PART ONE

AN INTRODUCTION TO PROJECT FINANCE

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OVERVIEW

§ 1.01 DEFINITION OF PROJECT FINANCE

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 the refinancing, of a particular facility in a capital-intensive industry, in which lenders base credit appraisals on the projected revenues from the operation of the facility, rather than the general assets or the credit of the sponsor of the facility, and rely on the assets of the facility, including any revenue-producing contracts and other cash flow generated by the facility, as collateral for the debt.[1]

In a project financing, therefore, the debt terms are not based on the sponsor's credit support or on the value of the physical assets of the project. Rather, project performance, both technical and economic, is the nucleus of project finance.

§ 1.02 CONFUSION OF TERMS

The term *project finance* is often misused, owing to a general misunderstanding of the term.[2] In some circles, it refers to raising funds to pay the costs of a project – *any* project. In others, the term is used to describe a hopeless financial situation remediable only with extreme financing options. The emerging meaning for the term is the definition above.[3]

The term project finance does not necessarily imply that the underlying debt is nonrecourse to the project sponsor. As the definition indicates, project finance debt can be nonrecourse or limited recourse. Project finance transactions can be placed on a continuum, with recourse to project sponsors ranging from nonrecourse to almost complete recourse, as is increasingly common in structured project finance. Complete recourse is a different financing technique, usually called direct lending.

§ 1.03 NONRECOURSE PROJECT FINANCE

As indicated above, a common form of project finance is nonrecourse[4] financing, predicated completely on the merits of a project rather than the credit of the project sponsor. The credit appraisal of the nonrecourse project finance lender is therefore based on the underlying cash flow from the revenue – producing project contracts, independent of the non-project assets of the project sponsor. Because the debt is nonrecourse, the project sponsor has no direct legal

[1] Scott L. Hoffman, *A Practical Guide to Transactional Project Finance: Basic Concepts, Risk Identification, and Contractual Considerations*, 45 Bus. Law. 181 n.1 (1989).

Other definitions have been suggested. *See, e.g.*, Clifford Chance, Project Finance 1 (1991) ("The term 'project finance' is used to refer to a wide range of financing structures. However, these structures have one feature in common – the financing is not primarily dependent on the credit support of the sponsors or the value of the physical assets involved. In project financing, those providing the senior debt place a substantial degree of reliance on the performance of the project itself."); Peter K. Nevitt, Project Financing 3 (1983) ("A financing of a particular economic unit in which a lender is satisfied to look initially to the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan.").

See generally Jeffrey Delmon, Project Finance, BOT Projects and Risk (2005); Graham D. Vinter & Gareth Price, Practical Project Finance (3rd ed. 2005); Hossein Razavi, Financing Energy Projects in Emerging Economies (1996); Clifford Chance, Project Finance (1991); Peter K. Nevitt, Project Financing (7th ed. 2000); John G. Manuel, *Common Contractual Risk Allocations in International Power Projects*, 1996 Colum. Bus. L. Rev. 37 (1996); Harold F. Moore and Evelyn D. Giaccio, *International Project Finance (A Practitioner's Guide to International Banking and Trade Finance)*, 11 N.C.J. Int'l L. & Com. Reg. 597 (1986); Stewart E. Rauner, *Project Finance: A Risk Spreading Approach to the Commercial Financing of Economic Development*, 24 Harv. Int'l L.J.145 (1983); Larry Wynant, *Essential Elements of Project Financing*, Harv. Bus. Rev., May–June 1980, at 165.

[2] One commentator has ventured to provide a short history of project finance, beginning in Roman times. Reinhard Zimmermann, *Non-Recourse – The Most Condemnable of Loan Transactions*, Project Finance International, July 3, 1996, at 62; *see also* Esteban C. Buljevich & Yoon S. Park, Project Financing and the International Financial Markets 87 n.1 (1999); Stewart E. Rauner, *Project Finance: A Risk Spreading Approach to the Commercial Financing of Economic Development*, 24 Harv. Int'l L.J. 146 (1983).

[3] "When *I* use a word," Humpty Dumpty said in rather a scornful tone, "it means just what I choose it to mean – neither more nor less." Lewis Carroll, *Through the Looking-Glass*, ch. 6 (1872).

[4] *See* Hauser v. Western Group Nurseries, Inc., 767 F. Supp. 475, 483 n.11 (S.D.N.Y. 1991).

obligation to repay the project debt or make interest payments if the project cash flows prove inadequate to service debt.

Because the ability of the project sponsor to produce revenue from project operation is the foundation of a project financing, the contracts form the framework for project viability and control the allocation of risks. Contracts that represent the obligation to make a payment to the project company on the delivery of some product or service are very important because these contracts govern cash flow.[5]

Each contract necessary to construct and operate a project, such as the output sales contract, feedstock contract, site lease, and construction contract, must not interfere unduly with the expectation for debt repayment from project revenues. If risks are allocated in an unacceptable way from the project lender's perspective, credit enhancement from a creditworthy third party is needed in such forms as letters of credit, capital contribution commitments, guarantees, and insurance. Also, the project finance contracts must be enforceable and have value to the lender as collateral security.

A project financing is also based on predictable regulatory and political environments and stable markets, which combine to produce dependable cash flow. To the extent this predictability is unavailable or the risks of dependability are allocated unacceptably, credit enhancement is necessary to protect the lender from external uncertainties, such as fuel supply, product market instability, and changes in law. Commonly, however, the project exists in an uncertain environment that subjects the project lender to some unallocated risks.

The project finance documents should be designed to anticipate regulatory problems unique to the project and the environment in which the project will exist. Many projects receive benefits from statutory and regulatory structures, which can be forfeited if the requirements are not fulfilled throughout the life of the project. Examples include conditions in government licenses and implementation agreements, statutory requirements for the efficient use of natural resources, and regulatory air pollution standards.[6] In these situations, the project documents should allocate responsibility for the risk that such standards are not complied with because of the fault of a project participant.

§ 1.04 LIMITED RECOURSE PROJECT FINANCE

The classic nonrecourse project financing would result in no potential liability to the project sponsor for the debts or liabilities of an individual project. It would be *nonrecourse*. This is rarely the case. In most project financings, there are limited obligations and responsibilities of the project sponsor; that is, the financing is *limited recourse*.

How much recourse necessary to support a financing is determined by the unique risks presented in a project and the appetite of the credit markets to accept the risks. For example, if the lenders perceive that a substantial risk exists during the construction phase of a project, they could require that the project sponsor agree to infuse additional equity if the risk actually materializes. The lender would have recourse to the project sponsor's assets until the risk subsides or construction is complete. Thereafter, the loan would be nonrecourse.

§ 1.05 STRUCTURED PROJECT FINANCE – TOWARD GREATER ECONOMIC EFFICIENCY?

An economic argument can be made that classic nonrecourse project finance is an inefficient, expensive financing technique. As discussed above, in a nonrecourse project financing, project finance lenders base credit appraisals on the projected revenues from the operation of the facility, rather than the general assets or the credit of the sponsor of the facility, and rely on the assets of the facility, including the revenue-producing contracts and cash flow, as collateral for the debt.

[5] *See generally* NEVITT, *supra* note 1, at 183–95; Joseph Ryan & Lorin M. Fife, *Take-or-Pay Contracts: Alive and Well in California*, 19 URB. LAW. 233 (1987); Robert B. Nolan, Jr., *Take-or-Pay Contracts: Are They Necessary for Municipal Project Financing?*, 4 MUN. FIN. J.111 (1983).

[6] Host-country concessions and implementation agreements are discussed in Chapter 14.

Any component of the project that could result in less revenue or greater expense than anticipated by the lender can result in project failure; that is, unexpected events are an anathema to project finance.

In answer to this risk, project financings are designed to avoid uncertainty. This is particularly true with the underlying contracts, and it is with the contracts that the economist makes the inefficiency argument.

For example, the construction contract in a project financing must serve to provide the project company with a finished facility that satisfies certain agreed-upon performance criteria for a fixed or reasonably predictable price on a definite date. The tension between the project company and contractor in a project financing is based on the turnkey nature of the construction contract: the contractor must deliver the project at a fixed or predictable price, on a date certain, warranted to perform at agreed levels. The contractor is, of course, concerned with the difficulty of predicting events that could result in delivery of a delayed project, at an increased price, that does not perform as expected. Thus, unless the contract price is extremely attractive (that is, the risk premium sufficiently high), the three main objectives of the contractor in contract negotiation are to limit risks of any change in the cost of the project, to ensure there is sufficient contractual excuse for late delivery, and to provide sufficient time to satisfy performance guarantees.

For the project company and lender, the risk that construction costs will exceed the funds available from the construction loan, other debt sources, and equity is a significant risk in a project financing. Increased construction costs may result in increased debt service costs during construction, unavailability of sufficient funds to complete construction, and even if funded, in the inability of the project company to pay increased interest and principal that result from the additional debt required to complete construction.

To convince the contractor to shoulder these risks, the project company must pay the contractor a premium for the risks taken. A customary reward for the contractor in return for assuming the risk of completion on a date certain for a fixed price is through both the contract price and a bonus payment, which is paid by the project company to the contractor if the project is completed ahead of the scheduled completion date. In return, the project company achieves predictability of construction costs. However, the cost paid for the risks allocated to the contractor is not inexpensive. In addition, the extra amount paid arguably adds minimal value to the project assets; that is, the additional money is attributable to risk assumed by the contractor, not equipment value or improved performance.

In situations in which the project company can access additional debt or equity needed to pay for construction cost overruns, it can decide to assume some construction cost overrun or delay risks. In such a situation, the price paid to the contractor is reduced because the risk premium, otherwise payable to the contractor, is not necessary.

This technique is called a *structured* project financing. In a structured project financing, the project sponsor assumes some uncertainty in the project in return for a reduction in the risk premium otherwise payable to various contracting parties. The financing is not without recourse to the project sponsor, however, because the lender will require that the risks not allocated to the various project contracting parties, such as the contractor or fuel supplier, be retained by the project sponsor. To be meaningful to the lender, however, the structured project finance technique requires that the project sponsor has the assets to infuse additional capital or debt into the project company if necessary.

For example, the project company and the project contractor could enter into a construction contract that requires the contractor to finish the project within a set period, well within the contractor's abilities. Feasibility consultants could agree that the contractor has a long period to complete the project and will likely finish construction well before the date required in the contract.

A delay in project completion may result in an increase in project construction costs and a concomitant increase in debt service costs. The delay may also affect the scheduled flow of project revenues necessary to cover debt service and operations and maintenance expenses. In addition, a delay in project completion may result in

damage payments payable under, or termination of, project contracts, such as fuel supply and output contracts.

Nonetheless, because of the unlikelihood of this, as verified by project consultants and the project sponsor's own expertise and experience, the project sponsor agrees to accept this risk. The project lender will require that the project sponsor enter into agreements to provide additional equity to the project company to the extent the risk materializes. The project sponsor, of course, must have the financial ability to complete such an obligation. In return, the project sponsor can reduce the construction price by avoiding the risk premium to the contractor. In effect, the project financing is recourse to the project sponsor, at least in part, during the construction phase of the project. Once the project is completed at the time required under the project loan documents, the financing is structured to transform into a nonrecourse financing.

§ 1.06 CONTRAST WITH OTHER FINANCING TYPES

[1] Balance Sheet Finance

A project financing is in contrast with balance sheet finance. With this approach, a company uses retained earnings or short-term debt to finance the development and construction of the facility. Upon completion, when the project requires permanent financing, long-term debt, equity sales, or other corporate finance techniques are used to obtain the needed funds.

Where debt is used, the lending decision is based on the overall corporate balance sheet, as opposed to a specific stand-alone project. The cash flow and assets of the company are relied upon by the lender as the basis for servicing the additional debt necessary to develop, construct, and operate the project and to collateralize the loan. The entire company is thus the focus of the credit decision, including the effect of the new project on the company's continued viability.

The decision to use corporate financing is primarily determined by corporate philosophy. The relevant criteria a project must satisfy to qualify for balance sheet financing include whether the corporation has access to the needed capital at a reasonable cost, whether the project feasibility study projects a return on investment acceptable to the project sponsor's internal investment criteria, whether the project risks are satisfactory, and whether other types of financing provide greater advantages to the project sponsor.

[2] Asset-Based Finance

The project financing and asset-based financing methods are very different. An asset-based financing is founded on the value of the assets financed. A project financing, however, is based on the ability of the project to generate sufficient revenue to service the debt. Indeed, in a project financing, the hard assets probably would not produce sufficient cash in a foreclosure sale to justify the value of an asset-based loan.

§ 1.07 USES OF PROJECT FINANCE

Project finance is an emerging solution for financing infrastructure needs in many parts of the globe. In emerging markets, where the demand for infrastructure far outstrips the economic resources, it provides a financing scheme for important development. In countries moving from centralized to market-based economies, it provides needed upgrades or replacement of existing infrastructure assets that have not been maintained adequately. The needs for enormous debt and capital, coupled with the risks involved in large project development, often make a project financing one of the few available financing alternatives in the energy, transportation, and other infrastructure industries.[7]

Projects financed using this model tend to be large and require large financing packages for two reasons. First, economies of scale can be enjoyed in both development and operation. Second, the needs that are the genesis for the projects necessitate that larger projects be developed to provide

[7] *See* Daniel Hurstel & Mary Ann Carpenter-Pecquet, *Privatization and the Public Interest*, 13 INT'L FIN. L. REV. 34 (1994). For an excellent summary of the recent efforts with privatization and foreign investment in developing countries, *see* Christopher J. Sozzi, Comment, *Project Finance and Facilitating Telecommunications Infrastructure Development in Newly-Industrialized Countries*, 12 COMPUTER & HIGH TECH. L.J. 435 (1996).

as much needed infrastructure as is possible, as soon as possible.[8]

§ 1.08 BASIC COMPONENTS OF PROJECT FINANCE

All project financings have nearly identical fundamental elements: debt, from banks or institutional and governmental lenders, or subordinated notes from the project sponsor or other project participants is, of course, the most common element. Collateral security is similarly present, in the form of assignments of contract rights and project revenues, to support the underlying debt obligations. Also, various types of credit enhancement from the project sponsor or third parties are included to support the risk allocation. Finally, equity, whether active or passive in management of the project, is needed. The precise structure selected is dependent upon a range of variables, influenced in large part by project viability and the goals of the project sponsor. Project finance structures are discussed in Chapter 6.

§ 1.09 ADVANTAGES OF PROJECT FINANCE

Project financing is used by companies that desire any or all of several objectives. Established, well-capitalized corporations often select a project finance structure to assist in undertaking large debt commitments with a minimum of risk. Entrepreneurial developers rely on project financing to permit development of several projects in different geographic areas, each based on the merits of the project, independent of the financial obligations of the other projects, and with minimal equity requirements. These objectives, which are discussed in more detail below, include: (i) elimination of, or limitation on, the recourse nature of the financing of a project; (ii) off-balance-sheet treatment of debt financing (where still available); (iii) leverage of debt to avoid dilution of existing equity; (iv) avoidance of restrictive covenants in other debt or equity arrangements that would otherwise preclude project development; (v) arrangement of attractive debt financing and credit enhancement, available to the project itself but unavailable to the project sponsor as a direct loan; (vi) internal capital commitment policies; (vii) diversification of the project sponsor's investments to eliminate political risk; (viii) risk sharing; (ix) limiting collateral to the project assets; (x) more incentive for the lender to cooperate in a workout of a troubled loan; (xi) matching specific assets with specific liabilities; and (xii) expanded credit opportunities. The advantages that result from a project financing differ based on the unique nature of each project, with different risks, capital needs, capital access, and motives.

[1] Nonrecourse Debt Financing – It Ain't Necessarily So

Classic nonrecourse project financing provides a structure that does not impose on the project sponsor any obligation to guarantee the repayment of the project debt if the project revenues are insufficient to cover principal and interest payments. The nonrecourse nature of a project financing provides financial independence to each other project owned and provides protection of the sponsor's general assets from most difficulties in any particular project. A typical nonrecourse project finance loan provision provides that no recourse is available against the sponsor or any affiliate for liability to the lender in connection with any breach or default, except to reach project collateral.[9] Thus, the lender relies solely on the project collateral in enforcing rights and obligations in connection with the project finance loan.

The nonrecourse nature of the debt in a project financing need not extend throughout the term of the financing. A project financing may be structured to provide recourse liability to the project sponsor during a limited period of the project

[8] *See generally* David Baughman & Matthew Buresch, *Mobilizing Private Capital for the Power Sector: Experience in Asia and Latin America*, Joint World Bank-USAID Discussion Paper (1994).

[9] The terms *nonrecourse* and *limited recourse* are sometimes used interchangeably. Regardless of nomenclature, unless otherwise agreed, a project financing is recourse to the project sponsor only to the limited extent of liability for fraudulent representations made in connection with the financing. *See generally* 12 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS §§ 1486–1509 (1970).

development. For example, under that structure, if a project uses a new, unproven technology that causes the lender to conclude that additional project risks are present, the project sponsor's full recourse liability for the debt could be limited to the construction period. Thereafter, if the technology satisfies minimum performance tests, the lender could release the project sponsor from recourse liability and shift the risk from the assets of the project sponsor to the project assets.

An example of a nonrecourse loan provision for use in a project finance loan agreement is reproduced below.

> The [*Project Sponsor*] shall not be personally liable for payment of the amounts evidenced by the Note executed by the [*Project Company*]. Nothing contained herein, however, shall (i) preclude the [*Lender*] or any holder of the Notes from exercising any right or enforcing any remedy under this Agreement, or the Note, whether upon an Event of Default or otherwise, under this Agreement, the Note, or any other Collateral hereunder or furnished as security for any of the indebtedness evidenced by the Note, or (ii) limit the [*Project Sponsor's*] liability hereunder in respect of any damages suffered by the Lender as a result of any inaccuracy of any representation in this Agreement or as a result of any fraudulent conduct on the part of the [*Project Sponsor*].

The nonrecourse provision is also a part of project finance documents other than loan documents. An example follows.

> Any claim against the Sponsor [*actual project owner*] that may arise under this Agreement shall be made only against, and shall be limited to the assets of, the [*Project Company*], and no judgment, order, or execution entered in any suit, action, or proceeding thereon shall be obtained or enforced against any partner of the [*Project Company*] or the assets of such partner or any incorporator, shareholder, officer, or director of the [*Project Company*] or such partner or against any direct or indirect parent corporation or affiliate or any incorporator, shareholder, officer, or director of any thereof for any purpose of obtaining satisfaction of any payment of any amount arising or owing under this Agreement.

A conceptual difficulty sometimes arises in project financings when one of the project sponsors agrees to act as the operator, fuel supplier, or as some other participant of the project financed. In those circumstances, although the underlying project finance loan is typically nonrecourse to the project sponsor in concept, liability may nonetheless arise from contractual undertakings, guarantees, or other obligations undertaken in the related project agreement.

[2] Off-Balance-Sheet Debt Treatment

A second objective of some project financings is the potential for using off-balance-sheet accounting techniques for project commitments.[10] From the perspective of the project sponsor, accounting rules in the United States generally require the consolidation of financial statements of a company and certain of its subsidiaries and other entities over which it can exercise control. A subsidiary controlled more than 50 percent by the parent company is consolidated on a line by line basis with the parent. Otherwise, the equity method of accounting is used whereby the investment in the subsidiary is shown as a one line entry. Debt in such circumstances is not reported on the parent company's financial statements.[11]

[10] For a general discussion of off-balance-sheet financing, *see* David L. Landsittel & John E. Stewart, *Off-Balance-Sheet Financing; Commitments and Contingencies*, in HANDBOOK OF MODERN ACCOUNTING 26–2 TO 26–23 (Sidney Davidson & Roman L. Weil eds., 4th ed., 1980).

[11] United States accounting rules are summarized in Accounting Research Bulletin No. 51 (consolidations); Accounting Principles Board Opinion No. 18 (nonconsolidated entities; equity method and joint ventures); American Institute of Certified Public Accountants Interpretation of APB Opinion No. 18 (application of Opinion No. 18 to partnerships and undivided interests). For a summary of U.S. accounting rules related to issues unique to project financings, *see* H. Ronald Weissman, *General Guidelines Under Present Accounting Rules*, *in* Project Financing, 23 PLI REAL EST. L. & PRACTICE COURSE HANDBOOK SERIES NO. 252 (1984).

The Financial Accounting Standards Board (FASB) in the United States Statement No. 94, Consolidation of All Majority Owned Subsidiaries, requires a company to consolidate financial information on all majority-owned subsidiaries in its own financial statements, even if those subsidiaries have operations that are different ("nonhomogenous") from the parent, have a large minority ownership interest, or are subject to substantial foreign restrictions. The statement requires consolidation of financial

In the United Kingdom, the advantage of off-balance-sheet debt treatment has declined.[12] Previously, legal structures were created that did not require consolidation of the project company with the project sponsor. These structures no longer accomplish that result, however, unless the project company is established as a joint venture.

The importance of off-balance-sheet debt treatment as an advantage for project financings in the United States and the United Kingdom is diminishing, if not completely eliminated in most situations. The risk of debt repayment to a company's potential lenders and investors is not diminished simply because it is not reported on a balance sheet. These entities, along with credit-rating agencies, are particularly adept at analyzing financial information, whether reported in a footnote or otherwise.

[3] Leveraged Debt

A third objective of project finance sponsors is the ability to finance a project using highly leveraged debt, without a dilution of existing equity. This advantage is available to a small entrepreneurial developer with limited resources and to large, well-capitalized corporations that have competing demands for capital investment.

That is not to say, however, that lenders do not look for a high level of equity investment in project financings. They do. The leverage acceptable to a lender varies from project to project. Often the leverage percentage is between 75 and 80 percent, but transactions are sometimes structured with ratios between 90 and 100 percent.[13] In general, equity requirements for projects in developing countries are in the 20 to 25 percent range, and often higher.

The amount of the equity contribution required depends upon the risk perceived by the lender. The exact percentage is influenced by many factors, including the country; the project economics and how much debt can be serviced by the project; whether any other project participants, such as the contractor or equipment supplier, invest equity in the project; and the competitiveness among project finance lenders to finance the transaction.

Also, a lender's view that a high level of equity will translate into a high commitment by the project sponsor, may influence how much equity the lender requires. This view holds that there is a direct correlation between the percentage of equity invested in a project and the project sponsor's dedication to the project success. The more equity contributed by the project sponsor, the greater the commitment.

This is particularly true in project financings of facilities in developing countries. A large equity investment, coupled with a reasonably high rate of return, will help ensure the involvement of the project sponsors when the project suffers from unanticipated risks.

The view that equity investment increases project sponsor support of a facility is similarly embraced by many output purchasers. In some developing countries, for example, minimum equity contribution requirements are imposed on project companies to help assure that a long-term supply of the contracted for good or service is available.

Subordinated debt can serve as an equity substitute in project financings. There are sometimes

statements unless control of the subsidiary is temporary or the majority owner does not have control of the subsidiary (i.e., where the subsidiary is in legal reorganization or bankruptcy). Also, the statement requires that summarized information about the assets, liabilities, and results of operations (or separate statements) of previously unconsolidated majority-owned subsidiaries continue to be provided after those subsidiaries are consolidated. Statement No. 94, Consolidation of All Majority Owned Subsidiaries, Financial Accounting Standards Board (Oct. 30, 1987).

[12] *See* Companies Act, 1995, ch. 6, §§ 258 *et seq.* (Eng.); Standard No. 5, Reporting the Substance of Transactions, Accounting Standards Board's Financial Reporting Standards (April 1994).

Section 258 of the English Companies Act may require a project sponsor to consolidate its own accounts with partnership accounts if it has a "participating interest" and if it exercises a "dominant influence" over the partnership. Companies Act, 1995, ch. 6, § 258 (Eng.). *Participating interest* is defined as "an interest held by an undertaking in the shares of another undertaking which it holds on a long-term basis for the purpose of securing a contribution to its activities by the exercise of control or influence arising from or related to that interest." *Id.* § 260(1). Twenty percent is presumed to be a participating interest unless facts to the contrary are shown. *Id.* § 260(2).

[13] Wynant, *supra* note 1, at 170. For a discussion of equity investments in international project finance, *see* Matthew Barrett, *Putting Your Equity on the Line*, EUROMONEY, October 1987, at 119.

advantages to a project sponsor that lends money on a subordinated basis, such as tax deductibility of interest payments. However, lenders will want the subordinated debt to be truly junior, in payment priority and lien priority, to the senior loans.

[4] Avoidance of Restrictive Covenants in Other Transactions

A fourth reason for selecting a project financing is that the structure permits a project sponsor to avoid restrictive covenants, such as debt coverage ratios and provisions that cross-default for a failure to pay debt, in existing loan agreements and indentures at the project sponsor level. Because the project financed is separate and distinct from other operations and projects of the sponsor, existing restrictive covenants do not typically reach to the project financing. Similarly, the distinct nature of the project financed permits the sponsor to leverage debt to an extent that may be prohibited under existing agreements. However, parent-level financing arrangements must be reviewed to make certain that covenants and defaults at the project level do not create noncompliance or default at the parent level.

[5] Favorable Financing Terms

A project financing is selected in many circumstances because more attractive interest rates and credit enhancement are available to the project than are otherwise available to the project sponsor. A credit appraisal of an individual project is sometimes more favorable than a credit appraisal of the project sponsor. Thus, a more attractive risk profile can result in more favorable interest rates and lower credit enhancement costs.

[6] Internal Capital Commitment Policies

The rate of return goals of the project sponsor for new capital investments can also make project finance attractive. Companies that typically establish goals for rates of return generated from a proposed capital investment often determine that the return on a project investment is improved with a project financing, which permits highly leveraged debt financing with a minimum of equity commitment.

[7] Political Risk Diversification

Establishment of project-specific entities that finance projects on a nonrecourse basis also serves to diversify the project sponsor's global investments and to eliminate the effects of political risk beyond any independent projects undertaken in a specific country. Thus, the economic effects of a political risk that exists in one country will not affect other projects in other countries.

[8] Risk Sharing

The risk allocation process in structuring a project financing permits the project sponsor to spread risks over all the project participants, including the lender. This risk diversification, or sharing, can improve the possibility of project success because each project participant accepts risks and is interested economically in the project success. Although there is an economic cost associated with allocating risks to other project participants, the project sponsor will accept the cost, if reasonable, as a necessary element of a nonrecourse or limited recourse project financing.

[9] Collateral Limited to Project Assets

Nonrecourse project finance loans are generally based on the premise that the only collateral that the project company must pledge to the lenders as security for the loans is the project assets. No other assets of the project sponsor are necessary as collateral. Although this is generally the structure, as is discussed in this chapter, limited recourse to the assets of the project sponsor is sometimes required.

[10] Lenders Are More Likely to Participate in a Workout Than Foreclose

The nonrecourse or limited recourse nature of project finance leaves few remedies available to project lenders in the event a project experiences financial problems. Also, because the project assets have value only with the project contracts, and because the project contracts have value only if the facility operates, the only practical way a lender can have its debt repaid is for the project to operate, not foreclose and sell the equipment. For example, it is of little use to the project lender to foreclose on a toll road project financing if less than expected use is the sole reason the project is in trouble.