

**SECURING PERFORMANCE IN PROJECT FINANCE: IS THE PLEDGE OF
RECEIVABLES ENOUGH FOR CREDITORS AS A MAIN SECURITY INTEREST TO
SECURE THEIR CLAIMS?**

By Tamás Kubassek

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PROFESSOR: Prof. Tibor Tajti

Central European University

1051 Budapest, Nádor utca 9.

Hungary

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ABSTRACT

The aim of this paper is to address the issue of change of fee-in tariffs in project finance transactions on the field of electricity production from renewable energy sources. The thesis discusses through this example that despite the complex state-of-the-art nature of project finance, certain risks cannot be entirely anticipated and passed on to other parties. After discussing the main notions of project finance deals which are necessary to understand the mechanism of a project finance transaction, the thesis specifically covers the issue of security interests in project finance. Finally, the thesis deals with the particularities of support schemes and the problems which can arise when the hosting government amends the law to decrease the feed-in tariffs. Such decrease may substantially threaten the repayment of loans as it directly affect the revenue making capabilities of the project company. The thesis supports the position that established security interests cannot provide the lenders enough protection against the risk non-repayment in this case. Therefore lenders must usually seek additional ways for more comfort, such alternatives may include implementation agreement with the hosting government, insurances and guarantees, the involvement of international community and comfort letters. However, the actual effectiveness of these supplemental devices against host governments legislative acts is still uncertain.

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LIST OF ABBREVIATIONS

CEE	Central Eastern Europe
EBITDA	Earning Before Interest, Tax, Depreciation and Amortization
BOT	Build, Operate and Transfer projects
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EPC	Engineering, Procurement and Construction
EU	European Union
IDA	International Development Association
IFC	International Finance Corporation
MIGA	Multilateral Investment Guarantee Agency
O&M	Operation and Maintenance
OPIC	Overseas Private Investment Corporation
PFI	Private Finance Initiative
RES	Renewable Energy Sources
SPV	Special Purpose Vehicle
UK	United Kingdom
US	United States of America
VAT	Value Added Tax

INTRODUCTION

Project finance has become an important tool of funding infrastructure developments in the CEE region over the recent three decades, especially in the field of public-private partnerships and energy.

In this region it emerged as a state-of-the-art method for such financings. However, it should not be forgotten that it has greater past in the western world, John D. Finnerty traces back the roots of project finance to the 13th century when the construction of Devon silver mines were financed from the loans of Italian bank Frescobaldi.¹ However, most of the sources find the origins of current project finance practices in Texas of the 1930's where the establishment of new oil wells were financed from the loans which were to be repaid from the revenues of the wells.²

Around seven decades later in the CEE region, this technique has played a crucial role in the development of renewable energy projects. Several CEE states joined the European Union (hereinafter the EU) in 2004³ and 2007⁴ and become subject to the renewable energy policy of the EU. At that time, EU already had an ambitious target to increase the share of renewable energy in the energy consumption of the Members States to 12% by 2010 and the incumbent and new Member States were both obliged to comply with this policy.

Most of these projects are financed on the basis that future revenues of the project will cover the repayment of the loan granted to the single-purpose project company. Therefore, the most powerful security interest which can come into question is the pledge of receivables of the project company. The main question addressed in this thesis is whether the security interests on receivables are enough as main tools of ensuring repayment, and what other techniques can also be applied to provide lenders with more comfort to lend money.

Firstly this thesis discusses the main characteristics of a project finance transactions in Chapter I, including the definitions of project finance, the participants, their contracts and the key features of

¹ See JOHN D. FINNERTY, PROJECT FINANCING : ASSET-BASED FINANCIAL ENGINEERING 4 (John Wiley & Sons 2nd ed. 2007).

² See E. R. YESCOMBE, PRINCIPLES OF PROJECT FINANCE 6 (Academic Press. 2002).

³ Czech Republic, Hungary, Poland, Slovakia, Slovenia,

⁴ Bulgaria and Romania

these transactions. The importance and main notions of security interests in relation project finance are covered in Chapter II. In Chapter III the particularities of project finance transactions in the field of renewable energy sources (hereinafter “**RES**”) are discussed, with special regard to off-take prices which form the source of revenues of the project companies and the securement of these claims for the benefit of lending banks.

Regarding the sources, this thesis concentrates rather on handbooks written by practitioners and up-to-date information from the internet than on primary sources of law, including cases. The main reason for that is in the nature of project finance, which is much more shaped by the business practice explained in handbooks than the law itself. This is particularly true in this region, where local laws usually use vague terms functioning as a frame. This frame is filled with the implemented version of international practice, usually transmitted by top UK and US law firms.

I. GENERAL NOTIONS OF PROJECT FINANCE

This chapter discusses the main notions of project finance, firstly by going through the definitions of main authorities, secondly by reviewing the typical structure and participants of a project finance deal, and finally by summing up the key features of these transactions.

1. Definition of project finance

It is hard to define project finance with a single-sentence definition, however each definition concentrates on one or more important notions of project finance.

Black's Law Dictionary describes project financing under the main article of financing as a "*method of financing in which the lender looks primarily to the money generated by a single project as security for the loan.*"⁵ Black's sub-article of project finance also highlights that this way of financing is tend to be used for high-profile projects where a special-purpose vehicle is usually put in place to develop and own the project.

Oxford Dictionary of Finance and Banking approaches the notion of project financing by focusing on "*an arrangement in which the money or loans put up for a particular project [...], are secured on that project, rather than forming part of the general borrowing of the company concerned.*"⁶ After the definitions of dictionaries, it is worth to have a glance on the definitions of authors who wrote on project finance from the perspective of economics.

Peter K. Nevitt's definition concentrates on the source of repayment by describing project finance as "*[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.*"⁷ However, he emphasizes throughout his

⁵ See BLACK'S LAW DICTIONARY 707 (West 9th ed. 2009).

⁶ A Dictionary of Finance and Banking (Fourth Edition). Oxford: Oxford University Press. p. 354

⁷ See PETER K. NEVITT & FRANK J. FABOZZI, PROJECT FINANCING 1 (Euromoney Books 7th ed. 2000).

work that the cash flows are only the initial sources of repayment and lenders usually require more comfort, eg. through the provision of guarantees.

According to Stefano Gatti, project finance *“is the structured financing of a specific economic entity – the SPV, or special-purpose vehicle, also known as the project company – created by sponsors using equity or mezzanine debt and for which the lender considers cash flows as being the primary source of loan reimbursement, whereas assets represent only collateral”*.⁸

The other main authorities are written by banking lawyers who have decades of expertise in advising clients on project finance transactions.

Graham D. Vinter, a former banking partner of UK law firm Allen & Overy, now a manager of an energy company, defines project finance being the *“financing the development or exploitation of a right, natural resource or other asset where the bulk of the financing is not to be provided by any form of share capital and is to be repaid principally out of revenues produced by the project in question”*.⁹

Hoffman, who is a partner at the American law firm Evans, Evans and Hoffman LLP describes project finance as 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 [...]”*¹⁰ Furthermore, he states that in project finance transactions *“[...] lenders base credit 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 debt.”*¹¹

Philipp R Wood, a well-known professor of law and also a former banking partner of Allen & Overy, concentrates on the role of banks running great amount of project risks when describing the meaning

⁸ See STEFANO GATTI, PROJECT FINANCE IN THEORY AND PRACTICE : DESIGNING, STRUCTURING, AND FINANCING PRIVATE AND PUBLIC PROJECTS 2 (Academic Press. 2008).

⁹ See GRAHAM D. VINTER, PROJECT FINANCE - A LEGAL GUIDE 1 (Sweet & Maxwell Third Edition ed. 2006).

¹⁰ See SCOTT L. HOFFMAN, THE LAW AND BUSINESS OF INTERNATIONAL PROJECT FINANCE 4 (Cambridge University Press 3rd ed. 2008).

¹¹Id.

of project finance.¹² Furthermore, he underlines that project finance clearly demonstrates the core nature of financing as a “medium of exchange” where banks collect money from people and enterprises to directly finance the establishment of “productive edifices”.¹³ Nowadays many of the elements of the electricity infrastructure are financed by banks through project finance transactions, out of the money of people and corporations holding their money in banks. Other examples for the application of project finance include Eurotunnel between France and UK,¹⁴ a fiberoptic line around the globe¹⁵, oil and gas fields on the North Sea¹⁶, nickel exploration works in Zambia¹⁷, highways in Hungary¹⁸, or even Iridium satellites in the outer space.¹⁹

The definitions above are rather illustrative than exhaustive as they concentrate on the notions of project finance which were considered to be important by the respective author. It is much reasonable to take a functional approach by looking on the key features of project finance transactions. These features are usually, but not necessarily present in each transaction. However, before discussing these features, it is inevitable to review the typical main structure and participants of such transactions.

2. Participants, their main interests and contracts in a project finance transaction

Project finance transactions usually involve many participants who, besides the main common interest in the success of the project, have different particular interests in the project. The understanding of these differences have crucial importance during the negotiation period and in the supervision of an event of default. Therefore, similar to the great predecessors in the literature of the antique Greece using the epic catalogue called *enumeratio*, it is wise to start the analysis of project finance with the

¹² See PHILLIP R. WOOD, PROJECT FINANCE, SECURITISATIONS, SUBORDINATED DEBT (Sweet & Maxwell, 2007).

¹³ Id.

¹⁴ See NEVITT & FABOZZI, Project financing 7. 2000.

¹⁵ See HENRY A. DAVIS, PROJECT FINANCE : PRACTICAL CASE STUDIES 171 (Euromoney Books 2nd ed. 2003).

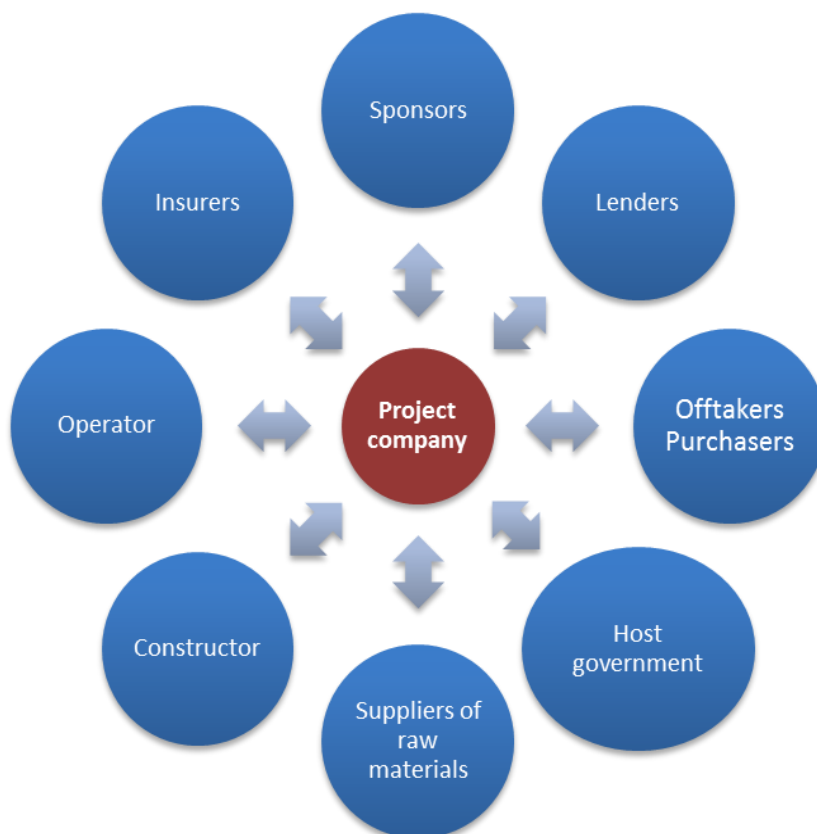
¹⁶ See VINTER, Project Finance - A Legal Guide 272. 2006.

¹⁷ See the publication of Watson, Farley & Williams LLP on mining project financing, p. 6. available here: [http://www.wfw.com/Publications/Publication476/\\$FILE/WFW%20Mining%20Project%20Financing%20Mini%20Brochure%2004.08.pdf](http://www.wfw.com/Publications/Publication476/$FILE/WFW%20Mining%20Project%20Financing%20Mini%20Brochure%2004.08.pdf), download date: 28 March 2013

¹⁸ See for instance M1/M15 highway, see Publication of PPIAF available here: <https://www.ppiaf.org/sites/ppiaf.org/files/documents/toolkits/highwaystoolkit/6/pdf-version/hungary.pdf>, download date: 28 March 2013

¹⁹ See NEVITT & FABOZZI, Project financing 15. 2000.

listing of key actors and the contracts between them. The chart below displays the main contractual relationships between the parties.²⁰



1. figure: Participants in a project finance transaction

In project finance transactions as Prof. Wood points out the „contract is king”.²¹ Contracts must cover the whole process of construction, operation and the related financing transactions and every possible risk should be addressed in them.

In order to avoid unnecessary repetitions, the agreements are also discussed in this chapter under the subheading bearing the name of the characteristic counterparty.

²⁰ See YESCOMBE, Principles of project finance 8. 2002.

²¹ See WOOD, Project Finance, Securitisations, Subordinated Debt 2-001. 2007.

(i) Project Company

Project company is in the central point of the network of contract as it is party to the most of the contracts.²² It is a single purpose vehicle usually owned by the sponsors whose liability is usually limited to equity contributions.²³ Hoffman defines project company as the company that will “*own, develop, contract, operate and maintain the project*”.²⁴ However, in practice, except for ownership, project company exercises these duties through other contractors.²⁵

(ii) Sponsors and shareholders agreement

Sponsors are the initiators of the project and the owners of the project company. Sponsors usually have strategic objectives to complete the project, however, they want to do it on an “off balance sheet” basis.²⁶ This is the reason why they create a project company instead of turning to the traditional ways of corporate finance (e.g. borrowing money directly from the bank or issuing bonds). Sponsors generally tend to expose themselves to risks only up to their equity contribution. However, such equity contributions are typically as low as 10-20 per cent. of the total value of the project.²⁷ Sponsors may seek to share the risks with lenders²⁸, however, lenders tend to limit their exposure to risks as minimal as possible.²⁹ Besides equity, the other form of contribution is usually subordinated debt.³⁰

²² However, it should be noted that project company is usually not party to the following agreements: shareholder agreements, intercreditor agreements and security agreements over the shares in the project company

²³ See HOFFMAN, *The law and business of international project finance* 71. 2008.

²⁴ Id.

²⁵ See GATTI, *Project finance in theory and practice : designing, structuring, and financing private and public projects* 238. 2008.

²⁶ See VINTER, *Project Finance - A Legal Guide* 4-5. 2006.

²⁷ See RUMU SARKAR, *TRANSNATIONAL BUSINESS LAW : A DEVELOPMENT LAW PERSPECTIVE* 117 (Kluwer Law International ; Sold and distributed in North, Central, and South America by Aspen Publishers. 2003).

²⁸ See VINTER, *Project Finance - A Legal Guide* 5. 2006.

²⁹ See WOOD, *Project Finance, Securitisations, Subordinated Debt* 1-007. 2007.

³⁰ See id. at, 3-003.

Sponsors are also entitled to extract profits from the company, however debt service to lenders should have priority over dividend payments on equity shares.³¹ Project sponsors may also be required to break through the concept of “non-recourse” by providing the lenders with guarantees.³²

If the project company is owned by more than one sponsor, sponsors set out the rules of their relationship vis-à-vis each other in a **shareholders agreement**.³³ Such agreement may contain norms on the capital and in-kind contributions, pre-emption rights, conflict of interests, voting rights and the constitution of management.³⁴

(iii) Lenders and finance documents

The lenders provide rest of the financing by lending around 80-90 per cent. of the total expenses of the project.³⁵ In most cases lenders need to establish a syndicate of banks under the leadership of the arranging bank in order to share the huge amount of credit commitments and to limit their risk exposure.³⁶ The syndicate usually appoints one of its members to be an agent and a security agent to simplify actions vis-à-vis other participants.³⁷ The main objective of lenders is to secure repayment, to make profit through lending, to minimize the extent of risks they need to assume, to have proper influence in the decision making, to have a continuous monitoring over the project and to have powerful step-in rights for an event of default.³⁸

The lenders are parties to two main groups of documents, the finance and the security documents.. Under finance documents the credit agreement and related other documents, such as preliminary information memorandum, mandate letter, intercreditor agreements and accounts agreement are understood.³⁹ Under security documents lenders, as secured creditors, are provided with security

³¹ See VINTER, Project Finance - A Legal Guide 5. 2006.

³² See NEVITT & FABOZZI, Project financing 299. 2000.

³³ See HOFFMAN, The law and business of international project finance 385. 2008.

³⁴ Id. at, 386. and see also VINTER, Project Finance - A Legal Guide 84. 2006.

³⁵ See YESCOMBE E.R., A PROJEKTFINANSZÍROZÁS ALAPJAI 295 (Panem. 2008). This is the Hungarian translation of Yescombe's Principles of Project Finance published in 2002 by Elsevier

³⁶ See HOFFMAN, The law and business of international project finance 72. 2008.

³⁷ Id.

³⁸ See VINTER, Project Finance - A Legal Guide 6-7. 2006. see also WOOD, Project Finance, Securitisations, Subordinated Debt 1-007. 2007.

³⁹ See GATTI, Project finance in theory and practice : designing, structuring, and financing private and public projects 242. 2008.

interests of and/over the project company.⁴⁰ In the following paragraph the finance documents will be briefly discussed, while the characteristics of security documents are explained in the second chapter.

Preliminary information memorandum (or offering memorandum⁴¹) is prepared by the project company or the sponsors to inform potential lenders on the main characteristics of the project with the sponsors' proposal for the term sheet.⁴² Banks may express their willingness to lend money by issuing a **letter of intent**, however the intention included therein does not constitute a commitment with legal effect.⁴³ The offer, in a legal sense, to lend money is expressed in the form of a **commitment letter**.⁴⁴

The **mandate letter** is an agreement between the sponsors, the project company and the arranger bank on the organizing of the funding.⁴⁵

The main finance document is the **credit agreement** under which lenders undertake to provide the project company with funds available up to a set out cap amount on demand with the condition that the project company will repay these funds with interest.⁴⁶ The provided funds consist of credit lines called facilities, each with a separate purpose and an own cap.⁴⁷ The main distinctive credit lines are basic credit line, stand-by facility and VAT facility.⁴⁸

The interest has two main elements: a base rate and the margin.⁴⁹ Base rate is usually an interbank market rate which is supposed to express the costs of money the bank borrows from other banks for lending to the project company.⁵⁰ The margin "above base rate" is supposed express the expenses related to the lending and the profit of the bank.⁵¹ Banks use so-called margin protection clauses to

⁴⁰ Id. at, 243.

⁴¹ See HOFFMAN, *The law and business of international project finance* 306. 2008.

⁴² See VINTER, *Project Finance - A Legal Guide* 161. 2006.

⁴³ See HOFFMAN, *The law and business of international project finance* 311. 2008.

⁴⁴ Id. at, 312.

⁴⁵ See VINTER, *Project Finance - A Legal Guide* 162. 2006.

⁴⁶ See GATTI, *Project finance in theory and practice : designing, structuring, and financing private and public projects*. 2008.

⁴⁷ Id. at, 244.

⁴⁸ According to Gatti basic credit line is for the general financing of the project, stand-by credit line's purpose is to provide the project company with a fallback financing solution for the case of unexpected hardships, while VAT facility covers the payment of value added taxes to the contractors, see id. at.

⁴⁹ See VINTER, *Project Finance - A Legal Guide* 176. 2006.

⁵⁰ Id.

⁵¹ Id.

ensure the profitability of lending by preventing unexpected expenses of lenders to eat up the margin.⁵² Furthermore, credit agreements must set out availability periods, drawdown and repayment mechanisms, repayment securing undertakings.⁵³ They must particularly define the events of default and provide for the consequences of such default (i.e. grace periods, acceleration mechanism).⁵⁴ Credit agreements contain an extensive list of conditions precedent for closing, each loan drawdowns and the conversion of construction loan into term loan.⁵⁵ In addition to the conditions precedent, several representations and warranties are given to provide lenders with more comfort.⁵⁶ Many of these representations are deemed to be repeated upon each drawdown or the occurrence of other events.⁵⁷

Intercreditor agreement governs the relationship between lenders themselves. It provides for, among other issues, the mechanisms of pro rata drawdown, the disbursement of repayments, the mandate of the agent bank, the rules of creditors' democracy and the limitations on lenders to act individually against the project company.⁵⁸

Accounts agreements provide the lenders with control over so called "control accounts" of the project company.⁵⁹ Project company is required to use exclusively these accounts for the project under the oversight of the lenders. Control accounts are disbursement accounts,⁶⁰ escrow accounts, proceeds accounts,⁶¹ compensation accounts,⁶² debts service and maintenance reserve accounts⁶³ and distribution accounts.⁶⁴ To establish control above these accounts the lenders must agree not only with the project company but also with the bank holding the account for the project company. Accounts

⁵² According to Vinter such margin protecting clauses include (i) gross-up clause; (ii) mandatory costs clause; (iii) increased costs clause; and (iv) market disruption clause, their main role is to shift the risk of extraordinary events from the lender to the borrower, see *id.* at, 177-178.

⁵³ *Id.* at, 175-180.

⁵⁴ See HOFFMAN, *The law and business of international project finance* 350. 2008.

⁵⁵ *Id.* at, 328, 335 and 337.

⁵⁶ *Id.* at, 123.

⁵⁷ See GATTI, *Project finance in theory and practice : designing, structuring, and financing private and public projects* 254. 2008.

⁵⁸ See WOOD, *Project Finance, Securitisations, Subordinated Debt* 5-038. 2007.

⁵⁹ See VINTER, *Project Finance - A Legal Guide* 199. 2006.

⁶⁰ Disbursement accounts are to monitor the expense payments of the project company, see *id.* at, 200.

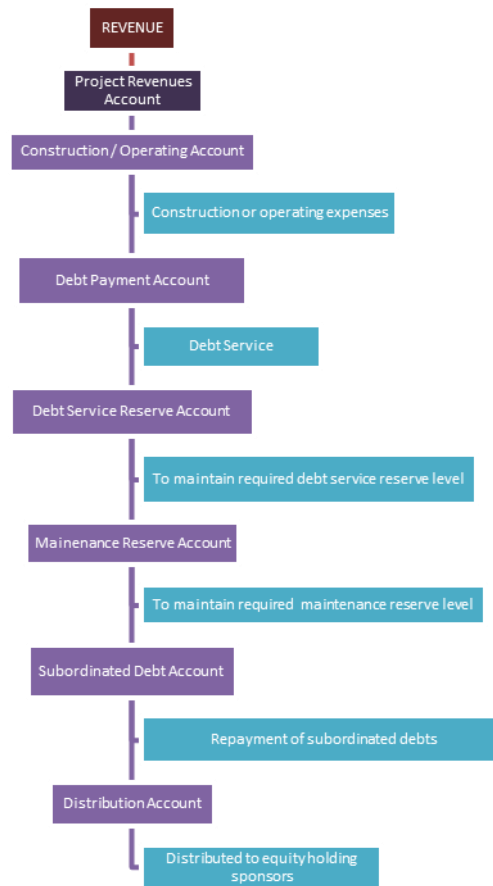
⁶¹ Proceeds accounts are to monitor the revenues of the project company, see *id.* at, 201.

⁶² Capital payments, liquidated damages or termination payments payable to the project company are transferred to compensation accounts, see *id.* at, 202.

⁶³ Reserve accounts for unexpected expenses or shortfall of revenues to repay debts, see also *id.* at, 202-205.

⁶⁴ Distribution account is the account for the payment to sponsors and is held free from security, see also *id.* at, 206.

agreements also define the order of payments which looks like a waterfall. According to this order, payments can be only made to the next account if the claims related to the previous account have been fulfilled. Chart No. 2 below displays a typical financial waterfall structure used in renewable energy projects.⁶⁵



2. figure: The typical waterfall structure for payments

Hedging agreements between the project company and different financial institutions providing hedging services are entered into with the purpose to protect the project company from adverse changes in the foreign exchange rates, the interest rates and the commodity prices.⁶⁶

Finally, the **direct agreement** establishes direct contractual relationship between the creditor and other participants on the most important issues regarding the repayment of the loan.⁶⁷ The rationale behind the direct agreement is that a default under the commercial agreements (eg off-take agreements, supply

⁶⁵ Based on figure published in CHRIS GROOBEY, et al., *Project Finance Primer for Renewable Energy and Clean Tech Project*.

⁶⁶ See VINTER, *Project Finance - A Legal Guide* 210. 2006.

⁶⁷ Id. at, 273.

agreements, O&M agreement) between the project company and other participants would materially endanger the revenue generating capability of the project company, and thereby the repayment to lenders as well.⁶⁸ These commercial agreements are the most important “assets” of the project company therefore lenders are understandably interested whether there is any default under them. As the commercial agreements are usually entered into only between the project company and its respective contractors, lenders usually do not have any right under these agreements. If lenders want to have any right in relation to these contractual relationships, they need to enter into a separate contract with these contractors of the project company.

Direct agreements usually provide for the contracting party’s consent to the assignment of project company’s rights to the lender, the limitation on contracting party’s termination rights regarding the commercial contract by providing the lenders with a prior written notice on the default with a considerable suspension period, the right of lenders to “step-in” during the suspension period for such defaults, and right of lenders to “step-in” in an event of default under the credit agreement.⁶⁹ Furthermore, lenders may also require these contracting parties to waive their rights of set-off and counterclaim in order to keep the planned cash-flow of the project company, and thereby the repayment of loans, undisturbed.⁷⁰ These additional rights allow lenders to have a better early warning system for defaults under contracts and they can be also very practical upon enforcement.

The relevant provisions of finance documents to secure the repayment of the loan are elaborated in the following chapter.

(iv) Public entity hosting the project and its agreements

The public entity, either the state or a municipality, hosting the project may have three main roles which may overlap in particular cases.

⁶⁸ See NEIL CUTHBERT, *ASSET AND PROJECT FINANCE : LAW AND PRECEDENTS E0/77* (Sweet & Maxwell. 1997).

⁶⁹ See WOOD, *Project Finance, Securitisations, Subordinated Debt 5-023*. 2007. see also VINTER, *Project Finance - A Legal Guide 273-274*. 2006. and CUTHBERT, *Asset and project finance : law and precedents E0/78*. 1997.

⁷⁰ See CUTHBERT, *Asset and project finance : law and precedents E0/78*. 1997.

Firstly, in all cases, the hosting public entity as a **law-making body** sets out the legal framework in which the project finance transaction takes place. With an investment-friendly, stable approach it may attract sponsors and lenders to do project finance in its jurisdiction and it should limit its freedom to adopt new laws. On the other hand, with a creditor-hostile or often changing legal regulation it can scare foreign investors away from doing business there.⁷¹ Hence the law-making powers of a public entity (typically a state) extend well beyond the general questions of contract law. For instance, they also cover key business concerns such as tax rates or the mandatory off-take prices of electricity produced from renewable energy sources.

Furthermore, public entity hosting the project acts not only as legislator, but also as a **regulator** applying the particular branches of administrative laws. This role has significant importance in highly regulated industries, such as energy or telecommunication.

According to Hoffman, **implementation agreement**⁷² concluded between the public entity and the sponsors are intended to provide the private parties with comfort against adverse interventions by the public entity.⁷³ Such agreement should protect the sponsors (and indirectly the lenders) from expropriation, nationalization, adverse change-of-law and discriminative treatment.⁷⁴ Concluding such agreements the public entity necessarily limits its freedoms derived from sovereignty which may rise constitutional issues.⁷⁵ The public entity may also grant tax benefits, state support or exclusive right to develop project⁷⁶, however, in EU Member States, these forms of support must comply with the competition law and state aid regulations of the EU. On the other hand, the project company is usually required to be a “good citizen” in the hosting jurisdiction and sometimes to make further social commitments.⁷⁷ The remedies for the breach of implementation agreement are renegotiations or the compensation of losses by the public entity.⁷⁸ The most significant risk regarding the implementation

⁷¹ See HOFFMAN, *The law and business of international project finance* 75. 2008.

⁷² See Also called as support or stability agreement according to Hoffman, see *id.* at, 147. see also YESCOMBE, *Principles of project finance* 125. 2002.

⁷³ See HOFFMAN, *The law and business of international project finance* 147. 2008.

⁷⁴ *Id.* at, 147-149.

⁷⁵ *Id.* at, 150.

⁷⁶ *Id.* at, 148-149.

⁷⁷ *Id.* at, 150-155.

⁷⁸ *Id.* at, 151.

agreement is the succession risk, i.e. whether subsequent governments are willing to obey the limitations of their power set out in the implementation agreement.⁷⁹

Secondly, the public entity may have an additional, specific role. In case of business activities subject to **concession** (eg mining or local water supply), the hosting entity is entitled to grant concession for the project company to conduct this activity.⁸⁰ For the concession the grantor public entity is usually entitled to a certain proportion of income realized from the concession by the project company, according to legislation applicable to the industry.

The rights and obligations of the sponsors, the project company and the public entity are set out in the **concession agreement** and are subject to local laws on concessions.⁸¹ In a typical BOT⁸² concession agreement, concession grantor are provided with several supervisory rights.⁸³ Besides these rights, concession grantor may undertake to obtain (by expropriation) and transfer the real estates related to the project to the project company⁸⁴, to pay fees to the concessionaire⁸⁵ or to prohibit the project company to assign its rights under the concession agreement⁸⁶. The project company needs to push the terms of the concession agreement through all other project agreements entered into with third parties.⁸⁷ Price controls are of crucial importance for both sides, as the price of the product embodies the revenues of the project company while the concession grantor has budgetary and/or political reasons to maintain control over pricing.⁸⁸

Finally, if the project is public-private partnership, the public entity is also contracting party as a **“buyer”** of the infrastructure or the service subject to the contract. In this scenario, the public entity either directly pays or sets up a system for payments by purchasers (eg highway users) to the project company. In this case, the public entity is party to the output contract.

⁷⁹ Id. at, 157.

⁸⁰ See VINTER, Project Finance - A Legal Guide 85. 2006.

⁸¹ See HOFFMAN, The law and business of international project finance 145. 2008.

⁸² See BOT means projects where project company undertakes to build, operate and, at the end of the operational period, transfer the project to the concession grantor

See see also HOFFMAN, The law and business of international project finance 145. 2008.

⁸⁴ See VINTER, Project Finance - A Legal Guide 86. 2006. see also WOOD, Project Finance, Securitisations, Subordinated Debt 2-014. 2007.

⁸⁵ See VINTER, Project Finance - A Legal Guide 87. 2006.

⁸⁶ Id. at, 88.

⁸⁷ Id. at, 90.

⁸⁸ Id. at, 87.

The public entity may also act in several other roles. It can grant a **guarantee** through its agencies to provide lenders with more comfort, especially in those jurisdictions where these lenders otherwise would not do business.⁸⁹

The main cause for a hosting public entity to take part in a project finance transaction is usually to promote economic development on its territory and to reach a specific economic objective.

(v) Output or offtake purchasers and offtake agreements

The output or offtake purchaser is the buyer of the products or services of the project company. The fees paid by offtake purchasers are considered as primary sources of repayment of loans given to the project company.⁹⁰ Offtake purchaser can be the hosting public entity, one or more companies or the general public. The pricing technique depends on the actual contract agreement with the output purchaser.

The contracts entered into with the purchasers of the project company's products are called **off-take agreements**.⁹¹ These agreements are of crucial importance from the perspective of the lenders, as these the prices payable under them constitute the main source of revenues and thereby the main source of debt service.⁹² Off-take agreements are usually concluded for a longer term, securing that the project will have a stable cashflow for most of project time. Given the significance of these agreements, the applied pricing structures are discussed later in this work in a more detailed manner.

(vi) Suppliers and supply agreements

Suppliers are the participants who provide the project company with raw materials necessary for the production at the project company.⁹³ The project company must have a continuous uninterrupted supply in order to be able to run its business activity.

⁸⁹ See NEVITT & FABOZZI, Project financing 300. 2000.

⁹⁰ See VINTER, Project Finance - A Legal Guide 113. 2006. see also HOFFMAN, The law and business of international project finance 73. 2008.

⁹¹ See HOFFMAN, The law and business of international project finance 209. 2008.

⁹² See WOOD, Project Finance, Securitisations, Subordinated Debt 2-020. 2007.

⁹³ See HOFFMAN, The law and business of international project finance 73. 2008.

Supply agreements⁹⁴ - similarly to off-take agreements – are usually concluded for long terms to secure the continuous supply of raw materials and fuel, thereby to secure the operability of the project⁹⁵. As Vinter points out, the roles can be the opposite as for the off-take agreements. Here the project company is the purchaser, while the supplier is the seller of a product under the offtake agreement.⁹⁶ However, there are several other types of supply contracts, such as output contracts⁹⁷, requirements contracts⁹⁸, spot contracts⁹⁹, fixed amount contracts¹⁰⁰ or supply-or-pay contracts¹⁰¹.

(vii) **Constructor and construction agreements**

The project company mandates a contractor to construct the project and the constructor may apply further subcontractors¹⁰². According to the principle of “backing up,” project company must ensure that it is protected from the default of or delay caused by the constructors so that it has no liability for such default or delay without indemnification claims against the contractor who caused the actual breach. Similarly, for the same reason, force majeure clauses should also be consistent throughout the documentation.¹⁰³ The other risk is the increase of construction costs, which may result that the available funds cannot cover the costs, or even if further borrowing is allowed, the financial planning of the project must be amended according to the new situation.¹⁰⁴ Fixed priced contracts allocate this risk to the constructor.¹⁰⁵

Construction agreements can differ a lot, depending on who is responsible for the design and the construction works themselves, whether there is a fixed price and a fixed date term in place and how is

⁹⁴ Also known as input contracts, see *id.* at, 188.

⁹⁵ See WOOD, *Project Finance, Securitizations, Subordinated Debt* 2-022. 2007.

⁹⁶ See VINTER, *Project Finance - A Legal Guide* 112. 2006.

⁹⁷ Contracts under which all of the production of the seller is sold to the buyer, it provides flexibility and certain market for the seller, see HOFFMAN, *The law and business of international project finance* 191. 2008.

⁹⁸ Contracts under which the seller must sell goods in the amount as required by the buyer, it provides great flexibility for the buyer, see *id.* at.

⁹⁹ Contracts under which the terms are set out according to the market terms at the time of the actual purchase, see *id.* at.

¹⁰⁰ Contracts under which the amount of goods sold is set out in advance, see *id.* at.

¹⁰¹ Contracts under which the supplier (i.e. seller) must provide the buyer with a certain amount of goods or it should pay liquidated damages, very advantageous for the buyer, see *id.* at, 189.

¹⁰² See VINTER, *Project Finance - A Legal Guide* 94. 2006.

¹⁰³ See HOFFMAN, *The law and business of international project finance* 167. 2008.

¹⁰⁴ *Id.* at, 166.

¹⁰⁵ *Id.*

the completion determined.¹⁰⁶ Engineering contracts usually only provide for engineering services, while procurement contracts cover the actual construction works when project company chooses to contract these works separately.¹⁰⁷ Furthermore, construction contracts, in a strict sense, are for construction services (eg. supervision, management of works) only¹⁰⁸, while an EPC contract covers all of these three main stages above in one complex agreement.¹⁰⁹ Regarding the pricing mechanisms, the contracts can be fixed priced, cost-plus-fee or cost-plus-fee with cap and incentive fee contracts.¹¹⁰ The most characteristic contracts are turnkey contracts under which contractor is obliged to complete all of the construction works for a fixed price by a fixed date while the project company needs only to pay the purchase price.¹¹¹ To secure performance under construction contracts, the constructor may be required to pay performance liquidated damages¹¹² in case of delay or other breach or to issue performance bonds.¹¹³

(viii) Operator and O&M agreements

The project company mandates not only a constructor, but also an operator for the project. Operator's main duties are to operate, maintain and, if needed, repair the project. Regarding the operation of the project, the most important factor is the availability of the project. Availability means the time when the project is able to make revenues, therefore parties are keen to set out the thresholds of availability both in operational and credit agreement. The project company must require the operator to have the same liabilities regarding the availability of the project as the project company has to other parties.¹¹⁴

The project company concludes an operation and management (so called O&M) agreement with the operator.¹¹⁵ Regarding the pricing of O&M agreements, fixed-price mechanisms are very rare, parties rather prefer simple cost-plus-fee contracts or more sophisticated cost-plus-fee contracts with price cap

¹⁰⁶ See VINTER, Project Finance - A Legal Guide 94-106. 2006.

¹⁰⁷ See HOFFMAN, The law and business of international project finance 169. 2008.

¹⁰⁸ See Vinter calls these contracts as project management agreements, see VINTER, Project Finance - A Legal Guide 95. 2006.

¹⁰⁹ See HOFFMAN, The law and business of international project finance 169-170. 2008.

¹¹⁰ Id. at, 170-171.

¹¹¹ Id. at, 171. see also VINTER, Project Finance - A Legal Guide 95. 2006.

¹¹² See HOFFMAN, The law and business of international project finance 166. 2008., see also VINTER, Project Finance - A Legal Guide 98. 2006.

¹¹³ See VINTER, Project Finance - A Legal Guide 101. 2006.

¹¹⁴ Id. at, 175.

¹¹⁵ Id. at, 108.

and bonuses.¹¹⁶ O&M agreements also address the issue of liability for nonperformance,¹¹⁷ the standard of duty of care of the operator by referring to good industry practices¹¹⁸ and the coordination duties of operator and the sponsors¹¹⁹

(ix) Insurers and insurance policies

Insurers offer insurance packages, often subject to the review of insurance consultants, for project finance participants to limit risks on an efficient way.¹²⁰ Insurance can thereby reduce or reallocate risks of project finance.

(x) Advisors

Given the complex nature of project finance transactions, the contribution of project advisors is also also needed. Technical advisors give opinions on the technical feasibility of the project¹²¹ while legal advisors opine on the legal issues in relation to the project.¹²² Financial advisors study the financial feasibility of the project.¹²³

¹¹⁶ See HOFFMAN, *The law and business of international project finance* 202. 2008.

¹¹⁷ Operator nonperformance can be caused not only by the operator itself, but also by sponsors or constructors, therefore operator may apply excuses, so the responsibility and the liability of operators should be precisely set out, see *id.* at, 201.

¹¹⁸ See WOOD, *Project Finance, Securitisations, Subordinated Debt* 2-027. 2007.

¹¹⁹ See HOFFMAN, *The law and business of international project finance* 201. 2008.

¹²⁰ *Id.* at, 77. and YESCOMBE, *Principles of project finance* 126. 2002.

¹²¹ See HOFFMAN, *The law and business of international project finance* 98. 2008.

¹²² *Id.* at, 301.

¹²³ See NEVITT & FABOZZI, *Project financing* 29. 2000.

3. Main features of project financing

From the definitions and the interests of the participants discussed above, the following descriptive elements of project financing can be established.

(i) Application of a project company as a single purpose vehicle responsible for a particular project

The most important feature of project finance is the existence of a single purpose project company. The project company is usually a limited liability company owned by the sponsors, who are key industrial players.¹²⁴ The limited liability is necessary from the sponsors' perspective as they want to protect themselves from risks and potential liabilities, especially the banks to seek repayment of loans from them in case of the default of the project company.¹²⁵ The actual concept and extent of limited liability is always subject to the company laws of the jurisdiction where the project company is incorporated.

The project company also serves the accounting purpose as the sponsors want the debts of the project company to be indicated separately from their own balance sheets.¹²⁶ Sponsors usually have several reasons for doing so.

Firstly, sponsors can preserve their own financial health and profitability, often expressed by debt to equity ratio potentially subject to thin capitalization requirements,¹²⁷ from a relatively risky project.

Secondly, through a separate project company, sponsors can ensure that internally set out target rates of return of new capital investments are met.¹²⁸ Capital investments of sponsors are injected in the form equity contribution in project finance. By seeking for as much credit as possible, sponsors try to leverage their capital investment. According to Raskar lenders require sponsors to put equity into the project company, usually in the amount between 5 and 25 per cent of the overall financial needs. On

¹²⁴ See GATTI, *Project finance in theory and practice : designing, structuring, and financing private and public projects* 235. 2008.

¹²⁵ See VINTER, *Project Finance - A Legal Guide* 56. 2006.

¹²⁶ *Id.*

¹²⁷ *Id.* at, 188.

¹²⁸ See NEVITT & FABOZZI, *Project financing* 5. 2000.

the other hand sponsors wish to maximize their return on each unit of equity contribution by minimizing the amount of equity injected and cover the rest of financial needs from commercial loans.¹²⁹ The main reason behind this structure is that banks wish to limit their risks to lending risks¹³⁰ while sponsors do not want to run risks exceeding the equity risk.

Thirdly, sponsors often have other credit agreements already in place and a further borrowing may constitute a breach under these existing agreements. For instance, such agreements normally have restrictive covenants on undertaking of future obligations, especially when these obligations increase the financial indebtedness of the given sponsor.¹³¹ The off-balance financing of new project helps them to avoid to breach or re-negotiate these already existing agreement.¹³² This practical cause may overlap with the first one, as explicit covenants of credit agreements actually circumscribe the general characteristics of financial health of a company.

(ii) The loans are expected to be exclusively repaid from the future income of the project

This feature is the second significant distinctive feature of project financing and is closely connected to the off-balance sheet management concept of the project through the project company. At the time of incorporation, the new entity has no financial track record or other business branches from which any revenue may come in. The main source of money can only be the fees which will be paid by its main costumers under the offtake agreements after the project has been successfully put into operation. This fee must cover the debt service, the operation costs, the costs of raw materials, goods and services acquired from suppliers, salaries of employees, insurance costs, taxes and the profit which can be paid out as dividends to the sponsors after all other stakeholders have got satisfied.¹³³

a. Pricing mechanisms under off-take agreements

¹²⁹ See SARKAR, *Transnational business law : a development law perspective* 118. 2003.

¹³⁰ See NEVITT & FABOZZI, *Project financing* 11. 2000.

¹³¹ See *id.* at, 80.

¹³² *Id.* at, 4.

¹³³ See GATTI, *Project finance in theory and practice : designing, structuring, and financing private and public projects* 103. 2008.

These fees set out in off-take agreements may vary in many ways, depending on the market and the end-consumers, however there are some main types of fees.

Under **take-or-pay contracts** the buyer undertakes to pay the price for a contracted amount of product as an unconditional consideration, irrespective of the amount of product actually bought.¹³⁴ These agreements are very often used in the oil and gas industry.¹³⁵ For instance, if the buyer obliges itself to buy 100 million barrels of Brent crude oil each year for USD 10 billion/year (i.e. USD 100/barrel), the buyer must pay the full annual price of USD 10 billion even if it actually bought only 20 million barrels that year. However, in gas business, next year the buyer is usually entitled to take the outstanding gas as additional gas as “make-up gas”, provided that he took delivery of all gas contracted for the next year.¹³⁶ This mechanism is obviously relieves the project company (and its creditors) from running any demand risk, while, on the other hand, it might be disadvantageous to the buyer. If the buyer has an uncertain or a decreasing demand, it may easily find itself in a situation of paying for something which is not needed by him and therefore was not actually delivered. Furthermore, the fluctuation of commodity prices may easily shift the benefits from one party to other. As a result take-or-pay contract necessarily involves the issue of “inadequate consideration”.¹³⁷ According to Vinter, English courts do not pay too much attention of this issue under English law, but this may cause problems in civil law jurisdiction.¹³⁸

In **take-and-pay contracts** the buyer is obliged to take any product that is offered for a contracted price, but this amount is still uncertain at the time of execution of the contract.¹³⁹ However, in this case, the buyer pays only for the actually delivered amount of product. Therefore the adequacy of consideration issue may arise only in respect of the fluctuation of contract prices but the buyer is not required to pay for a product which he has not taken. However, if there is some shortfall in the production capacities of the project company, the buyer must seek for substitute sources.

¹³⁴ See HOFFMAN, *The law and business of international project finance* 210. 2008.

¹³⁵ See VINTER, *Project Finance - A Legal Guide* 113. 2006. and GARNER & BLACK, *Black's law dictionary* 374. 2009.

¹³⁶ See VINTER, *Project Finance - A Legal Guide* 117. 2006.

¹³⁷ *Id.* at, 113.

¹³⁸ *Id.*

¹³⁹ *Id.* see also HOFFMAN, *The law and business of international project finance* 210. 2008. and WOOD, *Project Finance, Securitisation, Subordinated Debt* 2-023. 2007.

Both take-or-pay and take-and-pay contracts usually include two price elements. The first one is fixed cost (also called as capacity charge or availability fee) to cover the fixed costs (including the debt service) of the project company, while the second element is the variable cost (or energy charge) which represents the variable expenses directly attributable to the production of each single unit of energy.¹⁴⁰

Blended contracts combine the take-or-pay and the take-and-pay contracts by obliging the purchaser to pay upon specific cases of interruption.¹⁴¹

Under **traditional long-term sales agreements** the buyer must pay price only if the product has been delivered and meets the specifications.¹⁴² If the buyer does not intend to buy, it might be required to pay damages only but not the purchase price. This form is much closer to the everyday use of contracts, however, they are much risky for the seller (and indirectly its lenders).

Power purchase agreements of electricity sector are also relevant as more and more power plants are built on a project finance basis. Under such agreements the fees are usually divided into an availability (or capacity) fee and variable fee. The former covers the fix costs and is payable irrespective of the actual amount of electricity generated while the latter covers the variable costs of the actual electricity production.¹⁴³

Regarding the **renewable energy**, the situation is more complicated due to the often applied mandatory off-take regime. In the EU, Member States undertook to increase the participation of renewable energy within the overall energy consumption by 2020 by applying support schemes for energy producers.¹⁴⁴ As discussed later, these support schemes usually directly affect the pricing of electricity through the regime of feed-in tariffs.

¹⁴⁰ See HOFFMAN, *The law and business of international project finance* 210. 2008., see also VINTER, *Project Finance - A Legal Guide* 117-119. 2006.

¹⁴¹ See HOFFMAN, *The law and business of international project finance* 210. 2008.

¹⁴² *Id.* at, 211.

¹⁴³ See VINTER, *Project Finance - A Legal Guide* 121. 2006.

¹⁴⁴ As set out in Art. 3 of Directive 2009/28/EC of the European Parliament and of the Council of 23 April 2009 on the promotion of the use of energy from renewable sources and amending and subsequently repealing Directives 2001/77/EC and 2003/30/EC

b. Limited recourse vs. non-recourse approach

The principle of seeking payment of the project company's future revenues is also expressed by the restrictions of recourse in project finance transactions. Logically, in case of full recourse there would be no need to choose project finance instead of direct corporate financing of sponsors. Therefore, project finance transactions are concluded either on a non-recourse or on a limited recourse basis. However, there is some discrepancy among the leading authorities regarding the definition of these terms.

According to Vinter, non-recourse means that *“the lenders can in all circumstances only have recourse to the assets in question and never to the borrower”* while in case of limited recourse, under certain circumstances, the lenders *“tr[y] to preserve rights against the borrower if he does not comply with his part of the bargain.”*¹⁴⁵ Hoffman approaches these two terms in a different way by investigating lenders possibilities to seek repayment from sponsors. He considers non-recourse being limited to the project itself (but not only the project assets) as project sponsors do not have direct obligation to repay the project debt if project revenues do not cover debt service.¹⁴⁶ Under limited recourse he understands the possibility of lenders to turn against the sponsors relying on their limited obligations and responsibilities.¹⁴⁷ Therefore, it is important to clarify at the beginning what it is understood under these terms. Hoffman's use of terms are more preferable as he highlights the core relationship of lenders and sponsors. Sarkar also understands the same under non-recourse and limited recourse.¹⁴⁸

Tinsley highlights the fact that in practice limited recourse is a “must” until the completion, as the project cannot generate any revenue until that point of time and the value of a half-completed project is very questionable. Therefore banks generally reject the non-recourse approach for the completion phase and require further assurances of and limited recourse to the sponsors as there is no incoming

¹⁴⁵ See VINTER, *Project Finance - A Legal Guide* 181. 2006.

¹⁴⁶ See SCOTT L. HOFFMAN, *THE LAW AND BUSINESS OF INTERNATIONAL PROJECT FINANCE* 6 (Transnational Publishers ; Kluwer Law International 2nd ed. 2001).

¹⁴⁷ *Id.* at, 8.

¹⁴⁸ See SARKAR, *Transnational business law : a development law perspective* 116. 2003.

revenue until the commencement of the operational stage and the half-completed project does not have any value in case of enforcement of security. Therefore, the only time when non-recourse may come into question is the operation period when the project company is already able to generate incomes.¹⁴⁹

(iii) High-leverage financing comes from banks

In project finance transactions the main part of the financing usually comes from private banks and/or international financial institutions¹⁵⁰ (hereinafter the “banks”). They usually set up a syndication of lenders to be able to provide enough credit and to limit the credit risk on each lender.¹⁵¹ The services of banks are usually divided into financing services and actual lending of money) and advisory services (eg risk assessment, elaboration of financial model and time schedule).¹⁵² Arranging of the finance should be somewhere in the middle, Gatti orders it to the advisory services.¹⁵³ In respect of advisory services, consulting firms may compete with banks for appointment from the project company, while financing services can only be provided by banks.¹⁵⁴

Private banks do project finance purely to make profit through lending. As mentioned above, their profit comes from the margin element within the interest rate.¹⁵⁵

International financial institutions may have other objectives upon participating in a project finance deal. Such objectives can be regional development or the promotion of an internationally important goal, eg application of renewable energy sources or privatization. The advantage of such international financial institutions is that they can attract private banks to join the syndicate even when these private lenders otherwise would not have done business with the project company.¹⁵⁶ Furthermore,

¹⁴⁹ See C. RICHARD TINSLEY, *ADVANCED PROJECT FINANCING : STRUCTURING RISK 5* (Euromoney Books. 2000). and Sarkar 2003, 116

¹⁵⁰ Such as World Bank, IFC, EBRD, EIB

¹⁵¹ See VINTER, *Project Finance - A Legal Guide* 174. 2006.

¹⁵² See GATTI, *Project finance in theory and practice : designing, structuring, and financing private and public projects* 147. 2008.

¹⁵³ *Id.* at, 149.

¹⁵⁴ *Id.* at, 152.

¹⁵⁵ See VINTER, *Project Finance - A Legal Guide* 176. 2006.

¹⁵⁶ See NEVITT & FABOZZI, *Project financing* 69. 2000.

international financial institutions tend to demand lower margins and lend money for longer terms than commercial lenders do.¹⁵⁷

Besides private and international and/or regional banks, government export agencies¹⁵⁸ may also provide finance for projects in the form of export loans and/or guarantees.¹⁵⁹ However, export agencies are reluctant to assume project finance risks, therefore they usually require to rely on third party guarantees when lending money.¹⁶⁰

The advantages of financing from government export agencies are the same as discussed above in relation to international financial institutions, but export supporting nature of the financing may cause the project company to choose not the best available technical equipment but the most financially supported one.¹⁶¹

Furthermore, it must be noted, that project financing through commercial loan is not the exclusive mean of financing large infrastructure developments. In private sector the other main alternatives is to finance them through the traditional techniques of corporate finance, e.g. by corporate loans from the credit market or by bond programs from the capital market and sometimes it is much cheaper way of securing capital.¹⁶² Similarly, in the public sector the sovereign entity may also issue bonds or it can finance the developments from its own budget.¹⁶³ In public private partnerships project financing is neither an exclusively applied method of financing, the tools of financing mentioned above in respect of corporate finance may also apply.

¹⁵⁷ Id.

¹⁵⁸ Such as Compagnie Francaise d'Assurance pour le Commerce Exterieur (CoFACE) in France, Kreditanstalt für Wiederaufbau (KfW) and Hermes Kreditversicherungs AG in Germany, Export Credits Guarantee Department (ECDG) in the UK, OPIC and Export-Import Bank in the United States

¹⁵⁹ See NEVITT & FABOZZI, Project financing 70. 2000.

¹⁶⁰ See ISABELLE J. KAYALOFF, EXPORT AND PROJECT FINANCE : A CREATIVE APPROACH TO FINANCIAL ENGINEERING 70 (Euromoney Publications. 1988).

¹⁶¹ See NEVITT & FABOZZI, Project financing 70. 2000.

¹⁶³ id. at, 85.

¹⁶³ Id. at, 81.

(iv) High profile projects with many participants and complex “network” of agreements

Project finance transactions are usually very complex and involve a whole structure of interconnected agreements. The main reason for this is the huge amount of funds needed which requires the syndication of lenders and a detailed documentation of finance.

As discussed above, there are also many other interdependent stakeholders in a typical project finance transaction (eg suppliers, customers, concession grantor, operator, insurers) which makes the situation even more difficult. The relationships between these parties are primarily subject to their vis-à-vis agreements. However, the direct agreement creates a direct contractual relationship between each stakeholders.

As at the time of lending the project consists only of a nexus of contracts, these contracts should provide for the whole construction and operation of the project. Actually what lawyers do during drafting and negotiation contracts is very similar to engineers’ planning work from the perspective of anticipating and addressing complex issues. Nevitt argues that the principles of project finance apply irrespective of the project’s size.¹⁶⁴ Regardless of whether Nevitt’s argument above is theoretically true or false, the complexity and the scale of economics simply precludes the application of project finance to small businesses, general corporate lending is much more appropriate for them.

(v) Sophisticated allocation of risks

There are several risks involved in project finance transactions, usually much more than in conventional lending, given the complex nature these transactions. The task of lawyers is to foresee all of the risks which can endanger the project and the repayment of loans and allocate the risks in a reasonable way in light of the practices of the given industry.

A project has generally three main risk phases: firstly the construction phase, secondly the start-up phase and thirdly the operations phase.¹⁶⁵

¹⁶⁴ Id. at, 6.

¹⁶⁵ See LAURENCE W. CARTER AND GARY BOND, FINANCING PRIVATE INFRASTRUCTURE 68 (1996) see also ID. AT, 10.

In practice, lenders are mostly exposed to risks during the construction period, when they have already started to lend money, but the project is still not completed and does not even have the theoretical capability to promptly generate revenues.¹⁶⁶ However, in the second stage, lenders may worry about that the project will not meet the performance targets set out in the project document, and as a result, the financial model would get disrupted while the project will not be able to generate enough revenues for debt service. In that case, parties may need to agree on the amendment of the financial model of the project.

Risks can also be classified in several other ways. Hoffman separately discusses general risks of project finance, the risks specific to cross-border project finance and project finance commercial risks, however this approach tells us less about the nature of risks.¹⁶⁷ However, this classification is arbitrary to a certain extent as risks may easily overstep the borders of the categories above. For instance, change of law risk¹⁶⁸ or collateral risks¹⁶⁹ are treated as cross-border risks by Hoffman, however, they can endanger even a total indigenous project.

Risks can be also ordered according to their core nature and, accordingly, they can be commercial, legal and technical/engineering risks. This classification seems to be better as there are less overlaps if we consider the nature.

Commercial risks have their roots in the world of economy and they usually have direct effect on the capability of the debtor to repay the debt. Such commercial risks are, for instance, the change of the market of input and output products, change in the foreign exchange rates (provided that main suppliers or offtakers use a currency different from the currency of the loan), creditworthiness of the offtaker, change in the raw material supply. Regarding commercial risks, the main rule is to limit the

¹⁶⁶ Id. at, 308.

¹⁶⁷ See HOFFMAN, *The law and business of international project finance* viii-xi. 2008.

¹⁶⁸ Change of law risk is the risk that legislator puts the parties and the project into a different legal framework as it was anticipated during the conclusion of the project document, by adopting a new law. Typical examples for the changes of law are the amendment of import/export tariffs, taxes, the amendment of, especially in highly regulated fields such as energy or the telecommunication sectors are, the regulatory and the environmental norms, see id. at, 49-51.

¹⁶⁹ Collateral risks are risk related to the security interests. In project finance, similar to the traditional lending, the most significant one is the risk of unenforceability of the security interests, see id. at, 52-53.

risk taken by lenders to credit risk and leave the equity risk for the sponsors.¹⁷⁰ Banks are able to handle lending risks as they belong to their core business, while on the other hand, banks, even for a higher margin in the interest, should not take risks of equityholders.¹⁷¹

Generally the **risks of technical nature** should be very limited. As Nevitt points out, there is no room to introduce an entirely new, untried technology within a project finance transaction.¹⁷² If lenders were willing to finance such transactions, they would face several technology risks far beyond the standards of general lending risks. However, even if project finance is inappropriate for piloting new technologies without any operational experience, it has a great role in spreading tried state-of-the-art technologies where these technologies had not been applied before. For instance, many of the wind farm projects were financed on a project finance basis in Hungary.¹⁷³ Nevertheless, the best way to mitigate these risks is to obtain technical feasibility studies from independent engineering experts.¹⁷⁴ These studies may provide the sponsors and lenders with more comfort and, can reveal issues which should be addressed by lawyers upon negotiating contracts.

The law itself may add further risks to the project. These **legal risks** include the above mentioned change of law risk, the collateral risk and further risks having roots in the world of law. Lenders mitigate legal risks by obtaining legal opinions from law firms with significant expertise in the given jurisdiction regarding the legal issues, such as incorporation of the entities, concession rights related to the project, execution of contracts, perfection and enforceability of security interests.¹⁷⁵

The most important point is how these risks are allocated. The general principle for allocation of risks is to put each risk on the party who is mostly able to exercise control over such risks. The main purpose of project documents from this perspective is to address and allocate every imaginable risk without any gap in order to avoid uncovered issues which may serve with a great likelihood as a fuel to legal disputes. It can lead to a never-ending philosophical dispute whether it is theoretically possible

¹⁷⁰ See NEVITT & FABOZZI, Project financing 10. 2000.

¹⁷¹ Id. at, 11.

¹⁷² Id. at, 18.

¹⁷³ See EBRD's fact file on Magyar Wind project available here:

<http://www.ebrd.com/english/pages/project/psd/2010/40325.shtml>, downloaded: 28 March 2013

¹⁷⁴ See HOFFMAN, The law and business of international project finance 98. 2008.

¹⁷⁵ Id. at, 401.

to foresee everything what future might bring. Nevertheless, the most typical risks are usually known and therefore, are able to be addressed by the parties. The best way is the “**back-to-back” or matching technique upon contracting**, under which any liability or burden taken by the project company should be passed on to other interest parties, therefore all of the involved contracts should be consistent regarding the corner points where liability issues may occur.¹⁷⁶ It especially true for projects involving concessions¹⁷⁷ or pass-through offtake agreements¹⁷⁸.

For instance, taking the example of Vinter, regarding the provision of services under the concession the project company is usually in the position of the obligor vis-à-vis the concession grantor, however, it is obligee vis-à-vis its contractors regarding the outsourced works. Where the project company would be liable for liquidated damages attributable to its contractor’s fault under the concession agreement, the project company must require the contractor to assume liability or to indemnify it for such damages at least in the same amount.¹⁷⁹ Otherwise the liability for liquidated damages would remain at the project company. The same applies to the regulation of completion, the defects periods, the warranties, the extensions of time, the system of termination and the definition of force majeure and events of default and the indemnities.¹⁸⁰

(vi) Wide application in public-private partnerships

Due to budgetary reasons, states more and more intended to finance publicly needed infrastructures from private funds, despite the fact that financing through public-private partnerships (hereinafter PPPs) is overall often more expensive than public-sector borrowing.¹⁸¹ In Europe, definitely UK has been leading the way since the introduction of Private Finance Initiative in 1992¹⁸², besides schools¹⁸³

¹⁷⁶ Such as the conditions of completion, defects period, disputes, extension of time, indemnities, liquidated damages, payment terms, scope of works, termination clauses and warranties as listed in VINTER, Project Finance - A Legal Guide 444. 2006.

¹⁷⁷ Id. at, 80.

¹⁷⁸ Id. at, 117.

¹⁷⁹ Id. at, 80.

¹⁸⁰ Id. at, 80-82.

¹⁸¹ See E. R. YESCOMBE, PUBLIC-PRIVATE PARTNERSHIPS: PRINCIPLES OF POLICY AND FINANCE 18 (Butterworth-Heinemann. 2007).

¹⁸² Id. at, 9. see also id. at, 30.

¹⁸³ See NICHOLAS AVERY, PUBLIC PRIVATE PARTNERSHIPS 128 (Globe Law and Business. 2006).

and prisons¹⁸⁴ even military flight training systems have been established and operated through PPP structures.¹⁸⁵

According to Yescombe, one of the leading authorities on PPPs, PPPs involve a long term contract between a public entity and a private party; under which the private party undertakes to design, construct, finance and/or operate a public infrastructure for which the public entity or the general public pays a fee as a consideration and the public infrastructure will remain or will be reverted at the end of the project in public ownership.¹⁸⁶ The project finance techniques used in relation to power purchase agreements became the standard project finance methods often used in PPPs.¹⁸⁷

The features of project finance discussed generally in this chapter make this technique ideal for PPPs. Off-balance sheet treatment may be attractive for sponsors to keep the balance sheet free from the particular PPP project.¹⁸⁸ Higher leverage provides the sponsors with higher return on equity.¹⁸⁹ Higher leverage may also be beneficial for the whole market as it allows lenders to get involved in more projects triggering an increase in the level of competition.¹⁹⁰ Furthermore, the risks taken by the sponsors are limited to their equity contribution.¹⁹¹ The long-term nature of project finance also fits to the needs of similarly long PPP projects.¹⁹² The transparency required by lenders and due diligence exercises carried out by them also serve to decrease the risks of public authority and the general market as well.¹⁹³

(vii) Often applied in respect of project subject to concessions

As discussed above, project finance roots back to the financing of oil exploitations in Texas in the 1930's.¹⁹⁴ On a global level, also the field of mining was where project finance hacked its way

¹⁸⁴ Id. at, 87.

¹⁸⁵ Deal Report of Linklaters on UK Military Flight Training System, available here: <http://www.linklaters.com/News/LatestDeals/2008/Pages/3577.aspx> 1 March 2013 see also id. at, 143.

¹⁸⁶ YESCOMBE, Public-private partnerships: principles of policy and finance 3. 2007.

¹⁸⁷ Id. at, 6.

¹⁸⁸ Id. at, 122.

¹⁸⁹ Id. at, 120.

¹⁹⁰ Id. at, 123.

¹⁹¹ Id. at, 121.

¹⁹² Id.

¹⁹³ Id. at, 123.

¹⁹⁴ Id. at, 114.

through to the everyday's practice. Exploration, exploitation or transfer of natural resources are usually subject to state concession. Due to the intensive capital needs of this industry, project finance has become ideal solution for financing these projects.¹⁹⁵ For instance, exploitation of oil in North Sea is subject to license and the Crown is entitled to the ownership of reserves in ground.¹⁹⁶

(viii) Application of public procurement

Vinter emphasizes the importance of the connection between project finance and public procurement laws. In case of PPP projects, public procurement rules may also apply if the public entity is required to conduct a public procurement procedure to select the proper concessionaire. Certain lenders may also require transparency by setting out that the project company must conduct a public procurement above a certain threshold.¹⁹⁷ Currently public procurements in the EU are regulated on two levels. Firstly, the European Union (hereinafter the EU) passed two directives, Directive 2004/18/EC¹⁹⁸ on public procurements generally and Directive 2004/17/EC¹⁹⁹ particularly in relation to contracts in the water, energy, transport and postal services sectors, with the intention to unify public procurement procedure within the EU. Secondly Member States still have their own national laws on public procurement which should contain the implemented norms of the directives. Public and private entities subject to these laws need to obey rules on public procurement. Due to the complexity of public procurement, this field of law has become a quasi branch of law requiring expertise of lawyers advising on these issues.

¹⁹⁵ See FERENC MÁDAI & JÁNOS FÖLDESSY, *Mineral Resources Management*.

¹⁹⁶ See VINTER, *Project Finance - A Legal Guide* 362. 2006.

¹⁹⁷ *Id.* at, 10.

¹⁹⁸ Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the coordination of public works contracts, public supply contracts and public service contracts

¹⁹⁹ Directive 2004/17/EC of the European Parliament and of the Council of 31 March 2004 coordinating the procurement procedures of entities operating in the water, energy, transport and postal services sectors

II. LEGAL MEANS OF SECURING PERFORMANCE IN PROJECT FINANCE

1. Basic remarks on securing performance in project finance

Similar to general lending, securing performance has crucial importance in project finance transactions as well.²⁰⁰ Generally, in lending, the purpose of creating security interests over the assets of the borrower is to provide the lender with the opportunity to sell the encumbered assets of the borrower and seek repayment of debts from the income of such sale.²⁰¹ So, in case of enforcement, the lender may initiate an enforcement proceeding under which the encumbered asset will be sold to a third party and the lender can satisfy its claims from the proceeds of this sale, the rest of the sale price may cover the claims of other creditors (if any) or will be transferred to the sponsors.

However, this pure concept is subject to certain qualifications regarding the project finance. Firstly, the project assets usually have a very limited market.²⁰² Generally, the scope of possible buyers who are willing to buy a wind farm or an airport, is quite narrow. It is especially true when the project is only half completed or is in a developing country. In the latter case, if the cause of the default under the credit agreement was that the political climate has become hostile to the project and the measures taken by the local government made the project unprofitable, the number of investors who would like to step in the shoes of failed sponsors in this hostile environment is close to zero.²⁰³

Secondly, it is very hard to assess the proper value of the project. The issue is more complicated when the project has not been completed.²⁰⁴ The main question is what should be taken into consideration as a primary measure. The net value of the physical assets? The historical (if any) or projected income generating capability of the project (ie EBITDA²⁰⁵)? The value of other, alternative solutions serving the same purpose? At this stage, several further investments are required to reach the final completion

²⁰⁰ See HOFFMAN, *The law and business of international project finance* 367. 2008.

²⁰¹ See VINTER, *Project Finance - A Legal Guide* 247. 2006.

²⁰² *Id.* at, 248.

²⁰³ See HOFFMAN, *The law and business of international project finance* 364. 2008.

²⁰⁴ See VINTER, *Project Finance - A Legal Guide* 248. 2006.

²⁰⁵ The abbreviation stands for earnings before interest, taxes, depreciation and amortization

when the project can commence to generate any income. However, in case of market disruption, it is still questionable whether these necessary investments will pay off or is it better to sell the assets of the project “as they are” in this temporary phase?

Thirdly, third party consents are usually necessary to carry on the enforcement proceeding.²⁰⁶ This is particularly true for the case of concessions, where the public entity granting the concession may set out a consent or approval requirement for any change in the person of concessionaire.²⁰⁷ Local laws may prohibit the creation of security interest over a concession. Authorities may also prohibit the transfer of these concessions or stipulate it to the condition of their prior approval.²⁰⁸ In any of these cases, the leeway of banks to take over the project is very narrow.

Finally, as Hoffmann practically points out, in most of the cases, a project has value only if it is in operation and able to generate income, and this value is also greatly dependent on the location where the project was established.²⁰⁹ Therefore, it can be said that the actual value of the project is very much determined by the place and time and other circumstances which have effect on the project. For instance, a German off-shore wind farm project on the North Sea had had a totally different (i.e. lower) value before the Fukushima nuclear disaster than thereafter, at the time when the phase-out of German nuclear power plants was finally decided, causing an increase in the demand for alternative supply of electricity. This example clearly shows that even a tsunami in the Pacific may have a great effect on the value of renewable energy projects several thousand miles away.

Due to the difficulties discussed above, the main function of security interests has departed from the traditional concepts to a more sophisticated approach. Security interests regarding a project finance transaction are now described by all of the main legal authorities to serve both defensive and offensive purposes.²¹⁰

²⁰⁶ See VINTER, *Project Finance - A Legal Guide* 248. 2006.

²⁰⁷ See HOFFMAN, *The law and business of international project finance* 365. 2008.

²⁰⁸ *Id.*

²⁰⁹ *Id.* at, 364.

²¹⁰ See VINTER, *Project Finance - A Legal Guide* 248. 2006. see also HOFFMAN, *The law and business of international project finance* 364. 2008. and WOOD, *Project Finance, Securitisations, Subordinated Debt* 5-003. 2007.

Security interests serve primarily as a **defensive tool** against unsecured creditors given that their actual chances to sell the encumbered asset for a considerable purchase price is quite limited.²¹¹ Therefore, project lenders rather concentrate on their intention to prevent the disposal of core project assets without their consent. Lenders also want to avoid third parties to obtain any right on these assets.²¹²

Lenders also want to have **control** over the project company, especially from the moment when the first signs of a future default are apparent.²¹³ Such control includes the power to have a say in the decisions over the future of the project company, thereby lenders have the opportunity to push parties to the continuing operation of the project company if they see so appropriate.²¹⁴

Finally, security interests as offensive tools still serve the conventional purpose, helping the project lenders to get repaid after successful enforcement and sale of the encumbered assets. However, it should be noted that in project finance the most important assets of the project company are usually not its physical assets, as it is often the case with traditional lending, but its contracts and receivables.²¹⁵ Therefore, the most important security interests are also often security assignment of contracts and receivables.

It must be also noted that the non-recourse or limited recourse nature of project finance transactions also add a specific flavor to securing performance in these transactions.²¹⁶ As discussed above, in the lack of sponsor or state guarantees, the lenders can primarily turn only against the single purpose project company. This also increases the significance of reliance on the security interests established on the assets of the project company.²¹⁷

²¹¹ See WOOD, Project Finance, Securitisations, Subordinated Debt 5-003. 2007.

²¹² See HOFFMAN, The law and business of international project finance 364. 2008.

²¹³ See CUTHBERT, Asset and project finance : law and precedents E0/67. 1997.

²¹⁴ Id.

²¹⁵ See HOFFMAN, The law and business of international project finance 364. 2008.

²¹⁶ Id. at, 379.

²¹⁷ See CUTHBERT, Asset and project finance : law and precedents E0/64. 1997.

2. Wide application of English law

According to Vinter, English law is very popular among creditors and who usually insist to have the basic credit and security documents under this law as much as possible. The main reason is the high esteem of English law being predictable and creditor friendly.²¹⁸

Vinter collected several other advantages of English law which make it a favorable choice of governing law to the lenders at the negotiation table. Firstly, the scope of security interests is the greatest possible as English law provides for the creation of security interests over all types of assets, including future or bulk assets. The flexible concept of floating charge is also inherent to English law (however, should not be confused with the American concept of floating lien). Besides floating charge, English law also recognises all other sorts of non-possessory security interests. Regarding the enforcement, private sale or the step-in of the lender is also allowed. Fixed security holders enjoy priority against preferential creditors. In respect of perfection, English system is very user-friendly by requiring only a low amount of fees upon registering the security in the companies registry. Furthermore, the traditional common law concept of trusts makes the life of a lending syndicate much easier as they can appoint a security agent bank as a security trustee.²¹⁹

The notion of administrative receivership was also very attractive to the lenders, however its scope of application has become limited since 2002.²²⁰ Administrative receiver was a manager appointed by secured creditors with a floating charge and he acted in the interests of the secured creditor²²¹. Its activity necessarily conflicted with the powers of administrator appointed by the court on the initiative of unsecured creditors. The legislator solved the problem by depriving the secured creditor with floating charge from its right to appoint a receiver, subject to certain exemptions. These exemptions include project finance companies, so if a company qualifies as a “project company” as defined in the

²¹⁸ See VINTER, *Project Finance - A Legal Guide* 268. 2006.

²¹⁹ *Id.* at, 269. see also CUTHBERT, *Asset and project finance : law and precedents* E0/68-69. 1997.

²²⁰ See VINTER, *Project Finance - A Legal Guide* 250. 2006.

²²¹ *Id.*

Insolvency Act 1986, the floating charge holders can still appoint a receiver to represent their interests in case of insolvency.²²²

Not surprisingly, Wood considers laws of jurisdictions belonging to English common law group having “the most comprehensive and liberal system of security interests in the world [...]”.²²³ As a weakpoint, he mentions only that floating charge is subordinated to preferential claims (eg salaries of employees), however, these claims have much less significance in project finance transactions than in general corporate lending.²²⁴

Hence, for practical reasons, not all of the security interests can be created under English law in an international project finance transaction, as local laws may require the documentation of certain fixed charges to be governed by the law of the jurisdiction where the collateral is located or registered.²²⁵

3. Elements of a security package

The security package consists primarily security interests created by security agreements. According to Wood, “*a security interest gives a creditor prior property rights over an asset – the collateral – which enables the creditor to realize the collateral to pay the secured debt ahead of the most other unsecured creditors of the debtor.*”²²⁶

The actual security package in an international project finance transaction includes several security interests created under English law governed documentation, however, certain security agreements are required to be governed by local law. For instance, EBRD requires fixed charges on fixed (including land) and movable assets, assignment of hard currency, pledge of sponsors’ shares and assignment of insurance and other proceeds.²²⁷

²²² Id. at, 261. The conditions for the application of „project company” exemption are set out in Para 7(1) (positive list) and Para 7(2) (negative list) of Schedule 2A to the Insolvency Act of 1986, see also id. at.

²²³ PHILIP WOOD, COMPARATIVE LAW OF SECURITY INTERESTS AND TITLE FINANCE 22-016 (Sweet & Maxwell 2nd ed. 2007).

²²⁴ WOOD, Project Finance, Securitisations, Subordinated Debt 5-005. 2007.

²²⁵

²²⁶ WOOD, Comparative law of security interests and title finance 2-001. 2007.

²²⁷

(i) The notion of floating charge vs. fixed charge under English law

Floating charge

The concept of floating charge has its roots in the English law. As its name suggests, it floats above the all assets of the debtor without limiting the freedom of the debtor to dispose these assets.²²⁸

Romer J of Court of Appeal emphasized three key features of floating charges. Firstly, floating charge is a charge on “a class of assets of a company present and future”. Secondly, the actual assets of this class change during the ordinary course of business of the company. Thirdly, the company can do business with these assets in “the ordinary way”.²²⁹ Wood considers the last condition to be the most distinctive feature of floating charge compared to fixed charge.²³⁰

Consequently, a buyer of the assets sold acquires the assets without encumbrance. Floating charge should be registered in the company registry within 21 days after creation.²³¹ The watershed event is the so called crystallization occurring upon enforcement which means that the floating charge “hovering over the general class of assets” will be converted into several fixed charges attached to particular assets.²³² Crystallization may also happen automatically with the commencement of insolvency proceedings.²³³

Floating charge usually ranks behind subsequent fixed charge, even if that fixed charge is not registered.²³⁴ Generally, it is impossible to create a second floating charge with the same or higher ranking without an explicit permissive wording under the initial floating floating charge.²³⁵

²²⁸ See WOOD, *Comparative law of security interests and title finance* 22-019. 2007.

²²⁹ *In Re Yorkshire Woolcombers Association Ltd.* [1903] 2 Ch 284 as cited in JANET DINE & MARIOS KOUTSIAS, *COMPANY LAW* 238 (Palgrave Macmillan 7th ed. 2009).

²³⁰ See WOOD, *Comparative law of security interests and title finance* 22-023. 2007.

²³¹ Section 870 (1) Companies Act 2006

²³² See DOUGLAS SMITH, *COMPANY LAW* 154 (Butterworth-Heinemann. 1999). see also WOOD, *Comparative law of security interests and title finance* 22-019. 2007.

²³³ These events are the (i) appointment of the administrative receiver (by the secured creditor holding the charge), (ii) the appointment of the administrator, (iii) the commencement of liquidation and (iv) the cessation of business as listed in DINE & KOUTSIAS, *Company law* 241. 2009.

²³⁴ *Id.* at, 242.

²³⁵ *Id.*

The application of floating charge in English project finance transactions is very common.²³⁶ However, given the fact that project companies are usually registered in the jurisdiction where the project is situated, the floating charge under English law are not applied directly to projects companies outside the UK. However, local laws in the CEE, despite the fact that these are mostly based on German or Napoleonic traditions²³⁷, have opened to the concept of floating charge over the last decades. UNCITRAL and EBRD both have also played a crucial role in dispersing the notion of floating charge.²³⁸

For instance, floating charge is available in Poland, Hungary and Bulgaria subject to certain limitations.²³⁹ However, regarding the Hungarian practice, parties usually consider floating charge as a fallback solution and try to create fixed charges wherever it is possible.

Fixed charge under English law

Fixed charge is attached to a particular asset from the creation of the charge so the debtor cannot freely dispose these assets and the buyer will obtain these assets encumbered with the security interest of the creditor. Fixed charge can be established on several assets, including bank accounts and receivables as well. Fix charges on real property, book debts, ships, aircrafts, goodwill and intellectual properties under English law are subject to registration.²⁴⁰

Fixed charge have priority against preferential creditors (employees) and floating charge holders as well.²⁴¹ Given that that governmental creditors are not anymore preferential creditors, this aspect has become less relevant. More important is whether the debtor can dispose the collateral without the

²³⁶ See VINTER, *Project Finance - A Legal Guide* 269. 2006.

²³⁷ See WOOD, *Comparative law of security interests and title finance* 2-022. 2007.

²³⁸ See Recommendation 17 of UNCITRAL, *LEGISLATIVE GUIDE ON SECURED TRANSACTIONS* 81 (United Nations. 2010). supporting the possibility to encumber „all assets of the debtor”, see also Art. 5.2 of EBRD, *Model Law on Secured Transactions*, 1994, at 12.

²³⁹ In Poland, floating charge is available over all assets of the company, however, real estates should charged separately, see question 2 in WARDYNSKI & PARTNERS, *Security over Collateral - Poland*. In Bulgaria floating charge can be established on accounts receivables, machines and equipment, inventory and dmaterialized securities, see *INTERNATIONAL SECURED TRANSACTIONS BUL-15* (Oxford University Press. since 2003). Hungarian law also recognises the notion of floating charge, however, it requires this charge to be created in a notarised security agreement and to be registered int he registry of charges held by the notary public (see Art. 266 (1) of Act IV of 1959 on the Civil Code of Hungary). However, for the sake of certainty, parties do not rely solely on floating charge if they want to create a security interest on a real property in Hungary, therefore they usually also create mortgages.

²⁴⁰ Section 870 (7) Companies Act 2006

²⁴¹ See VINTER, *Project Finance - A Legal Guide* 269. 2006.

consent of the creditor.²⁴² If the answer is affirmative, it is much closer to floating charge. If the answer is negative, we have fixed charge at hand.

The distinction above is less clear-cut regarding the charges on receivables and bank accounts. Vinter pointed out that courts have increased the threshold in the scale of control to qualify as charge as a fixed charge.²⁴³ Therefore, if the debtor still has the right to drawdown money from its account, without any limitation, the charge on bank accounts would rather qualify as a floating charge.²⁴⁴

Other forms of English security interests, such as mortgage, liens and pledges are usually not used in project finance transactions outside of UK.²⁴⁵

(ii) Other Security Interests

Security over ownership interests of the sponsors in the company

Security over ownership interests enables lenders to acquire direct control over the company in case of default on a quick and efficient way.²⁴⁶ In this case, the security providers are the sponsors of the company while the security agreement creating is under the law of the jurisdiction where project company is incorporated. Security over ownership interests can be security over quota (in case of limited liability company) or security over shares (or stocks, in case of public companies).²⁴⁷ The main concepts are the same. However, in relation to limited liability companies, special attention should be given to the regulation of pre-emptive rights under the local law and the constitutional documents of the company. Regarding public companies, the issue of preferred shares, especially the issue of golden shares with veto rights of other shareholders can cause problems for lenders stepping in.

²⁴² Id., see also WOOD, Comparative law of security interests and title finance 22-023. 2007.

²⁴³ See VINTER, Project Finance - A Legal Guide 270. 2006.

²⁴⁴ See Vinter referred to the following cases while he came to this conclusion: Re Brumark Investments Ltd. [2001] 2 A.C. 710 and National Westminster Banks plc. v. Spectrum [2005] 3 W.L.R. 58, see id. at.

²⁴⁵ As Hugh Middlemass points out in DAVID R. FRANKLIN & STEVEN A. HARMS, INTERNATIONAL COMMERCIAL SECURED TRANSACTIONS 77-82 (Carswell. 2010). in English law lien means the retention of an asset for the payment of price, pledges is generally a possessory security interest while mortgage consists of the transfer of title to the lender until full repayment. All of these security interest are extraneous to project finance transaction outside the UK given their main features indicated above.

²⁴⁶ See HOFFMAN, The law and business of international project finance 367. 2008.

²⁴⁷ Id.

Charging and assigning of receivables under contracts

As discussed in the definitions of the first chapter, lenders can seek repayment primarily from the receivables of the project company under sales (or offtake) agreement. Furthermore, these receivables under long term contracts constitute the most valuable assets of the company. Therefore, security interests over these receivables play an ultimate role and are of high importance for the lenders. Usually, the law under the security is provided coincides with the governing law of the underlying agreement. Further question is whether and how the respective counterparties of the project company should be notified. The safe practice is to notify the respective counterparties.

Regarding receivables, there are two main ways which can ensure the repayment. Firstly, they can be encumbered with charge, subject to the local law on security interests. For agreement under English law, the charge is also under the laws of England. The dual system of fixed and floating charge also causes some problem and courts tend to consider charges over receivables as floating charges given the constantly changing nature of these collaterals and the control of security provider over them.²⁴⁸

Secondly receivables can also be assigned as rights for security purposes, usually subject to the local law on contracts and the assignability clause of the underlying contract (if any). Lenders usually require project companies to conclude project contract in a way that they allow the assignment of receivables due to the project company. English law differentiates between equitable assignment and statutory assignment. The former is based on the freedom of the parties while the latter requires writing form and absolute nature, relation to the whole debt and notification to the debtor in writing.²⁴⁹

It should be noted that United Nations Convention on the Assignment of Receivables in International Trade may also cover such assignment.²⁵⁰

²⁴⁸ See WILLIAM JOHNSTON, SECURITY OVER RECEIVABLES : AN INTERNATIONAL HANDBOOK 151 (Oxford University Press. 2008).

²⁴⁹ Id. at, 148.

²⁵⁰ Id. at, 602.

Banks accounts

Project lenders often require the project company to establish “control accounts” and to use these accounts for the main cashflow operations of the company. Security interests can be, and usually are created on such accounts, usually under the law of the jurisdiction where the account is held.²⁵¹ Furthermore, account holding banks are often required to waive their rights to create any security(including liens) on these accounts or apply set-off against project company’s amounts on these accounts, for the benefit of lenders.

Security interests over bank accounts ensure the proper operation of waterfall mechanisms. Local laws may require project companies to conduct money transfers from and to tax authorities exclusively through local bank accounts, therefore certain local accounts should also be opened. In these cases the local account agreements are usually under local law. However, for the main cashflow, lenders prefer the use of offshore accounts, mostly opened in London, which are out of the scope of the local legislation. The security agreements related to these offshore accounts are usually governed by the respective jurisdiction (eg by the law of England). Still English law is uncertain regarding the security over bank accounts, therefore lenders require a specific security package called “triple cocktail” to be established on bank accounts.²⁵² This package consists of a charge over deposit, a set off right for the lender for amount of money on the deposit and the payment obligations owed to the lenders, and a “flawed asset” provision acknowledging the limited powers of deposit holder to the accounts.²⁵³ However, CEE jurisdictions tend to be more uncertain regarding security interests over bank accounts. In Russia,²⁵⁴ it is still questionable whether such security interests are valid, while in other jurisdictions, like Poland²⁵⁵ or Hungary, deposits in banks are deemed to be receivables.

Security Interests on Physical assets

²⁵¹ See HOFFMAN, *The law and business of international project finance* 368. 2008.

²⁵² See JOHNSTON, *Security over receivables : an international handbook* 154. 2008.

²⁵³ Id.

²⁵⁴ Id. at, 438.

²⁵⁵ Id. at, 418.

Certain physical assets of high value are also often subject separately to charge.²⁵⁶ These assets can be machines, equipment, usually which can be sold on the market separately from the project. It goes without saying that only non-possessory security interests are practicable in relation to project finance transactions.

Furthermore, it should be noted that every project has its maximum value only if it is actually in, or if it is reasonably capable to be in, operation. Such operability requires the main money making assets to be in place. Therefore the enforcement of charges on physical assets separately from the project itself makes sense only as an option of last resort when the project cannot be taken over or sold as a going concern.

(iii) Other contractual means of securing performance

Besides security interests created by separate security agreements, certain provisions of credit agreements, guarantees, comfort letters and agreements with the host government may provide the lenders with additional comfort. Therefore, the securing of performance cannot be investigated purely on the basis of security interests. Without going too much in the detail, it is necessary to have a glance on these tools as they supplement the security interests in securing the debt service.

(a) In the credit agreement

All credits agreements of structured finance deals contain several provisions serving the purpose to provide the lenders with more certainty regarding the repayment of loans. Each credit agreement has a complicated structure of (i) representations and warranties, (ii) covenants and (iii) conditions precedent.

²⁵⁶ See HOFFMAN, *The law and business of international project finance* 365. 2008.

(i) Representations and warranties

Representation is a “statement by a contracting party to another contracting party about a particular fact that is correct on the date when made.”²⁵⁷ Its purpose is to induce duty, establish the standards of liability and to allocate risk between the parties.²⁵⁸ If a fact represented turns to be false, avoidance and restitution can be claimed for such misrepresentation qualifying as a tort.²⁵⁹ Warranty is “a guarantee that a given fact will exist as warranted at some future date.”²⁶⁰ Breach of a warranty leads to contractual breach and the remedy of damages can be claimed for.²⁶¹ Parties usually use the term of “represent and warrant” to for important statements of fact, where “represent” refers to the statement itself while “warrant” refers to the contractual liability which extends beyond the case of simple misrepresentation.

Among several representations and warranties, which are put in place to, directly or indirectly, provide the lenders with more comfort, some representations and warranties are particularly closely connected to securing the repayment. Firstly borrower is required to make a representation and give a warranty stating that the credit agreement is “in full force and effect, legal, valid and binding, and enforceable”.²⁶² It is also important to represent and warrant for that the project company owns its assets and these assets are not encumbered by any security interests except for security interests permitted by the credit agreement.²⁶³ Following the same logic, project company may also be required to give a similar representation and warranty particularly in relation to collaterals. Such covenant covers that the project company has a good title to the collateral and the security documents create valid and perfected security interests with first priority.²⁶⁴

Regarding the project contracts, borrower must represent and warrant that all of these contracts are “in full force and effect”, no default has occurred and the project company complies with its obligations

²⁵⁷ Id. at, 122.

²⁵⁸ See TINA L. STARK, DRAFTING CONTRACTS 33 (Aspen Publishers. 2007).

²⁵⁹ See HOFFMAN, The law and business of international project finance 122. 2008.

²⁶⁰ Id.

²⁶¹ See STARK, Drafting Contracts 33. 2007.

²⁶² See HOFFMAN, The law and business of international project finance 128. 2008.

²⁶³ Id. at, 132.

²⁶⁴ Id.

undertaken in these agreements.²⁶⁵ There is also a general representation and warranty regarding the compliance with laws as well.²⁶⁶

(ii) Covenants, including the negative pledge covenant

The credit agreement also includes several undertakings, so called covenants to secure the repayment. Almost all of the covenants are supposed to provide lenders with more comfort, however, certain covenants are much more closely related to this point than the others.

Negative pledge covenant, functioning as a quasi-security, is undoubtedly the most security related covenant in the agreement. Under such clause, the borrower undertakes not to create security interests over its assets for the benefit of other lenders, other than permitted security interests.²⁶⁷ Such permitted security interests include for instance statutory liens or the retention of title.²⁶⁸

There are further covenants regarding the performance of project documents. A separate covenant controls level of **indebtedness** by prohibiting the project company to assume debts other than the debts under the project credit agreement, the subordinated debts (if any), debts regarding equipment purchasing up to a certain amount and generally debts up to a given threshold.²⁶⁹ Another covenant prohibits the dividend payments ahead of debt service due.²⁷⁰ The so called “**use of proceeds**” covenant ensures that the loan drawdowns will be used for the given purpose of the project.²⁷¹ In a further covenant the project company usually undertakes **to maintain and preserve the security interests** (and their ranking) created under the security documents. Credit agreements also include a supplemental covenant requiring the project company **to use control accounts** subject to the accounts agreement.

(iii) Conditions precedent

²⁶⁵ Id. at, 133.

²⁶⁶ Id. at, 135.

²⁶⁷ See WOOD, Comparative law of security interests and title finance 2-030. 2007.

²⁶⁸ See HOFFMAN, The law and business of international project finance 345. 2008.

²⁶⁹ Id.

²⁷⁰ Id. at, 346.

²⁷¹ Id. at, 348.

Conditions precedent (hereinafter CPs) include documents and actions which should be in place before a certain event occurs. There is a separate list of CPs for closing and the first drawdown, subsequent drawdowns and the conversion of the construction loan into a term loan.²⁷² Besides the fact that almost all CPs are intended to provide the lenders with more certainty about the lending, certain CPs have particular importance regarding the repayment of loans.

The credit agreement and the related financial and security documents should usually be executed by the first drawdown.²⁷³ Furthermore, depending on the deadlines set out by local law, certain filings of security interests should also be made by that day.²⁷⁴ The project agreements (e.g. the construction agreement, the off-take agreement and the supply agreements) should also be executed in a form satisfactory to the lenders.²⁷⁵ This often causes a “timing” problem during the preparation for closing of the credit agreement, as the project company may have agreed and executed these agreements with the respective counterparty already before the negotiation of the financing. However, lenders usually insist to include certain terms (eg regarding the assignment) in these contracts. In this case, project company is needed to re-negotiate and to amend the project contracts to implement the terms required by the lenders. Legal opinions regarding the validity, effect and enforceability of the financial, security and project agreements are also required by the lenders.²⁷⁶ These opinions should cover all respective jurisdictions involved.

(b) Guarantees

Lenders often not convinced that the security package and the contractual measures will provide them with satisfactory security and require other parties to provide guarantees to the project.

Firstly, **sponsors** can give parent guarantees by breaking through the concept of limited and non-recourse.²⁷⁷ However, that case, as Nevitt points out, the debts of the project company is indicated on the consolidated balance sheet of the sponsor acting as a guarantor. Sponsors may also provide the

²⁷² Id. at, 328.

²⁷³ Id. at, 329.

²⁷⁴ Id.

²⁷⁵ Id. at, 330.

²⁷⁶ Id. at, 334.

²⁷⁷ See NEVITT & FABOZZI, Project financing 299. 2000.

lenders with completion guarantees under which sponsors undertake to give a “full guarantee” of the financing for the case when project does not meet completion requirements set out by the completion date.²⁷⁸ Sponsors may also give shortfall guarantees as a fallback solution, ensuring the satisfaction of the lenders for the case when the proceeds from enforcement security interests cannot cover the debts of the project company.²⁷⁹

Secondly, guarantees can be provided by **third parties** as well. For instance, take-or-pay offtake agreements are often regarded as indirect guarantees as the offtaker has an unconditional obligation to pay the purchase price.²⁸⁰ Other banks may issue letter of credits to protect the lenders of the project company from the project company’s failure to repay the debts.²⁸¹ In developing countries with relatively uncertain political environment, lenders may also require local governmental agencies to provide them with a guarantee against political risks, including the risk of change of law or nationalisation.²⁸² Governmental financial institutions, such as OPIC²⁸³, having interests in promoting development may also assist projects in the developing world with loan guarantees, however in this case the benefits of the economy of the guarantor should also be proved.²⁸⁴ Guarantees can be limited both in terms of amount and time.

(c) Comfort letters

Vinters lists comfort letters given by sponsors as the weakest mean to provide lenders with more comfort as they generally do not have legally binding force.²⁸⁵ They usually express only the intention of the comfort letter provider to maintain ownership and supportive attitude to the project. If parties

²⁷⁸ See VINTER, *Project Finance - A Legal Guide* 245. 2006.

²⁷⁹ *Id.* at, 246.

²⁸⁰ See HOFFMAN, *The law and business of international project finance* 250. 2008. see also NEVITT & FABOZZI, *Project financing* 323. 2000.

²⁸¹ See HOFFMAN, *The law and business of international project finance* 252. 2008. see also NEVITT & FABOZZI, *Project financing* 303. 2000.

²⁸² See NEVITT & FABOZZI, *Project financing* 318. 2000.

²⁸³ *Overseas Private Investment Corporation*

²⁸⁴ See NEVITT & FABOZZI, *Project financing* 323. 2000.

²⁸⁵ See VINTER, *Project Finance - A Legal Guide* 249. 2006.

intend to implement a specific, legally binding undertaking into a comfort letter, it should be very explicit in terms of wording of the binding legal nature.²⁸⁶

III. PARTICULARITIES OF RENEWABLE ENERGY PROJECTS IN RESPECT OF SECURING DEBT REPAYMENT

1. Support schemes for electricity produced of renewable energy sources

The European Union has become the engine of the promotion of renewable energy source in Europe over the last two decades. It has confirmed both the United Nations Framework Convention on Climate Change concluded in Rio de Janeiro in 1993²⁸⁷ and the Kyoto Protocol²⁸⁸. The Commission issued a Green Paper in 1996²⁸⁹, and then a White Paper in 1997²⁹⁰ on the renewable energy sources. In 2001 the European Parliament and the European Council adopted the Directive 2001/77/EC on the promotion of electricity produced from renewable energy sources in the internal market. This directive was the first legislative act on EU level on this topic and set out the target of 22.1 % for the share of electricity produced from renewable energy source in the total electricity consumption of the EU by 2010.²⁹¹ In 2006 the European Commission published its “Renewable energy road map” which was first to set out the new target rate for 2020 under which the share of renewable energy sources should be at least 20% in EU’s total energy consumption.²⁹² Art. 194 (1) (c) of the Treaty on the Functioning of the European Union also points out it is EU’s policy to promote the development of renewable energy sector. This target was implemented by Article 3 (1) of Directive 2009/28/EC. In light of this target, Member States were required to elaborate national action plans and were encouraged to apply support schemes for private enterprises.²⁹³ However, it is up to the discretion of Member States to choose the preferred scheme of support and, consequently, the form and amount of support of

²⁸⁶ Id.

²⁸⁷ See 94/69/EC Council Resolution entering into force on 21 March 1994, see also official website on Rio Convention available here: http://unfccc.int/essential_background/convention/status_of_ratification/items/2631.php, download date: 28 March 2013

²⁸⁸ See Official website on Kyoto Protocol available here: http://unfccc.int/kyoto_protocol/status_of_ratification/items/2613.php, download date: 28 March 2013.

²⁸⁹ See COM (1996) 576 final.

²⁹⁰ See COM (1997) 599 final.

²⁹¹ Article 3 (4) of the 2001/77/EC Directive

²⁹² See COM (2006) 848 final

²⁹³ See Art. 3(3) and Article (4) of the 2009/28/EC Directive

renewable energy is regulated in national laws. The EU law at the time being contains only the obligation of Members States to meet their national target rate of renewable energy sources in the overall consumption.

The most widely applied system is the **feed-in-tariff mechanism**, in which, under long-term agreements, the grid operator is obliged to accept the delivery of electricity produced of renewable energy sources for a price set out on the basis of the costs of generating electricity from renewable energy sources.²⁹⁴ This system was initially introduced by Germany in 1990²⁹⁵ and is now widely applied by Bulgaria, Hungary, Slovakia and Slovenia in the region.²⁹⁶ Given the fact that a unit of electricity produced from renewable energy sources (eg wind, hydropower, solar energy, biogas) is generally still more expensive than a unit of energy produced from conventional energy sources (coal, natural gas or nuclear energy), government needs to provide for the supplement of the price difference. Regarding the pricing of electricity, feed-in tariffs can be set either on a fixed-price basis or on a premium price basis.²⁹⁷

In feed-in tariff system with fixed fee the producer of renewable energy sells the energy for an already set out fixed price which should cover the costs of producing renewable energy on a long term basis, and therefore, is usually above the market price level. The fixed price can be calculated by relying primarily on the “levelized costs of energy”, the value of renewable energy generation, the results of an auction or by simply taking into account an independent fixed-price incentive.²⁹⁸ It also usually differentiates on the basis of technology applied, size of the project, quality of the resource or the value of generation to the market.²⁹⁹ Certain automatic price adjustment mechanisms can be also

²⁹⁴ See TOBY D. COUTURE, et al., A POLICYMAKER'S GUIDE TO FEED-IN TARIFF POLICY DESIGN 6 (NREL July 2010 ed. 2010).

²⁹⁵ Id. at, 9.

²⁹⁶ See RES-Legal database on each country available here: <http://www.res-legal.eu/search-by-country/>

²⁹⁷ See COUTURE, et al., A Policymaker's Guide to Feed-in Tariff Policy Design vii.

²⁹⁸ Id. at, 7.

²⁹⁹ Id. at, 23.

added.³⁰⁰ Overall, it is still true that fixed price feed-in system uses a pricing scheme which is independent of the constant fluctuation of market prices.

The feed-in tariff system with premium uses the actual spot electricity price as a benchmark and the premium is added to the spot prices. The amount of premium can be also changing by using so called sliding premium-price mechanisms which may allow that in case of an increase in the market price, the premium can be lowered (and the way around) not to have excessive prices. On the other hand, in case of low market prices, the amount of premium can be increased to cover sufficient revenue needs of the producer.

Generally, jurisdictions having the feed-in tariff system are for either the fixed price (Slovenia, Hungary, Croatia) or for the premium model. However, Czech Republic allows the plant operators to choose between the fixed price model and the premium model of feed.in tariffs.³⁰¹

There is another system of **quota**, which simply obliges the electricity network to take delivery of certain amount of green energy. In the region, quota system is used by Poland³⁰² and Romania³⁰³. The Romanian system is combined with the notion of green certificates according to which electricity suppliers and producers are required to present a given amount of green certificates. This obligation is supported by a penalty system.³⁰⁴ Poland has a more sophisticated system as it offers electricity producers and suppliers the opportunity to pay fees instead of presenting green certificates and there is also a penalty system to force them to comply with one of the two alternatives.

³⁰⁰ Such as tariff degression set out in advance, annual inflation adjustments front-end loading and different prices reflecting the time of consumption (peak time and non-peak time). see id. at.

³⁰¹ See up-to-date information database on Czech Republic's regulation on RES available here: <http://www.res-legal.eu/search-by-country/czech-republic/single/s/res-e/t/promotion/aid/feed-in-tariff-act-on-the-promotion-of-the-use-of-res/lastp/119/>, download date: 28 March 2013

³⁰² See up-to-date information database on Poland's quota system for RES available here: <http://www.res-legal.eu/search-by-country/poland/single/s/res-e/t/promotion/aid/quota-system-2/lastp/175/>, download date: 28 March 2013

³⁰³ See up-to-date information database on Romania's quota system for RES enacted by Law No. 220/2008 available here: <http://www.res-legal.eu/search-by-country/romania/tools-list/c/romania/s/res-e/t/promotion/sum/184/lpid/183/>, download date: 28 March 2013

³⁰⁴ RES-Legal available here: <http://www.res-legal.eu/en/search-by-country/romania/single/s/res-e/t/promotion/aid/quota-system-4/lastp/183/>, download date: 28 March 2013.

2. The change of law risk regarding the state support to these projects

The risk of change of law regarding the regulation of feed-in tariffs is of crucial importance as an adverse change of law may affect the main revenue source of the project and thereby disrupt the financial plan and, in particular, the debt service capability of the project company. Similarly to change in tax law, these amendments do not need to be most fascinating reforms of legal history to have grave monetary consequences on the business community. If there is a decrease in the feed-in tariff compared to the anticipated level of tariffs, the project company may have much lower amount of revenues. As a result, the project would be less able to repay its loans to the lenders.

Governments may have several reasons to change the law by increasing the feed-in tariffs. Firstly, if the support element of the feed-in tariff is directly paid from the budget, a new government or the same one under worse financial conditions may be in the need to free up amounts originally intended to promote the exploitation of renewable energy sources and to use this amount for other purposes considered more important. Secondly, if the support element in the feed-in tariff is paid by the users, the government might be interested to mild the burden of users, who are actually also voters, for political reasons. This risk is primarily of political nature regarding its origin.

Whatever the reason of the government for the decrease of the feed-in tariff is, a decrease in the feed-in tariff has always the same negative effect, namely the decrease of revenues and, in the amounts of funds available for loan repayment. For instance, in Bulgaria, the feed-in tariff for solar power in Bulgaria was reduced from around BGN 560 to around BGN 170.³⁰⁵ It can be easily calculated that such decrease to one-third of the original pricing levels also decreases the revenues of solar plants there in the same scale.

In that situation the traditional security interests discussed above have less use for the lenders. Generally, these security interests are effective in protecting the creditors from the misuse of proceeds

³⁰⁵ The exact reduction for solar plants other than installations integrated on rooftops and facades was from BGN 576/MWh to BGN 193/MWh (up to 30 kWp), from BGN 567/MWh to BGN 188.10/MWh (30 - 200 kWp) and from BGN 486/MWh to BGN 171.37/MWh (above 200 kWp). See RES Legal current data for Bulgarian available here: <http://www.res-legal.eu/search-by-country/bulgaria/single/s/res-e/t/promotion/aid/feed-in-tariff-8/lastp/111/> and archive data on RES Legal for 2011 available here: <http://www.res-legal.eu/archive/>

in case of default. Their main purpose is to canalize the incomes of the project company directly to the lenders. Therefore, in case of default, security interests on, or the assignment of receivables or bank accounts can preclude the project company to use the receivables for purposes other than repayment of loans. However, they cannot mitigate the issue when the incomes themselves are low because of an adverse change of law. Furthermore, the enforcement of security interests on real properties, fixed and movable assets would be an improper approach as these security interests can be used only as a last resort when there is no hope for keeping the project alive.

3. Can effective countermeasures be put in place to mitigate the change-of-law risks?

Given that security interests cannot mitigate the risk of an adverse change of law regarding the feed-in tariffs, lenders need to apply other, non-security interest based approach to mitigate this risk.

Firstly, an **implementation agreement** containing several clauses on the commitment of the host government can be put in place.³⁰⁶ Parties may also agree to include governing law clause setting out the laws of England or New York as applicable law and jurisdiction clause referring any dispute to foreign courts or arbitral tribunals.

The **involvement of international community** as much as possible may also reduce the intention of the host government to change these law.³⁰⁷ The higher the number of countries affected by such change is, the worse consequences such change may have on the foreign relations of this government. The involvement of several large international sponsors and lenders may have a deterrent power as these entities affected may use their lobbying power to put the host government under political pressure in order to protect the interests of the project lenders. The same logic applies for the involvement of national export-credit agencies. The details of informal negotiations behind the scenes remain most of the cases undisclosed, however, they presumably play a huger role.

³⁰⁶ See HOFFMAN, *The law and business of international project finance* 149. 2008.

³⁰⁷ *Id.* at, 72.

There are also specific **political risk insurances** available which may cover such events.³⁰⁸ Both government agencies and private insurance companies can offer such policies. For instance, OPIC provides eligible US investors starting business in developing countries with an insurance coverage up to 90 per cent of their investment provided that there is an inter-governmental agreement between US and the host government in place.³⁰⁹ This program protects against “Expropriation and Other Forms of Unlawful Government Interference” which covers the risk of “abrogation, repudiation, and/or impairment of contract”.³¹⁰ MIGA³¹¹ also offers political risk insurances for project finance transactions which can protect against a breach of contract by the hosting government or the non-payment of the sovereign financial obligations.³¹²

Similarly to insurances, **guarantees** provided by international finance institutions are also available for political risks. For instance, World Bank offers partial risk guarantee through IDA.³¹³ This partial risk guarantee provides coverage for the failure of host government’s obligations under the concession or the implementation agreement and ensures that in case of termination by the host government, the project company gets “termination payment” under these agreements.³¹⁴

The host government may also give a **comfort letter** to the parties, however, such letter usually does not contain any enforceable legal obligation. Therefore, reliance exclusively on comfort letters cannot provide sponsors and lenders with sufficient comfort.

These instruments are all of ancillary nature and, except for guarantees and insurances, their legal effectiveness is very uncertain.

³⁰⁸ See NEVITT & FABOZZI, Project financing 341. 2000.

³⁰⁹ To be eligible for such insurance, the investor should be a citizen of the United States or should be a business entity incorporated there and the foreign business should be owned at least in 95 per cent by such investors, see in id. at, 342..

³¹⁰ See official publication of OPIC on its website available here: <http://www.opic.gov/what-we-offer/political-risk-insurance/types-of-coverage/expropriation>, download date: 28 March 2013

³¹¹ Multilateral Investment Guarantee Agency

³¹² See official publication of MIGA on its website available here

<http://www.miga.org/investmentguarantees/index.cfm?stid=1797#toc5> download date: 28 March 2013

³¹³ IDA is International Development Association, an institution of World Bank for financing developing states which have otherwise no access to the loans of World Bank, see YESCOMBE, Principles of project finance 241. 2002.

³¹⁴ See official publication of World Bank on its website available here:

<http://web.worldbank.org/external/default/main?theSitePK=3985219&pagePK=64143534&contentMDK=20260268&menuPK=64143504&piPK=64143448>, download date: 28 March 2013

CONCLUSION

As proven above, project finance has become an everyday solution for the financing of capital intensive development projects.

It involves a sophisticated system of contracts to allocate the risks. Its key features allow sponsors to limit their exposure to risks by using a separate SPV with separate liabilities, off their balance sheets. In most of the cases, loans are properly secured and, therefore, repaid to lenders. Furthermore, project finance transactions also contribute to the development of several countries by implementing advanced technologies which have not existed there before.

Most of the elements of a project finance are not characteristic solely to project finance and can be found in several other transactions. What makes project finance special is the interdependent nature of these agreements and the way how to conclude these agreements to establish a comprehensive structure covering every important aspects and allocating every risk which can be anticipated, already at the very beginning of the project.

This complex system of contracts cannot be complete without a security package in place. The exact content of the security package changes from transaction to transaction and is also very much dependent on the particularities of local laws. The main purpose of the security package is to provide the lenders with the greatest extent of comfort and control possible. As the receivables under offtake agreements constitute the main source of repayment at the project company, the charging and assignment of receivables has a distinctive role within the security package.

However, despite the sophisticated nexus of contracts and the increasing amount of expertise, certain risks still cannot be mitigated with a total certainty by project finance. The amendment of offtake tariffs as a change of law risk in renewable energy project poses such a threat. Hosting governments may push for the decrease of such fees, thereby dramatically reduce the revenues of the company. As the traditional elements of the security package themselves cannot protect against a decrease in the amount of receivables, lenders need to rely on ancillary solutions such as special

covenants in implementation agreement, lobbying power of multinational parties involved, insurances and guarantees of international financial institutions or, in the worst case, the mere promise of the hosting government made in a comfort letter. However, it cannot be forgotten that these instruments can provide lenders only with limited comfort.

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