AUGUSTO & CO SEMINAR ON PROJECT FINANCE

KEY LEGAL ISSUES IN PROJECT FINANCE IN NIGERIA

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Introduction

- Efficient & reliable infrastructure is critical to attracting long-term FDI, expanding international trade, and catalysing growth.

- State of a country's public infrastructure is a key index for measuring its economic development & growth.

- Like most African countries, Nigeria's infrastructure has been comatose for decades, plagued by several challenges including, without limitation:

  - underinvestment
  - Population explosion and urbanisation
  - Corruption
  - non-maintenance & neglect

Introduction (Contd.)

- Following return to democratic rule in 1999, efforts made at revamping Nigeria's ailing infrastructure and encouraging private sector funding/participation include:
  - Increased budgetary allocation to infrastructure (maintenance; renovation; rebuild)
  - Establishment of due process office
  - Creating enabling environment for private sector investment
    - Market reform
    - Strong regulator, e.g. NERC, NCC, ICRC
    - Appropriate pricing
    - Unbundling state monopolies

Introduction (Contd.)

- enactment of relevant legislation – e.g. Infrastructure Concession Regulatory Commission (Establishment, etc) Act, 2005 ("**the Infrastructure Act**") – established Infrastructure Concession Regulatory Commission ("**ICRC**"); Lagos State Roads, Bridges and Highway Infrastructure (Private Sector Participation) Development Board Law, Electric Power Sector Reform Act ("**ESPR Act"); Fiscal** Responsibility Act
- Policy Enhancements
  - Banking reform (consolidation & capital increase), enhanced capacity to fund big-ticket transactions
  - growing recognition by government of utility of PPPs for financing provision & rehabilitation of public infrastructure e.g. recent construction of MM Domestic Terminal 2; prospect of road tolling (Lekki road concession) and proposed Lagos rail project
  - of current administration's 7-point Agenda, 3 relate to infrastructural development (power & steel, mass transportation, qualitative & functional education).
  - stemming corruption - establishment of EFCC and the ICPC

What is Project Finance?

- "a method of funding in which the lender looks primarily to the money generated by a single project as security for the loan. This type of financing is usually used for large, complex and expensive single-purpose projects such as power plants, chemical processing plants, mines and toll roads" **(Black's Law Dictionary, p. 663; 9th ed)**

- "is the financing of long-term infrastructure and industrial projects based upon a complex financial structure where project debt and equity are used to finance the project, rather than the balance sheets of project sponsors. Usually, a project financing structure involves a number of equity investors, known as **sponsors**, as well as a **syndicate** of banks that provide loans to the operation". **(Scott Hoffman, The Law & Business of International Project Finance (3rd ed. 2007, Cambridge Univ. Press) cited in www. wikipedia. org**

Origins of Project Finance

- Although there was an explosion in project finance in the late 1980;s and 1990s,both in Europe and the rest of the world, the financing of projects on limited or non-recourse terms is not a relatively new concept.
- Historians assert that same had been used in Greek and Roman times, mostly on account of the dual perils of storms and pirates.
- Risk-averse merchants taking out a fenus nauticum (sea loan) with a local lender with a view to sharing with that lender the risk of a particular voyage.

Origins of Project Finance contd.

- The fenus nauticum was structured such that the loan was advanced for the purpose of purchasing goods on the outward voyage, which loan would be repayable out of the proceeds of the sale of these goods (or more likely) other goods bought overseas with these proceeds.

- If the ship did not arrive safely at the home port with the cargo in question on board then, according to the terms of the fenus nauticum, the loan was not repayable. Although viewed as a form of marine insurance but can as well be classified as an early form of limited recourse financing.

- Some brave lenders even took the risk of sending one of their slaves on the voyage in order to ensure that the merchant did not cheat- early ancestors of the modern security trustee!

- Panama Canal; North Sea

Key difference between Project and corporate finance

- Extent of recourse to the assets of a borrower: in a project finance, recourse is limited to an identifiable pool of assets, whereas in corporate finance, the lenders can have recourse to all the assets of the borrower (to the extent that same have not been charged to other lenders)

Features of Project/Infrastructure Finance

- **Separate entity**

  The borrower is usually a Special Purpose Vehicle (SPV) that is financially and legally independent from the sponsors.
- **Long tenor**

  Usually spanning between 7 to 30 years to match life of and returns on project.
- **Limited recourse/Non-recourse**

  Lenders usually have only limited recourse (or in rare cases, no recourse at all) to the sponsors. in strict terms, non-recourse financing is rare given that there is some (limited) recourse back to the borrower/sponsor beyond the assets that are being financed. For example, full or partial pre-completion guarantees and undertakings to cover cost overruns

Features of Project/Infrastructure finance cont'd

- **Capital Intensive**

  The amount of finance required for most infrastructure projects may run into several million US dollars. D-G of ICRC recently quoted as saying that $100bn will be required to fund infrastructure projects over the next six years

- **Depending on nature of project/ infrastructure, repayments based on cash flows (projects which attract private investment)**

  Investors usually re-paid from cash flow of project or earnings on infrastructure developed, e.g toll fares.

- **Higher Risk**

  Huge capital + long maturities + repayment structure = increased investment risk.

Identification and evaluation of Risk

- Black's Law Dictionary defines risk as the **uncertainty of a result, happening, or loss; liability for injury, damage or loss if it occurs".**
- Risk is unavoidable in any project financing
- The key to success of any project financing is the appropriate structuring of risk. This means identification, analysis and quantification of risk on the one hand, and allocation and management of such risk on the other hand.

Identification and evaluation of Risk (cont'd)

- The risks unique to project financing in an emerging economy like Nigeria's, include, among others:
- **commercial risks consisting of**

  (a) risks connected with developing and constructing, operating and maintaining the assets and finding a market for output of the project and

  (b) broader economic environment risks related to interest rate changes, inflation, currency risks, international price movements of raw materials and energy inputs;
- **non-commercial risks covering**

  (a) legal and regulatory environment, and

  (b) political risks

Effective Risk Allocation

- Major driver in the structuring of project finance is allocation of risk which includes completion risk, technology risk, political risk.

- No universal formula for risk allocation. However, risk in a project should be borne by a party where;
  - the risk is within that party's control, ie. it is best able to manage and control that risk;
  - that party can transfer the risk (for example, via insurance) and it is most economically beneficial to deal with the risk in this fashion;
  - the economic benefit of controlling the risk lies with the party in question; and
  - Placing the risk upon the party in question will improve efficiency

Effective Risk Allocation cont'd

- To mitigate e.g. construction risk, lenders will seek to ensure that there are no delays or cost-overruns or even that the technology adopted is one that is proven.
- Lenders will also prefer that contracts be fixed-priced and turnkey, contain liquidated damages for delay and have performance bonds.
- Operating contracts that sponsors execute with contractors must include a clear definition of the standard of performance to be applied, and include incentives and penalties for meeting standards, as well as adequate monitoring and performance bonds.
- Supply contracts for e.g. raw materials must be long-term commitments as to quality and price.

Sponsors' and lenders' risk

- Please note that sponsors and lenders are not the only parties to a project finance. There are contractors, suppliers, purchasers, etc.
- From the sponsors' perspectives, they will particularly try to ensure that they have identified and understood all risks that they will be assuming in connection with the project.
- They will also want to ensure that they are able to manage these risks effectively and in the event they are not able to do so, either to pass them on to another party involved in the project, e.g. a contractor, or where this is not possible, to find some other way of managing the risk such as by taking on insurance or more radically, altering the structure of the project to extinguish the risk or at least reduce it.

Sponsors' and lenders' risks cont'd

- Sponsors are best able to manage commercial risks which includes risks relating to the development, construction, operation and maintenance of a project. For example, these risks could be managed by either taking out insurance or by transferring same by way of contract. For example, a sponsor can decide to pass the risk of cost-overruns or delay in a construction project to the EPC contractor.

Sponsors’ and Lenders’ risks cont’d

- From a lender’s point of view, there will also be similar concerns as indicated in preceding slide. Additionally, a lender will have the following concerns:
- In assuming any risks associated with a particular project, a lender will want to be satisfied that there are no regulatory constraints imposed on them by a regulator, say, CBN or pursuant to laws applicable to them.
- They may have to report non-credit risks assumed by them in connection with their activities to their regulator.
- The more risk a lender is expected to assume in connection with a project, the greater the rewards in terms of interests and fees they will expect to receive from the project

Sponsors' and Lenders' Risks cont'd

- Lenders are exposed to non-commercial risks including political risks and legal risk. The former could be managed by obtaining political risk insurance, while the latter could best be managed by ensuring meticulous drafting of the project documents.
- Political risk insurance is available to cover various events such as

- confiscation, expropriation, and nationalisation
- Forced abandonment of the project
- Civil war, internal revolts, acts of terrorism

Risk Mitigation Strategies

- parties to a project financing may attempt to allocate and mitigate project risks through, among other things:
  - pre-completion undertakings by sponsors;
  - sophisticated intercreditor and security sharing arrangements;
  - participation by multilateral and bilateral project lenders, e.g. IFC, FMO;
  - insurance

Bankability

- A bankable contract is a contract which satisfies the requirements of the lenders, i.e. the project documentation/contracts must be acceptable to the banks.
- The main aim of lenders is to ensure that the project is bankable i.e. creditworthy. Lenders will be more risk-averse than sponsors so they want to ensure that the repayment of their loans is secure and that as many commercial risks as possible are passed on to the project company's counterparty.

Bankability cont'd

In the financing documentation, the lenders will:

- not accept change of law risk, meaning that the sponsors have to obtain political risk insurance;
- not accept the risk of discriminatory or project-specific taxation by the host government;
- not permit distributions to be paid to sponsors unless and until debt service has commenced and even when debt service has commenced payment of distributions will depend on meeting and maintaining coverage ratios;

Bankability cont'd

- require the project company to bear only those risks under the project documentation which it is fair and reasonable for the project company to bear and which it can reasonably be expected to be able to manage; and
- require the sponsors to adequately capitalise the project company and to provide a sufficient proportion of the total project cost - usually between 20% to 40%.

Bankability and Legal Due Diligence

- The Lenders’ legal advisers would undertake a legal due diligence audit of the project and project contracts. They will thereafter issue a due diligence report giving a summary of the project and its formal and substantial bankability.
- The report will also address issues like the nature and characteristics of the project company, project contracts, administrative consents and permits and general regulatory framework for the project.

Security in Project Finance

- Based on the transaction structure determined by the Lenders, the legal advisers will prepare, review, negotiate and finalize the term sheet and the financing and security documentation, which will include, but not be limited to:
  - Facility or Credit Agreement (which will depend on the transaction structure);
  - Security Documents (which will be subject to Transaction structure);
  - Common Terms Agreement;
  - Trust Deed;
  - Guarantee (if required);
  - Intercreditor Agreement;
  - Accounts Agreement (if required);

Security in Project Finance cont'd

- **Object of project security**

  The main objects of security are to trump unsecured creditors; to act as a defence against unsecured creditors and to confer control of the project property on an event of default.

- **Security structure**

  Project lenders' security interests in project financing can be broken down into two categories: **offshore security and onshore security.**

Security in Project Finance contd.

- **Typically, offshore security includes:**
  - an assignment of rights in the project company's offshore bank accounts;
  - an assignment by the project company of its rights in respect of insurance proceeds;
  - an assignment by the project company of its rights under project agreements such as O & M agreements, offtake agreements, supply agreements, etc.

Security in Project finance cont'd

Onshore security includes:

- a charge over the project company's accounts receivables
- a pledge of rights in the project company's onshore bank account contracts;
- an assignment by sponsors of their rights in respect of subordinated debt and/or preference shares of the project company;
- a mortgage or pledge by the sponsors of their shares in the project company- this will enable the banks to appoint directors on default;
- a fixed and floating charge over the project company's assets including plant and machinery, real estate- this will enable the banks to appoint a receiver.

Post-completion formalities

- **Legal Opinion by Lenders' Counsel.**

  The opinion will cover the legality, validity and enforceability of the transaction in general, and the financing documentation in particular. The borrower's counsel will also provide a legal opinion -will usually be a condition precedent to drawdown;
- **Advice on Conditions Precedent**

  Advising on the appropriate conditions precedent to drawdown and confirming to the Facility Agent that same have been satisfied or waived;
- **Perfection**

  Ensuring perfection of security interests with relevant authorities. This includes stamping, registration and where landed property is involved, obtaining of governor's consent

Case study 1- Cement project

- Details to be provided
- Division into groups, interactive brainstorming/discussion among group members followed by brief presentation by group’s spokesperson.

Case Study 2- Monorail Project

- Details to be provided.
- Division into groups, interactive brainstorming/discussion among group members followed by brief presentation by group's spokesperson.

Some Thoughts on PPPs

In a PPP, the private sector partners with a government or governmental agency to finance the development or refurbishment of infrastructure and or deliver services traditionally financed or provided by the public sector; .

- ✓ PPPs could take on a variety of concession models: DBCF, BOT, BOO, BOOT, LBOT

- ✓ Common features: private investors contract with government, obtain requisite consents, approvals or permits from the latter, to hold, construct & maintain infrastructure over agreed concession period, with requirement in some cases, to transfer infrastructure to the government at expiration of concession period.

Some Thoughts on PPPs contd.

Rationale for PPPs

- one of the most effective ways of improving infrastructure and stimulating economic growth in Nigeria
- dwindling Govt revenues

- Concession agreement-project company acquires the right to build, use and operate the project
- EPC/O&M contracts

Key issues in PPP

Parties, scope of project, term of concession, concession fee, exclusivity, obligations of the parties, permits and consents role of independent engineer, rights over land, provision of security, performance standards, revenues and tariffs, taxes, FGN support, change of law, force majeure, MAGA, insurance,third party claims, change of control, default event, compensation on termination, etc

Funding Options & Finance Providers

Funding options

- **Government Budgetary Allocations**
- **Loan financing (strict and institutional financing from local banks, bilateral and multilateral agencies)**
- **Equity (resources) of promoters/sponsors of the project**
- **Debt Capital Markets** involving the issuance of bonds or notes purchased by institutional investors and HNIs for the financing of an underlying infrastructural project
- **Structured Finance** method of financing whereby financing risk is transferred, using complex legal and corporate mechanism e.g. securitisation, collateralised debt obligations & credit derivatives.

(most infrastructure projects now financed by a mix of these options)

Challenges

- Inadequate legislation and gaps in existing statutes
- Lack of depth in debt capital market
- Global economic downturn
- Lack of Tax Incentives
- Country risks
- Absence of political will
- Weak local banks
- Bureaucracy

Recommendations

- Improvement of enabling legislation
- Elimination of bottlenecks by SEC/NSE
- Further reduction of regulatory fees
- Re-orientation for private sector investors
- Provision of suitable tax and other incentives
- Political will

QUESTIONS?

THANK YOU