Project finance involves the creation of a legally independent project company financed with nonrecourse debt for the purpose of financing a single purpose, industrial asset<sup>11</sup>. The Project Company is this independent entity established by the Project Sponsor for the special purpose of owning the project assets and consequentially entering into the project contracts. It basically undertakes the construction and operation of the project for and on behalf of the Sponsor. He acts in the capacity of the Sponsor and performs all other acts which the Sponsor would ordinarily have been required to perform particularly as it pertains to the actual construction and operation of the project while the latter remains invisible and is rather seen through the project company. For the project to be structured without recourse to the Sponsor, the Project Company must be an independent entity. And for the Project Company to function effectively, it must be a juristic personality duly recognised by the laws of the host country and would have received all the necessary permits and authorisations from the Government or its agencies. It could be a subsidiary of the Sponsor, an independent company incorporated by the Sponsor, a partnership or a joint venture. Whatever the case may be, its structure must be such as to fit into the legal system of the host country without attracting undue duties, taxes and rates.

**Contractor:** This is the entity which handles the actual construction of the project, makes supplies upon demands and ensures that products and services meet up with the required standards. He may or may not also be the operator of the project. In most cases there are several contractors supplying goods and services of various forms at various stages and there may also

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<sup>11</sup>BC Esty, *Modern Project Finance: A Casebook* (New York: 2004) p. 25

be a main contractor who primarily oversees the other contractors. In such a setting, the main contractor is held accountable for any lapses of the subsidiary contractors.

**Lenders:** This is the major financier of the project. This is the party that contributes the major percentage of the funds needed to finance the project. There is often more than one Lender in such transactions. Lenders may involve a conglomeration of commercial banks and financial institutions. These may not necessarily be the domestic banks of the host country. However, it is often better to involve transnational as well as domestic banks and financial institutions depending on the nature of the project. This will help avoid the effect of any governmental policy targeted against foreign investors or any reforms which negatively affect domestic banks. It also creates room for risk diversification among investors considering the nonrecourse nature of project finance. Lenders in a single transaction may also include the World Bank or International Monetary Fund. Their involvement guarantees further security. Bilateral and governmental financial agencies aimed at providing developmental funds may also be involved. Lenders may also include output purchasers who contribute to the financing of the project in exchange for bulk, long-term supply of the output of the project.

In some cases, we see Lenders handling specific aspects of the project and in most other cases the various Lenders just concentrate on various stages of the project. However, all work together to ensure the successful execution of the project. Thus we may have Construction Lenders who handle the actual construction work being different from Design and Architectural Lenders who see to the production of a standard architectural and structural design. And we may also have Temporary Lenders (who provide project loan on a short-term basis) as a backup for, or in addition to and aside from Permanent Lenders (who provide project loan on a long-term basis). In most cases we see the Lenders grouped according to the tasks they perform in the transaction. Thus we see one serving as an agent to the Sponsor in coordinating the Syndicate of Lenders and is answerable to the Sponsor while another keeps custody of all collateral and yet another liaises between the Lenders and the other parties to the transaction.

**Equity Investors and Bondholders:** Depending on the nature of the project to be financed, some external investors may be invited to bring investment capital to supplement equity invested by the project owners. These investments may take the form of subordinated debts, stock ownership in the Project Company or even partnership in the Project Company. Bondholders are made to purchase project debt in the form of bonds thereby creating further funds for the financing of the project. Just like the Lenders, their contributions are nonrecourse to the Sponsor yet they are targeted at profit creation for the bondholder. Equity investors and bondholders may include the Sponsor, Government, banks and financial institutions or other corporate organisations.

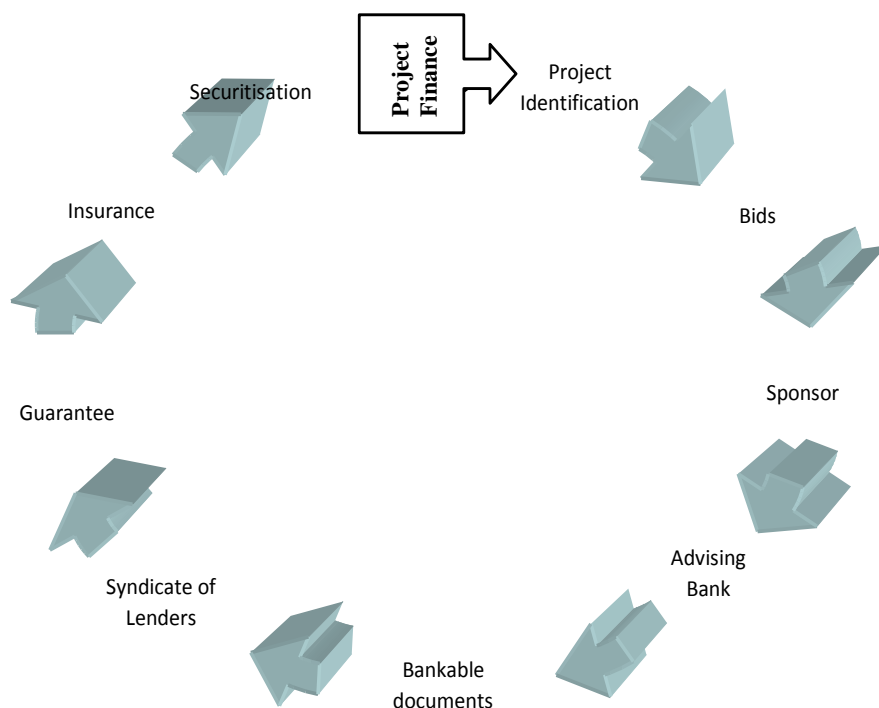
**The Host Government:** This is the Government in whose territory the project is situated. It is this party that provides the location as well as enabling commercial and political environment for the project through its legal system and other associated legislation (e.g. exemptions, permits, property rights, etc.). It also supplies basic facilities like accessibility (roads, rail, etc.), light and water for the territory. It makes short term as well as long term gains from the project. The project creates job opportunities, labour improvement, infrastructural development and other gains for the Government without recourse to government funds and assets. The Host Government may be required to participate in the contract in a number of ways. It is the Host Government that grants all necessary permits, exemptions and waivers to the Sponsor and Project Company. In certain cases, the Host Government is also the Sponsor which initiates the

project. For projects of very high magnitude and importance, the Government may be required to provide guarantees. It may be guarantees as to the validity of the contract or as to the fact that all statutory requirements have been met and all necessary permits obtained, or even guarantees as to the credibility of the Project Sponsor. It may be required to supply raw materials, provide fiscal support, equity contribution, etc. It may also be required to liaise with other governments where necessary for export and transit permit of project supplies as well as fiscal and other benefits.

In most cases, the Host Government ends up the operator or actual owner of the project depending on the structure of the transaction. Subject to the terms of the agreement, it may repossess the project upon completion. It may also arbitrarily expropriate the project depending on its relevance and importance to the Government and its economic advancement. Their actions affect the contract at every stage. In some cases, the Lenders would want the Government to sign an agreement, not to deviate from the terms of the contract, however it is not always possible to hold the Government down and prevent it from changing its laws. The Government is also required in some cases to increase its risk capacity or equity contribution so as to ensure its commitment to the success of the project.

**Experts and Professional Advisers:** These are persons and companies contracted to render professional advice of different forms and at different stages of the transaction. These may include legal advisers who are specialised in the area of project finance and in the law governing the contract or the applicable laws of the Host Government. It may also include financial advisers, commercial surveyors and evaluators who are contracted to estimate and advise on the possible costs which the project may incur vis-à-vis the final output of the project and its estimated ability to service debts. It may also involve quantity surveyors, environmental surveyors, estate managers, geologists, architects, engineers, miners, investment and insurance brokers, technical advisers, etc.

### 3.2 Procedures:



As we can see from the diagram above, project finance transactions proceed through a series of contractual phases before it attains successful completion. The first stage is the **Project Identification** whereby the Government identifies the project to be embarked upon. It then calls for **Bids** and the various intending Sponsors submit their tenders for the Government to select a qualified company which it contracts to **sponsor** the project. The Sponsor then contracts the **Advising Bank** which offers professional financial advice and services and also prepares the **Bankable Documents** for the transaction. The Advising bank then forms a **Syndicate of Lenders** with other banks and financial institutions which is more or less an alliance to fund the project by providing syndicate loan and spreading the risks. The Lenders would most often require some form of **Guarantees** from the Sponsor, Contractors, Suppliers, Experts and the Government to serve as security considering the nonrecourse nature of the loan involved. Consequently, the Government may be required to bring a certain percentage of the required amount and the loan sum ends up being a percentage of the estimated cost of the project and not the full cost. The Lenders would also require **Insurance** for specific parts of the project and for specific project risks. The insurance policy must be clear on the interests, liabilities and limits of the parties; who pays the premium and who the beneficiary is. **Securitisation** which is the final stage is the creation of asset-based securities i.e. securities backed by a stream of cash flows<sup>12</sup>. It implies that the loan is attached to something, usually the project itself.

This procedure is not a universal trend. Some project finance transactions skip some of these procedures or merge some steps in one while some others are more complex and involve more procedural steps than we have outlined in this discourse. The baseline is that project finance transactions could be a complex web of agreements and each transaction is structured to handle its own peculiar circumstances.

## 4. The Merits and Demerits of Project Finance

### 4.1 Merits

- i) Project finance is particularly useful for the infrastructural development of emerging markets. Where heavy projects are to be carried out and the cost of executing same is enormous to the Sponsor, project finance is often seen as a way out. It allows for development of several projects in different geographical areas, each based on the merits of the project, independent of the financial obligations of the other, and with minimal equity requirements. The high risk and capital involvement of such enormous projects make project financing one of the few available financing alternatives in the energy, transportation, and other major infrastructure industries.
- ii) Nonrecourse debt financing: Project Sponsors are able to obtain loans and funding for onerous projects without having their personal assets attached as collateral for the loan rather the loan is dependent on the project assets as collateral. In certain cases however, the personal assets of the Project Sponsor are attached to a limited extent and for some specific reasons. This depends on the peculiarities of each case.
- iii) Off-balance-sheet debt treatment: The Sponsor creates a legally independent entity to own the project assets; as such the project financing is off the Sponsor's balance sheet. Because of this, project finance is especially attractive to the private sector. The project assets and liabilities do not appear on the Sponsor's balance sheet. However where the organisational form is not well structured, the project assets and liabilities could still appear on the Sponsor's balance sheet<sup>13</sup>.

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<sup>12</sup>Money Terms, *Securitisation* Available at <http://moneyterms.co.uk/securitisation/>. Last accessed 31/07/2009/.

<sup>13</sup> Project Finance Models, *Project Finance: Definition, Participants and Agreements* Available at: <http://www.project-finance-models.com/project-finance.html>. Last accessed 31/07/2009.



- iv) Leveraged debt: This involves borrowing money to finance a project in the hope that the project will make enough profit to cover the loan sum and all accrued interests without diluting the existing equities. However, the equity contributions of the parties may vary for numerous reasons. The Sponsor's equity requirements for projects sponsored by developing countries for instance may be up to 25% or more as this serves as a form of guarantee to the Lenders and averts possible risks of the projects failure to produce sufficient funds to service debts. In such cases this advantage is compromised.
- v) Avoidance of restrictive covenants in other transactions: Unfavourable and restrictive covenants are more easily avoided using project finance because the project to be financed is distinct from other operations of the Sponsor and the collateral is often limited to the project financed and nothing more.
- vi) Favourable financing terms: Lenders may offer a more attractive interest rate and credit enhancement costs when the credit appraisal of a project is involved rather than when that of a Sponsor is involved. Though this is not always the case.
- vii) High capital returns: As a leveraged debt financing with minimum equity commitment, the rate of returns of the project often outweigh the Sponsor's capital investment.
- viii) Political risk diversification: The economic, political and other risks encountered in one country will not affect projects in other countries because the Sponsor's global investments are diversified by the establishment of project-specific entities that finance projects on a nonrecourse basis.
- ix) Risk sharing: Heavy, long-term projects involve several risks and uncertainties. The probability of project success is enhanced by the fact that the risks are spread among the various parties and each has economic interest in the project and takes responsibility to the extent that it is allocated to him.
- x) Collateral limited to project assets: The collateral for the loan is ascertainable and it is limited to the project itself. The Sponsor's other assets cannot be attached.
- xi) Lenders are more likely to participate in a workout than foreclose: Where the project experiences financial problems or other form of frustration, the Lenders are left with one reasonable option which is to resolve the issues rather than foreclose and sell off the equipment. This is because the only possible way of getting the loan sum back is by ensuring that the project is finished and operated successfully and this is one thing that gives value to project finance transactions.
- xii) Matching specific assets with liabilities: The profits of each individual project is easily ascertainable because the assets and liabilities of each project are matched and judged separately, independent of other projects undertaken by the parties. This is unlike what is obtainable in the balance-sheet financing where the lending decision is based on the overall corporate balance sheet.
- xiii) Expanded credit opportunities: Where the output purchaser enjoys a higher credit rating than the Sponsor, Sponsor may still be able to enjoy from this higher credit rating and obtain lower costs of borrowing.
- xiv) Limited liability: The borrower's personal liability is limited due to the nonrecourse nature of project finance.
- xv) Funding for projects: money for projects that is otherwise not available can be sourced through project finance
- xvi) The Lender is also able to use the project as collateral to obtain loans and to perform other transactions. This right is however influenced by the structure of the contract.

Project finance is particularly useful for the execution of heavy cost intensive projects by both industrialised and emerging markets. Such projects may include mining, telecommunication, road, rail and bridge construction, energy generation, building and maintenance of oil pipelines

and refineries, etc. Its uses are endless, provided there is a predictable means of revenue returns from the project.

#### **4.2 Demerits:**

The disadvantages of project finance are not as numerous as the advantages. However, the weight of these disadvantages are such that it may erode the usefulness of project finance and to some extent make the practicability of project finance largely complicated and unattainable. Some scholars including Hoffman<sup>14</sup> have identified the disadvantages of project finance to include:

- i) **Complexity of risk allocation:** The apportionment of risks is a vital issue that goes to the substratum of project finance. Various types of risks arise at various levels and often create issues as to who bears which liability. For instance, the risk allocation tensions between the Lender and Sponsor regarding the degree of recourse for the loan, between the Contractor and Project Sponsor concerning the nature of guarantees and so on. The complexity of this issue has in many cases slowed down the project finance process and in many other cases, invited prolonged negotiations which are not only time consuming but cost effective. And if it is not well handled it could lead to a series of other complications which might defeat the aim of project finance.
- ii) **Increased Lender risk:** Due to the nonrecourse nature of the loan, the risk borne by the Lender is higher than it would be in alternative financing measures.
- iii) **Expensive and protracted due diligence:** It is generally lengthier and more expensive than alternative recourse financing for several reasons:
  - It requires much labour, expertise, professional consultations and insurance. This on its own increases the overall cost and time frame.
  - Because of the high level of risks involved in project finance transactions particularly where it is hard to effectively allocate risks, the fees and charges demanded by professionals and consultants is usually very high.
  - Higher interest rates and charges: Owing to the peculiar nature and imminent complexities of project finance, higher interest rates are charged, over and above what is obtainable in the recourse loan and finance.
- iv) **High risks to Lenders leading to stringent terms, rates and supervision:** Because of the high level of commitment which project finance demands of the Lender, he is often forced to take extreme measures to ensure the successful completion and operation of the project. This may involve placing heavy restrictive covenants on the Project Sponsor as well as maintaining high level supervision of the project which may equally attract extra costs.
- v) **Lender reporting requirements:** The nature of project finance also demands that highly effective communication be maintained between the parties. The Lender for instance may not be actively involved in the construction but would want to directly follow up on events. Thus he places high reporting demands on the Project Company. This may include financial reporting, frequent work-progress reporting, *inter alia*. And this is as expensive as it is effective.
- vi) **Increased insurance coverage:** Because of the complex nonrecourse nature of project finance, a higher insurance coverage than what is obtainable in the normal recourse loans is required. Wider insurance coverage entails higher premiums and charges which invariably increase project costs.
- vii) **It encourages unacceptable risk taking:** The nonrecourse liability of the Sponsor may be abused as the he may adventurously undertake certain investments and risks which he would prudently have avoided if his personal assets were attached.

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<sup>14</sup>SL Hoffman, *The Law and Business of International Project Finance* (Cambridge: 2008) Pp. 9 - 12

- viii) Complicated and complex: Because of the multiple parties and numerous contracts involved, the process is multi-faceted, extremely complex and complicated.
- ix) It often ends up as a long-term transaction. The agreement may involve a concession period of up to 30 years or more as a long operation period is higher guarantee that project output would sufficiently service debts. It becomes disadvantageous as infrastructural development is not deemed as belonging to the Government until the expiration of such long tenures.

## **5. The Structures of Project Finance Contracts**

Project finance could take on several structures and forms in order to ensure the successful execution of the project and repayment of project loan. Parties to each agreement usually work out which structure would be most effective for them considering the nature of the project and their peculiar circumstances. Some of the structures commonly adopted are:

### **5.1 Build-and-Transfer (BT) Arrangement:**

This is the Build-and-Transfer arrangement. The project is built at the initiation of the Government. The Project Company undertakes the financing and construction of the project and upon completion, hands it over to the Government. Project is built to suit Government specifications. Ownership and the right of operation are not vested in the Project Company. Upon completion of the project, it is transferred to the Government who owns and operates it and pays the project debts from the project output.

### **5.2 Build-and-Operate (BO) Arrangement:**

This is the Build-and-Operate arrangement. In this arrangement, the project is fully constructed, managed and operated by the Project Company. However, the Project Company only possess the right to operate and this does not come with the right of ownership. Ownership vests in the Government to which the Project Company pays royalties, taxes, fees and duties. It turns out as a form of lease agreement because while Project Company possess and operates the project, ownership vests in the Government which reserves the powers to revoke the Project Company's right to operate (subject to the terms of the agreement).

### **5.3 Build-Operate-Own (BOO) Arrangement:**

This is the Build-Operate-Own arrangement. It is a contractual arrangement whereby the Project Company is authorised to finance, construct, own, manage, operate and maintain an infrastructure or development facility from which the Company is allowed to recover its total investment, operating and maintenance costs as well as a reasonable return thereon by collecting tolls, fees, rentals or other charges from facility users<sup>15</sup>. In this arrangement unlike the **BO**, ownership lies in the Company which equally pays royalties, taxes, fees and duties to the Government.

### **5.4 Build-Operate-Transfer (BOT) Arrangement:**

This is the Build-Operate-Transfer arrangement and is most commonly employed. It is an arrangement whereby the Project Company builds the project, operates it and eventually transfers it to the Government<sup>16</sup>. Project Company only receives concession to finance, design, construct, and operate the facility stated in the Concession Agreement. This enables the project

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<sup>15</sup> Chan Robles Virtual Law Libry, *Philippines Foreign Investment Laws* Available at: <http://www.chanrobles.com/default7.htm>. Last accessed 31/07/2009

<sup>16</sup> Investopedia, *Build-Operate-Transfer Contract* Available at: <http://www.investopedia.com/terms/b/botcontract.asp>. Last accessed 31/07/2009

proponent to recover its investment, operating and maintenance expenses in the project<sup>17</sup>. It is a long term concession arrangement. Fees, rates and prices are determined by internal and external factors to ensure that adequate returns are gained from the project to service project and associated debts. Thereafter the project is transferred to the Government which takes over its operation. During the concession period, actual ownership lies in the Government. The Project Company is only empowered to construct the project, operate it for the agreed period and transfer project to the Government/public entity. The project is built to meet the specifications of the Government so that at the end of the transaction, transfer runs a smooth course. The powers and limits of the parties must be clearly defined to avoid any feuds. At the end of the concession period all the parties are satisfied and the Government acquires the project.

### **5.5 Build-Operate-Own-Transfer (BOOT):**

This is the Build-Operate-Own-Transfer arrangement. Under this arrangement Project Company constructs, owns, manages, and operates the project for a concession period. At the end of the concession period it transfers the operation and ownership of the project to the Government. The difference between this and **BOT** is that in this case, the actual ownership of the project for the concession period vests in the Project Company which can exercise ownership rights including using the project as security for loan within the concession period.

## **6. Conclusion**

The document which embodies the project finance contract is the substratum of the fruitful or unproductive project finance contract. It is imperative that every lawyer who wants to build a career in international business law must understand the rudiments of project financing and project finance contracts. This is because the life of the contract itself flows from the terms of the agreement and it is only when a legal draftsman has been able to understand and truly appreciate the rudiments of project finance that he would be able to draft an effective contract agreement to govern the said project finance contract.

No two contracts are the same and it takes a proactive well informed legal draftsman to give life to a project finance contract. The ultimate goal is analyse the import of each contract, conduct a deep research into it, decipher and incorporate the applicable laws and by the effective use of clear, precise and unambiguous terms draft an effective project finance contract. The draftsman, should be able to tactically prevent, evade and effectively manage the possible risks which may arise at any point of the contract by making provisions for them even before they arise.

Another major issue which the legal draftsman should be wary of is the use of archaic, ambiguous and unclear terms in drafting the agreement. The draftsman must always remember that the need to communicate and be clearly understood supersedes the need to bamboozle the client with superfluous semantics. The draftsman should look out for unhealthy gaps and cover every loophole.

Some model contracts have been developed overtime and introduced into the international business world. The essence is not for the draftsman to copy them and re-present it to the client. These model contracts could be adopted as a guide with variations and alterations made at every necessary point to fit into the peculiarities of each contract. Some international

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<sup>17</sup> Wikipedia, Build-Operate-Transfer Available at: <http://en.wikipedia.org/wiki/Build-Operate-Transfer> Last accessed 31/07/2009

organisations, project financiers, project finance lawyers and consultants have developed guiding laws, and model international trade laws like the UNCITRAL<sup>18</sup> Model Laws and ICSID<sup>19</sup> Rules have been made to govern such contracts and investment relations. In all, the draftsman must be conscious of all applicable laws to each contract and to each location so that he does not come up with terms and conditions which are not enforceable by law. An unenforceable contract is as good as a piece of love letter.

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<sup>18</sup> United Nations Commission on International Trade Law

<sup>19</sup> International Convention for the Settlement of Investment Disputes