LEGAL ASPECTS OF PROJECT FINANCE IN NEPAL

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About the speaker

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- Anjan specializes in corporate, M&A, and project finance. He has advised international banks and financial institutions such as FMO, IFC, GuarantCo, Deutsche Bank, Bank of China, China Development Bank, China Exim Bank, Sinosure, ICICI, and others. He has experience in cross-border financing of projects such as Lower Solu (82MW), Kabeli-A (37MW), and Hongshi Shivam Cement Project. He also advises in M&A, due diligence, and joint venture transactions for hydropower projects.

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Topics

- Basic introduction to project finance
- Overview of current project financing trends
- Risk allocation
- Key project finance documentation
- Legal and policy barriers

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What is project finance?

- "Financing the development or exploitation of a right, natural resource or other asset where the bulk of the finance is not provided by share capital and it is to be repaid principally out of the revenues produced by the project in question (G. Vinter, Project Finance A Legal Guide).

- "The term *project finance* is generally used to refer to a *nonrecourse or limited recourse* financing structure in which debt, equity and credit enhancement are combined for the construction and operation or refinancing of a particular facility in a capital intensive industry in which *lenders base their credit appraisals on the projected revenues from the operation* rather than general assets or credit of the sponsor and rely on the asset of the facility, revenues producing contracts or other cash flow generated by the facility as collateral" (Hoffmann, Law and Practice of International Project Finance)

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Misuse of term project finance

- Sometimes it is used for raising fund to pay for costs of a project – *any project*
- Project finance does not imply that the debt should be entirely non-recourse or limited recourse, but it can also be in a continuum with almost complete recourse
- Contrast with other forms of financing:
  - **Asset based finance** – asset based financing depends on the value of the collateral or asset to be financed
  - **Balance sheet finance** - lending decision is made based on the balance sheet of the borrower or guarantor, not on the project
- In project finance, auction of collateral will not produce sufficient cash in foreclosure sale to justify asset-based loan

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Why project finance?

- In emerging markets including Nepal, demand for infrastructure outstrips economic recourses
- Huge amounts in infrastructure lending most often not possible to mitigate risk by taking assets as collateral or by balance sheet financing
- Project finance provides:
  - Long term debt
  - Higher debt structure
  - Robust contractual structure in bankable projects
  - Non-recourse and off balance sheet treatment

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Disadvantages of project finance

- Complexity of risk allocation
- Increased lender risk
- Higher fees and interest rates
- Lender reporting and supervision
- Increased insurance coverage
- Only feasible for larger projects because of higher costs

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Current financing trends

- Commercial banks in Nepal
  - Financing capacity per project
  - Total financing available
  - Liquidity crisis
- Government institutions in Nepal
  - HIDCL
  - Employment Provident Fund
- International development finance institutions
  - IFC; FMO; DEG; Proparco; GuarantCo
- Foreign commercial banks
  - Usually banks of the country of key sponsors
- Project bonds
- EPCF

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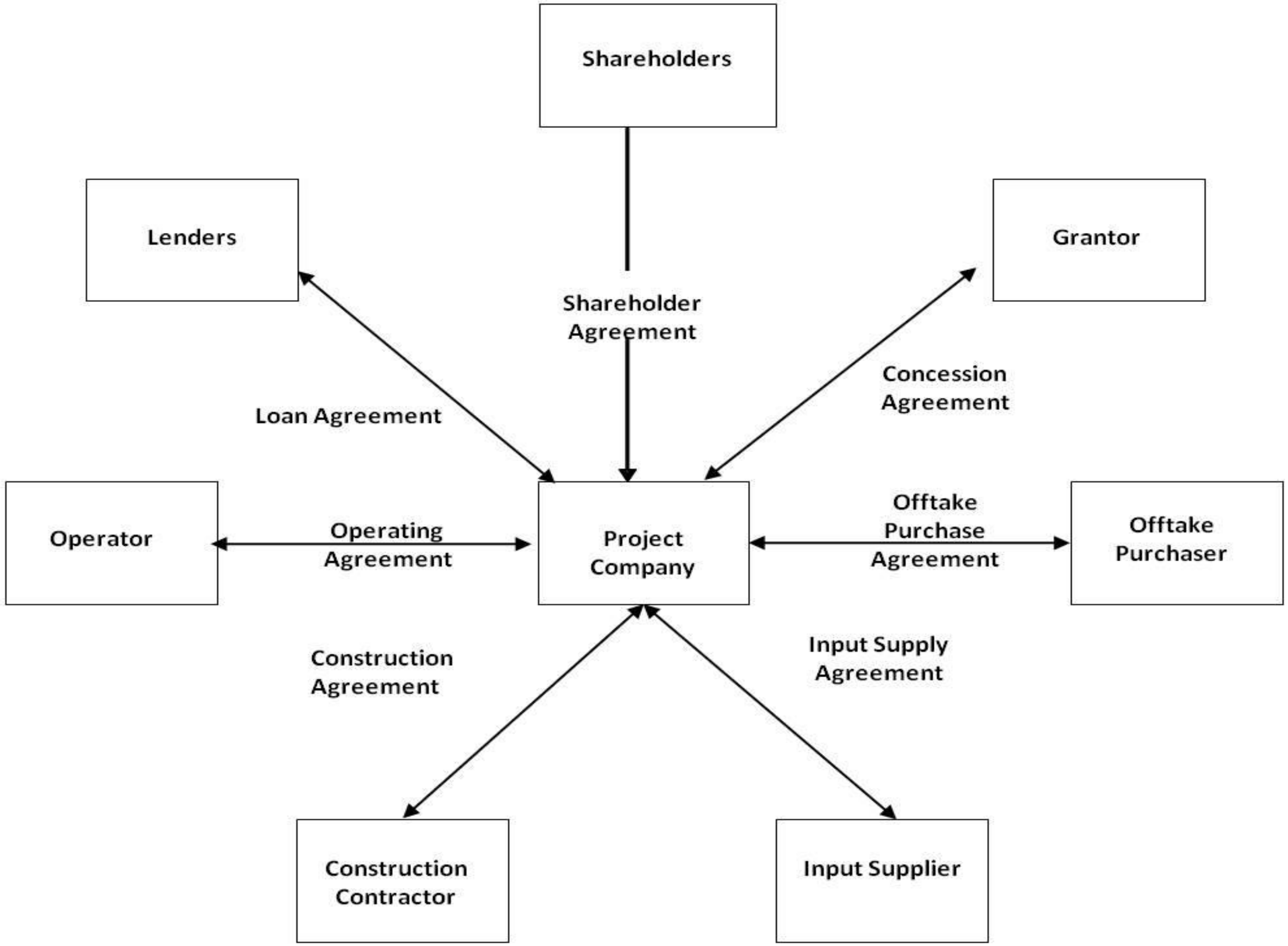
Key parties in project finance



Source: World Bank PPP Legal Resource Centre

Project risk allocation

- A project has many risks
- Lenders need to undertake a risk assessment
- Project needs to be "bankable"
- Risks should be allocated to the party best suited to bear them
- All risks need to be appropriately allocated
- International lenders are very strict about risk allocation and many projects in Nepal have been denied financing because of bankability issues
- Commercial, technical and legal due diligence is required to assess risk

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Cross border risks

- Currency Related Risks
  - Non-convertibility of currency
  - Currency transfer and expatriation risk
  - Exchange rate and devaluation risk
  - Offshore accounts
  - Special considerations for large projects and cross-border projects
- Permit and license risk
- Expropriation risk
- Change of law/price controls
- Political force majeure risk
- Collateral risk
- Legal system risk

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Mitigation of cross border risks

- Concession Agreement/Project Development Agreement
- Power Purchase Agreement
- Currency risk mitigation
  - hard currency payment
  - commercial hedging
  - insurance,
  - indexed local currency payment
  - government sponsored hedging?
- Legal system due diligence

Commercial risks

Completion Risk
- Increase in construction cost
- Delay in completion/COD
- Force majeure in construction contracts
- Capacity of contractor
- Building materials
- Site conditions
- Technology
- Construction of related facility (transmission/substation)
- Force majeure during construction

General
- Sponsor and management risk
- Equity contribution
- Contract mismatch risk
- General contractual risk (legality, validity, enforceability)

Operation risk
- Creditworthiness of off-taker
- Market for product
- Shortfall in output
- Hydrology
- Operating risks
- Operator experience
- Permits and licenses
- Interest rate
- Force majeure during operation
- Environment risk
- Economic projection and feasibility inaccuracy risk

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Mitigation of commercial risks

- Experienced advisors - financial advisors, technical consultants, legal advisors, insurance, E&S advisors
- Construction risk mitigation
  - Contractual undertaking
    - EPC Contracts – fixed price, liquidated damages, performance damages
    - PPA/Connection Agreement – take or pay, liquidated damages
  - Contingency equity funding arrangements
  - Insurance (force majeure)
- Operation risk mitigation
  - Take or pay PPAs
  - O&M Contract
  - Contingency reserve accounts
  - Cash traps/cash sweeps
  - Hydrology risk – PPA/Concession/Sponsors?

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Contracts in project finance

- "Contracts are king in project finance" –(Hoffmann, The Law and Business of International Project Finance)
- Risks and mitigation through contractual and legal documents
- Drafting and negotiating contracts
- What remedies do contracts offer:
  - Damages
  - Liquidated damages
  - Specific performance
  - Injunction
- Dispute resolution
  - Arbitration – international v local
  - Problem with improper use of UNCITRAL Rules
  - Same dispute resolution method for all potential disputes
  - "Court of arbitration of UNCITRAL" in Model PPA does not exist

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Project documents

- Project Development Agreement (Concession)
- Power Purchase Agreement (Off-take)
- Grid Connection Agreement (Evacuation)
- Shareholders Agreement
- Project Licenses
- Land Ownership Certificates
- Lease Agreements
- Construction Agreements
- Operation and Maintenance Agreements
- Insurance

Finance documents

- Credit agreements
  - Common Terms Agreement
  - Facility Agreements
- Inter-creditor Agreement
- Accounts Agreement
- Sponsor Support Agreement
  - Equity commitment
  - Completion support
  - Post-completion
- Security Documents
  - Mortgage Deed
  - Assignment Deeds
  - Hypothecation Deeds
  - Share pledge
- Direct Agreements
  - Contractors; GON; NEA; Land Lessor
  - Information, notification, step-in rights

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Completion and Operation Risk Allocation

1.	***Completion Risks***	**Party**	**Method of allocation**
a.	Delay risk	EPC Contractor	Delay liquidated damages
b.	Cost overruns within contractor control	EPC Contractor	Fixed price EPC contract
c.	Cost overruns or delay due to natural force majeure	Insurer	Insurance
d.	Cost overrun or delay due to political force majeure/change in law	GON /Sponsor	Extension of time/Damages under PDA/PPA/ Sponsor Support
e.	Technology Risk	EPC Contractor	Fixed price
f.	Completion Testing	EPC Contractor	Testing provisions in EPC
g.	Revenue risk due to construction fault	EPC Contractor	Liquidated damages in EPC
2.	***Operating Risks***		
a.	Decreased output and revenues due to operational fault	O&M Contractor	O&M Contract
b.	Water supply/hydrology risk	Historical hydrology data/NEA	PPA provision to renegotiate

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Revenue and Currency Risk Allocation

3.	*Currency Risks*	Party	Method of allocation
a.	Currency revenue risk	NEA	Mixed USD tariff
b.	Currency convertibility and repatriation risk	GON	PDA
4.	***Revenue Risks***		
a.	Revenues from sale of Electricity	NEA	Take or pay PPA
b.	Change in law affecting revenues	GON	PDA compensation
c.	NEA creditworthiness risk	GON	Government guarantee of NEA obligation under PDA

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Political Risk, Force Majeure, E&A

5.	***Political Risks***	**Party**	**Method of allocation**
a.	Expropriation	GON	PDA compensation; entire equity and loan should be paid
b.	Change-in-law	GON	PDA compensation
c.	War and disturbance	GON	Risk should insured or be allocated through PDA
6.	***Natural Force Majeure***		
a.	Natural calamities e.g. earthquake, fire, landslide, flood etc.	Insurance	Insurance/time extension under project documents
7.	***Environment and Social Risks***		
a.	Social disturbances during construction and operation	EPC/O&M Contractor	Social disturbance is not an event of force majeure under the EPC Contract and the O&M Contract.
b.	Environment Law Liabilities	EPC Contractor/Insurers	EPC Contractor should assume risks

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Legal and policy barriers

- Currency risk
  - Mixed USD PPA for 10 years is this enough for debt repayment? What about equity investors?
  - Model PPA provides damage awards to be in rupees
  - Hedging fund – how will it work?
  - Why government should take currency risk?
- Currency transfer risk
  - Approval for each payment of interest and fees to foreign lenders
  - Delay and uncertainty
- Revenue risk
  - Take or pay/take and pay debate?
  - Take or pay 75%
- Transmission evacuation risk
  - Only 5% damages for delay paid by NEA previously
  - Increased to 45% in the Model USD PPA – is this enough?

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Legal and policy barriers

- Social disturbance and illegal strikes
  - Not classified as force majeure
  - Project term not extended
- Security
  - Only 50% land above land ceiling allowed to be mortgaged
  - Government of Nepal (Council of Ministers) approval required to create security in the name of foreign lenders
- Direct agreement
  - Previously NEA and GON did not want to enter into direct agreement with lenders citing lack of legal provisions
  - New provisions in the PPA and PDA
- Guarantee of NEA obligations
  - Now available through PDA

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Legal and policy barriers

- Termination payment
  - Not available under PPA
  - Available under PDA
- Penalty for reduced capacity
  - Ongoing damages are applicable
  - Should be one-off liquidated damages
- Force Majeure
  - Losses resulting from political force majeure will be compensated equal to costs incurred as a result of such event and loss of revenue from the PPA.
  - For non-political force majeure affecting the Project Company, will not receive any revenue from NEA, and thus will need to rely on insurance.
  - For non-political force majeure affecting NEA, only extension of term provided to the extent not covered by loss of profit insurance.

Legal and policy barriers

- Permits
  - Cross-termination provisions and lack of lender step-in
  - Failure to grant permits (if the Project Company meets the relevant requirements) and non-renewal or revocation of permits (without Project Company breach of conditions) is a GON Event of Default under the PDA.
  - However, failure to obtain permits is a termination event under the PPA.
- Land lease agreements
  - Currency draft is not balanced or appropriate to attract international lenders
  - Robust direct agreement is also required
- Offshore accounts for international financing
  - Provisions in the PDA, however, difficult to obtain permit from NRB

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Thank you

- Any questions?

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