[A] Introduction

[B] What Is Project Financing

Project (or non- or limited-recourse) finance refers to a type of debt financing (in either the private or the capital markets) that does not rely for repayment on the general corporate credit of an operating company with a financial history, but instead on dedicated, sometimes contract-based revenues from a single asset or a defined group of assets held by a special-purpose entity.\(^1\) Project developers resort to this form of financing in order to (1) leverage their equity investment and (2) keep the resulting liabilities off their balance sheet.\(^2\) Project finance lenders will generally require that the sponsors commit to contribute a minimum level of equity, and that as many project risks as possible be allocated via contracts for the life of the debt to creditworthy entities who have the experience to manage the risks. Finally, the lenders will insist that the resulting contracts be assigned to them as security for the borrowing entity’s

\(^1\) The asset in question will usually be built with the proceeds of the project financing, but it can then be refinanced on a nonrecourse basis as well; alternatively, a project built with sponsor funds or guarantees can be refinanced on a nonrecourse basis on completion.

\(^2\) Not all project sponsors favor project financing. Because of the increased risk involved for the lenders, project finance debt is generally more expensive in terms of interest rates and fees than conventional corporate financing. As will be seen from what follows, the same heightened risk profile results in arduous and uncertain negotiations over contractual allocation of the risks. Accordingly, sponsors with large balance sheets will often choose to use them to facilitate a cheaper, “cleaner” financing. Project financing, however, can be a powerful tool in the hands of capital-constrained but capable developers; a number of today’s global energy companies, for example, started life as a few individuals with an idea and a calculator, and a knack for closing complex non-recourse financings.
obligations, and that they also receive a first-priority lien over all the borrower’s other assets and revenues, including in particular the revenue-generating asset being financed.

The type of contracts which typically support a project financing will of course vary with the type of project being financed. There are two general categories of projects in this regard, those that benefit from long-term offtake contracts as their main source of revenue and those that sell products or services in a competitive market (“merchant” projects). Merchant projects have also historically not had to secure a long-term supply of a critical input, such as fuel. Power and many industrial projects have historically fallen into the first category, but this is now changing. The second category has traditionally been represented by telecom and transport (road, rail or airports) projects. Water and other industrial projects have fallen in either category. Merchant power projects have migrated from one to the other.

Common to most projects financed on a non- or limited-recourse basis are (1) a “turnkey,” fixed-price, date-certain engineering, procurement and construction contract with an experienced and creditworthy contractor (though this is a modular element--sponsors can dispense with it by guaranteeing completion, and “go non-recourse” thereafter) and (2) an operation and maintenance contract with a qualified operator. The details of the allocation of risks in these various project contracts are beyond the scope of this report, but set forth below is a diagram of the structure common to most of these transactions:
COAL FIRED POWER PLANT

Contractual Structure

- **Power Purchaser**
- **Sponsors**
- **Lenders**
- **Engineering Procurement & Construction (EPC)**
- **Government Support**
- **Operation & Maintenance (O&M)**
- **Insurers**
- **Fuel Supply**

Diagram:
- Power Purchase Agreement (PPA)
- Financing Agreements
- EPC Contract
- Govt. Support Letter
- Insurance Arrangements
- Coal Supply Agreement
It is by no means the case, however, that all risk is allocated away from the project and its lenders. Contract counterparties will naturally seek to limit their exposure, while project sponsors and lenders will ordinarily settle for a contractual structure that sufficiently allocates incentives to overcome particular risks to the parties in the best position to do so. For example, the risk of delay in completion is customarily addressed through the imposition of liquidated damages on the construction contractor. The amount of damages payable is calculated, at a minimum, to cover project debt service payable during the period of delay. Usually, however, such amount (together with damages for performance shortfalls) will be “capped” at 20-40% of the contract price, on the theory that fixed damages in that amount provide sufficient incentive for the contractor to perform without exposing him to unlimited liability for delay, while allowing sufficient time and funds to fix the problem so the project may commence generating sufficient revenues to service the debt. Finally, the finance documents will give the lenders and their engineer the final say over any proposed remedial program.

[B] Project Finance Debt Documentation

Project finance debt documentation is generally understood to consist of a loan agreement or agreements \(^3\) between the entity which owns the project (the “project company”), as borrower, and one or more lenders who typically agree, subject to the terms and conditions of the agreement(s), to advance funds to the borrower to finance the cost of building the project pursuant to the related construction contract, as well as associated “soft” costs such as financing fees and expenses, development costs and interest during construction. Ordinarily, as stated above, the project company will have no other assets, and no other party will guarantee or otherwise assume liability under the loan agreement(s).

Accordingly, the lenders will have to look for repayment to the revenues from the sale of products or services generated by the project. They will insist on a first priority security interest in project assets, including plant and equipment, all project agreements and insurance policies, all revenues of the borrower and all its other assets, as well as a pledge of the equity interests in the borrower. \(^4\) In the case of projects in emerging markets with volatile currencies, they will also require that cash balances (see “Account Agreement” below) be held to the extent feasible

---

\(^3\) Documentation for the issuance of bonds and for the incurrence of debt in connection with a leveraged lease is considered separately below. However, much of the discussion of conventional project loan documentation will be germane to bonds and leveraged leases as well.

\(^4\) Sponsors may resist giving such a pledge, but lenders will usually demand it as the only practical means of addressing gaps in the security over the project assets. These can include, for example, the non-assignability of critical government permits, or the inability to acquire a perfected lien over personal property. In the absence of these elements of the security package, a pledge of all the equity can give the lenders the control over the project they would expect to have in the event of a default.
in hard currencies in offshore accounts,\(^5\) and that the lenders’ collateral agent control the flow of funds to ensure application to the contemplated purposes and availability to service debt.

The project sponsors will seek to maximize both their control of the documentation process and competition among funding sources to ensure the best available terms. This is achieved by soliciting underwritten bids from all likely sources to as detailed a term sheet or heads of agreement as possible, and only \textit{after} project agreements have been largely negotiated. Bidders are asked to specify any exceptions to the term sheet and project agreements, and these are taken into account in evaluating proposals. Such an approach can greatly reduce the time and expense of negotiating documentation, permits optimal market timing and keeps parties focused on substantive financial and commercial considerations.

Once underwriting commitments are obtained, strict timetable discipline and regular face-to-face documentation meetings with immediate turnaround can maintain the desired momentum. When multiple funding sources with differing approval requirements and processes (including in particular government lending agencies) are involved, this can be almost as challenging as scheduling the construction process itself! Closing a successful project financing will involve orchestrating a large cast of participants to a common end.

Technology, including real-time, laptop word processing and Internet message and document communication, if properly managed, can aid greatly in foreshortening the documentation process and thus maximize the chances for a successful closing. Traditional documentary procedures, however, including original signatures, notarization and other rituals involving paper, personal presence and even reading aloud continue to impose a rhythm of their own.

The balance of project finance pricing and structuring in favor of the borrower or the lender swings on a pendulum with market conditions. At the height of the competitive, liquidity-driven global project finance boom in 1996-7 terms and conditions approached those of corporate credits, effectively allocating much of project risk to lenders with little compensation. The global financial crisis and bank consolidation have dried up liquidity and tipped the balance the other way, in favor of fuller (and even “flex”) pricing and tighter structures. Some have, at some risk, tried to tide projects over with bridge or short-maturity “mini-perm” loans with a view to refinancing longer-term, perhaps in the capital markets.

The nature of power project financings, in particular, is evolving. In part because of rigidities inherent in long-term power purchase agreements, the trend in mature markets is toward “merchant” plants selling in an unregulated power market rather than under contract. This will require a different analysis on the part of lenders, different deal structures and therefore different documentation.

\(^5\) Revenues of infrastructure projects are usually received in local currency.
After a brief review of the sources of nonrecourse debt finance for projects and the roles of the various participants, this report will examine in detail the various components of the documentation for the financing of a “greenfield” or new build project, including:

- the information memorandum
- the term sheet
- definitive documentation, including the loan agreement, security documents (including agreements governing the project company’s bank accounts), equity funding arrangements, hedging documents and intercreditor agreements
- bond documentation
- leveraged lease documentation

The report will also:

- highlight some of the differences present in “merchant” financings
- examine the impact of increasing participation of local sponsors and lenders on the documentation of emerging market projects
- describe the impact of the financial crisis in emerging markets and the dynamics of restructuring a project financing
- elaborate on some case studies of the foregoing, including the particular issues involved in documenting project financings in China and restructuring projects in Indonesia

[A] Sources of Project Finance Debt

Reference has been made to private and capital markets for project debt financing. The private market consists of commercial banks, insurance companies and other traditional private lenders. Internationally, they have been supplemented and/or supported by official lending institutions. The latter fall into two primary categories: export credit agencies, whose mission is to promote their countries’ exports of goods and services that are incorporated or utilized in overseas projects, and multilateral development agencies, whose mandate is industrial and infrastructure development in emerging economies. The capital markets are the securities markets in the world’s financial centers and, increasingly, domestic bond markets in the host countries themselves.

The bond market is the promised land. This is because bond investors are the least demanding in terms of both maturity and control, leaving maximum “upside” for project
sponsors (especially those facing essentially fixed revenue streams). This market, however, is notoriously fickle in terms of price (and even availability at any price) and has a particularly limited attention span for “story” credits, which nonrecourse projects inevitably are. In addition, short of outright default, it is cumbersome to the point of impracticality to return to bondholders to try to negotiate a restructuring, if necessary. Emerging host country bond markets are less skittish about country risk (sometimes to the point of being subject to official policy direction), and represent the best long-term hope for local infrastructure financing.

Commercial banks and other private lenders are the traditional providers of nonrecourse finance. They have historically shown the most flexibility in providing firm underwriting commitments meeting sponsors’ needs, and later in restructuring a troubled credit if necessary. They tend to exact their price in the form of shorter tenors and tighter structuring and control.\(^6\) Recently, as the bank market has gained more institutional participants (mere buyers to whom bank originators distribute product they have structured), it has taken on more of the characteristics of the bond market, with what some feel is a consequent loss of comparative advantage.

Official lenders’ main mission is to assume country risk where the latter is discouraging private investment. As will any proactive insurer, official lenders tend to seek to put themselves out of business by encouraging emerging country governments to adopt policies and create institutions that will foster private (and in particular domestic) investment.

[A] Project Participants

By now a picture will have begun to emerge from the foregoing of the various participants in a project financing and how their interests differ. The sponsors are the drivers of a project, the ones whose business strategy the project serves and who stand to gain the most if it succeeds. Local governments are often intimately involved, whether in the guise of offtakers or regulators (sometimes, unhelpfully, both), in either case whose objectives tend to be constituent service at lowest cost (and not project investor profits). Other project contract counterparties are focused on cash sales to the project and will seek to minimize their exposure to project risk. Finally, the lenders are the ones with the most funds at risk, who have left the “upside” to the sponsors in return for priority of payment.

Because of the complexity and the many disciplines involved in a project financing, sponsors will most often find it cost-effective (indeed, third-party financiers will require it) to engage the services of a number of specialized advisors in structuring the transaction. The fields involved include technical (industry expertise, fuel), financial, insurance, market and

---

\(^6\) As the project finance market evolves toward a merchant (or market risk), as opposed to a contractual, model (particularly in rapidly developing sectors such as the US “CLEC” or competitive local exchange telecoms carrier market), participants are moving away from tight structures in the direction of higher levels of equity and a more corporate (and less restrictive) style of finance.
legal. While the project company (or the sponsors) are normally responsible for advisors’ compensation, their independence must be maintained vis-a-vis third parties such as financiers. Financial advisors face perhaps the greatest inherent tension between their professional obligation to their clients the sponsors and their interest in earning the fees (often far outweighing advisory fees in rate of return on resources expended) associated with providing the financing. Expertise gained in backing real-world transactions, however, is invaluable, and sponsors gain comfort from an advisor’s willingness to support its advice with its balance sheet.

On the financing side, one or a few lead institutions (perhaps including the financial advisor) will be appointed to act as arrangers and/or underwriters of the project debt. They and their advisors will work with the sponsors and their advisors to structure the financing. The arrangers will then be responsible for syndicating the financing, and one of them will usually be designated to act on a going-forward basis as agent for administrative purposes. Each of these lead roles carries with it substantive duties and corresponding remuneration in the form of up-front and/or ongoing fees.

[A] Preliminaries: the Commitments

The project sponsors and their advisors will launch a financing by circulating an information memorandum and term sheet with a request that prospective lenders respond with definitive commitments by a certain date. This requires lenders to perform their due diligence and obtain credit approval. This will often be assisted by a “road show” in which the sponsors and their financial advisors tour the various targeted financial centres to pitch the deal and answer questions.

[B] Information Memorandum

The information memorandum is intended to provide basic information on the project, the sponsors and the proposed terms of the financing. It is not intended as a complete basis for a prospective lender’s decision to lend to the project; each participant will be expected to conduct its own investigation (including addressing questions to sponsors and arrangers, at road show presentations and otherwise) and to make its own credit decision. In the US, where bank loans have traditionally not been held to constitute securities, liability for information contained (or not contained) in a related information memorandum is limited to actual misrepresentations, the presumption being that bank lenders are sophisticated enough and have enough resources to be able to determine independently the credit and other risks involved in the proposed loan. Given that an information memorandum is as much or more a marketing document as a shield against liability, a bank-style document should not be used unmodified to offer project debt securities in the capital markets (see “Integrating Capital Markets Financings—Differences from Bank Debt” below). The information memorandum is delivered against receipt of a confidentiality agreement in which the prospective participant agrees to maintain the confidentiality of the information contained (divulging it only as may be legally required or to its employees and advisors working on the proposed transaction and who

---

Page 8
are bound by similar confidentiality obligations) and not to use it for any purpose other than evaluating the proposed financing.

The information memorandum customarily contains the following sections:

[C] Disclaimer.

This is legally protective language intended to limit the responsibility of the sponsors and arrangers for prospective lenders’ decisions regarding the proposed financing. Among other things, this section will disclaim any obligation to update information in the memorandum, discourage reliance on financial and other projections included in the document and refer readers to original documents for their content rather than summaries included for convenience. Even the most ironclad disclaimer, however, cannot deflect liability for deliberate or grossly negligent misrepresentations, and most sponsors and their financial advisors will be concerned that the document reflect well on their commercial and professional reputations. As indicated above, in the US any disclaimer in a document offering securities has to be drafted with statutory antifraud liability in mind, and cannot substitute for accurate and complete disclosure.

[C] Executive Summary.

This is a brief summary of the highlights of the project, sponsors and consultants, the financing plan and schedule and salient financial projections. Potentially misleading as is any summary likely to be unduly relied on by harried readers, it should refer to the main body for a fuller discussion, especially with respect to financial projections.

[C] Risk Factors.

The sponsors and arrangers and their advisors must reconcile the inherent tension between the information memorandum’s role as a marketing document and its legally protective function. On the one hand, the authors will want to emphasize what they see as the strengths of the project and the proposed financing terms relative to competing transactions; on the other, their lawyers will want them to spell out the risks involved to deflect complaints if things go wrong. The compromise usually struck is to include a discussion of project strengths, as well a description of project risks (sometimes called “investment considerations”) together with a description of mitigants employed by the sponsors to reduce such risks. The risk discussion will be more full-blown and formalized in an offering circular issued in connection with a bond offering (see “Integrating Capital Markets Financings” below). The investment considerations can be divided into four main categories: (1) construction risk, (2) operating risk, (3) market risk, and (4) various country and political risks (including currency risks, general political and expropriation risk, legal risk, and environmental and other regulatory risk.)

- Construction Risk. This is the risk the project will not be completed on time, to specifications and/or within budget. Delays, increased costs and/or reduced
performance will jeopardize the financeability of the project and its ability to generate sufficient revenues to repay debt. A number of factors, many beyond the sponsors’ control, will affect the construction outcome. Such factors include shortages of equipment, materials and labor, strikes, work stoppages and other labor disputes, inclement weather, unforeseen engineering, archaeological, environmental and geological problems, changes in law, delays in obtaining governmental approvals or revocation thereof and force majeure events.

• Operating Risk. Operation risk is the risk that after the project has gone online, it will face unforeseen increases in operation and maintenance costs, and/or will not function at the anticipated level. Operation risk can be affected by many of the same factors that affect construction risk, including failure or underperformance of equipment, unavailability of necessary fuel or raw materials, labor disputes, catastrophic natural events, and so on. Occurrence of any of these conditions can result in higher operating costs and inability of the project to meet contractual obligations to customers or lenders. These risks can be mitigated through such devices as:
  • customary business interruption insurance
  • insurance against natural catastrophe
  • warranties from project constructors and equipment suppliers
  • maintenance of adequate spare parts supplies, and/or
  • maintenance of a major maintenance reserve account.

• Fuel Supply Risk. Fuel or input supply and price risk is an important operating risk specific to power and industrial plant projects. This is the risk that a stable and secure supply of fuel or other inputs necessary for operating the project (e.g., coal for a coal-fired power plant) will be adversely affected in some way. This risk can be mitigated through such devices as:
  • long-term supply agreements
  • long-term transportation agreements (for delivering supplies to the project)
  • use of multiple suppliers (to spread risk)
  • demand that suppliers demonstrate access to sufficient reserves to meet contracted for amounts of fuel, and
• maintenance of back-up fuel stockpiles sufficient to address short-term supply shortfalls.

• Market Risk. This is the risk that the project will not be able to generate sufficient revenue to pay for the costs of operation and debt service, let alone generate profit. The risks will differ between projects that benefit from long-term offtake contracts, and so-called “merchant” projects that sell goods or services on the “spot” market. In projects where the revenue stream is derived from long-term offtake contracts (typically with one or a few customers), the loss of one or more customers (or failure of such customers to meet its contractual obligations to the project) can have a significant impact on the project’s ability to meet its obligations to lenders. This risk is counterbalanced by the greater predictability and risk-mitigating effect of a long-term offtake contract. A paradigm example of this sort of arrangement is the power plant project that provides power to a single customer (e.g., a utility) pursuant to the terms of a power purchase agreement (“PPA”). The level of risk in this context will depend on such factors as the general financial condition of the customer(s), regulatory issues affecting the industry (e.g., regulations limiting the price at which a utility may sell electricity), and/or the level of creditor protection under local bankruptcy law.

“Merchant” projects that sell products or services on the “spot” market, such as telecom networks, airports or toll roads, may be more susceptible to the effects of economic downturn. In the event of reduced revenues in such a downturn, the project may be unable to meet its operating and maintenance budget, or its obligations to lenders. A discussion of market conditions and industry competition (supported by appropriate market studies) is important to a comprehensive discussion of the risks for this type of project.

• Country and Political Risks

Currency Risks

• Foreign Exchange Risk. A project that generates local currency revenues (as do most infrastructure projects), but must meet foreign currency loan obligations, is subject to two general types of foreign exchange risk: (1) devaluation risk (also called exchange-rate risk), and (2) inconvertibility risk (also called transfer risk).

• Devaluation risk is the risk that in the event of local currency devaluation, the project will not be able to earn sufficient local currency to meet foreign exchange obligations. Such risk can be managed by obtaining currency or payment guarantees from sovereign governments or multilateral lenders, by use of derivative products (such as options, caps, futures, or swaps), and
by shifting risk to third parties through provisions in contracts governing
the project.

- **Inconvertibility risk** is the risk that the project will be unable to convert
  enough local currency into hard currency to meet foreign currency-
denominated debt service and other payment obligations. This can be the
result of foreign exchange shortfall (due to economic factors such as the
country’s trade performance) or change in government policy with regard
to convertibility of local currency. Inconvertibility can be an issue that
arises in the normal course of business or when realization of collateral
upon foreclosure results in receipt of significant amounts of local currency.

- Inflation Risk. This is the risk that inflation in any of the countries from which
  the project obtains goods and services will cause an increase in project operating
costs. Inflation risk can be mitigated by linking prices charged for services
provided to some appropriate inflation-related index.

General Political and Expropriation Risk. Many projects are situated in developing
countries where the political, social, and economic climates are subject to greater instability
than in developed nations. Such instability, in the form of political unrest or unpredictable
shifts in legal and regulatory regimes, may hinder completion of project construction or
limit the project’s ability to provide goods or services to customers. This risk can be
mitigated through political risk insurance or, in the case of a long-term offtake contract, the
use of force majeure clauses, deemed dispatch (in the event of political interruptions)
and/or tariff adjustments.

In some countries there may be a risk of expropriation or nationalization of project assets.
This risk is particularly acute in high visibility projects that tend to be associated with public
ownership, such as power or mining projects. Political risk insurance can mitigate the risk
that assets will be arbitrarily expropriated without adequate compensation.

Local Legal Risk.

- **Enforcement of Foreign Judgments.** Many project contracts provide for
  adjudication in courts or tribunals outside the country in which the project
  is located. When this is the case, the risk of a local court not enforcing the
  foreign judgment is of concern. Some countries (such as China) are known
  for their low enforcement rates of even domestic adjudicatory decisions.
  Consultation with local counsel may be necessary to ascertain the level of
  enforcement risk.

- **Limitations on Enforcement of Rights and Realization of Collateral.** The rights of
  creditors in the project country may not be as well established (through
  legislation or judicial precedent) as in developed countries. An assessment
should be made of the law concerning foreign ownership, liens and security interests in order to ascertain the rights of creditors should foreclosure be required. The rights of lenders to foreclose on collateral may be subject to perfection and priority issues and to practical problems associated with realization of security interests. Furthermore, legal requirements and procedures for transferring permits and other rights associated with a project (and the affiliated risks) will differ from country to country.

Environmental and Other Regulatory Risk. Projects will generally be subject to a number of standards and required approvals related to energy, labor, environmental and other laws. Failure to meet such standards or obtain required approvals may delay construction, interrupt continuous operation and/or generally add to the cost of the project. A thorough understanding of the local legal and regulatory regimes can significantly mitigate this risk. Less easy to plan for is the risk that new laws or regulations, not foreseen at the outset of the project, will be passed or promulgated. This risk can be mitigated through clauses in offtake agreements that entitle the borrower to force majeure relief, deemed dispatch and/or tariff adjustment in the event of change of laws, policies or regulations.

[C] Project Strengths.

It may be desirable to incorporate a section near the outset of the information memorandum highlighting what appear to be the strengths of the project. This can be an appropriate place to focus attention on such factors as the strengths of the sponsor group, favorable aspects of supply and offtake contracts, any indications of government support, and/or positive forecasts of future market and economic conditions. This section will necessarily be counterbalanced by the delineation of risk factors (or “investment considerations”).


This is a description of the proposed sources and uses of debt and equity funds and the sequence of disbursement. It may also include a projected repayment profile, which may show cash flow coverage over the life of the project loans. This section may also include a description of the project’s interest rate and currency hedging program. It usually includes a proposed financing timetable to which the sponsors will want to hold participants. Graphs and tables can be used to good effect to clarify oftentimes complex financing structures.

[C] Project Description.

This is a general overview of the project to be built. This section can include a brief background or history of the project, a description of the physical site of the project, and an explanation of steps to be taken to secure rights to land necessary to the project. More importantly, the section should include a description of the technology to be utilized, the plan (including time line) for
project construction, strategies for project operations and maintenance, as well as plans for securing supplies and raw materials necessary for project operation.

[C] Project Participants.

This section will include a description of the sponsors and other major parties to the transaction (contractor, offtaker or concession grantor, fuel supplier, operator) and their experience and financial capacity. Obviously, these will be relevant to any lender’s evaluation of the strengths and weaknesses of a project. Criteria will include the extent of participants’ track record in similarly situated projects; affiliation or prior experience of working together will be a plus, provided conflicts can be managed. Strategic fit with the sponsors’ businesses will be important. Particular scrutiny will be directed at local participants in emerging markets (see below); where local parties lack qualifications, government participation or support will be sought. On the other hand, geographic proximity and insulation against country risk will be viewed as mitigating factors.

[C] Contract Summaries.

The major project contracts will be summarized for convenience. Copies of the actual documents will be provided with the information memorandum. Nevertheless, as a practical matter, readers will use the summaries of what are likely to be lengthy and complex agreements as at least an initial guide for spotting key issues in the transaction.

Care must be taken to secure counterparty consent to disclosure of confidential commercial terms. Some recent proposed project bond offerings have faltered due to failure to obtain such consent to disclosure in the offering document.

[C] Regulatory Discussion

This section provides an overview of the various legal and regulatory considerations that will affect the project. Since many projects are in heavily regulated industries (e.g., power and telecom), often the first and most important part of the discussion is of general industry regulations. Furthermore, the section should include any relevant aspects of the foreign investment law, tax considerations, and foreign exchange regulations. Legal regimes concerning arbitration, environmental permitting, other miscellaneous permits or licenses, and any regulatory regimes relating to financing or supplies should be discussed as well.


This will discuss the supply and demand environment for the product (and inputs) of the project, past and likely future trends, impact of government policies, infrastructure, etc. This section will be particularly critical in a “merchant” or market-risk project such as a telecom network or a toll road. In these instances it will include an extensive discussion of the results of market studies by specialized consultants. The financeability of these projects depends heavily
on the reliability of traffic and similar projections, which can in turn vary widely with the
degree of competition, general level of economic activity, rates etc.


Detailed cashflow projections over the life of the project debt will be included, spelling out the
assumptions on which they are based and including sensitivity analyses of alternate scenarios
testing the project’s performance under possible adverse conditions.


A glossary of defined terms will be included.

Reports of technical, fuel, transportation, insurance and market consultants will also be
included. Although ideally all project agreements and studies will be in place when the
information memorandum is circulated (and any long-term offtake contract will certainly have
been concluded), there is usually some overlap in time between the financing process and the
project development process. Sometimes difficult judgments must be made regarding the
degree of specificity to be included in advance of final agreement with project counterparties.
While too much detail can “lock in” lender expectations which may be difficult to realize, a
definitive presentation helps the financing process, and can serve to put pressure on
counterparties (and even partners) to “get with the program.” Once loan documentation is
signed, a more definitive version of the information memorandum can be prepared for use in
syndicating the loan facilities.

[B] Term Sheet

The main goal of the term sheet is to set out principal common terms of the financing.
Borrowers naturally seek the most favourable terms and the greatest flexibility in managing
their projects; however, the minimum requirements of financeability must be observed to
ensure success. Lenders in turn must ensure that any credit requirements are included; as
stated above, the borrower will seek to negotiate a detailed term sheet which leaves relatively
little room for further discussion. In particular, while lenders would prefer that the term sheet
not be exhaustive, borrowers will seek to limit substantive terms and conditions to those
expressly negotiated.

Significant contractual terms deserving particular attention at this stage include:

- Sponsor commitments. See “Equity Funding Arrangements” below.

- Material adverse change (“MAC”) conditions (to funding and to future borrower
  actions) and events of default. As has been demonstrated again by the recent
global financial turmoil, MAC clauses can be critical in the event of unforeseen
problems, so the breadth of the MAC definition is a key issue. At a minimum
lenders will want to cover events which affect the borrower’s ability to repay project loans or the lenders’ rights or security (including its value); borrowers will resist MAC conditions to funding and events of default. Though common in the international market, it is difficult to justify a MAC event of default; a New York court, at least, would be reluctant to enforce an acceleration based on such subjective grounds. In practice, lenders usually seek to rely on other, contractually specified events, even merely to suspend funding.

- Use of proceeds. This is limited to project costs in accordance with an agreed budget and technical specification. Issues include payment of sponsors’ development costs/fees and use of undrawn commitments to fund reserves described below.

- Conditions precedent. These are the conditions to the lenders’ funding obligations. The borrower will seek to define these as narrowly as possible (ideally limiting them to readily satisfied document delivery requirements), while the lenders will seek to ensure their credit requirements are met and to protect themselves against unforeseen adverse events occurring between commitment and funding.

- Representations. These establish the credit baseline against which the lenders are willing to lend, and are intended by the lenders to allocate to the borrower the risk that all legal and other requirements are not in place for the financing to proceed. The borrower will be concerned that the representations are practically capable of being made (or are the subject of appropriate exceptions), and will seek the lenders’ agreement as to which requirements must be met. A particular issue is the fact that the lenders will expect the representations be currently true in all material respects as a condition to each drawdown; the borrower will resist this “bringdown” of representations or seek to except certain ones, or variances that could not reasonably be expected to have a material adverse effect on its ability to repay the loans. Lenders, however, generally believe it is appropriate for the borrower to bear the risk of adverse developments affecting the credit, whether or not these are within its control. One representation which is hotly debated relates to the accuracy and completeness of the information memorandum; consistent with the expectation that lenders will perform their own due diligence, borrowers will seek to limit this to a negative assurance that they are not aware of any facts which would render inaccurate the information given.

- Covenants. These are the borrower’s undertakings during the life of the financing, and they are customarily (if somewhat arbitrarily) divided into affirmative obligations and restrictions on the borrower’s freedom of action, or “negative” covenants. Affirmative covenants will include, among other things,
compliance with law, financial and other reporting and maintenance of insurance. Negative covenants include a “negative pledge,” or agreement not to create additional liens on or otherwise dispose of the project, restrictions on the incurrence of other indebtedness and the making of equity distributions and a prohibition of material amendments of project agreements without the lenders’ consent. The borrower, anxious to retain sufficient flexibility to deal with the contingencies of its business, will seek to temper the resulting obligations with materiality thresholds (numerical or general), exceptions (such as the ability to incur additional debt subordinated to the lenders’ loans on terms satisfactory to them or to refinance the loans, to pay dividends if financial tests are met and to enter into replacement project agreements), contest rights and a standard of reasonableness.

• Distribution/“clawback” of excess cash flow. See “Equity Funding Arrangements.”

• Cash, letter of credit or other reserve requirements (such as for debt service, maintenance, taxes, etc.). The borrower may seek to have the lenders provide these, as well as other security required to be provided to the offtaker, concession grantor, fuel supplier, etc. The lenders will seek to impose these obligations on the sponsors, without recourse to the project.

• Insurance and hedging requirements. See “Hedging Documents” below. In the case of some assets, such as power plants, casualty insurance is critical in ensuring lenders and sponsors come out whole in a disaster scenario; in the case of modular, more dispersed assets, such as telecom networks, it is less so.

• Application of insurance proceeds. Generally these will be applied to reinstate the project, and may even be payable to the borrower, but above certain thresholds the lenders’ engineer may have to certify the feasibility of reinstatement within a reasonable period of time, failing which the proceeds must be applied to repay the loans.

• Restrictions on recapitalization and/or transfers of assets or equity interests in the borrower. See “Equity Funding Arrangements.”

• Financial ratios. These are perhaps more appropriate in a more corporate-style financing than in a project financing based on contracted cash flows.

• Consents to assignment and other third-party documents (which, being beyond the control of the parties to the financing, pose risks of delay; see below).
• Refinancing. The borrower will want the right to refinance particular facilities on more favorable terms. While lenders may generally be amenable to this, it may be an issue for fixed-rate lenders such as official lending agencies.

• Exercise of rights under project agreements. See “Loan Agreement” below.

• Events of default. These are events which, so long as they are continuing, entitle the lenders to stop funding, accelerate the loans and/or realize on their security. They include external events such as a default by another party to a project agreement, unprovoked revocation of a project permit or a change in control of the borrower as well as breaches by the borrower of its obligations. In addition to materiality thresholds and exceptions as described under “Covenants” above, the borrower will try to negotiate appropriate grace periods to avoid hair-trigger events of default and permit curable events to be remedied (cure periods for operational problems can be quite lengthy, provided the borrower is diligently pursuing a remedy). Lenders will resist their application to negative covenants, on the theory that breaches of these are not capable of being cured, and to some affirmative covenants, such as the obligation to maintain insurance, where the impact of a breach is serious and immediate. Likewise, it should be obvious that the filing by the borrower of a voluntary bankruptcy petition should constitute an immediate event of default, though 60 days are normally given to obtain dismissal of an involuntary petition.

• Cure rights. Lenders will want the right to cure borrower defaults before project agreements are terminated.

• “Gross-up” for, or absorption of, withholding taxes.

• Lending syndicate formation, voting and transfers. Lenders naturally wish to be free to syndicate the loans as they see fit. Borrowers have an interest in the composition of the syndicate in relation to future dealings with respect to the credit and the borrower’s cost reimbursement obligations. Related to this is the issue of what level of lender approval is required to exercise remedies or waive or amend provisions of the loan agreement. (This issue is particularly complicated in multifacility financings--see “Intercreditor Agreements” below.)

---

7 Some forms of loan documentation do not so condition the lenders’ right to exercise remedies upon the occurrence of an event of default. Such treatment is extremely impractical and may be unenforceable in New York. A borrower suffering an event of default under such documentation has no ability to cure the event of default, is subject to cross-defaults under other agreements and cannot raise new financing.

8 The appropriate period will depend on the specific procedures applicable in the relevant jurisdiction.
The bar for exercise of remedies should be set high, but short of requiring unanimity, often lenders holding two thirds of the principal amount of the loans. On the other hand, a bare majority in interest is most practical for relatively minor changes that will inevitably be routinely required. Finally, some matters, such as changing the amount of the commitments or the terms of payment of the loans, will ordinarily require the consent of each affected lender; this involves the finding of the right compromises on reasonable approval rights and voting thresholds. (The global financial crisis suggests some built-in flexibility to extend the time for payment against adjustments in pricing and/or security might not be misplaced.)

The choice of law and forum for resolving disputes presents a vexing issue in international project financings. This is because the natural preference of foreign financiers for foreign law and jurisdiction is often not respected by the project’s host country. The alternative of international arbitration, even where available pursuant to international convention, is unappealing to lenders who expect to have at least the theoretical ability to execute a summary judgment or its equivalent against a borrower’s assets. A creative resolution of this dilemma that has been suggested is to include what is in effect a nonexclusive submission to jurisdiction and arbitration clause pursuant to which a lender may opt for arbitration if that seems at the time of a dispute to be the most promising route to recovery. It is not clear, however, whether the exercise of such an option would be legally enforced.

Even the choice among different foreign legal regimes can have a significant impact. Common and civil law systems differ in various areas such as defences, forms of security and enforcement. Even common law systems vary, some emphasizing the formalities of legal arrangements, others focusing more on practical implementation of the parties’ intent. Some matters, such as corporate formalities, regulatory compliance and the taking and enforcement of certain forms of security, are mandatorily governed by the laws of particular jurisdictions. It is good practice to comply with the requirements of all relevant jurisdictions unless they are inconsistent; this maximizes the chances of the parties’ intent being given effect.

A word about process: the selection and management of lenders’ counsel, who will usually draft the financing agreements and whose fees and expenses are customarily borne by the project, can have a dramatic impact on overall legal costs. The principal objective should be twofold: first, to limit the number of lawyers involved to the minimum necessary to bring the transaction to a prompt and successful conclusion; and second, to secure a competitive fee proposal. Minimizing the number of different funding sources can, to the extent feasible, help reduce the number of counsel involved. Persuading lenders to retain common counsel is the most economical approach, but perceived intercreditor issues among different types of lenders may limit the degree to which this can be achieved. Each party will usually have more than one firm on its “approved” list, and of course firms differ in their experience, cost and approach. If different groups of lenders insist on retaining separate counsel, common tasks should to the extent possible be divided among them to reduce duplication. Single points of contact should
be designated to streamline communication. Meetings should be kept to the minimum number of necessary participants. These guidelines should be set out at the beginning of the financing process.

[A] Definitive Documentation

[B] Loan Agreement

[C] Common Terms

This is the basic agreement governing the financing. In financings with more than one source of funds (e.g., commercial banks, export credit agencies), each lender or lending group may require its own facility agreement, but common terms applicable to all funding sources are best set forth in a single agreement (called a “common,” “common terms,” “omnibus” or “participation” agreement). This agreement coordinates funding and payment terms and mechanics, sets out conditions precedent to the lenders’ obligations, contains the borrower’s representations on which the lenders will rely, imposes a set of covenants governing the borrower’s operations and lists events of default entitling the lenders to accelerate the project debt and foreclose on their security.

If the parties have agreed a detailed term sheet at the time financing commitments are obtained, it should theoretically be straightforward to reflect their understanding in definitive documentation. In practice, however, no matter how detailed the term sheet, it must be fleshed out in ways that inevitably generate further discussion and negotiation. As definitive documents are usually drafted by counsel to the lenders, the borrower and its counsel will seek to “police” the lenders’ lawyers’ adherence to the letter and spirit of the term sheet, and to call foul when they stray out of bounds.

Each facility in a multisource financing will have its own borrowing procedures, but both borrower and lenders will seek some standardization and coordination of funding mechanics and conditions precedent in the common terms agreement. Borrowings will not always be pro rata, since different lenders (for instance, export credit agencies) may lend for different specific purposes (including in different currencies). There will, however, be a common set of conditions precedent to the lenders’ obligations.

The most basic function of the conditions is to ensure the legal requirements are in place to support the borrower’s obligation to repay the financing. These include execution of the financing agreements, certified copies of corporate resolutions authorizing the transaction and all permits then required to have been obtained, perfection of security and confirmatory legal opinions. Other conditions have to do with the credit underpinning the financing, such as the truth of representations, receipt of satisfactory consultants’ reports, evidence of insurance, receipt of equity contributions and the absence of materially adverse developments, including default and litigation. Facility agreements for export credits often have complicated certification and other mechanics designed to police legal eligibility requirements.
The common terms agreement may contain uniform provisions applicable to payments, such as provisions permitting and/or requiring prepayment of the loans in certain circumstances, and indemnities for increased costs and withholding taxes. As the agreement will specify in the case of payments generally, prepayments are usually required to be made on a pro rata basis among all participating lenders, but sometimes the borrower will be permitted to refinance individual facilities on terms no less favorable to it than those of the facility being prepaid. Prepayments must be made on a certain period of notice to give the lender time to plan redeployment of the funds, and if made in the middle of an interest period or on fixed rate loans they must ordinarily be accompanied by payment of a funding cost indemnity.

As mentioned above, the common loan agreement will also contain uniform representations, covenants and events of default. As in the case of conditions precedent, the basic function of representations is to establish (and, by “bringdown” at each borrowing, to maintain) the legal and credit baseline against which the lenders are prepared to advance funds.

One contentious area in project loan documentation is the degree of discretion permitted the borrower in implementing the construction and operation of the project, particularly in exercising rights under the project agreements which have been assigned as security, but also in expending funds. Examples include change orders during construction, commissioning of the project and variations from the operating budget. Lenders, with the most funds at risk, will generally seek to impose more onerous conditions than the offtaker/concession grantor, and to direct the borrower’s enforcement of its rights under project contracts. In a problem situation, the borrower will want maximum latitude to remedy the difficulty, while lenders will want to step in early and take control. One way to resolve these issues is to adopt various materiality thresholds for lender intervention. MAC clauses have already been mentioned; another device is to define “Major Project Participants” with respect to which adverse events will trigger lender rights, while giving the borrower the right to replace other project participants not so defined without lender intervention.

The common loan agreement will provide for the exercise of remedies by the lenders upon the occurrence (and, properly, during the continuance) of an event of default. Ordinarily, remedies will be exercised by a single agent on behalf of all participating lenders voting pursuant to the intercreditor agreement (see below). Occasionally, however, the agreement will permit lenders voting under each separate facility to trigger enforcement independently, which is then carried out on behalf of all the lenders. The agreement will also contain indemnities of the borrower for costs incurred by the lenders in connection with the transaction.

One such provision that can be quite contentious is an indemnity that is sometimes requested against environmental liabilities, particularly if the lenders request that it be backed by the project sponsors. The sponsors will seek to have the lenders satisfy themselves prior to signing, time permitting, by means of a technical investigation and report.

Finally, the loan agreement will contain procedures for transfers of the loans by the lenders, notices, setoff and governing law and jurisdiction. In a multifacility transaction, individual
facility agreements will specify particular payment terms, additional borrowing procedures and conditions and intrasyndicate voting. As is the case with a number of other provisions, articles dealing with the appointment, duties, rights and compensation of agents for the other lenders under the various facilities may be included in the common agreement or in individual facility agreements. Occasionally, particularly in a cross-border financing where local currency lenders are involved, local law, jurisdiction and language will be chosen to govern a facility agreement, but this can create potential conflicts in interpretation with the common agreement.


A word about currency provisions, which are key in any cross-border financing, especially in emerging markets subject, as is the case currently in Asia and Latin America, to sometimes severe exchange rate fluctuations and restrictions on foreign currency availability. They are particularly crucial, and problematic, in the financing of an infrastructure project earning revenues in local currency.

The cross-border loan agreement will typically require repayment in the currency advanced, and contain an express indemnity against payment in a different currency. The indemnity aside, the currency of payment will ordinarily be upheld under New York law, even in the face of local exchange controls, absent overriding conditions of comity (not held to be presented by a currency crisis without more).

As will be seen below, the account agreement will contain provisions requiring regular conversion of local currency revenues in excess of operating expenses into, typically, US dollars and transfer to offshore accounts held as project collateral. Payments under an offtake agreement will themselves (though not universally) be indexed, at least in part, to the exchange rate of the local currency for the US dollar and will sometimes also contain some contractual protection against currency inconvertibility and/or unavailability. Where this is the case, substantial devaluations such as have taken place in Asia and in Latin America jeopardize the ability of the offtaker to raise its selling price sufficiently to make bloated payments under the offtake agreement. The loan agreement will also contain events of default triggered by any action by the host government to interfere with foreign currency payments, repudiate the offtake or concession agreement or otherwise to assert control over the project.

[C] Role of the Agent

A critical role is played in ensuring a smooth working relationship between a debtor and its lenders by the institution acting as agent for the lenders participating in a syndicated financing. Customary loan documentation and its prior legal application provide some guidance, but are no substitute for judgment and experience in discharging an agent’s duties.

It may seem obvious as a legal matter where the agent’s duty lies; it is less so as a practical matter. Often the agent is the borrower’s principal bank (sometimes even its financial advisor, see “The Role of Advisors” above) in addition to representing the syndicate of lenders. The
agent’s relationship with the lenders and the borrower is further complicated by the fact that many syndicate members will have sold “silent” participations in their loans, which may legally or practically constrain them in dealing with the credit.

Syndicated credit agreements normally contain specific provisions setting forth the agent’s responsibilities, limiting its liability absent negligence or wrongdoing, and indemnifying it against losses suffered in the performance of its duties. Typically the agent has no duty to inform syndicate members of the occurrence of an event of default, other than to transmit formal notices received from a lender or the borrower. Sometimes the agent will be obligated to notify lenders of events of default (or even incipient defaults) of which it has knowledge (appropriately defined as actual knowledge by an officer responsible for the credit). This is a false security for syndicate members: it can be counterproductive and inflammatory as a practical matter for the agent to be under pressure to send out notices of events which may be ambiguous, immaterial or imminently curable.

The agent is ordinarily protected in relying on requisite lender instructions or advice of counsel, and in an emergency or otherwise absent timely instructions may take such action as it deems to be in the best interests of the lenders. It should be emphasized that provisions exculpating the agent are for its legal protection and do not excuse its gross9 negligence or willful misconduct; a professional agent, secure in its contractual protections, will nevertheless be expected to be responsive, responsible and even prudently proactive in administering the credit, promoting the smooth and timely flow of pertinent information and actively coordinating lender action where required by the circumstances.

[B] Security Documents

These will normally have to be drawn up under local law.10 Exceptions include security deposit agreements governing offshore accounts, if any, and assignments of offshore contracts, which would normally be governed by the law of the jurisdiction where the accounts are located and the law(s) of the assigned contracts, respectively. The lenders will normally authorize and

---

9 The concept of “gross” as opposed to ordinary negligence appears unknown to common law systems outside the United States. Under New York law, neither gross negligence nor willful misconduct may be waived contractually.

10 Often this will be dictated by local law itself, but foreign commercial law will frequently require the same result, particularly where under domestic law obtaining effective security requires acts which can only be performed locally (for example, registration in a domestic office or on the books of the borrower), and does not recognize foreign methods of perfection (e.g., possession of share certificates transferrable by negotiation and delivery). The New York Uniform Commercial Code, for example, contains mandatory conflict-of-laws rules which provide that local law will govern crucial aspects of the perfection of security interests and its effects. One result of this bifurcation of documentation is overlap of conventional representations and covenants contained in local security documentation with those negotiated in the foreign-law loan agreement.
direct a collateral agent to take and administer the security on their behalf and pursuant to their instructions.

In a project financing the collateral will normally consist of the following:

- the plant or other physical asset;
- the borrower’s interest in the plant site;
- the borrower’s rights under project agreements;
- the borrower’s rights to the proceeds of insurance (other than liability insurance);
- any receivables or inventory of the borrower;
- the borrower’s bank accounts (the borrower will seek to exclude accounts holding funds for the borrower’s unrestricted use, such as a distribution account, or dedicated to meet third-party costs, such as an operating account); and
- lenders will request a pledge of the sponsors’ equity interests in the borrower (as mentioned above and further discussed below, in jurisdictions with weak security regimes this may be the only effective means of control over the project).

In emerging markets rules for taking and enforcing security are in large part relatively undeveloped and untested. Some of the gaps can be disconcerting in the context of contract-based financing. The very notions of assigning contracts as security and perfecting security in personal property are unknown (or at least untried) in some jurisdictions, such as Indonesia (except for property which may be physically pledged). In China, while in theory land use rights may be mortgaged, a mortgage recording system exists in only a few places.

Substitute devices such as fiduciary transfers and powers of attorney can be imperfect and even fail utterly in a bankruptcy, necessitating additional agreements on the part of contract counterparties to terminate project contracts, including any offtake agreement (assuming they can effectively do so), and enter into replacement agreements (in Indonesia, where this problem exists, this has been accepted). Foreclosure on collateral (or even just terminating contracts, as in Indonesia) may require judicial proceedings. Some of these legal impediments may be waived, but not all. In Indonesia, for example, the requirement of judicial termination should be waived in all project and financing agreements with Indonesian parties. A recent mortgage law in that country permits a private sale of mortgaged property without judicial consent, but only with the consent of the mortgagor. Pledged shares of Indonesian companies may only be sold at a judicial auction. Etc.

In some countries (such as China) while security over project assets is theoretically available as a legal matter, government policy restricts customary project finance security arrangements. In
such countries lenders must rely on pledges of majority equity positions (and even these can be restricted, at least at the project company level) and other contractual arrangements designed to insulate the borrower from competing claims and/or accord priority to project lenders.

Other issues are common to mature and emerging markets. For instance, lenders will be concerned to avoid adverse claimants to the plant site thereby acquiring claims to the plant. The lenders’ success in insulating themselves from this risk will depend in part on the nature (fee title, leasehold, etc.) of the borrower’s interest in the site. Where the risk cannot be avoided creditworthy indemnities will be sought.

One (perhaps surprisingly) contentious set of documents are the consents by counterparties to the project agreements (offtake or concession, construction, fuel supply and transportation, operations and maintenance) to the assignment to the lenders of the borrower’s rights thereunder as security for the loans (called “consent and agreement” in US practice and “direct agreement” in UK practice). This is because, while the practical ability to exercise these rights can be critical to the lenders in working their way out of a troubled project, the counterparties (particularly utility purchasers who are, in effect, forced buyers rather than eager suppliers) resist having to deal with anyone other than the project company or being subject to burdens beyond those assumed under the assigned agreements (including, for example, giving lenders notice of and an opportunity to cure borrower defaults under assigned agreements and, where necessary, agreeing to enter into replacement agreements in the event of a termination in a bankruptcy of the borrower or otherwise by operation of law). The resulting negotiations are often the last item resolved before closing.

Lenders will not lend without the minimum undertakings from contract counterparties legally and practically necessary to give effect to the security assignment (which vary from jurisdiction to jurisdiction but most often include express consent to assignment and enforcement, direct payment to collateral accounts and cure rights); counterparties often succeed in limiting their undertakings to those items, or extract sponsor concessions for additional agreements. Lenders’ cure rights, for example, will often interfere with counterparties’ rights under the assigned agreement to suspend performance or terminate the agreement for nonperformance by the borrower; contracting parties will seek to require that lenders cure within grace periods already negotiated with the borrower in the agreement. In the case of supply or even construction contracts where the borrower’s primary obligation is to make payments, lenders should not require a long period within which to decide whether to make a defaulted payment.

Another contentious issue in these agreements is the extent to which lenders or their transferees must cure the borrower’s past defaults when they enforce their security. The compromise most often struck is that they must cure defaults capable of being cured by the payment of money. Contractors will also be concerned about the creditworthiness of any subsequent transferees from the lenders. Lenders will often require evidence of the counterparty’s corporate authority to enter into the agreement and the consent and agreement, and may require ongoing periodic financial and/or other reporting by the contractor, who will often resist the additional administrative burden involved. Lenders will often ask the contractor to submit to foreign law
and jurisdiction under the consent and agreement, even where the project agreement is
governed by local law.

Particular problems in this regard arise where, as occurs increasingly frequently, the
counterparty is also a special-purpose project-financed entity. In addition to issues regarding
security of performance, often the same contract is cross-assigned to both sets of lenders, who
must then enter into an intercreditor or coordination agreement governing exercise of their
respective rights in the contract (sometimes the borrowers will anticipate the need for such an
agreement and incorporate the necessary provisions in the project agreement or a separate
related agreement which is also cross-assigned).

Insurance assignments present their own issues, often exacerbated from lenders’ perspective by
requirements that primary insurance be placed locally. Lenders will require the maximum
possible reinsurance in the international market and “cut-through” endorsements giving
recourse directly to reinsurers. Delivery of notice of assignment to, and receipt of agreements to
pay the collateral agent from, insurers will be required.

Some types of projects present particular challenges in terms of taking security. Included in this
category are “network”-type projects such as pipelines or telecom systems, as well as transport
concessions over roads, railroads or airports. The difficulty arises due, in the first case, to the
physical dispersal of assets over wide areas subject to differing, including public, ownership,
and in the second case due to legal constraints on alienating the “hard” assets involved, as
opposed to the contractual rights under the concession agreement and the resulting revenues.
Government agencies are often reluctant to grant long-term rights-of-way over public roads or
other facilities.

In these cases lenders have sometimes been persuaded to rely on more intangible revenue-
generating rights than on the specific right to occupy a given space and control bricks and
mortar (subject to remedies available in the event of government interference with the rights the
project company does enjoy). In “network” projects, a failure or interruption of one part of the
network will not always affect the operability of the rest of the system. In the US, gas pipeline
projects enjoy a statutory right of condemnation conferred on them by the required Federal
Energy Regulatory Commission permit.

[B] Account Agreement

A security deposit or trust agreement will ordinarily govern the establishment, maintenance
and operation of the borrower’s bank accounts, which will be pledged to the lenders’ collateral
agent and subject to its control. The agreement will require the borrower to direct payments to
the appropriate pledged accounts and will specify the order of application of deposited funds
(the flow of funds or “waterfall”).
TRUSTEE GENERAL
REVENUE
ACCOUNT

TARGET O&M AMOUNT – AMOUNT DETERMINED
BASED ON APPROVED ANNUAL BUDGET

OPERATING
ACCOUNT

AGGREGATE DEBT SERVICE DUE UP TO &
INCLUDING THE NEXT SUCCEEDING PAYMENT
DATE

DEBT SERVICE
ACCOUNT

MAJOR MAINTENANCE RESERVE REQUIREMENT

MASTER
MAINTENANCE
RESERVE ACCOUNT

REQUIRED DEBT SERVICE RESERVE BALANCE
EQUAL TO SUCCEEDING PAYMENT DATE

DEBT SERVICE
RESERVE ACCOUNT

FUNDS TO BORROWER (TO PAY SUBORDINATED
MANAGEMENT FEE, DEBT SERVICE ON SPONSOR
SUBORDINATED DEBT AND DIVIDENDS)

DISTRIBUTION
ACCOUNT

RESTRICTIONS AS SET FORTH IN ACCOUNT
AGREEMENT
In an internationally-financed, emerging-markets project financing, the agreement will instruct the collateral agent to convert periodically local currency proceeds to hard currency which will then be held in offshore accounts and be available to meet offshore debt service. If local currency funding is involved, issues will arise regarding allocation of foreign exchange risk: local lenders will likely be expected to take the risk that currency depreciation will reduce their share of available local currency, but they should not be required to forego payment of their share in local currency if conversion and remittance of foreign lenders’ share in foreign currency is restricted.

Again, in some countries (such as China) conventional trust arrangements governing project accounts are not available. Much the same effect, however, can be achieved by contract and irrevocable instruction. This, however, leaves a greater exposure to default and insolvency of the depositary. Nor does China generally permit maintenance of project accounts offshore.

The account agreement may at first appear merely technical and administrative in nature, but as it has the effect of controlling the borrower’s cash flow (and trapping substantial amounts equivalent to several months’ revenues in various reserve accounts), it attracts a fair degree of attention and negotiation. The borrower will be concerned that its day-to-day operations not be hamstrung by extra layers of banking bureaucracy (a legitimate concern), and lenders will often need to exert a high degree of control over the flow of funds, not only for security reasons but even, in some legal systems, in order to have effective legal security over the borrower’s accounts.

The parties will argue over the investment of deposited funds (usually limited to an agreed list of secure but remunerative investments) and default conditions (event of default/incipient default, payment default, single lender notice v. majority vote) permitting the collateral agent to “trap” monies and apply them to repay project debt. Discussion will even extend to such matters as who may instruct the collateral agent (may the borrower do so absent default?) and provisions purporting to exculpate it from liability for certain acts or omissions (requirement of reliance on outside counsel, good faith belief in accuracy of information). (See “The Role of the Agent” above.)

The borrower may seek to exclude from the collateral accounts to which funds have been transferred in accordance with the “waterfall” and which are earmarked to pay expenses during the ensuing monthly period and/or equity distributions. Again, while this may appear reasonable, when the music stops this can be crucial, particularly in the case of operating expense amounts which in the ordinary course are payable before debt service regardless whether a default exists. The lenders will accordingly seek to trap all funds still held by the borrower on a default regardless of their destination.

The crucial importance of the account agreement cannot be overstated. If things go wrong (as they have recently in Asia), this agreement will be the first (after the loan agreement itself) to be opened by the parties’ lawyers as they joust over control of the borrower’s cash. In any such clash the collateral agent will be in the front line, having to take crucial decisions to act or not, in
reliance on indemnities (either in the appointing agreement, or renewed in time of difficulty) from the borrower and, crucially, the lenders, often in the face of threats of litigation by the borrower, possibly unhappy lenders and even third party contractors anxious to get paid.

[B] Equity Funding Arrangements

These are the agreements pursuant to which each of the project sponsors agrees severally to provide up to a specified amount of funds to the borrower in the form of equity or subordinated debt on a schedule linked to the loan drawdown schedule. Lenders will normally require that creditworthy sponsors commit to fund 20%-30% of project costs. Lenders will often require sponsors to agree to provide additional agreed amounts to cover cost overruns and other contingencies.

Sponsors will be keen to ensure their obligations are limited to their agreed equity commitment, thus preserving the non-recourse nature of the senior debt financing. However, lenders will ordinarily insist on some additional sponsor undertakings. These will include items such as:

- representations and warranties;
- compliance and reporting covenants;
- restrictions on transfers of interests in the project company (see below);
- subordination of sponsor claims against the borrower. This will include sponsor loans, development expenses/fees, management fees, sometimes even the fee portion of project contracts with affiliates; and
- agreement not to precipitate a borrower bankruptcy, which under US law, unlike a similar covenant of the borrower, should be effective.

There may be a further requirement to post a letter of credit to fund agreed reserves as a condition of receiving distributions (the sponsors may seek to have project lenders provide such letters of credit as part of the financing), and/or “clawbacks” of distributions received in the event of certain defaults. These are compromises designed to reconcile the desire of sponsors to tap excess cash flow (perhaps to fund other projects) with the reluctance of lenders to permit effective reductions of equity capital if these would put the project at risk. Another issue which arises in this context is whether equity funding obligations may be accelerated on a borrower default; sponsors will seek to limit this to amounts required to repay debt which has actually been accelerated.

Restrictions on transfers of interests in the project company can be controversial. Lenders rely on the original sponsors to continue their commitment to the project, particularly during construction. They are wary of any changes in ownership of the project company that might have an adverse regulatory or economic impact on the project. Official lenders will have
statutory criteria regarding the identity of transferees. While substantial power developers are committed to their business, at some point (sooner in the case of financial investors) sponsors will want the ability at least partially to cash out of their investment and redeploy their development funds. Compromises are often worked out imposing credit and other criteria for permitted transferees.

[B] Hedging Documents

In view of the fact that payments under the offtake agreement to which foreign lenders look for repayment of floating-rate loans are generally in a fixed amount and are denominated in local currency, the lenders will normally require that a substantial portion of debt service payments be hedged against interest rate (and, if not adjusted for under the agreement and there exists a market in the relevant currency) currency fluctuations. Providing the necessary “swap” transactions has become an increasingly important (and lucrative) part of any project finance transaction. In order for these derivative products to be provided on an economic basis, the providers must share rateably in the project security to the extent of the borrower’s obligation to make fixed payments under the swaps (or the net amount, if any, in excess of the fluctuating payments owed by the counterparty).

The lenders whom the swaps are ultimately meant to protect are naturally reluctant to share their security (not to speak of the fees available for providing the swaps) with swap providers not otherwise participating in the financing. Accordingly, they will often insist such security is only available to swap providers who are also lenders in the transaction or their affiliates, effectively limiting the universe of swap providers to the syndicate of lenders. Intercreditor issues still arise, however, because the borrower will wish to ensure competitive swap pricing through an auction, which will ordinarily result in some lenders having more swap exposure than others.

While lenders not participating in the swaps are prepared to share the project security rateably with lenders providing swaps, they nonetheless may tend naturally to view the project financing as the main event, and (though not universally) in the ordinary course to ensure available funds are applied first to debt service and that sharing of funds and voting occur in the first instance in proportion to lenders’ shares of the loans (or even that swap providers not be entitled to participate in any decisions regarding the loans or the security other than with respect to the swap agreements themselves). They will also wish to ensure, for example, that in the absence of a default directly affecting a particular swap transaction, a swap provider not be entitled to “unwind” the swap in the absence of an acceleration of the loans. The swap agreements are, of course, assets of the borrower, and project lenders will expect them to be included in the security package.

---

11 Of course, fixed-rated bonds are a natural interest-rate hedge, which is part of their appeal.
Using the standard ISDA form of documentation in a project financing (or as a specific hedge for any financing) requires some adaptation, which is normally done in the “Schedule” containing the particular terms of the swap transaction. Issues in addition to the ones mentioned above include:

- **Cross-default**: In light of the discussion above and the recent experience in Asia, the parties should limit the swap provider’s ability to terminate for default under the borrower’s other agreements (not otherwise constituting a default under the swap) to an actual acceleration of the project loan agreement; on the other hand, some level of default by the counterparty on its other obligations should give the borrower (and its lenders as assignees of its rights under the swap) the right to unwind the swap.

- **Generally**, standard ISDA form defaults (such as the “Credit Event upon Merger”) by the borrower should be excluded in favor of events corresponding to events of default under the loan agreement.

- **The swap should be capable of being unwound in part to match any prepayment of the loan**.

Finally, the standard ISDA form of documentation can raise issues under local law. For example, in some jurisdictions, the provisions of the agreement permitting netting across different transactions may not be given effect in a bankruptcy of the borrower.

Swaps played a critical role in the Asian currency crisis, itself arguably triggered by a rapid build-up of unhedged short-term foreign currency liabilities. Financings that benefitted from significant currency hedges fared much better than others in the current turmoil. As discussed below, however, restructuring has been hampered by lenders offsetting swap obligations against outstanding loans.

[B] **The Role of Official Lenders; Political and Commercial Risk Insurance**

Official lenders include primarily national export credit agencies and multilateral lending agencies. Bilateral and multilateral political risk insurers also play an important role in mobilizing private capital in emerging markets. In fact, until the recent boom years, these were indispensable parties in financing any projects in developing countries. At the height of the boom sponsors and private lenders and investors persuaded themselves the official lenders and their cumbersome policies and procedures could be dispensed with, but with the advent of the financial crisis they have once again become essential.

In addition to direct lending and equity investment, official agencies provide political risk insurance to lenders and investors, generally covering only expropriation, war risk and currency inconvertibility and transfer risk. The jury is still out, but this cover may prove of limited utility in the current crisis where the primary problem has been collapse of illiquid
currencies rather than the classic insured risks. Some agencies, such as Japan’ Ministry of Trade and Industry, provide commercial risk insurance as well. This can be particularly useful in the case of government offtakers, whose contractual default, while not meeting standard political risk criteria, is nevertheless often motivated by political or policy reasons as much as commercial considerations.

In addition to their direct lending and insurance functions, official agencies’ participation in a financing can provide private lenders with a level of de facto assurance that local authorities will be reluctant to interfere with the project (often this cover is provided through “fronting” a loan funded by private lenders—the so-called “A loan/B loan” programs). Of late these entities have been trying to develop more flexible product offerings, including more tailored policies, nonrecourse financing through construction, guarantee and securitization programs and local-currency lending, to magnify the market impact of their limited resources and compete effectively (and sometimes cooperate) with private providers. The public agencies nevertheless remain expensive and rigid in their approach, and their mixed public policy/commercial mission can often result in conflicts in dealing with host governments. Their biggest current challenge is perhaps to encourage host governments to rationalize the development of their legal and regulatory systems and ensure policies are articulated effectively and applied consistently.

[B] Intercreditor Agreements

In multiple-source financings, particularly where there are structural conflicts inherent in different types of financing or insurance, intercreditor arrangements will be required to determine respective voting, enforcement and sharing rights. For example, “takeout” lenders providing post-completion financing only will have limited voting rights pre-completion, even if they provide a conditional commitment at closing.

Working out appropriate voting arrangements for varying contingencies among disparate groups of lenders can become a mind-numbing arithmetical exercise. The borrower will seek to require aggregate votes across all facilities, with low percentage interest thresholds to do things it wants done (such as waive defaults) and high thresholds to do things it does not want done (such as enforce remedies). Lenders or lending groups with divergent interests, however, will each seek the right to act independently, or at a minimum to veto important actions. Each of the parties’ views on these matters will be colored by its perceptions of the others’ motives; for example, official lenders constrained by policy and politics and commercial lenders may regard each other warily, and foreign lenders may perceive that local lenders are too closely tied to local sponsors and authorities. Lenders under individual facilities should be able to modify their agreements (and even waive conditions precedent for themselves) separately so long as such action does not effect a change in terms common to all lenders.

Political risk insurance presents particular intercreditor issues. The definition of covered risks will often be controversial. Insurance available to one tranche of debt will not be shared with other tranches. Political risk insurers will want the right to take over, unencumbered, claims
(and collateral therefor, such as the shares of stock in the project company) in respect of which they have made payments and over which remaining lenders will expect to have continuing first-priority rights.

Intercreditor agreements will often appoint a common agent who will be empowered to take certain actions without seeking a vote of all the lenders, such as technical approvals within certain limits, verification of calculations, certain technical amendments and other ministerial acts. (In borderline situations, however, particularly involving the arguable existence of events of default, agents will be loath to act without instructions, even on seemingly technical matters.) Such agreements often set time limits (say, 30 days to six months, depending on the nature of the issue—whether it is a waiver of reporting requirements, for example, or, by contrast, action to enforce security) within which lenders must vote on or be deemed to have approved proposed actions. These provisions are of great practical importance, because lenders will be required to make decisions under the financing documentation from the day it is signed, including on waivers and amendments (often entered into as early as the signing or closing date!).

[B] Mezzanine and Subordinated Debt

Some have argued emerging markets project finance lacks a basic tool in the modern finance kit, namely third-party debt that is subordinate to conventional senior secured project debt and bears a higher interest rate. Sponsor subordinated debt as an alternative to pure equity is not unknown to these markets (though local authorities regard it with suspicion as less committed than equity and a drain on the fisc via the deductibility of related interest payments), and mezzanine finance would seem a logical alternative for yield-conscious investors who believe equity risk is undercompensated. Issues regarding the enforceability of subordination agreements under local law, however, and lack of familiarity with the related intercreditor regime have held back the development of this useful product.

[A] Integrating Capital Markets Financings

[B] Differences from Bank Debt

Market conditions permitting, project financings around the world increasingly involve tranches of debt issued in the international capital markets in the form of long-term bonds. Unfavorable market conditions, however, can and have made capital markets financing through bonds quite difficult and expensive. Indeed, in the wake of the Asian financial crisis many investors appear to be quite wary of investing in project finance bonds, particularly in emerging markets. Compounding the problems created by the financial crisis is the fact that project finance bonds are characterized by relatively low liquidity.

The secondary market in these bonds has been slow to develop likely because investors and traders are deterred by the lack of homogeneity in the projects, the great variety of risk factors involved, and the complex structure of most projects. This low liquidity matched with volatile
economic conditions can make project bond financing extremely expensive. Project finance
bonds that yielded 150 basis points over U.S. Treasuries during better financial times, were
yielding 200 to 250 basis points after the financial crisis. One recent Rule 144A bond issue (for
the Cadereyta refinery in Mexico) reached a record 653 basis points over Treasuries.

It remains to be seen when the market will return to pre-financial crisis conditions.
Nonetheless, it is likely that capital markets financing will become an important financing
source once again as economies recover from the impact of the Asian financial crisis.

While project bonds normally share rateably in the project security, they are sufficiently
different from bank loans that they raise new issues regarding lender oversight and decision-
making, and therefore in turn regarding how to coordinate these offerings with parallel project
loans. The principal difference relates to the practical inability of individual bondholders (even
institutional investors), as compared to specialized lenders, to monitor a project and make
collective decisions regarding its implementation.

There is another important difference, and that relates to the role of, and liability for, disclosure,
particularly in the US capital markets. An information memorandum targeted at commercial
lenders who have the capability of performing their own independent investigation of the
project will not suffice for investors, even institutional ones, with a lesser capacity for
independent evaluation and, critically who enjoy the protections of the antifraud (and in the
case of registered securities, the registration) provisions of the US securities laws. Structural
and marketing considerations also vary in the capital markets, investors (or their proxies, the
rating agencies) requiring more and different assurances than commercial lenders. Even
though the bank and bond markets have been converging recently in many respects, these
crucial differences remain.

In addition to the need for a rewritten offering circular, an entirely separate additional process
must ordinarily be gone through in order successfully to launch a project bond issue, and that is
the rating agency process. The agencies will require their own presentations, diligence, legal
opinions and deal structural supports. Especially in emerging market projects the specific level
of rating achieved will have a substantial and often determinative impact on the pricing, and
therefore ultimately on the feasibility, of the financing. Achieving the desired rating may
require credit enhancement, which in turn carries an additional cost.

Many of the criteria used by the rating agencies will remain uniform across different types of
projects (e.g., mining, power, or telecom; long-term offtake contract or merchant). Certain
criteria will be more important or only relevant to certain types of projects (e.g., ore body risk in
mining projects. Major rating agencies, such as Standard & Poor’s, Moody’s and Duff & Phelps,
will look at a broad range of criteria when rating projects. These criteria (similar to risk factors
set forth in bond offering materials) include:

- sponsor risk factors, such as the experience and financial health of the project
  sponsors, and the participation of local sponsors;
• **pre-completion risk factors**, including the experience and financial health of the contractors, the reasonableness of construction budget projections, allocation of risk for budget over-runs and delays, riskiness of technology utilized, availability of equipment and materials, risk of not receiving required permits, potential labor problems, difficulty of the terrain upon which the project is being constructed, and the existence of contract terms providing for adequate insurance, dispute resolution mechanisms and performance incentives for meeting contract time lines and quality standards;

• **operation risk factors**, such as the experience and financial health of the operator, the volatility of operating expenses, the risk that chosen technology will not perform as expected, and the risk that supplies (such as fuel or ore reserves) will be inadequate;

• **offtake risk factors**. In “merchant” projects, such as telecommunications and transport projects (and, increasingly, power projects--se below), an assessment of the market for the good or service produced, and the industry competition will be most relevant. In long-term offtake contract scenarios assessment of offtake risk will require a determination of the risk of the offtakers’ failing to meet their contractual purchase obligations;

• **country risk factors**, including the economic health of the country, the political and regulatory environment, and currency risk;

• **project structure**, which is an assessment of cash flow mechanics, capital structure, and legal issues in order to determine how much of project risk is allocated to other parties.

Project ratings are typically limited by the sovereign rating of the country in which the project is located; however, projects have attempted to achieve ratings higher than the country by purchasing adequate political risk insurance, utilizing preferred creditor status available with certain multilateral lending and export credit agencies, and generating hard currency offshore. Furthermore, projects can achieve investment-grade ratings even if they face a number of risks, so long as the project is properly structured to allocate the risk to other parties (e.g., the constructor, operator, or insurance company).

In separate transactions, rating agencies, and therefore bondholders, tend to have more rigid, but lower, thresholds than commercial lenders in terms of project structural security, and to compensate for remaining disclosed or perceived deficiencies in ratings and pricing. Banks can be more demanding, but they can also be more flexible in accommodating risk. Official lenders can be both demanding and inflexible. In combined financings with common terms, the borrower may end up with the lowest common denominator in terms of lender risk aversion; the good news it should be able to agree a single set of terms, and, as will be seen, to structure
lender decisionmaking to vest effective control with institutions with whom it is possible practically to negotiate.

In transactions without policy-constrained official lenders, it may be possible to leverage banks closer to the minimal threshold protections that will satisfy the rating agencies, while enlisting the former in persuading the agencies to take a view (or even in assuming the risk, for a fee!) where one of their set requirements cannot be met. In fact, there is some indication that bond market competition is driving private lenders to recast their documentation in a “covenant-lite” version, ceding more operational discretion to the borrower, in return for more bond-like “flex” pricing and liquidity.

Paradoxically, this has the effect of eroding the “free-rider” protection enjoyed by bondholders in multisource financings. This is one of the reasons behind calls for greater information and a “super agent” or “enhanced trustee” to protect bondholders’ interests (see below). The only effective way to minimize unpleasant surprises, however, may be for institutional investors to bolster their own internal credit function.

To the extent that banks have not turned to so-called “flex” pricing, sponsors may be able to achieve greater certainty concerning the amount and pricing of funding forthcoming through syndicated bank loans than through bond issues. The reason is that with bond issues, sponsors will not know for certain how much funding the bonds will raise until the date of pricing the deal. Pricing (and thus the amount of money that can be raised through the issue) can be significantly affected by unexpected market, economic, or other downturns prior to pricing. The result can be an inability to raise the expected amount of funding from the bonds, and a higher cost of money raised. In contrast, in bank financing, once bank commitment letters are given the sponsor can be fairly certain that the specified amount of funding will be available at the agreed rate absent some major adverse occurrence.

Banks and other investors are still likely to retain the protection afforded by the inherently more controlled single-asset project environment (one reason, for example, why they tend to permit current payment of dividends if baseline projections are met, in contrast to the corporate high-yield market), while enjoying the enhanced liquidity provided by more capital markets-like features. Again, for sponsors the trade-off remains flexibility vs. knowing whom to call if there is a problem.

The offering circular for a project bond issue will differ from a bank information memorandum, among other ways, in the following respects (in addition to differing conventional formats):

- The role of the technical experts will be significantly expanded: they will be required to state specific conclusions both (i) geared to support the requirements of the financing and (ii) similar in form to those supporting similar financings; and throughout the life of the financing they will be expected to render certifications in lieu of bondholder consent to various proposed issuer actions.
• Risk factors will be considerably more developed; marketing will be more restricted to project-specific factual material, rather than arguments based on comparisons to other projects, while the focus in the offering circular is much more on legally protective disclosure, in a form that will facilitate comparisons to similar disclosure on other projects.

• The non-recourse nature and other structural aspects of a project financing, elements that would be taken for granted in a bank financing, will be highlighted.

Sometimes, paradoxically, capital markets structures will permit a lower level of disclosure than a traditional single-asset bank information memorandum. This is the case where, for example, the bonds are backed by a monoline insurer, or where several projects are pooled in a single issue (see below).

In the US bonds are issued pursuant to an indenture, which is the equivalent of a loan agreement, with a trustee the equivalent of an agent. A bond indenture may, however, impose on a trustee a higher duty of care to bondholders in a default situation than a loan or intercreditor agreement will on a bank agent in relation to syndicate members. On the other hand, it may permit the trustee to ignore majority bondholder instructions if it determines in good faith they would adversely affect the minority.

The indenture will have provisions for calling bondholder meetings or otherwise soliciting consents or waivers, and voting thresholds for binding decisions. In the case of the exercise of remedies, the trustee for the bondholders is granted significant authority to act on the instructions of a relatively low proportion in the interest of holders or even without instructions. In the case of borrower actions not permitted as of right, or waivers of noncompliance with financing agreement terms, it is generally impractical, both procedurally and substantively, to put them to a bondholder vote, especially during a tight construction schedule (when in any event, unlike bank and official lenders, bondholders will already have made their entire investment; indeed, as a result they have no say in whether conditions precedent to other lenders’ fundings are met or waived). Accordingly, the effort is to condition such actions or waivers on objective criteria and/or expert third-party (consultant and/or rating agency) certification (that the proposed action will materially adversely effect neither the borrower’s ability to meet its obligations nor the rating of the bonds), in addition to majority bank consent. Another difference from most loan agreements is that bondholders may not sue the issuer individually on unpaid instalments unless the trustee fails to act on bondholder instructions.

Where obtaining bondholder consent has traditionally been unavoidable (as is usually the case for any modification of payment terms), the unwieldiness of the process (and the absence of other disincentives, such as the obligation to share recoveries present in most syndicated loan documentation) has often meant that in a crisis bondholders escape a restructuring that might objectively be considered beneficial from all parties’ perspective. Suggestions arising out of the
global financial crisis for facilitating necessary restructurings via documentary changes for both loans and bonds will be discussed below.

[B] Effect on Intercreditor Arrangements

The practical effect of these differing bond finance arrangements in multiple source transactions (at least where the capital markets do not supply a majority of the debt) is to vest control over the transaction in the banks (including for this purpose official lenders) until their debt is retired. They (and not the bondholders) will have the benefit of more onerous conditions, representations, covenants and events of default and higher approval thresholds for particular actions. While the bank debt is outstanding the bond trustee will ordinarily not be able to exercise remedies without the banks’ consent. The banks will often be able to act without bondholders’ concurrence, not only in enforcement but equally in, for example, granting waivers and releasing security. (All the foregoing is true notwithstanding the fact that bonds will mature later than other loans (which also amortize), and therefore bondholders’ interests may diverge increasingly over time from other lenders’.) Strict parity must be maintained, however, in the application of payments and proceeds of collateral.

[B] The “Super Agent” or “Enhanced Trustee”

Dissatisfaction with unpleasant surprises in recently offered stand-alone project bond issues has led to contradictory proposals, on the one hand to increase the flow of information to investors, and on the other to empower a “super agent” or “enhanced trustee” to make decisions on their behalf without the need for cumbersome bondholder meetings. It has been proposed that the latter be the project finance arm of a commercial bank. Whether it is realistic to think banks would take on the potential liabilities involved remains to be seen. (Streamlining the voting/meeting process has also been proposed.) In offerings insured by a financial guarantor (see below), the latter effectively serves this function, but of course, takes the risk of the transaction and charges accordingly. Some additional authority, akin to that routinely exercised by bank agents, for trustees to discuss issues not left to engineer/rating agency determination with the project sponsors and, if necessary, participate in creditor meetings and committees, subject to obtaining the requisite level of instruction on any effective action, would facilitate the waiver/restructuring process.

[A] Leasing

In some jurisdictions, such as the US, so-called leveraged leasing is used as an alternate financing method. Often this is not strictly project financing in the sense that the ultimate credit or lessee is a substantial company rather than a special-purpose vehicle, but the technique can be and has been used on a nonrecourse basis as well. It permits 100% financing, with the equity being supplied by a financial investor able to use the tax benefits of ownership (e.g., depreciation deductions), thereby resulting in a lower all-in cost of funds to the lessee.
The leveraged lease entails two levels of financing documentation, the principal credit document being the lease of the facility to the lessee by a special-purpose lessor, often a trust in the US, which in turn raises the funds to acquire the asset on a secured, nonrecourse basis from debt and equity investors. The debt is normally documented pursuant to an indenture, and can also be raised in either the private or the public markets. The lease is usually entered into when the asset has been built, and is often preceded by a secured construction loan with a lease commitment from the same or a different investor(s).

The apparent complexity of leveraged lease documentation is in inverse proportion to the degree of controversy it generates, which has become negligible. Over the years a highly standardized approach has developed to the various issues involved. The primary differences from a typical project financing relate to the special role played by leveraged lease equity.

The equity investor in a leveraged lease is not a sponsor of the project (the sponsor is usually the lessee); rather, it is a passive financial investor. Moreover, its return does not derive from the project’s cash flow; instead, it derives from the above-mentioned tax benefits associated with ownership of the asset, principally the ability to take deductions from other taxable income for depreciation and for interest expense on the leveraged lease debt. Accordingly, the equity investor will expect the lessee to indemnify it for any acts or misrepresentations that might threaten its ability to realize the expected tax benefits, while effectively entering into an intercreditor agreement with the lender much as would a holder of subordinated or mezzanine debt.

[A] Competitive or “Merchant” Projects

As stated in the introduction, while the “classic” model of project financing (historically dominant in the power industry) is based on the revenue stream generated under a long-term offtake contract, this contractual underpinning has never been practical in sectors, such as telecoms and transportation, selling services at retail. The latter are subject to the whims of a competitive market, and parties financing such projects on a nonrecourse basis must accept a substantial degree of market risk. Mitigants that have been developed (discussed further below) include expert market studies, high levels of equity and application of “upside” or excess cash flow to prepay debt.

12 Electricity, too, of course, is ultimately sold in a competitive market. It is the recognition of this reality on a policy level that has led to the current wave of deregulation and the move to “merchant” plants.

13 Successful merchant projects (such as a telecom buildout or an airport) quickly evolve into more conventional corporate businesses financed using traditional corporate financing techniques; unsuccessful ones (such as the Indonesian KSO telecom projects or the Dulles Greenway toll road in Virginia) must endure painful restructuring.
As the global electric power industry undergoes fundamental change, stand-alone project financings based on power sales agreements are no longer the dominant capital-raising technique for power generation companies either. Innovative financing methods are emerging. Merchant power is the industry theme in developed markets, and an avowed goal in developing markets. In the U.S, tens of thousands of megawatts of generation capacity are either being acquired or reported to be under development without the benefit of long-term offtake arrangements. Although traditional project financings will continue to be selectively employed in these markets (as they are in other sectors which have traditionally not benititted from long-term offtake agreements), power generation companies are now examining a wide array of financing options in the capital, bank and leveraged lease equity markets in order to obtain adequate and cost-efficient funding sources for the acquisition and construction of power generation assets.

Legislative and regulatory developments have created an increasingly competitive environment for electric utilities and non-utility power generation companies. In the U.S., the Energy Policy Act of 1992 and related regulatory orders have facilitated open access to electric transmission and distribution networks owned by utilities and the free market trading of power. The new competitive era is well underway in California and the Northeast, and several integrated electric utilities in these regions have divested all or a significant portion of their power generation assets in order to focus on electricity transmission and distribution. New England Electric System, Southern California Edison Company, Pacific Gas & Electric and Maine Central Power have auctioned approximately 24,000 megawatts in generation capacity for billions of dollars to non-utility or other utility affiliated power generation companies, a significant portion of which constitutes merchant power. Nationwide, in excess of 13,000 megawatts of non-utility merchant power is currently in operation.

In order to finance the acquisition of these generation assets, purchasers are typically forming special purpose subsidiaries with limited equity capital and tapping the traditional bank market for the balance of the acquisition funding. However, large bank acquisition financings are increasingly becoming only the first step as power generation companies analyze the relative merits of refinancing assets on a stand-alone or pooled basis in the capital markets as well as examining the financing and accounting benefits offered by leveraged leases.

The sale of power generation assets by utilities has not slowed the pace of new development. In fact, the newly competitive environment has stimulated the need for efficient low-cost power as generation companies strive to become low-cost producers. Currently, over 6,000 megawatts of capacity are under construction in the U.S., another 8,000 megawatts are under development and in excess of 50,000 megawatts are planned. The construction financing of these “greenfield” merchant power plants will benefit from the rigorous financial analysis conducted with respect to traditional project financings. However, without fixed price supply and off-take arrangements, projections with respect to electricity price and facility operation become all-important; as described above in the case of telecom and transport projects, the need to rely on
such projections diminishes the likelihood such plants will be financed on a stand-alone basis without substantially more equity.\textsuperscript{14}

A number of techniques are evolving to address the market risks inherent in these transactions. Essentially, in order to support a nonrecourse project financing, demand and pricing risks formerly borne by a single creditworthy power purchaser must be reallocated. Interestingly, in markets such as the U.S. where the fall in underlying energy prices has undermined the economic viability of long-term PPA’s, recent acute peak power shortages, leading to major price spikes in a deregulated environment, have restored the attractiveness of above-market-priced contracted supplies for some buyers.

In addition, the development of the power marketing and energy derivatives businesses (roughly equivalent to “contracts for differences” in the U.K. or the “vesting” contracts used in the Australian electricity privatizations) has made it possible to hedge many of the risks previously covered by a PPA. The catch is that, unlike the traditional PPA, none of these mechanisms can yet achieve the long-term protection needed to support a typical project financing. They can, however, provide crucial support in the most critical early years of the life of any project.

In today’s reshuffled energy market, one apparently willing candidate to shoulder some of the risks previously borne by the power purchaser is the fuel supplier. In some of the U.K. merchant projects, the latter has entered into contracts whose price is linked to the electricity pool price. A related technique has been to subordinate all or a portion of the purchaser’s obligations under the fuel supply contract to its debt service obligations (with perhaps an agreed upward price adjustment if deferral of fuel payments is actually triggered), thereby giving project lenders an additional cushion against the uncovered offtake risk.

As mentioned above, lenders will often require additional base and/or contingent equity in these transactions. Mezzanine or subordinated debt (see above), whether from sponsors or third party financiers, can also be helpful in this regard. Other techniques include mandatory prepayments from, or sharing of, excess cash flows, and flexible amortization schedules and pricing depending on project financial performance.

In merchant plant financings based on market revenue projections, ongoing financial tests, in particular projected debt service coverage, take on an importance absent in projects with contracted offtake (and an even greater importance than in a conventional corporate borrowing). These tests will be set at levels high enough to absorb downside scenarios and cover the life of the project debt, and will govern items such as additional debt, capital

\textsuperscript{14} Electricity is a commodity which can be instantly produced, but only with substantial prior fixed investment, and is subject to instant demand fluctuations but cannot be stored. Hence the extreme volatility of an unregulated power market, even in comparison to other commodity markets.
expenditures and dividends. The underlying projections may be required to be updated periodically based on fresh market studies.

Merchant projects outside the energy industry have some advantages not enjoyed by contract-based counterparts. They tend to involve simpler, more modular construction that can be designed to generate revenues as it progresses (think of a telecom network or a transport link). Their sources of revenues are more potentially diverse and not limited contractually.

How soon emerging countries will be able to move to the new competitive market model is unclear. Affordability of service remains a basic issue. While long-term power purchase agreements indexed to strong currencies, for example, seemed a good way to attract foreign investment, the capacity of emerging economies to absorb the resulting costs in local currency terms has been called into question. Also, absent such agreements, workable substitute mitigants will have to be found for the remaining perceived political risks of investing in such countries.

[A] Common Issues

[B] Syndicate Expansion and Diversification

Large, complex, multi-source loan financings and bond financings are tending over time to converge in the size, composition and unwieldiness of their syndicates. Accordingly, similar voting mechanisms are being adopted for each. In general, they involve lowering voting percentages required to amend loan agreement provisions or enforce remedies, sometimes progressively over time if voting thresholds for action cannot be achieved.

[B] Refinancings

Sponsors increasingly want the flexibility to refinance portions of the project debt and equity (including on a non-pro-rata basis) in the debt and equity markets as and when conditions are favourable without having to seek existing lenders’ consent. Presumably any such refinancing would only improve the financial condition of the borrower. Banks, official lenders and other interested project participants (such as power purchasers who may have a buyout obligation on termination), however, are still feeling their way on this issue.

One concern is that the ability to refinance freely most directly benefits the sponsors and the lenders being repaid at the expense of the other remaining participants. Remaining lenders are concerned about the effect on intercreditor arrangements and dynamics, and fear the consequences of any dilution of the original sponsors’ equity position and of the lenders’ pledge over the shares of the borrower. Power purchasers are concerned their buyout exposure will remain greater for longer as maturities are extended. All participants are gradually coming to accept that a refinancing, provided it is on more favorable terms, almost always improves the project credit and therefore lowers stakeholder risk.
[A] Impact of Local Participation

At the onset of the recent wave of emerging market infrastructure development, much of the required capital and expertise was offered by sponsors based outside the projects’ host countries. Local partners were sought for their access to and ability to mediate with government agencies having jurisdiction over the projects in question. Soon enough, however, even where local capital markets were not already well developed or host state utilities themselves did not insist on significant participation, local sponsors with experience in or related to the industry involved, together with their local capital providers, focused on these strategic sectors. Local parties’ participation beyond a token level in international project equity and lending consortia raises difficult issues of parity where they do not face the same country risk as their foreign partners.

[B] Local Sponsors

Local sponsors have been afforded large opportunities in part by the slow absorption of foreign capital, due in turn to, among other things, difficulty in allocating country risk. They are still anxious to secure foreign capital and expertise, but have felt entitled to greater participation and better terms, including regarding transfer of technology and know-how. Foreign sponsors continue to be concerned about management of risk, including technical and country risk.

In addition to taking a different view of country risk, local sponsors will often have differing perspectives on investment and financing structures. For instance, they may be accustomed to easy terms for corporate finance, or even historically to ready finance on the strength of a founder’s personal guarantee. Foreign sponsors may be willing to pay more for non-recourse financing, and to negotiate harder for the robust contractual risk allocation required to support it. Conversely, local sponsors may have more limited resources and thus more need for non-recourse funding than foreign corporates. They may want to maintain significant cash balances in high-earning local bank accounts, which may raise transfer and security concerns for foreign sponsors and lenders.

In the recent global financial crisis, many local sponsors faced a severe liquidity crunch, resulting in somewhat of a reversion of large portions of their interests in projects, often to foreign developers. The crisis also showed that local participation does not inoculate a project against political risk. Host utility participation raises its own issues, including conflicts of interest.

[B] Local Lenders

Local lenders benefit from two principal advantages from the perspective of foreign syndicate members. First, as stated above, they need not face the same currency, transfer and other political risks. (Indeed, local state bank participation is often viewed as some protection from the latter.) Second, they are likely to enjoy a closer relationship with local sponsors. (There may
be other potentially significant differences, such as exemption from withholding tax, statutory priorities accorded state banks, differing funding costs, etc.)

These differences strain the traditional principle of equal treatment among syndicate members. Foreign lenders may wish to have independent recourse to any foreign support, and they may feel that items such as expropriation proceeds are not appropriately shared, at least with lenders owned by the expropriating authority. There may be issues regarding conversion of insufficient local currency revenues to service foreign-currency debt.

Local lenders, however, particularly if they are privately owned, or even if they are state-owned but seeking to conduct their business on a commercial basis, are concerned that they be treated on a par with other syndicate members. They may be new to the type of lending involved (such as project or other structured finance). They may seek to use foreign lender participation to counter leverage their local customers and government authorities may have over them. They will thus insist on pari passu treatment with respect to all aspects of project security and decisionmaking.

In addition to differing risk perceptions, international lenders will be concerned about the depth and expertise of the local syndication market. Conventional intercreditor arrangements are complicated when local lenders provide bridge financing or letters of credit that must be incorporated in a long-term international refinancing.

A recent project combining all these elements was the Shandong Zhonghua power project in China. The particular issues raised by local participation in Chinese projects are discussed below in a case study. In Indonesia, the financial crisis removed local participants’ ability to fund their commitments.

There are no easy solutions to the novel issues raised by increasing local participation in infrastructure project development in emerging markets. The long-term trend of increasing mobilization of local capital, however, can only be encouraging from the perspective of reversing the lag between infrastructure needs and project implementation. There are inefficiencies inherent in cross-border investment that cannot help but be alleviated by local capital formation. The challenge will be to integrate the latter with still-needed international sources of capital and expertise.

[A] Impact of Financial Crisis; Restructuring

The real test of project debt documentation is of course when problems arise, as they have recently in Asia. While the point of documentation is naturally to enable parties to stand on their rights, at least where a project would remain viable if restructured it is clearly to be hoped (and surely in their interests) that both sides would approach a problem situation in a practical spirit. The borrower, on the one hand, should hew carefully to the terms of the contracts, interpreting ambiguities to support sensible solutions consistent with the parties’ original intent. Being able to argue plausibly it is not in default is a tremendous advantage to a
borrower trying to keep in place a financing on terms it could no longer negotiate in a distressed market. The lenders, on the other hand, while prudently protecting their position, should remain mindful that too “triggerhappy” or aggressive an approach to a problem credit can backfire and even result in lender liability.

A borrower request for financial concessions may provide the lenders the opportunity to negotiate better terms and conditions. As in martial arts, a counterparty’s own momentum may give one leverage over it. Naturally, the use to which the parties seek to put the documentation is influenced by external factors, such as the parties’ general financial situation and the legal means available to enforce agreements. Reliance on literal terms to achieve unrelated objectives, however, might well be discouraged by judges and arbitrators in troubled situations.

Events in troubled project credits tend to unfold in a predictable sequence:

- First, lenders will be concerned to stop throwing good money after bad; they are best placed to do this where there is a clear, matured and uncured event of default--successfully invoking a MAC clause absent a(nother) default requires (i) a sufficiently broadly drawn provision and (ii) a causal link between an identifiable covered event (e.g., repudiation of an offtake agreement by the offtaker) and justifiable lender insecurity in the credit at hand. Even where conditions exist entitling lenders to stop funding, however, they will have to weigh carefully the likelihood of recovery absent completion of the asset financed (and in some cases immediate protective measures will require the expenditure of additional funds). In a general crisis as in Asia recently, some lenders, themselves adversely affected, may have lost the flexibility to continue to fund a troubled project.

- Next lenders may seek to freeze any cash in project accounts; this will ordinarily require the subsistence of a matured event of default.

- Then lenders will face a choice whether to exercise their cure rights and keep project contractors paid currently, or permit them to terminate their contracts for nonpayment.

- Ultimately in a default situation they will have to decide whether to accelerate the loans and enforce the project security.

Assuming the parties come together to try to negotiate a voluntary restructuring, the first issue presented is whether they should enter into an interim standstill agreement to give ten time to work out a permanent rearrangement. This can be a useful way of disciplining “rogue” lenders whose interests diverge from the rest: acceleration and enforcement normally require a supermajority, and a majority waiver of nonpayment defaults usually binds dissenters. Of course, individual bank lenders can ordinarily still sue for overdue amounts owed to them.
Since in any event bondholders, trade creditors and possibly other creditors cannot practically be included, and (unlike in a general corporate restructuring) most of the intercreditor aspects of a standstill agreement will already be covered in the intercreditor agreement, often the time of those who are able to negotiate a restructuring is better spent focusing on the ultimate goal rather than on constructing temporary arrangement; less formal temporary waivers can often accomplish the same result. If the problem really is only temporary, a standstill agreement limited in time may suffice as an end in itself. In some jurisdictions, the directors of the borrower will require an agreement in order to be able to continue trading without liability.

Any voluntary restructuring is obviously complicated by the presence of multiple obligations owed to disparate groups of lenders. These can be composed of commercial banks, official credit agencies, trade vendors and/or institutional or retail investors. A particular challenge is presented by publicly held debt issues, since as discussed above procedures for calling bondholder meetings can be time-consuming at best, and at worst inconclusive if the requisite level of consents cannot practically be obtained (either because holders cannot be contacted, or because they lack the means or willingness to evaluate alternative plans).

Accordingly, private lenders are often persuaded to permit current servicing of bond obligations, which are normally longer-term, while agreeing to reschedule bank and other loans. At the same time, the debtor and its advisers must be careful to avoid “tripping,” or defaulting, outstanding bond obligations (thus permitting or causing them to be accelerated) in dealing (or not dealing) with private creditors. Another way of “restructuring” public debt which a debtor’s financial difficulties have caused to lose trading value is to offer to exchange it for securities with more favorable terms or to buy it back at a discount.

One reason borrowers have to deal with banks and can afford to be more “relaxed” about bondholders is that generally, as mentioned above, banks in a syndicate retain the right to sue individually on unpaid installments, subject to an obligation to share; bondholder action usually requires a threshold collective decision (though normally set at a lower level than in a bank syndicate). Bond trustees are usually vested with more discretion (and have a higher level of duty) than bank agents in a default situation (sometimes to the point of being entitled to ignore instructions to enforce remedies), though they tend to defer to collective bondholder instructions.

Institutional lenders will also often permit trade creditors to continue to be paid currently for fear they will stop shipping needed inputs to the debtor. The need to keep paying trade creditors is a primary source of the liquidity dilemma discussed below. For this reason, notwithstanding the lack of legal priority of existing trade creditors, most reorganization plans traditionally provide for payment of trade debt in full.

The agent must navigate with finesse between distraught lenders and debtor management, who can be unrealistic and sometimes worse in seeking breathing space in which to save the business. In a formal judicial proceeding, applicable insolvency law will override the documents in crucial respects and thus diminish their controlling nature. Procedures and
deadlines will be specified for filing and voting claims. Creditors’ committees may be formed and recognized by the bankruptcy court, and agents must reconcile any committee role with their representation of existing bank groups.

In a project financed on the strength of a long-term offtake agreement, the need to restructure, though it can arise due to cost overruns or technical problems, often flows from the current or prospective inability or unwillingness of the offtaker to pay in accordance with its minimum take obligations. This can occur because an oversupply or drop in demand prevents resale of the output purchased under the contract (or its product), because the purchaser faces economic or regulatory constraints on the rates it can in turn charge its customers or due to adverse foreign exchange adjustments. While the latter factor has received the most publicity recently in Asia, all three are really at work in the region’s infrastructure sector, sometimes mutually reinforcing each other. Accordingly, in such a situation (again, unlike in a corporate workout) a successful restructuring will require the participation of the offtaker in what is likely to be a highly politically charged environment. The same will likely be true in the case of a concession agreement.

[A] Case Studies

[B] Documenting Project Financings in China

[C] Structural Issues

China presents particular issues in trying to implement a traditional project finance structure. In the past few years, as part of a long-debated policy reorientation, the Chinese government has undertaken a significant rationalization of the legal regime governing the development and financing of infrastructure projects. At first, aided by serendipitous timing in relation to the financial crisis engulfing the rest of Asia, this had the intended effect of accelerating the successful completion of project financings in China.

Nevertheless, the rulemaking process has not been as effective as it might have been in achieving the government’s objectives. Moreover, since the collapse of Guangdong International Trust and Investment Corp., the recent implementation by the State Administration of Exchange Control (“SAFE”) of measures to control the outflow of foreign exchange and a recurrence of concern over an oversupply of electric power in certain regions, the pace of project finance closings has slowed in China as well.

The difficulty is to some extent inherent in the basic system of administrative control which continues to form the “socialist” part of the socialist market economy. At least until the recent enactment of a unified contract law, private parties were not, as elsewhere, free to structure arrangements in accordance with neutral rules of general application. Instead, a separate rule was promulgated, if not for every occasion, at least for each different transaction structure receiving official sanction.
Put another way, rather than (as in other countries in the region) permitting domestic and foreign\textsuperscript{15} parties to finance projects under general principles of company, commercial and foreign investment law, different rules are laid down for each of what are perceived to be the available financing alternatives. Since it is difficult, if not impossible, to anticipate all specific financing structures, this results in (1) gaps which parties are left to exploit or suffer from, as the case may be, (2) varying treatment of common issues and (3) unnecessary concessions by the authorities.

For example, there are at least four regimes which could apply to the raising of foreign debt financing for projects in China. At least until SAFE’s recent pronouncements, general regulations governing offshore borrowing permitted foreign invested enterprises to take out foreign loans without specific approval (though the proceeds cannot be deposited offshore without SAFE approval). However, approval is required for “project financing” (defined as financing recourse for which is limited solely to the assets and revenues of the project whose construction will be funded by the proceeds) or the issuance of bonds.

Predictably, project sponsors unhappy with these constraints will simply arrange their financings so as to fall outside their field of application. Moreover, for parties frustrated at the difficulty of dealing with local counterparties, yet another avenue is now available, the BOT regime.

The most commonly used alternative funding vehicle is for the foreign shareholder or an affiliate to borrow the funds, in either the bank or capital markets, and onlend the proceeds to the project company (or invest them as equity\textsuperscript{16}). Another approach sometimes used in conjunction with the first is to dedicate existing project or tax revenues to repay the financing for the new project.\textsuperscript{17} Under the BOT regime, while approvals are required, assuming they are obtained foreign developers enjoy enhanced government support, support that would not be necessary if parties were free to structure their arrangements under general commercial law.

To some extent the BOT concession agreement is a vehicle to overcome problems associated with Chinese commercial counterparties, such as conflicts of interest and the absence of financial information on which to base an assessment of creditworthiness. It is questionable, however, whether it is necessary, for example, for provincial governments to assume, as they do in the BOT approach, obligations under project contracts. It is even more doubtful they need to

\textsuperscript{15} The term “foreign” as used here does not include offshore “window” companies owned by PRC entities; though the latter may use similar financing techniques, they may be subject to additional approval and other requirements not applicable to foreign investors.

\textsuperscript{16} Chinese cooperative (as opposed to equity) joint ventures (the preexisting functional equivalent of BOT structures) permit arrangements effectively giving foreign equity preferred status.

\textsuperscript{17} Developers with a portfolio of projects may find it easier to raise offshore debt, whether investment- or non-investment grade, or even equity, ultimately on a corporate basis.
assume, as they do in BOT projects, payment obligations in the event of force majeure or termination, obligations to provide land, utilities and transmission facilities, and fuel supply risk, from all of which other governments in the region are moving further away.

When Chinese authorities become aware of some of these drawbacks, they tend either to issue pronouncements that they are aware of loopholes and intend to crack down on them in future rulemakings, or to change the applicable regime altogether (as they appear to have recently in the power sector by abolishing long-term take-or-pay power purchase agreements and announcing a move to a power pool market system). The result is continuing uncertainty for foreign investors and continuing suspicion on the part of the authorities. Far better to promulgate neutral rules of general application than to believe one can ever anticipate every possible specific transaction structure.

The authorities would better achieve their infrastructure development objectives through a single unified program than with a patchwork of special regimes. Based on experience elsewhere in the region, the program would contain two principal elements: (1) domestic and foreign investors would be free to structure their investments in accordance with regulations generally applicable to the formation and funding of enterprises in China (including those relating to secured foreign borrowing); and (2) necessary agreements with local utilities, whether in the nature of offtake, concession or interconnection agreements, would either be competitively bid up front or, in the case of interconnection agreements, based on generally applicable tariff schedules set at reasonable levels. This would eliminate unnecessary inconsistencies and permit policymakers to focus on the underlying institutional issues of macroeconomic management, attracting foreign investment and cost-effective infrastructure development.

[C] Documentation

When China reopened its market to foreign investment in the late 1970’s, it had to forge anew the means of conducting commercial negotiations with foreign parties. Chinese parties’ decisions have historically been constrained by policy factors and have thus not necessarily been made on a commercial basis. As stated above, constant policy and regulatory changes and the resulting inconsistencies have inhibited the development of the predictability which is the basis of commercial transactions (and, not incidentally, of the independent advisory professions that aid in such development).

In spite of recent concerns regarding overcapacity, China continues to require infrastructure expansion. The supply of local capital available for construction of new capacity, while recently mobilized in greater amounts, remains limited. Foreign capital is expected to make up the shortfall in local capital. In addition, foreign entities can still provide more advanced technology and equipment.

As has been said, several forms of regulatory experiments have been undertaken by the Chinese government with respect to foreign-invested infrastructure projects. Until recently foreign
investments in infrastructure projects (similar to foreign investment in other industries) have largely utilized the joint venture structure, with local utilities or governments as partners. Because of the applicable US$30 million threshold (relatively low for an infrastructure project), almost all foreign-invested infrastructure projects are required to receive approval from the central government.

From time to time, new policies and regulations have been introduced to address particular issues in relation to foreign-invested infrastructure projects (including at one time capping the rate of return to foreign investors). As mentioned above, “project financing” is one area of particular concern to the Chinese government and, as a result, several restrictive regulations have been promulgated in this area. The government appears to consider this internationally used funding technique to be relatively costly and to involve conflicts of interest on the part of foreign parties and an undue increase in the country’s foreign debt.

Recently, the Chinese government has adopted the BOT scheme to attract foreign investment in infrastructure projects located in economically less developed areas. This has involved bidding processes designed to yield lower tariffs while permitting 100% foreign ownership and avoiding direct rate-of-return regulation.

Although the market economy is encouraged by the Chinese government for certain industries, most economic activity in China, including development and financing of infrastructure projects, is still subject to stringent governmental control through planning and approval processes. The policy of the Chinese government of subjecting all foreign-invested power projects to central planning and approval requirements has recently been reinforced. These processes involve protracted and difficult coordination among various local and central government ministries.

Consequently, although local governments and utilities are the signatories to project-related documents, relevant ministries of the central government have the right to review such documents and express opinions on material terms, such as price, tariff, rate of return and foreign exchange matters. In many instances, central government ministries, fearing that foreign parties may take advantage of local governments, have acted as invisible hands setting out negotiation terms for local authorities. It has been reported, however, that local participants in BOT power projects based on competitive bidding processes have experienced less interference by the central government during negotiations.

Chinese financial institutions have been less active than local sponsors in funding foreign-invested infrastructure projects. Most Chinese lending to foreign-invested projects in the past has taken the form of government-directed loans, which were executed largely out of policy concerns. The proceeds of these loans were provided to borrowers directly by the central government or funnelled through “policy” banks. Payments on such loans received by the funnelling financial institutions were passed directly to the relevant fund provider. Therefore, such loans did not present any credit risk to the financial institutions funneling the funds to the projects.
Until recently, the participation of Chinese financial institutions in foreign-invested power projects has been more frequent in the area of agency functions, such as security agent, account bank or conversion agent, due to legal restrictions on foreign participation in such functions. Such institutions also act as depositaries of project revenues, which adds significant cash flow to local accounts. Chinese banks, however, have recently stepped up their extension of commercial loans to foreign-invested projects as a result of escalating competition among local and foreign financial institutions and in an attempt to utilize increased domestic liquidity to expand their business portfolios.

Commercial funding by Chinese financial institutions may become more frequent as renminbi (RMB) lending may offer a natural hedge against project revenues. In addition, reduced RMB interest rates have added to the attractiveness of RMB lending versus foreign funding. Moreover, Chinese banks’ commercial lending may be viewed as an additional level of Chinese governmental support for project financings due to the government ownership of most Chinese financial institutions.

Nevertheless, as discussed below, lending by Chinese financial institutions will be subject to numerous planning and approval processes. Policy restrictions will continue to be imposed, such as SAFE’s bans on RMB refinancing of foreign exchange loans and funding of imports and wholly-foreign-owned projects. Therefore, unless approval requirements are loosened and the regulatory inflexibility on lending is lifted, Chinese funding will be less competitive (despite any short-term availability and/or pricing advantage) and Chinese financial institutions will be likely to have limited roles in funding foreign-invested projects.

In China, the concern of getting the right approvals has often received greater emphasis than structuring enforceable project documents, because such approvals symbolize the support of the government, which has traditionally been more significant to a project’s success. In fact, the central government has asserted to foreign investors on numerous occasions that the requirement of central government approval is to ensure government support if adverse conditions ever arise. It is common in financings of foreign-invested projects in China that the responsibility for obtaining the necessary Chinese government approvals is allocated to local sponsors on the argument that they are the representatives of the government and should bear the risk that any required approval is missing or ineffective.

Tariff adjustments require annual pricing bureau approval. The pricing bureaus often suppress tariff adjustments out of concern for inflation. Pricing formulae, therefore, should be carefully drafted and specifically approved by the relevant pricing bureau to maximize the likelihood of implementing future tariff adjustments.

Local participants are usually asked to take the risk of changes in Chinese law on the theory that they are participants in the Chinese political system and are thus better equipped to influence the formation of new policies or prevent change in existing policies. This rationale is further augmented by the active involvement of the central government in most larger projects as discussed.
As stated above, local participants are attempting to assume more arm’s-length commercial roles and persuade foreign partners to share what the latter view as political risks, but this effort is complicated by the fact that the Chinese parties usually act in several different capacities. In addition to acting as joint venture partners, local entities usually act as offtakers, operators, suppliers and/or members of the construction consortium, as well as concession grantors and regulators. These multiple roles of Chinese participants result not only from policy requirements (it is reported that the PRC government prefers that projects be contracted to or operated and managed by local companies) but also the intent of Chinese participants to maximize their economic interest during the construction of the projects and the term of the joint ventures. Foreign parties also encourage local parties to assume multiple roles in the hope that the local partners will take approval risks and to some extent, economic risks such as, in the case of fuel supply, lack of creditworthy fuel suppliers and potential fuel price hikes in the event of the government loosening its currently tight fuel price controls.

The multiple roles of local participants have created peculiar concerns for both foreign and local participants because of possible conflicts of interest involved. Requiring Chinese entities to keep confidential information pertaining to one capacity, for example, may prove problematic. Differing roles in evaluating commissioning test results will create uncertainty in achieving commercial operation. Foreign parties have attempted to structure away any risk involved in such multi-role arrangements by allocating default risks under one function of the local entities to their other functions. Increasing corporatization and separation of differing commercial and regulatory functions in Chinese counterparties will likely over time alleviate these concerns, as well as those regarding the financial and credit transparency of these entities.

Language and governing law are among the most critical issues for Chinese entities. Although English is commonly used to draft project-related documents, Chinese authorities and sponsors usually require a Chinese translation of every document drafted for approval purposes and the use of Chinese as the language of the documents in the event of disputes. Insistence of Chinese parties on the prevailing or equal effect of Chinese translation derives not only from their pride in the mother tongue but also discomfort with the idea of projects located in China being governed by foreign languages. Equal effect for Chinese and foreign languages may be appropriate in a non-confrontational setting as parties can refer to their respective languages for operational guidance. Translation of a western language into Chinese, however, is a painful process which not only involves substantial additional costs but, like most translation work, invites future disputes in respect of discrepancies in the translation.

Chinese parties are also naturally uncomfortable with foreign laws governing project-related documents and foreign arbitration or litigation. As foreign investors are required to incorporate their investment vehicles in accordance with Chinese laws, it has been argued by Chinese parties that Chinese laws and jurisdiction should govern because no foreign parties are involved. Foreign parties and financiers, on the other hand, usually require foreign governing law and jurisdiction or arbitration unless there is an compelling reason to use Chinese laws or to
solve disputes in Chinese fora, such as the possible unenforceability of foreign law governed documents in China.

An acceptable compromise, however, may be reached if the law of Hong Kong is chosen as the governing law and any dispute is required to be arbitrated in Hong Kong as projects in China governed by Hong Kong law have been financed internationally. In addition, Hong Kong, which is a Special Administrative Region of the People’s Republic of China with a legal system in theory fixed by treaty, may be viewed by Chinese authorities as a more neutral forum than any foreign jurisdiction.

The acceptability of the use of any foreign law or jurisdiction (including Hong Kong) should be confirmed by central approval authorities. We are aware of at least one instance in which they have not approved foreign law (including Hong Kong law) as the governing law of the financing documents in connection with the financing of a power project in China.

As mentioned above, Chinese financial institutions have in the past been more active in agency roles. Chinese banks often act as onshore security agents under the instruction of an offshore or global agent. Security packages and the performance of fiduciary duties as instructed by other agents need to be reviewed to ensure compliance with Chinese laws and regulations. For instance, the English law floating charge is not a concept permissible under Chinese laws.

Account structures present difficult approval and enforcement issues and, thus, require careful review. One example is that foreign-invested entities without periodic income may not establish settlement accounts denominated in foreign currencies. Conversion banks will review conversion requests to make sure all necessary approvals have been obtained and conversion will be subject to availability of foreign currencies (unless conversion banks are specifically compensated to bear availability risk).

One type of document traditionally perceived as a palliative to legal risk in China is the government “support letter,” a non-binding assurance or comfort letter issued by each central, provincial and sometimes local agency having jurisdiction over a critical aspect of project development (including contracting by Chinese counterparties) and financing. Such support letters can at best serve as a temporary expedient pending more thoroughgoing legal reform.

As discussed above, Chinese funding of foreign-invested infrastructure projects has taken the form of policy lending and, to a lesser extent, commercial lending. Regardless of whether commitments to projects are made on a policy or commercial basis, the making of such commitments requires planning approval, i.e., lending will be subject to an annual review based on a nation-wide funding review. As such, lending decisions of Chinese financial institutions, unlike those of commercial banks in more developed economies, may involve considerations not directly related to borrowers’ credit or their need for funds.

In addition, many aspects of lending practices in China lack flexibility and are not adapted to long-term project financing requirements. Lending for a term longer than five years, which is
not unusual for international project finance lenders, may pose an additional approval issue for Chinese banks. RMB lending is, in essence, extendable short-term lending. Long-term “fixed asset” loans (i.e., term loans) are subject to annual planning review. Borrowers are required to submit to the planning authority prior to the end of each calendar year an application for all drawings for the following calendar year, in which the amount and use of proceeds of each drawing during the following calendar year must be specified. Any drawing not in compliance with the application submitted in the previous year will be subject to penalties. Revolving credits, therefore, technically do not exist as reborrowings at the borrowers’ discretion may pose an operational problem.

RMB borrowing rates and default rates are set by the People’s Bank of China (“PBOC”) and may be adjusted from time to time in accordance with directives of the PBOC. Interest payments are required to be made on a fixed date in each March, June, September and December. Application of the requirements described above has posed thorny inter-creditor issues for foreign lending institutions which in general do not appreciate additional drawing conditions particular to RMB loans and different repayment schedules. In addition, RMB lenders have been asked by foreign lenders to take the risk of expropriation of the project under the argument of governmental control of the financial institutions in China. Moreover, pari passu treatment as between RMB lenders and foreign lenders is not necessarily a norm and is often subject to heavy negotiation.

There is a convergence underway in the Chinese project finance market. Chinese participants are increasingly willing to take (and pay for) independent professional advice on what constitutes international commercial standards of doing business. In return, they expect foreign parties to treat them as equals rather than the stepchildren of government policy. On balance, this should bode well for cooperation between Chinese and foreign parties in furthering the development of China’s economy.

[B] Restructuring Projects in Indonesia

Indonesia, unfortunately for that country, has provided a textbook laboratory experiment in the role played by contractual documentation in dealing with a troubled foreign-invested project. The destination of choice for project financiers in the boom years of the mid-1990’s, the Indonesian market of that time represented perhaps the high water mark of balance in the negotiation of terms and conditions between lenders and sponsors in the international project finance market. Elaborate international-style loan and security documentation was drafted and negotiated by teams of high-priced lawyers, foreign and domestic.

As is well known, legal lacunae aside, even the best drawn contract cannot ensure a project’s success. A poorly conceived agreement can, however, impede the resolution of a troubled project. How have the Indonesian project financing agreements held up in the disaster that has befallen that economy? The provisional answer seems to be tolerably well (again setting aside the vagaries of the Indonesian legal system) but nevertheless with some object lessons for the future and for other jurisdictions.
The above diagram (disclaiming all arithmetic accuracy or scale!) charts the utilization of debt and equity commitments in a typical non-recourse greenfield project financing. The proportion of final commitments constituted by debt and equity and the shape of the "S-curves" of expenditure and commitment utilization are based on a simplified set of fairly conventional assumptions. As we shall see, tweaking these assumptions can result in a wide variation in outcomes.

Some additional points should be noted which do not appear on the face of the graph. First, in the event of a default under the loan agreements during construction, lenders will normally be entitled to stop disbursing loan proceeds, accelerate the loans and/or foreclose on the project security. Second, base (forecast as opposed to contingent) equity is usually firmly committed; in particular, in the event of a default under and/or acceleration of the loans during construction, the lenders may draw in the full amount of committed equity. Finally, expenditures do not equal value: while some components may be resold, a project will ordinarily not attain a value equal to its cost until it is completed.
Hence the “crossover point” shown in the diagram. This is the last point at which remaining equity commitments are sufficient to repay outstanding loans to the project. If a default occurs prior to that point, lenders will be strongly tempted to “cut and run” while they stand a reasonable chance of being made whole. The later disaster strikes after that point, the more strongly they will be motivated to complete the project to try to maximize its realizable value.

As stated above, this “steady state” dynamic will be significantly affected by changes in its underlying variables: for instance, the ultimate value of a project will fluctuate with the relevant economy, whether directly in the case of a “merchant” or market-risk project, or through the financial condition of the offtaker in the case of a project with contracted output. While the equity committed to a project provides its lenders with a buffer against such fluctuations, as the value of that buffer is eroded by adverse economic conditions, the project’s sponsors lose incentive to cooperate in a restructuring. Obviously, the parties’ positions would also differ if, for example, the sponsors’ equity commitments were not accelerable on a default (or even if acceleration of the loans were a precondition to drawing the balance of the equity), or if lenders or sponsors believe their risk will be borne by political risk or other insurers.

In a “meltdown” scenario such as the recent global financial crisis, the parties’ options become more constrained. Lenders as well as sponsors may experience difficulty funding their commitments, let alone coming up with any additional sums which may be required, and may face accounting, tax and even regulatory barriers to granting concessions in a restructuring.

Needless to say, whatever the nature, scope and timing of the difficulties encountered, the parties will quickly open their transaction binders and scour the documentation for options and obstacles. As stated above, there is a natural sequence to this process. Responsible borrowers will normally strive to avoid outright default as long as possible, so as not to give the whip hand to their lenders and to preserve valuable financing commitments (and, where applicable, hedging arrangements). The first issue presented by the occurrence of general economic calamity affecting a project is whether the borrower will seek to draw additional loan funds to continue construction. The existence of an event of default under the loan documents would entitle the lenders, in the first instance, to refuse such a request.

A sufficiently well-capitalized borrower may be able to suspend construction and avoid further borrowings until the situation stabilizes. If, however, the borrower needs to tap additional loan funds to pay contractors, in the absence of a specified event of default the lenders will be faced with a determination whether to invoke the notorious “material adverse change” clause usually found in their documentation to refuse a drawdown request. As we shall see, this line of defense is one readily breached in practice. Lenders facing increased funding costs may seek to pass these through to the borrower under “yield protection” provisions in the documentation, and may seek to resolve this issue as a condition of further advances.

However the initial post-disaster drawdown skirmish is resolved, there usually ensues a protracted period of “wait-and-see” or perhaps even “cat-and-mouse” while the parties assess the situation and review and perhaps test their options. Borrowers may de-mobilize...
contractors; lenders may, at least where a default is present, “freeze” any cash trapped in project accounts.

When the parties have had time to evaluate their positions realistically, a moment will usually come when some or, it is hoped, all of them decide it is in their respective interests to resolve the situation, either by a consensual restructuring or, in the absence of agreement, by resort to legal remedies. At each step in the process, the loan documents will define the parameters within which, or at least the baseline from which, the parties can determine their fate.

In the summer and fall of 1997, currency crises attacked Thailand, Indonesia, Korea, Malaysia and, to a lesser extent, other countries in the region. The particular significance of the first three countries to our story is (1) Indonesia is a large country rich in resources whose rapid growth from a relatively low base had attracted large amounts of foreign currency funding, in particular from Japanese and Korean banks (ditto Thailand); (2) Korea “fell” in part from the domino effect of its banks’ exposure to the other countries whose currencies had collapsed; and (3) the impact of the crisis in those three countries on Japanese banks was substantial (if not as immediately critical), with the effect of freezing credit to the troubled debtor countries.

One of the most immediate impacts of the crisis on lenders in the region (particularly acute in the crisis countries themselves) was on their ability to fund their existing assets and on the cost of such funding. A number of banks (and, even more so, unregulated finance companies which had rapidly accumulated sometimes questionable assets) in Korea, Thailand and Indonesia were ordered to stop trading and, in some cases, closed.

These developments initially moved affected lenders to attempt to exercise the traditional “Eurodollar disaster” clauses in their loan agreements. A “baseline” form of such clause is reproduced below:

**2.16 Inability to Determine Interest Rate.** If prior to the first day of any Interest Period:

(a) [...] or

(b) the Administrative Agent shall have received notice from the Majority Facility Lenders in respect of the relevant Facility that the Eurodollar Rate determined or to be determined for such Interest Period will not adequately and fairly reflect the cost to such Lenders (as conclusively certified by such Lenders) of making or maintaining their affected Loans during such Interest Period,

the Administrative Agent shall give telecopy or telephonic notice thereof to the Borrower and the relevant Lenders as soon as practicable thereafter. If such notice is given...
[often provides for negotiation of alternate rate, failing which each lender’s cost of funds is used as the base rate for interest on its loans].

Borrowers object to this holdover from the early, uncertain days of the Euromarket, principally because the provision could have the effect of passing onto them increased costs due to deterioration in the lenders’ financial position. This is particularly true where, as is often the case, the threshold amount of affected loans is a minority, typically one third, of outstandings. Borrowers have attempted with some success to insert language excluding the effects of variation in the credit standing of individual banks by, for example, prohibiting claims where the requisite deposits are “generally available to creditworthy banks in the interbank Eurodollar market... at or about” the agreed benchmark Eurodollar base rate.

In view of the sensitivity of the issue, these provisions have historically rarely been invoked even when they have arguably been triggered. But the last 18 months have been far from ordinary times for Asian financial institutions struggling to survive the regional economic turmoil. They stand squarely at the center of the “free-fire zone” between skittish global capital markets and distressed regional borrowers.

The documentary variations described above, as well as disparities among affected regional lenders, have resulted in conflicting outcomes in this zone, remote as it is from the benchmark funding market. Asian-based banks argued the spike in their funding premiums in late 1997 bore only a remote relation to credit disparities, and that western banks with similar credit ratings enjoyed a windfall funding cost advantage. Distressed borrowers, naturally, were less than eager to bail out their lenders; single-asset project companies are particularly vulnerable to unhedged additional costs.

As mentioned above, in the case of some banks and finance companies at “ground zero” of the crisis which faced regulatory intervention and/or closure, funding problems were even more acute. Borrowers and their remaining lenders had to scramble to replace affected commitments. Traditional project finance loan documentation treats the lenders’ obligations as several, that is, no lender is responsible for, or excused by, another lender’s failure to fund its commitment. Such documentation also typically conditions each lender’s obligation to fund on the borrower having sufficient financial resources available to complete the project, and subjects even budget reductions to lender approval. These provisions have the effect of requiring the borrower to replace defaulting lenders’ commitments (and maintain a proportionate level of equity commitments) even if it could otherwise reduce the budget in the face of reduced projections.

On the other hand, “intervened” lenders cannot claim the benefit of an illegality clause, which usually only goes to the ability to lend on a Eurodollar rate basis. Remaining lenders and the borrower are left to struggle with the issue of what rights defaulting lenders retain under the loan agreement, and how to deal with a lender who can’t return phone calls.
Setting aside funding problems and assuming no other defaults, project borrowers requiring moneys to pay construction contractors may well seek to continue to draw committed amounts from lenders. Lenders anxious to limit their exposure to the crisis will be tempted to invoke the material adverse change clause to refuse to lend. In the absence of a specific impact on the borrower, however (which will often result in another specified event of default), lenders tend to be reluctant to invoke the clause since its application is open to dispute and lenders fear being held liable for damages, or having their commercial reputations tarnished, for breach of their commitments.

In a distressed project under construction where substantial amounts remain to be expended, whether by voluntary forbearance on the part of the borrower or because lenders find grounds to stop funding, a standoff is usually reached within a few months where no further loans (or equity—as a matter of practice and comity, lenders will be hard-pressed to argue additional equity should be put in if they are unwilling to lend) are drawn and work stops. It is at this point that attention focuses on any balances remaining in project accounts (whether loan or equity proceeds or, in phased or completed projects, existing revenues and required reserves), which are typically pledged to a collateral agent for the benefit of the lenders. The borrower will want the use of what it considers to be its funds; the lenders see the account balances as both their most valuable collateral and a reserve to fund protective measures—in fact if balances are significant in relation to outstandings they have a strong incentive to apply them in repayment to avoid them being tied up in any insolvency of the borrower.

It is during this period that the agent for a syndicate of lenders really earns its keep. On the one hand, it worries about discharging its duty to anxious lenders with respect to actual and prospective credit deterioration and default. Fortunately for the agent, customary documentation is quite protective in this regard. The agent, however, will be concerned to try to work out positive solutions and build consensus for them, while preserving the lenders’ position.

Borrowers and their lenders may face problems with project contractors during this period if banks are unwilling to release funds to pay them. Contractors will accuse borrowers of breaching their contracts, and borrowers will accuse lenders of breaching their commitments. The threat of a borrower bankruptcy lurks constantly in the background.

In a project financing, contractors whose agreements have been assigned to the lenders as security will have agreed in a consent to assignment to afford lenders a reasonable period of time within which to cure any borrower defaults under the project contracts before the contractors exercise their customary termination right for such defaults. The borrower may suspend the works or even persuade vendors effectively to extend financing to the project by deferring amounts owed. Such a scenario, while welcomed by lenders, raises complex intercreditor issues, including in relation to security in the works.

Ultimately the success of any infrastructure project restructuring will depend critically on the ability successfully to restructure the borrower’s rights and obligations under the related offtake
or concession agreement. Particularly in a crisis situation such as in Indonesia, this will often have to abide the outcome of policy and/or political developments beyond the parties’ control (witness the slowness of the PLN restructuring process, or the deferral of the recent Telkom KSO tariff increases). Lenders will not escape pain, but they need to see the light at the end of the tunnel in order to justify concessions.

After the parties have convinced themselves that neither side will escape unscathed and that time is not their friend, it becomes possible to hold concrete discussions on a restructuring. As indicated above, a well-capitalized borrower that has “kept its powder dry” by managing to avoid default while limiting expenditure is in the strongest position to seek lender concessions (and/or to avoid making concessions itself). The standoff described above can serve effectively as a standstill while the parties negotiate; in our experience, more formal standstill agreements are of limited usefulness (and at least under New York law and practice, not necessary to preserve rights), and consume time and energy better spent on devising a permanent solution. (In countries such as Indonesia, where the legal infrastructure is also still “under construction,” the prospect of resorting to legal remedies is sufficiently unappealing.)

Another incentive to negotiate is that both sides usually want to achieve something more than restoration of the status quo ante. Both will likely want to reduce their obligations to a more sustainable level in the new economic environment; both will likely want to take back some concessions originally made in better times. For lenders it is an occasion to improve pricing and security, to recover additional funding costs described above and to “clean up” their documentation, purging it to the extent possible of loopholes negotiated by the borrower when market conditions favored it.

As mentioned above, economic conditions will affect projects either directly (in the absence of an offtake agreement) or indirectly via the financial condition of the offtaker. For infrastructure projects earning revenues in local currency (whether or not indexed to foreign currency under an offtake agreement), the collapse of Asian currencies compounded the effective slashing of revenues in foreign currency terms (or the ballooning of foreign currency debt service and import costs in local currency terms, with the same impact on any offtaker subject to a currency adjustment clause) with the resulting deflation of demand, confounding the projections underpinning the original extension of credit. In the few instances where hedges were put on which alleviate this effect, standard swap documentation permitting such arrangements to be unwound on a “mark-to-market” basis on an acceleration of the underlying debt obligations created additional pressure on lenders to “cut and run” and try to set off the resulting obligations, rather than serving as an asset of the borrower available to support a long-term restructuring. Radical currency realignments hopelessly confuse balance sheet accounting, opening huge holes in local currency terms (which may not be offsettable by the value of hedges described above), thus complicating the task of arriving at revised projections on which to base a restructuring.

The following lessons (doubtless among others) may be drawn from the experience with troubled infrastructure projects in Southeast Asia over the last year and a half:
1. Historical boilerplate language in Eurodollar loan documentation (e.g., the yield protection provisions) should be updated to reflect current market conditions and practices, e.g., the prevalence of swap-based financing, and to clarify the parties’ economic obligations, e.g., by more specifically defining both the circumstances triggering a rate adjustment and the calculation of any such adjustment.

2. Standard ISDA swap documentation needs to be further adapted to serve its intended purpose of providing a long-term hedge against market fluctuations, e.g., by not permitting termination so long as payments may be set off under the swap and the project is “in the money,” i.e., so long as no amounts would be owed by the borrower on termination.

3. Financial covenants should operate on a “mark-to-market” basis.

4. Borrowers and lenders would both benefit from more flexibility to respond to economic crises by reducing budgets and associated equity commitments and replacing or simply removing lenders who can’t or won’t meet their commitments.

5. In this context, lenders would do better to devise specific drawstops than to rely on a largely illusory MAC clause.

6. Improved enforcement and bankruptcy procedures would reduce uncertainty and moral hazard, and motivate both sides to reach consensual accommodation quickly, while disposing of hopeless cases with a minimum of collateral disruption.

7. The parties could anticipate adversity in more creative ways, e.g., by permitting binding extensions of time for payment (but not reductions of amounts owed) within limits with less than unanimous lender consent (or even automatically in the event of non-catastrophic projected cash shortfalls) (principal amortization is the prime trigger of liquidity crises), perhaps with pre-agreed compensation in pricing and/or conditioned on the provision of additional security and/or the imposition of appropriate additional covenants.

In these ways and others it is to be hoped that out of adversity can come more robust arrangements that will encourage recovery, revive economic activity and insure sustained growth.

[A] Conclusion

It is clear that many competing interests go into crafting financing documentation for a project. It is important for all parties to keep before them the main objective of a successful closing. This can be achieved by a goal-oriented approach which strikes the right balance to permit timely completion and economic operation of the project.
Project Documentation Glossary

BOT (Build-Operate-Transfer): The project financing business model in which the government permits the developer to build the project, to operate it for a period of time, then to transfer ownership of the project to the government.

Bridge financing: Short-term loan that provides funding before more permanent financing is put in place.

Bringdown of representations: The process of ensuring that the borrower’s representations and warranties remain true at the stages of draw down of funds subsequent to the signing of the financing agreement.

Clawbacks: The process of giving back funds received, on the occurrence of certain specified events; e.g., sponsors re-contributing to the equity of the project company amounts previously received as dividends on the occurrence of an event of default.

Collateral agent: The institution that holds, as agent, collateral security granted by the borrower for the benefit of the lenders.

Concession agreement: An agreement between the project company and the government for the project company to operate the project and collect revenues.

Country risk: The risk that the host country currency will depreciate or that political events there will interfere with the construction or operation of a project or the conversion or remittance offshore of funds in respect thereof.

Cross-default: The circumstance in which default in one contract triggers a default under another contract.

Cure rights: The right of lenders or other third parties to cure defaults of the borrower under project contracts.

Deemed dispatch: A type of contractual clause stipulating that the offtaker will be required to pay the purchase price for the project output, regardless of whether the project is producing the output; e.g., the purchaser is required to pay for the output although the project has been curtailed due to fault of the offtaker.

Distribution account: A bank account created for the sole purpose of distributing dividends to developers. This is one of the accounts typically found in a project “waterfall,” and will often be excluded from the project security.

Enhanced trustee: See “Super agent.”
**Greenfield project:** A project to be newly constructed, as opposed to the acquisition of an operating project.

**Gross negligence:** A U.S. legal term for conduct characterized by “reckless disregard,” as opposed to “ordinary” negligence characterized by a mere failure to act with reasonable care.

**Gross-up:** The payment by the borrower of additional amounts to compensate for withholding taxes levied on loan payments.

**“Market Flex” pricing:** A term of a bank loan commitment that permits adjustment of interest rate margins in the event of adverse market developments; intended to provide the flexibility of a capital markets underwriting, but is viewed by some borrowers as defeating one of the main advantages of the bank market.

**Mezzanine debt:** Debt which is subordinated to non-mezzanine project debt, and is typically characterized by higher interest rates.

**New build projects:** See “Greenfield projects.”

**Offtake contract:** A contract for purchase/sale of the product output (or offtake) of the project. The contract is typically long-term, and accounts for the vast majority of the project’s revenues. Power projects are the paradigm traditional examples.

**Offtaker:** The purchasing party in an offtake contract.

**Pari passu:** Equally or without preference; refers to obligations having equal priority in recovery of assets or funds.

**Political risk:** See “Country risk.”

**Power purchase agreement:** A type of offtake agreement for power plant projects. Often the purchaser is a government utility.

**Soft costs:** The category of costs necessary to completion of project construction, but not directly related to the construction of the project’s “hard” assets. Such costs include advisors fees, payments to local communities, financing fees and development costs.

**Subordination:** The act of ranking a lender’s rights or claims below those of another.

**Super agent:** An agent with some authority to make decisions with respect to a project in order to safeguard the collective interests of bondholders.
**Turnkey:** An agreement that provides for all services necessary to obtain a given result, *e.g.*, a construction contract that provides for all labor, materials, insurance, and so forth to enable the owner to receive the ownership of a completed project at the end of the agreement.

**Waterfall:** The order of priority in which funds in project accounts are to be applied.