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## **Financing of Infrastructure Projects in South East Asia**

Financement des projets d'infrastructure en Asie du Sud-Est

Finanzierung von Infrastrukturprojekten in Südost-Asien

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### **SUMMARY**

The paper provides a review of the opportunities available in South East Asia for those providing "project finance" in connection with infrastructure projects and highlights some of the difficult issues which must be faced by lenders in negotiating and structuring project finance within the region.

### **RÉSUMÉ**

L'article passe en revue les possibilités de développement dans le "financement de projets" en Asie du Sud-Est. Il se réfère aux besoins existants et mentionne quelques difficultés rencontrées par les investisseurs lors de la négociation et de la mise en place de tels financements.

### **ZUSAMMENFASSUNG**

Der Aufsatz sichtet die Möglichkeiten, die sich einem Anbieter von "Projekt-Finanzierung" bei Infrastrukturprojekten in Südost-Asien auftun. Insbesondere werden einige schwierige Fragen angesprochen, denen sich Gläubiger bei der Aushandlung und Strukturierung von Projektfinanzierungen in dieser Region stellen müssen.



The brief from the Association was to provide a paper for discussion related to the topic "Project Financing - World Trends".

The world is a large canvas from which to identify images and always a greater insight can be drawn from focusing upon the segment of the picture one sees every day. I have lived and worked in South East Asia for the last 16 years and as a result the trends I am familiar with are those which have been and are currently taking place in South East Asia.

#### PROJECT FINANCE IN SOUTH EAST ASIA - AN OVERVIEW

During the past decade the growth rates of many of the economies of South East Asia have exceeded double digits. Manufacturing output has increased rapidly, service sector industries has developed and living standards have risen. The growth will continue well into the next decade. Indeed so fast has been the industrialisation and urbanisation of several of the Asian nations that governments have been unable to provide the necessary infrastructure and power resources to meet demand. In several countries it is now clear that the limiting factor upon the rate of economic expansion is the availability of power and infrastructure. Moreover investors are increasingly reluctant to further invest in countries which cannot demonstrate a means of improving or upgrading transportation communication and power generation facilities.

The ceilings placed on public sector debt together with other political considerations have led many of the governments in the region to turn to the private sector for assistance in providing these much needed facilities. The response of the private sector has been encouraging and project finance has been provided for a number of major projects. Indeed the availability of project finance for these important projects is seen as vital if high growth rates are to continue.

But what is "project finance"?

Put at its simplest, project finance will be provided for specific projects or operations where the security to the lenders of the finance lies in the revenue or cashflow and assets of the project itself. It is a notable feature of project financing that the lender bears some of the risk. Such financing is often termed "limited recourse lending" because the borrower's assets are not generally available as security (though fully non-recourse lending is rare). The practical consequence of such lending is that the lender is critically concerned to assess the cash flow assets and general viability of the project rather than with the balance sheet of the borrower.

Project finance or financing is not a term of art. It is often misleadingly applied to projects generally where the special characteristics of project financing may not be present. While it is important to avoid the jargon which is a feature of this kind of lending it remains true that project financing is sophisticated and technical because of the complex risk analysis and allocation which is required.



The legal vehicle for project financing may be a partnership, company, trust or joint venture. Typically a single purpose entity will be established by project sponsors whether incorporated or not.

Why will those raising finance for the project seek single purpose funding or as we call it project finance?

An important reason for seeking project financing is that the project itself requires huge sums for its implementation which a borrower is unable or unprepared to borrow on the strength of its balance sheet alone. It may also be important to a borrower to limit, or isolate, its liability to the project cash flow and assets and thereby protect its other assets so as to maintain maximum flexibility to deal with economic downturns. Project financing will be "tailor made" to the needs of each project and may minimise the equity outlay. It may also be important to a borrower to avoid breaching negative pledge restrictions which exist in relation to other borrowings. Particular advantages of project lending from the borrower's perspective are that the funding sources can be broadened, tax optimisation can be achieved and specific risks can be passed on to the lenders.

Banking procedures and legal mechanisms to facilitate project financing have been developed and driven by resources exploitation in the oil, gas, mining and timber industries. Providing project finance for the construction and operation of facilities such as airports, road and rail links is an infinitely more complex matter.

Those providing project finance for major projects in South East Asia look for relative political stability, a sound banking system, a liquid capital market, a high credit rating based on conservative borrowing policies and low public sector debt before they will risk financing long term infrastructure projects.

The deregulation of South East Asia's financial markets and virtual removal of exchange controls have clearly been of assistance to project financiers.

The following are some "thumb-nail" sketches of the economic and political environments for project financing in the region.

### Thailand

At present there can be no doubt that infrastructure in Thailand is inadequate. Manufacturers from elsewhere wishing to relocate to Thailand are presently dissuaded from doing so because of the massive congestion on the roads and ports. Lack of efficient telecommunications within the country also adds to the apprehension of investors. For these reasons public project financing in urban transit, national highways, ports, power generation and telecommunications is likely to remain popular for at least the next two years. Other reasons which are favourable are that economic growth still runs at nearly 10% a year and there has been relative political stability and a high credit rating based on low public sector debt. (Thailand's debt service ratio is down to 6% for the public sector alone and just above 10%, if long term borrowing is included). The annual ceiling on new government-sector debt commitments was raised to US\$1.5 billion so that, although Thailand has already awarded contracts for most of its big projects, further contracts are hoped for.



Because of the public borrowing ceiling, and because large state projects have to be screened by the National Planning Board of the Finance Ministry, ministers are tending to turn to projects with various degrees of private sector participation. Some, like the planned raising of railway tracks, would require a private contractor to build the facilities, to operate them for a period and then to transfer ownership back to the state agency concerned.

Economists argue that these so-called private projects should be brought back into the national screening procedures, partly to reimpose discipline on the borrowing commitments involved. To do so would slow down investment, but it would ensure that the economy is maintained on a controlled basis and that the country remains attractive for project financing.

### The Philippines

A significant problem when considering project financing is the exposure to a foreign exchange risk. Toll roads are more difficult to finance in the Philippines and Indonesia where the peso and the rupiah have been drifting downwards and loan maturities tend to dry up after 10 to 15 years. In the Philippines the oil price has been one further blow in a year of civil unrest, devaluation and mounting shortages of foreign exchange.

### Indonesia

Indonesia has been subject to some instability when its rapidly expanding banking system wobbled after the rescue of the country's fifth largest bank. With the civil service unions lobbying for pay rises, a foreign exchange risk and the prospect of an oil glut in 1991, Indonesian ministers are reluctant to pledge the country's extra cash to help finance infrastructure. Nonetheless, the dollars appear to be pouring in for infrastructure investment, perhaps as a response to tax incentives, cheap labour and available land. There is talk of allowing "commercialisation" in Indonesia which may come close to the kind of privatisation taking place in Malaysia.

### Malaysia

A feature of foreign investment lending in South-East Asia is the requirement in some jurisdictions that foreign investment may be made only where there is a local equity participation. In Malaysia, for example, the New Economic Policy, which was introduced in 1971, requires companies to structure their equity so that there is a ratio of 30% for foreigners, 40% for non-Bumiputra Malaysians and 30% for Bumiputras. However, in the late 1980s, the priority has moved towards the encouragement of more investment to combat a feared recession of the economy. For this reason, it is now possible for investors to retain a full share ownership of projects. The government has confirmed that this incentive to foreign investment will continue.

Generally speaking the Malaysian Government has embraced the concept of "build, own and operate", ("B.O.O.") wholeheartedly. The construction of the North-South Interurban Expressway by a private consortium on a B.O.O. basis has been extremely successful and work on the M\$3,500,000,000 tolled expressway stretching from Thailand to Singapore is approaching completion. Similar transportation projects to be undertaken on a B.O.O. basis are planned and include The Second Crossing from Singapore to Johore, the Kuala Lumpur Light Transit System and the Kuala Lumpur Monorail System.



## Hong Kong

Perhaps the largest fund raising in the region will be that related to development of the new airport and ports in Hong Kong. Plans for raising the necessary capital have not yet been announced however the model may well be the Mass Transit Railway Corporation where in connection with the construction of the Mass Transport Railway ("MTR") the Government provided 20% of the capital cost and guaranteed 10% of the funding. The rest of the security was against the Corporation's own resources which were boosted by the provision of land provided by the Government for property development.

While the MTR was a project of the 1970s, the Government is today likely to play a more active role in the capital raising exercise. In doing so, it can draw on a steadily growing Capital Works Reserve Fund which now holds HK\$10.5 billion, with an expectation of a further HK\$40 billion on the realisation of land sales on the site of the airport and surrounding areas. In addition, there is a large "treasure chest" contained in the Foreign Exchange Reserve Fund, the contents of which remain secret.

## SOME IMPORTANT ISSUES IN PROJECT FINANCING

### State Agreements

The huge sums involved in project financing and the necessary involvement of governments (and consequential political and legal uncertainty) has led to the use of State Agreements. These are agreements under which the relevant state government will contract directly with project sponsors to inter alia grant the concession (if any) to construct and operate the facility, secure title and ensure government consents and authorities. In some cases, the state will pass legislation to "adopt" the agreement upon which the project is based. The object is to "entrench" the agreement as part of state legislation and ensure that the obligations of the state under that agreement have the full force and protection of the law.

There are certain constitutional difficulties with such State agreements, not the least of which being that they may constitute a fetter on the discretion of a minister to grant a licence or export permission etc. These agreements have, nonetheless, during the 1970s and 1980s, been effective in facilitating projects and in ensuring that they have gone forward in relative legal and political security.

Where project financing has been impeded by political and legal systems which have little experience with foreign investment and project development, State Agreements could prove useful in avoiding problems such as ministerial discretion in granting land tenements, expropriation (or legislative or ministerial action which is tantamount to expropriation), and obtuse bureaucratic procedures. The adoption of a State Agreement, setting out rules relating to employment, environment, taxation, land use, etc., enables financiers to resolve the legal uncertainties and to complete the project.

Whilst generally there are clear benefits to be derived from enshrining the terms of the contract between the state entity and the project sponsor into legislation there can be pitfalls which need to be addressed particularly in relation to the enforcement of the provisions of the contract.





Firstly, where rights are granted under a private contract, any breach of the contract by the state entity such as the improper termination of the concession would entitle the project sponsor to damages, and in some cases specific performance of the terms of the contract. Where the rights are granted under statute, these remedies may not be available to project sponsors. Under English law jurisdictions the project sponsor would be required to enforce its rights by making an application to the courts for judicial review of the states' action or inaction under the contract and the powers of the courts to grant relief to the project sponsor are purely discretionary.

Secondly, in the case of rights granted under statute, third parties may potentially have the right to apply to the courts for an order requiring the state to comply with the provisions of the statute, and possibly, enforce provisions of the contract which either commercially or politically the state may not wish to enforce, eg., environmental protection powers. In the case of rights granted under private treaty, of course only the parties to the contract can enforce its terms.

Thirdly, whether granted under statute or private treaty, the state often reserves to itself certain discretions or powers of approval in relation to matters which are the subject of the contract. For example, the contract may provide that the state, through its Minister or Department Head, has the power to approve the design or method of construction of the facility. Under English law jurisdictions, the rules of administrative and public law require that any officer of a state entity shall exercise any power or discretion devolved to him fairly and impartially and that any complainant may, in certain circumstances, require the courts to judicially review the manner in which the discretion or power was exercised. In the case of a discretion or power given to or reserved by one of the parties under a private agreement, the manner in which the discretion or power is exercised is not fettered unless express provisions are included in the agreement to provide so.

Fourthly, a project sponsor should also take note that parties to a private treaty or contract may alter, amend or relax the terms of any concession granted at the stroke of a pen. Any rights granted under statute may usually only be altered by the enactment of further legislation which may be costly and time consuming.

Finally, it is interesting to note how differently projects are structured from jurisdiction to jurisdiction. In Malaysia the concessions granted by the state or state controlled bodies to project sponsors are invariably private contracts. On the other hand in Hong Kong concessions granted to the project sponsors of both the Eastern Harbour Crossing and the Tates Cairn Tunnel (two of the major toll road projects recently completed in the Territory) were by statute.

#### Protection of the Project Financier On A Borrower's Default

It is critically important that the project financier should have the ability ie., the legal right under the concession agreement to take over and operate the project in the event of a default. A default should not enable the concession to be revoked. The project financier as lender should have the right to "stand in the shoes" of the project sponsor or borrower as "the new owners".



Common legal consequences of default are:

Loss of voting rights

The party in default may lose its voting rights and thereby enable the non-defaulting party to vote to abandon the project or to place the project on a "care and maintenance" basis. It is necessary to ensure that provisions are drafted to require unanimity or to ensure that the project financier retains control of the project.

Exercise of pre-emptive rights

The project financier or lender would prefer that pre-emptive rights did not apply to a sale by it or by a receiver. If, however, pre-emptive rights are conceded by them, it is important that where a non-defaulting party purports to sell its shares, a minimum price mechanism is adopted to ensure that the shares are sold at a price which covers the amount owing to the lenders. If a non-defaulter does not exercise the right to purchase, the lender would then be free to sell to anyone at any price, (constrained, of course, by the usual fiduciary duties of a mortgagee). Such provisions are, however, open to objection by a non-borrowing project sponsor on the ground that it constitutes underwriting the financing of the borrowing joint venturer.

Compulsory contributions

Clauses creating an obligation to contribute to unpaid calls can create disadvantages for a lender. Under contribution clauses a lender may become bound to pay the share of a non-defaulting party of the defaulting party's unpaid calls. Failure by the non-defaulting party to pay may, itself, be an event of default and have the effect of causing each joint venturer to default in turn. Care should be taken either to avoid such clauses or to ensure such payments are debts and subject both to interest and to cross-charges.

Sale of operation of the project

Where there has been **joint** financing and cross charges, the lenders can enforce their security against the whole project and cannot be out-voted by non-defaulting parties. The lender or a receiver and manager appointed by the lender can operate the project. (They can do this by either controlling the manager or exercising their voting rights to appoint a new one). By contrast with **several** financing, the lenders do not have an opportunity to take over the project which will be operated by a manager. Importantly, where a lender can take over the entire project, it has the option to sell the project and, thereby, to ensure the best possible price on the market.





### Completion Risks

As lenders depend upon the cash flow, it is necessary that the project is completed and brought into operation. Lenders must consider the risk of cost overruns and time delays and the technical aspects. Banks will not, however, generally accept completion risks. In order to overcome these problems, a completion covenant should be drafted under which the borrower covenants to complete the project and the security extends to assets of the borrower. In this sense, recourse is not fully "limited". Where the borrower is a single purpose company (with no assets other than those of the project itself), it becomes necessary that this completion covenant is also given by the parent or sponsor or shareholder of the borrower.

The term "completion" must be drafted carefully to cover physical aspects such as infrastructure, and to cover performance and production, sales tests and ratio tests. It may also be possible to include a cost overrun facility and to provide that insurance be taken in relation to all insurable assets.

### THE CHANGING ROLE OF BANKS IN PROJECT FINANCING

A recent trend in project financing can be described by analogy with "relationship" banking in the corporate field. Banks typically retain a close working knowledge of and relationship with the project and exercise a close scrutiny and control over each stage of the project. Indeed, in one reported project development a company's treasury staff received more than 200 visits from representatives of banks involved in the financing! There are obvious and significant advantages to lenders in maintaining such a close involvement with the project itself so that they remain fully informed and able to respond quickly if necessary.

Early intervention by the lenders is necessary in major project financing because in part the lead times for the construction of railways, port facilities or accommodation for workers can take some years to complete before the first sod of earth can be turned for the project itself.

Of course the scale and complexity of many B.O.O. or B.O.T. projects cannot be underestimated and the risk analysis to be undertaken by the project sponsor and the project financier straddles many issues. There has to be a team approach between the project sponsor and its bankers.

By way of example several toll expressway projects in Malaysia, Thailand and Indonesia were only financially viable because of the provision of government cash subsidy or support. Increasingly this form of direct financial support has become politically unacceptable and although "subsidy" is still necessary in order for many projects to make commercial sense the nature of the subsidy provided has changed. For example it is increasingly the case that the government will make available to the project sponsor development rights over land adjacent to the project or over the air space above the project eg., the right to develop station sites along a rail system. Bankers evaluating the cash flow of a project now need not only to assess operating revenue derived from the project but also the revenue to be derived from the exploration of such ancillary rights. Strategies for the exploitation of ancillary rights need to be developed by the project sponsors in association with their bankers as part of a team approach.



A further trend is the introduction of more flexible financial packages which now include:

- a wider range of floating rate funding sources;
- tax efficient vehicles such as leveraged leases;
- co-financing with international financing agencies;
- integration with government export incentive financing;
- complimentary financing with local governments (eg., infrastructure - OK Tedi);
- quasi-equity financing, such as commodity bonds, redeemable preference shares; and
- interest rate and currency swaps.

I hope that these observations assist in highlighting some of the issues in financing projects in South East Asia.

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