

International Comparative Legal Guides



Project Finance 2021

A practical cross-border insight into project finance

10th Edition

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Why the World Needs Project Finance (and Project Finance Lawyers...)

Milbank LLP



John Dewar

Introduction

“Any fool can make something complicated. It takes a genius to make it simple.” – Woody Guthrie

The financial crisis of 2008 exposed weaknesses in a number of structured finance products (such as collateralised debt obligations, structured investment vehicles and certain derivatives) and business models that were, in essence, arbitrage plays, heavily dependent on short-term debt funding to finance portfolios of long-dated, illiquid investments. By way of contrast, project finance has proved itself to be an asset class that has demonstrated the intrinsic value of productive tangible assets, extensive due diligence, strong collateral packages and transparent financial structures that have become increasingly relevant post financial crisis.

Despite the recent market volatility arising from the COVID-19 pandemic, there remains a pressing need throughout the world for large-scale investment in infrastructure across a broad spectrum of industries (in particular, in emerging markets such as Africa). Large-scale project finance typically focuses on “greenfield” projects in sectors ranging from power generation (conventional, nuclear and renewables) to transmission, oil and gas, petrochemicals, infrastructure, mining and telecoms. Not surprisingly, with the heightened focus on climate change, there has been an increased focus on projects which will facilitate the “energy transition” away from our dependence on hydrocarbons. Global economic growth and demand for energy and commodities is a major driver for capital investment in these sectors and notwithstanding recent market volatility, the economies of fast-growing countries such as China, India and Brazil have underpinned the upward trend in energy and commodity prices. Some of the largest projects in the world are currently being developed in emerging markets: projects involving capital expenditures of \$10–50 billion are moving forward in countries such as Saudi Arabia, the United Arab Emirates and Malaysia.

The increase in global competition for resources has led to a corresponding increase in the size and complexity of infrastructure projects. Today’s governments, institutional investors and the private sector are unable to shoulder the burden of financing projects of this scale alone. This means that large-scale infrastructure projects are now financed using ever more sophisticated and complex financial instruments which are, in turn, provided by an increasingly diverse pool of public and private finance institutions. In recent years, project financiers and sponsors have become adept at mobilising these diverse sources of finance and developing innovative structures combining commercial banks, capital markets investors, Export Credit Agencies (“ECAs”), multilateral Development Finance Institutions (“DFIs”), Islamic banks, and loans sourced from government-affiliated lending

institutions; while debt and equity from infrastructure and private equity funds have become increasingly important, even in emerging markets. As a result of this seismic shift in the financial landscape, project finance lawyers require a degree of familiarity with a range of financial instruments, including commercial bank loans and conventional capital markets instruments, domestic government-funded loans, export credit and multilateral agency loans and guarantees, and Islamic *Shari’ah*-compliant financing structures.

Whilst providing desperately needed sources of liquidity, this diversity of finance and financing structures (combined with the expansion of project finance into new industry sectors and jurisdictions) has meant that the accompanying legal issues have become progressively more complex. Notwithstanding this complexity, a combination of proper legal frameworks, sound commercial structures and robust collateral packages have helped ensure that these new structures have been welcomed and effectively integrated into the project finance market.

The financial crisis and the ongoing COVID-19 pandemic have demonstrated that the key to a successful project financing (or indeed, financing of any nature) is due diligence. A full awareness of the risks inherent in a particular project and its host country (and who bears which of the many costs involved in financing a project) is the first step in identifying mitigants to those risks. A project finance lawyer must be fully conversant with ever-shifting market trends as well as the project company’s business because, in order to advise their clients on the risks associated with a project, they will need to have first considered all aspects of the underlying project. Only once a comprehensive analysis of the underlying project has been undertaken – from the security of its feedstock and fuel supply right through to any potential political, regulatory, legal and environmental issues – will it be possible to identify the material risks to that project’s future success.

Having considered the technical, political and legal risks of the project, a lawyer will then use this expertise to help the parties structure the project and its financing, secure consensus as to how those risks should be mitigated and, finally, accurately reflect the parties’ agreement in the underlying project agreements and financing documentation.

Before we consider further the all-important question of why the world needs project finance lawyers, we have set out below some key issues that any participant in a project financing should consider.

A Brief History of Project Finance

Although project finance techniques are applied throughout the world today in a wide range of industries, project finance can trace its roots back to ancient Greece and Rome where it was

used to finance maritime operations and infrastructure development (shipping merchants utilised project financing techniques to dilute the risks inherent in maritime trading as loans would be advanced to a merchant on the basis that the loans would be repaid through the sale of shipped cargo; in other words, the financing would be repaid by the internally generated cash-flows of the project). Project finance in the Civil Law jurisdictions of continental Europe (in the form of “public-private partnerships”) can find their origins in the Roman concession system. Project finance in the Anglo-American world came to prominence in the mid-20th century in the United States where it was used to finance mining and rail companies and evolved into its modern incarnation in the 1980s when it was principally used by commercial banks to finance the construction of natural gas projects and power plants in Europe and in North America following the 1978 Public Utility Regulatory Policy Act. Project finance techniques developed in the 1980s were subsequently honed in the 1990s in emerging markets such as the Middle East, Latin America and Asia. In the 1980s and 1990s, project financiers and sponsors (the term used to describe the ultimate owner of a project company) were predominantly based in London, New York and Tokyo.

Until the financial crisis, commercial banks had dominated the project finance lending market; however, in recent years there has been a dearth of liquidity from such institutions (an issue further amplified by the application of Basel III, which means that commercial banks now have to assign a higher percentage of their liquidity to back long-tenor commercial debt financing). As a result, many sponsors have had to look elsewhere to find sources of finance and in recent years we have seen many new entrants to the project finance market, including commercial banks from Asia, the Middle East and Latin America as well as larger roles for ECAs and DFIs. Due to funding pressures facing commercial banks, ECA direct financing has become an increasingly important feature of greenfield infrastructure finance in emerging markets. Finance has also been forthcoming from the Islamic finance market and (for the larger projects) the bond markets. A number of the institutions that have stepped in to fill the funding gap left particularly by European banks (such as Japanese commercial banks) appear to have access to relatively deep pools of lower-cost dollar funding, low exposure to sovereign debt, and continue to maintain and expand their project finance loan portfolios.

The involvement of an ECA in a project financing can be invaluable, not least due to their provision of either/both direct loans and/or credit protection for the development of projects, but also because ECAs act as important anchors and facilitators to attract commercial banks to club deals or syndications where banks would otherwise be hesitant to participate due to risk allocation or credit concerns. Similarly, the involvement of a DFI (such as the African Development Bank, the Asian Development Bank or the International Finance Corporation) can also be critical in providing a so-called “halo” effect for a project.

Although project finance is often seen as a tool for investment in emerging markets and a means of facilitating the construction of infrastructure in developing countries, global concerns relating to climate change have led to increased activity in mature project finance markets such as Europe and North America. Government stimulus programmes, targeted efforts to promote investment in renewable energy and other forms of low-carbon power, have resulted in an increase in project finance activity in jurisdictions such as Europe where ambitious renewable energy targets have been set. The focus on the “energy transition” has been accentuated and with the recent inauguration of the Biden administration, the US will now resume its commitment to addressing the issues arising from climate change which will

help drive the global shift towards renewables and other technologies (such as battery manufacturing, smart grids and micro grids).

What is Project Finance?

Defining “modern” project finance is an increasingly difficult task; there is no universally adopted definition. As project financing has evolved, it has imported techniques and market evolutions from other banking disciplines. One example of this can be seen in the increase in the use (particularly in natural resource based projects) of completion guarantees and other forms of sponsor support, which historically has not been a feature of limited or non-recourse lending. Notwithstanding this difficulty, definitions of project finance will generally focus on the basic premise that:

- a newly formed, often thinly capitalised, special purpose vehicle (the project company) will own an asset (which may at that time amount to little more than a collection of licences and contracts granting the project company the right to develop and construct the project); and
- that project company’s lenders will finance (in part) the development and construction of the project on the basis of their evaluation of the projected revenue-generating capability of the project.

There are key characteristics that are common to most project financings:

- the project is developed through a separate, and usually single-purpose, financial and legal entity;
- the debt of the project company is often completely separate (at least for balance sheet purposes) from the sponsors’ direct obligations;
- the sponsors seek to maximise the debt-to-equity leverage of the project, and the amount of debt is linked directly to the cash flow potential, and to a lesser extent the liquidation value, of the project and its assets;
- the sponsors’ guarantees (if any) to lenders generally do not cover all the risks involved in the project;
- project assets (including contracts with third parties) and revenues are generally pledged as security for the lenders; and
- firm contractual commitments of various third parties (such as construction contractors, fuel and other feedstock suppliers, purchasers of the project’s output and government authorities) represent significant components of the credit support for the project.

Risk: Assessment and Allocation

At the outset of any project financing, the project’s lenders will require a lawyer to produce a comprehensive legal due diligence report identifying the key risks to the future success of the project. This is a vital stage of the financing process, as an unidentified, and therefore unmitigated, risk has the potential to jeopardise the stability of a project. In order to produce such a report, the lawyer will need to work closely with a series of specialist advisers (typically including insurance advisers, technical advisers and environmental consultants) and local lawyers in the relevant jurisdiction.

As the project’s sponsors (who are providing the equity) and the project’s lenders (who are providing the debt) may have differing perspectives as to the likelihood of future adverse events and which party should bear the risk of those events occurring, during the financing process the due diligence of a project is of great importance because a project’s risk profile will directly influence the structuring of its overall debt and equity

arrangements. An example of how this works in practice can be seen in Middle Eastern power projects. Middle Eastern host governments deliberately structure their tendering processes for the right to build the power plant, so as to ensure that they will have to pay the lowest possible electricity tariff. Typically, this is achieved by the host government's utility company guaranteeing to purchase both the project's power capacity *and* its actual generation. This arrangement significantly decreases the project's risk profile as the lenders can take comfort from the utility's strength as the off-taker and can accurately predict the revenues that the project company will receive once the project has been constructed and is generating power. A lower risk profile allows lenders to offer longer tenors and lower margins. This decreases the sponsors' cost of funding which enables the project company to offer a more competitive electricity tariff whilst still preserving the sponsors' equity returns.

By way of contrast, in industry sectors such as mining and petrochemicals, a project company's off-take arrangements will typically be calculated by volume and the (variable) market price for its output (the project takes market risk). Because market risk means that the project's revenues are less predictable, lenders will typically require sponsors to invest a greater proportion of equity into the project. In a project where market risk is an issue, a market analyst's report, which will predict future off-take and feedstock supply prices, will be of paramount importance to lenders and sponsors alike.

In order to be able to raise finance for a project, the sponsors will need to demonstrate to potential lenders that the contractual arrangements are "bankable". The less comfortable the lenders are with provisions involving the contractor's ability to claim extensions of time or additional costs, the greater the amount of equity support the sponsors will have to provide. When asked to advise as to the "bankability" of a project, a project finance lawyer will need to pay particular attention to the supply and off-take arrangements and the risk allocation arrangements in a project's construction contract. A large-scale infrastructure project will typically have a construction contract with an established (and creditworthy) engineering and supply contractor under a market-tested "bankable" contractual form known as an Engineering, Procurement and Construction ("EPC") contract, which will typically include provisions for testing and the payment of liquidated damages in the event that the project is not constructed by a certain date. Failure to comply with any requirements of an EPC contract will usually result in a contractor incurring monetary liabilities.

The "bankability" of a project will of course differ depending on that project's industry sector or jurisdiction. By way of example, the technology risk and regulatory risk associated with a satellite project will be greater than the technology risk and regulatory risk of a power project. Similarly, the key bankability concerns for investors in a mining project situated in a developing country are likely to be influenced by factors such as political, environmental and social risk, which are not likely to be key concerns in a satellite project.

Broadly speaking, in a successful project financing, the material project risks will have been allocated (under contracts that will withstand legal challenge) through the project company's contractual arrangements with its sponsors, lenders, suppliers and purchasers, so that the party best able to bear a risk will do so. Once the project's material project risks have been identified, the key role of a lawyer is to advise as to the optimal allocation of those risks and, so far as is possible, mitigate them through the documentation process. In a perfect world, a lawyer would hope to see:

- the project's construction risk allocated to a contractor with an acceptable credit standing through a "turn-key" EPC contract;

- the project's supply risk allocated through "firm" supply contracts that guarantee a steady supply of feedstock, fuel or other necessary resources; and
- the project's off-take risk allocated through a "firm" long-term sales contract with an off-taker with an acceptable credit standing that contains firm pricing and minimum purchasing obligations (commonly known as "take or pay" commitments).

Naturally, the actual outcome will be driven by a host of commercial, legal and other factors affecting the relevant project.

Security

Project financings are, in essence, complex secured lending transactions. The willingness of lenders to extend long-term credit to a project may depend on the degree of comfort they take in the viability of the underlying security package. The structuring of security packages across jurisdictions and diverse assets can present numerous and unique challenges. The strength of the security package on offer will also impact the "bankability" of a project. The security package is key, as lenders' only collateral is the project's assets. Typically, lenders will seek to take security over all of a project company's assets. However, in a project located in an emerging market with an undeveloped collateral framework, the practical reality of creating and/or enforcing security is that it may be expensive, time-consuming and uncertain in outcome. In practice, therefore, enforcement of security over a project company's assets is generally seen by lenders as a last resort. For many lenders, the main driver in taking security over a project company's assets is, should the project company face financial difficulties, to maximise the strength of their bargaining position against (i) the project company's other creditors, (ii) the host government, and (iii) the project company's sponsors. Should a project face financial difficulties, the lenders' ability to enforce their security (with, subject to local law requirements, no obligation to share the benefits of the enforcement proceeds with anyone else) puts them in the strongest possible position in the context of any restructuring negotiations.

As noted throughout this guide:

- regimes for creation or perfection of security vary greatly between different jurisdictions – whether a security interest has been validly created and whether it has priority over competing security interests are questions of local law;
- the strength of a lender's security package will be influenced by the relevant jurisdiction's applicable insolvency law; and
- restrictions on foreign ownership of assets will impact the efficacy of a lender's security package.

Project financiers will want to establish at the outset of a project whether the law of the jurisdiction where the project is located will recognise their rights as secured creditors and, if the project company becomes insolvent, whether their claims will be dealt with equitably. Any relevant issues would typically be described in a legal due diligence report in which, amongst other things, a lawyer, working closely with local counsel, will (at a minimum) need to establish (i) whether the relevant jurisdiction has a registration system for the filing of security interests, and (ii) whether the relevant jurisdiction's courts, liquidator or equivalent officer will respect the security interests granted by a project company.

It should also be noted that in many jurisdictions (particularly those with little or no track record of complex financings) the cost of filing or registering security can be significant (sometimes a percentage of the total amount being borrowed) and sponsors may argue that the creation of security is unduly burdensome and that the practical value of the security to the lenders

does not warrant the related expense, particularly in jurisdictions with little experience of complex financings. Lenders will often seek to mitigate this by (if permitted by local law) requiring that certain of the project company's assets, such as its bank accounts, are held offshore in a jurisdiction with a favourable security regime (such as England & Wales or New York).

Foreign Investment and Ownership Restrictions

Where large sums of money are at stake, sponsors and project financiers should assume that host governments will be insistent on ensuring that they receive what they view as their rightful share of the profits of a successful (i.e. revenue-generating) infrastructure project. As host governments will often require project companies to be incorporated under local law, it will need to be established at the outset of a project how the law of that jurisdiction may affect the governance of the project company. The sponsors will look to satisfy themselves that the project company has the ability to distribute surplus funds to its shareholders. Foreign sponsors (who are shareholders alongside domestic sponsors) will wish to satisfy themselves that whatever rights they have over the project company will be both respected and enforceable. Lenders will also take an interest in how the legal regime of the relevant jurisdiction treats foreign sponsors, because, should they need to enforce their security and sell the project company assets, they may eventually need to replace the original sponsors.

Regulatory Restrictions

Typically, a host government will impose certain regulatory restrictions on how its public utilities, natural resources and infrastructure are owned and operated. It will therefore need to be established at the outset of the project what impact, if any, that country's regulatory regime will have on the project's construction and operation.

For most projects, the legal analysis of the regulatory environment will involve two basic areas of investigation: (i) a determination of the rights granted to, and the obligations imposed on, the project company; and (ii) an assessment of the risks associated with the change in a country's regulatory regime. In order to minimise the risk involved in infrastructure development, a host country will demand that a project be completed to the government's specifications as quickly as possible and seek adequate safeguards and assurances that the project will be operated properly and in line with the public's interests.

The second of these two areas of investigation is particularly important because, although initial certainty as to the scope of a jurisdiction's regulatory regime may be achievable, there will always remain the risk that the regulatory regime will change. In circumstances where there is significant uncertainty as to the stability of a jurisdiction's regulatory regime, in order to encourage foreign investment in their infrastructure, host governments may be willing to enshrine specific contractual commitments into national law, thereby allowing greater certainty that those commitments will have precedence over competing, and often inconsistent, laws and regulations. The host government may also opt to enter into direct contractual undertakings with the project company and/or its sponsors. These vary from legally binding undertakings, the breach of which will entitle the claimant to sue for damages or other pre-agreed levels of compensation (such as termination payments which cover the project company's outstanding indebtedness), to "comfort letters" which offer little, if any, certainty of remedy.

Government Approvals

In addition to the above-described regulatory restrictions, a host government will usually require any large-scale infrastructure project to obtain a broad range of permits and consents in relation to matters such as site use, environmental impact, health and safety and industrial regulation. In order to determine the permits and consents that will be required by a project company, a project finance lawyer will need to work closely with local lawyers and specialists in the relevant jurisdiction. These specialists will also advise as to the existence of any restrictions on the provision of insurance by foreign insurers, the hiring of foreign workers and importing equipment into the country. At a minimum, any legal due diligence report should identify:

- what permits and consents the project company will require in order to carry out its business;
- whether enforcement of any security interests over a project's assets could lead to a permit being revoked; and
- whether, following the enforcement of a security interest, the entity to whom the lenders sell the project would be entitled to the benefit of that project's permits and consents.

Risk relating to regulatory restrictions and approvals may be mitigated by obtaining legal opinions confirming compliance with applicable laws and ensuring that any necessary approvals are a condition precedent to the drawdown of funds under the loan agreement.

Environmental & Social Issues

Large-scale infrastructure projects will inevitably have an environmental and social impact and sponsors seeking access to the financial markets will usually need to demonstrate a high level of environmental and social compliance. Most industrial facilities emit at least some waste and pollutants into the air, water and soil, and require permits and other authorisations to operate. Environmental concerns have become more prominent as a result of increased public awareness, more stringent environmental, health and safety laws and permitting requirements, and heightened liability for the identification and clean-up of hazardous materials and wastes.

Traditionally, lenders have required, at a minimum, that the project company undertakes to comply with all applicable environmental and social laws and regulations; however, in recent years, lenders (especially ECAs and DFIs) have typically required the project company to adhere to a set of guidelines known as the "Equator Principles", which are a financial industry benchmark for determining, assessing and managing social and environmental risk in project financing. The Equator Principles incorporate the International Finance Corporation and World Bank environmental performance standards and guidelines. Thus, the Equator Principles extend these international project-based environmental and social standards into the realm of private financings. Amongst other things, adherence to the Equator Principles requires the project company to develop and comply with an agreed environmental and social management plan focusing on areas such as:

- labour and working conditions;
- pollution prevention and abatement;
- community health, safety and security;
- biodiversity, conservation and sustainable natural resource management; and
- protection of indigenous peoples and cultural heritage.

While such requirements are principally for the protection of the project's host country, they are also very important for lenders, as high-profile international lending institutions do not want to be associated with projects that have an adverse environmental or social impact (and the reputational damage potentially caused by any resulting negative publicity).

Governing Law Issues

Sponsors and lenders to large-scale cross-border infrastructure projects will typically seek to have the finance documentation governed by either English or New York law. Although the law of each of these jurisdictions in relation to the enforceability of customary finance documents is broadly similar, lenders may still have strong preferences based on familiarity with customary forms and terminology. However, sponsors and lenders will not usually have the ability to choose the governing law of the project's other agreements, as conflict-of-law principles, such as the doctrine of *lex situs* (the rule that the law applicable to proprietary aspects of an asset is the law of the jurisdiction where the asset is situated), may dictate which law is to be applied for specific purposes (notably the creation of security interests). Although there is no equivalent legal doctrine that stipulates that project agreements should be governed by the law of the jurisdiction in which the project is located, it is often a requirement of the host government that its own domestic law be specified as the governing law of certain agreements. This is particularly true of any agreements to be signed by the government or a governmental entity.

Since the manner in which a project's agreements will be interpreted or enforced will differ, sometimes significantly, according to the governing law of the contract, the following will need to be established at the outset:

- the effectiveness of the choice-of-law clause to govern the various project agreements; and
- the extent to which agreements governed by local law are legal, valid, binding and enforceable (i.e. whether there are mandatory provisions of local law that will override the terms of the contract).

It is of course of fundamental importance that the parties are aware at the outset of the project if a country's domestic law prohibits fundamental aspects of the transaction (for example, a project company's obligation to pay interest on a loan is unenforceable in some jurisdictions by virtue of general principles of Islamic *Shari'ah* law).

Disputes

A project finance lawyer will also be concerned with establishing the impact of the choice of the forum for the determination of disputes arising from the transaction (including the extent to which judgments or arbitral awards that emanate from that forum will be enforced in other relevant jurisdictions). Of particular interest to lenders and sponsors will be the following issues:

- Is the forum likely to be neutral in its decision-making?
- Will the chosen forum apply the law specified by the parties in the contract?
- Which evidential or procedural rules will apply in the forum?
- Will judgments or arbitral awards be enforced in the home jurisdictions of the parties to the dispute?

As a result of the increasing popularity of arbitration as a means of settling disputes, the parties will also need to consider at the outset whether any dispute should be the subject of judicial or arbitration proceedings. The advantages in opting for judicial proceedings will depend on the country in question; however, key considerations will be:

- Do the country's courts have a tradition of reported case law or judicial precedent (in order that a party might be able to predict the likely outcome of a dispute)?
- Are there established procedural laws?
- How independent is that country's judiciary from the legislature and executive?

In recent years, the election of arbitration as a means of settling disputes has become increasingly common, due to the relative speed and privacy that an arbitral process affords. Another significant advantage of arbitration, given the often complex nature of disputes that arise from project financings, is the ability to designate an arbitrator better equipped to address complex technical issues than a judge with more general skills. It is also the case that, in some instances, an arbitral award may be more likely than a court judgment to be enforced in the home jurisdiction of the party against whom it is made, as international treaty arrangements, such as the New York Convention, call for Member States to give effect to arbitral awards made in other Member States.

Judicial proceedings, in some circumstances, may still be preferable to arbitration, particularly if that jurisdiction's courts have the ability to compel parties to refrain from certain actions, disclose documents and order interim relief (which can be very useful when one party is seeking to prevent another party from moving assets out of a jurisdiction). Further, there is a perceived tendency of arbitrators to arrive at compromise positions – so-called “rough justice”. For these reasons, lenders will typically insist that the finance documents include an arbitration clause which applies only for their benefit, thus preserving the possibility of recourse to the relevant jurisdiction's courts. In addition, as arbitration is a product of contract, only parties that have specifically consented to the arbitration of a dispute can be compelled to proceed in that forum.

Sovereign Immunity

Another potential issue that a project finance lawyer must consider is the possibility that host governments or state-owned stakeholders in the project (and their assets) may well be immune from proceedings before the courts of the host state, with the result that a successful judicial or arbitration proceeding may prove to be a wholly unsatisfactory means of recourse. Sovereign immunity is widely acknowledged to be a matter of international law. However, there may be exceptions to its application, which means that, if required, sovereign immunity can usually be mitigated at the outset of a project, either because as a matter of local law a state entity acting in a commercial capacity may not benefit from immunity in all (or any) circumstances, or because it is usually possible for a state entity to waive its right to immunity.

Change of Law/Political Risk

As project finance loans are generally repaid over a relatively long timeframe, the host country's laws are liable to change during the tenor of the project's debt. Political risk arises from actions by host governments that have a negative impact on the financial performance or commercial viability of a project. In an unstable country where regime change is frequent and competing policy objectives vary widely, it follows that the risk of a change in law adversely impacting a project will be greater. At the more extreme end of the scale, actions by a host government, such as expropriation of the project or the imposition of restrictions on the repatriation of a project's foreign currency earnings, can have an extremely negative impact on the commercial viability of a project. Economic cycles will shift the relative negotiating balances between investors and host governments and, as a host country's economy develops, its government may seek to re-negotiate contracts in order to extract more favourable terms.

As practitioners of energy law in Europe will attest, this is not just an issue in emerging markets. In 2011, in response to the Fukushima nuclear disaster, host governments in Germany and Italy took significant decisions with regard to their nuclear programmes that would have long-term impacts on the price of energy and the direction of energy infrastructure investment in Europe. The premature shutdown of nuclear power plants in countries such as Germany makes the long-term revenue streams of nuclear power projects less certain for sponsors, especially in countries where policy decisions are greatly influenced by public opinion.

Notwithstanding this uncertainty, at the outset of a project, sponsors and lenders will still seek to satisfy themselves that they are comfortable with the political, judicial, economic and social stability of the country in which a project is situated. In cases where there are concerns as to the stability of the host state, such concerns may be capable of being addressed through the use of political risk insurance (for many commercial lenders, political risk insurance is often a prerequisite to their internal credit approvals) or the involvement of multilateral and other public sector lending institutions (such as ECAs and DFIs) whose participation may act as a deterrent to adverse interference by the host government. Other potential mitigants to political risk include:

- requiring the host government to “freeze” the laws that apply to the project company (through, for example, the execution of investment agreements);
- requiring the project’s off-takers to compensate the project company through tariff adjustments to cover increased costs arising from changes in law or regulation; and/or
- reliance on bilateral investment treaties which afford nationals of a contracting state treaty protection from specified actions by the government of another contracting state.

Tax and Customs

Virtually all projects are subject to some form of taxation, and the tax regime will generally have a significant impact on the project’s economics. Typically, a project company will be required to pay corporate tax which will be determined on the basis of the profits that it generates. In some jurisdictions it may also be obliged to pay royalties to the host government calculated on the gross value of its sales. Stamp taxes, registration taxes and notarial fees may be significant and may also impact on a project’s economics. In addition to establishing the level of such fees and taxes at the outset, a project’s sponsors and lenders will want to know whether the laws of the host country will require the project company to make withholdings on account of tax on interest and dividend payments it makes to overseas lenders and shareholders.

If interest payments made by a project company to its lenders attract withholding tax then those lenders will require the project company to “gross up” interest payments so that they receive the same amount of interest that they would have received in the absence of the withholding tax. The role of a lawyer in this scenario will be to determine if relief from the effects of withholding requirements can be found under an applicable double taxation treaty or the domestic tax laws of the jurisdiction in which the investors or lenders are situated.

Whenever goods or individuals cross a border, they become subject to the laws of both the country they are leaving and the country they are entering. It will be necessary to ensure that the project company has the ability to import into the host country the goods, equipment and raw materials required for the project,

as well as the ability to employ expatriate managers, engineers and labour. Typically, customs restrictions will take the form of simple import duties; however, certain jurisdictions impose absolute prohibitions on the import of certain goods. The immigration laws of many countries will permit the employment of qualified expatriates on a limited basis, but prohibit the employment of expatriates without particular skills or qualifications. Some host countries may permit a large influx of foreign workers during the early stages of a project (particularly during the construction phase), after which indigenisation laws may require that an increasing number of local citizens be trained and employed by the project company.

Why Does the World Need Project Finance Lawyers?

As well as the ability to negotiate a deal that works for all parties throughout the life of the project, project finance lawyers need to be able to assess the bigger picture, understand which points really matter in the overall commercial context, and, as the quote at the beginning of this chapter alludes to, try to ensure that what is already a complex and challenging undertaking does not become unnecessarily complicated.

Given the long-term nature of a project financing, the documentation must be sufficiently robust to withstand long-term volatility. It is also important that the parties realise from the outset that, even after the relevant financing and project documentation has been executed, they must make an effort to sustain the relationships that underpin the project. This is because, no matter how extensive or well-drafted the legal documentation, virtually every project encounters technical or commercial problems over its life, and will face some kind of economic, political or legal change. Despite the mountain of documents governing the project participants’ relationships, issues that had not been contemplated at the time of signing (and which are therefore not addressed in the documentation) can, and often do, arise. A key role for the project finance lawyer is to attempt to minimise the frequency with which any project encounters problems, by undertaking a careful initial assessment of the project risks and encouraging a consensual approach between the parties to resolving risk allocation issues which arise.

Given the complexity of the process and the large sums of money at stake, project financing is a document-intensive process and project finance lawyers play a crucial role in managing that process. In many ways, the legal skills required to close a project finance transaction are often as much to do with process management as legal analysis and drafting. As it is not unusual for a project’s sponsors, lenders and advisers to be based in different jurisdictions across differing time zones, keeping on top of the complex set of documents required for the closing of a project financing can be a significant undertaking, and it is important that the lawyers work together to ensure that signing arrangements do not become overly complex or contingent.

Today’s project finance market sees sponsors and lenders from increasingly diverse backgrounds working together on larger and more complex projects in ever more remote and challenging jurisdictions. In this exciting and evolving marketplace, project finance lawyers have the unique and crucial role of being able to advise their clients, whether sponsors or lenders, on the effective management of risk in order to enable them to continue to push the frontiers of project financing and ensure the development and construction of much-needed large-scale infrastructure projects around the world.



John Dewar is a partner in the London office of Milbank LLP and a member of the firm's Global Project, Energy and Infrastructure Finance Group. John is widely recognised as a leading individual in his field by a number of journals, among them: *Chambers UK* (which designated him among the first tier of project finance lawyers in the UK), *Chambers Global*, *The Legal 500*, and *Who's Who of Project Finance*. He has built an extremely broad practice and outstanding reputation for advising on the most innovative and significant "market first" transactions around the world. His practice focuses on advising parties in the development and financing of oil and gas, natural resources, independent power, telecommunications, satellite and other infrastructure projects. He has particular expertise in multi-sourced financings, including those involving multilateral and export credit agencies and Islamic institutions.

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