Contractual Relationships and Agreements in Project Finance

BY RICHARD MANGI

Introduction

In my previous article, we discussed the pitfalls in project finance as well as the mitigants and this week's article focuses on the central themes that have emerged in relation to the importance of contractual relationships in project finance. Because of the long term nature of projects, commitment to deliver by parties in a project finance arrangement is therefore paramount in order to entice project funders to participate in the project.

The calibre and track record of the parties executing agreements requires proper due diligence to ensure confidence by all parties. The selection process of parties to a project which may include public or private tendering, also lends credence to the calibre of the parties in the project. The various relationships of parties in a project finance transaction are therefore safeguarded by entering into contractual agreements by the various parties.

Figure shows the diverse relationships in a typical project finance transaction. This article will focus on the various contractual relationships, what they entail and their importance in a project finance transaction.

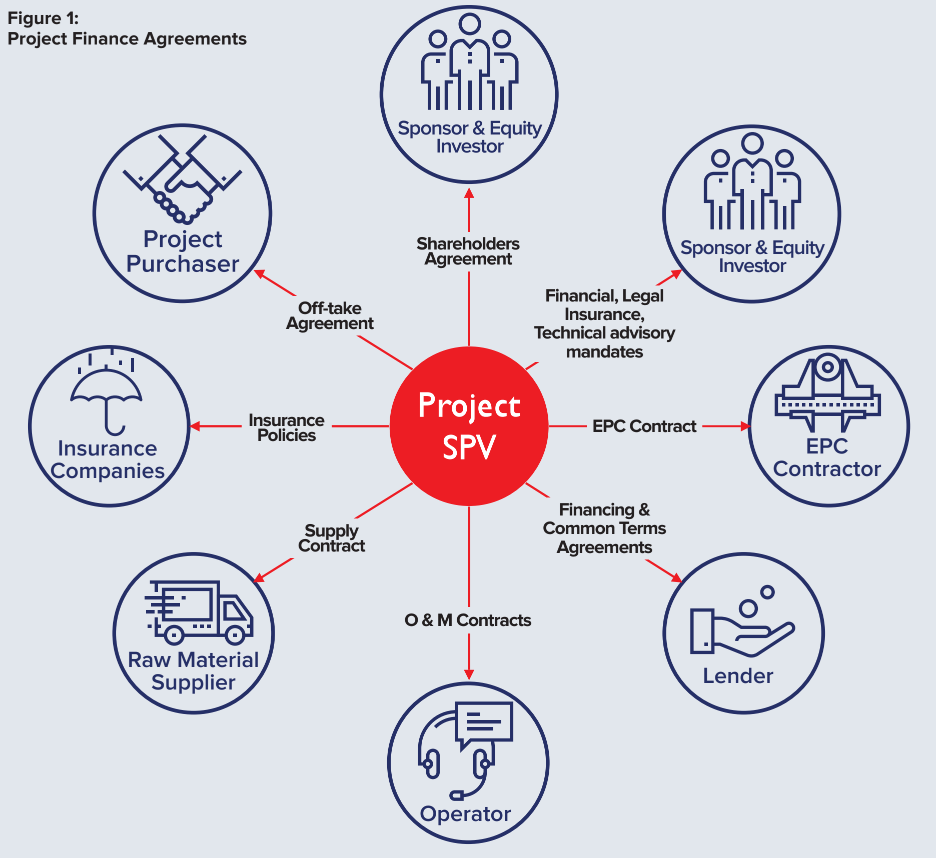

Figure 1:
Project Finance Agreements

Some of the most important contractual arrangements that project finance funders and other stakeholders are keen to review include the following:

1. Shareholder Agreements;
2. Engineering, Procurement and Construction Contract (EPC);
3. Financing Contracts;
4. Operations and Maintenance ("O&M") Contract;
5. Concession Agreements;
6. Off-take agreements; and
7. Supply Contracts.

Shareholder Agreements

Shareholder agreements basically define the nature of the contract between the shareholders of a company in which they agree on how the Project Company will be run. Generally, the relationships between the shareholders and the company are also regulated by the Memorandum and Articles of Association. The Shareholder Agreement is considered an important document that guides the relationship between shareholders with respect to the company. Shareholder agreements therefore seek to provide protection around ownership and the procedures to be taken in relation to certain decisions.

Shareholders' agreements are generally considered confidential between the parties to the agreement unlike a company's constitutional documents which are available for public inspection. In project finance transactions, parties such as Bankers, EPC contractors and Insurance companies usually want to be privy to the shareholder agreements in order to fully understand the status of the contracting parties. Areas of interest include modalities for injection of share capital by shareholders, voting rights which have implications on protection against a majority using their voting power to the detriment of project funders, and project dividend policy to assess whether it is detrimental to achievement of financial covenants details under the section on financial agreements. Transfer of shares by a shareholder and dispute resolutions also have implications on effective resolution of disputes that may arise without jeopardising the progress of the project.

EPC Contract

The EPC Contract is one of the most important contracts in project finance as it gives responsibility to an entity for critical project activities such as design, procurement, construction, commissioning and handover to the end-users or project owners. The contractor is awarded the contract to build and deliver the project on a turnkey basis, at a pre-determined price. An EPC contract is normally complicated as it has to deal with facets of the procurement process, certainty of final price in the face of cost escalations and completion date.

Project promoters and Lenders in EPC/Turnkey projects are particular about price certainty and completion dates as these aspects determine project cost and return on the project. The conditions of Contract for EPC/ Turnkey Projects are usually based on the Silver Book published by the International Federation of Consulting Engineers (FIDIC). The FIDIC Silver Book, was originally produced in 1999, in response to the need to ensure certainty of final price and completion dated in project finance contracts.

It is therefore recommended that the EPC contractor engages specialists in the negotiation and execution of EPC contracts in line with FIDIC Silver Book. Compliance to the tenets of FIDIC Silver Book is therefore of interest to financiers and promoters in order to manage risks during construction.

In EPC contracts, prominence is also given to the testing, commissioning and handover of the works and how this is to be undertaken given that Lenders' security in a project finance arrangement is dependent largely on the ability of the completed facility to operate and generate revenues. In this regard, the FIDIC Silver Book stresses that completion of the project should be considered together with passing of tests on project completion.

Of importance to the Project finance lenders with respect to the EPC contract is the credit quality of the main contractor or its parent company as the contractor may be called upon to provide guarantees for obligations under the EPC contract. In the event that the contractor does not deliver the facility by a specific date, the contractor may be required to pay damages for each day the project is not completed.

Operations and Maintenance ("O&M") Contract

Prior to delivery of the project, the Project Company and project finance lenders place focus on operation of the project to generate cash flows. The O&M contract sets out the terms and conditions under which the operator agrees with the Project Company to operate and maintain the facility in accordance with specified performance standards.

The Project Company and Operator establish their relationship through an O&M contract. This contract will effectively delegate the operation and maintenance obligations to the operator. The operator can be one of the sponsors of the project or they can be a third party operator. The important aspect in the selection of an O & M partner is to ensure that operations and maintenance risk is mitigated. This is usually achieved by choosing an experienced operator with a strong track record of operating assets of a similar nature and size. Just as highlighted in EPC contracts, O&M contracts usually include liquidated damage provisions to mitigate the risk of poor performance. It is usual that original equipment manufacturers can be given the O & M Role and this would be a preferred arrangement by funders as manufacturers have an in depth knowledge of the equipment and are able to provide original backup parts and services, thus limiting equipment downtime.

Financing Contracts

Financing contracts require an appreciation of all the other contracts depicted in Figure 1 above. In most instances the other contracts may not merely be conditions precedent to the financing contracts but are a prerequisite before even negotiating a term sheet for the facility agreement.

The drafting and review of financing contracts normally takes prolonged periods of time mainly because the inputs into a financing agreement are determined by the finalization of several other agreements such as the EPC contract.

The nature of the funding agreement depends on the proposed type of funding that best suits the proposed utilisation within the project. Funding agreements therefore can take the form of supplier credit agreement, senior debt or junior debt funding arrangements, bond issue, lease finance facilities for equipment and project vehicles, overdraft facilities for working capital and mortgage finance facilities for project buildings.

In all these forms of funding agreements, certain basic provisions of financing contracts are apparent, notably the following:

Economic Terms of the Loan

Economic terms of the loan focuses on the facility tenor, repayment schedule and the rate of interest.

Financial covenants

A peculiar aspect of project finance agreements are financial covenants that the project is expected to adhere to during the loan period. Cover ratios are used on a continuing basis to evaluate the performance of the project over the life of the project. Period of testing and the consequences to the borrower/ Project Company and the project sponsor are also important aspects.

Some of the common cover ratios in project finance include the Debt Service Coverage Ratio (DSCR) which compares the amount by which the net cash flow for a given period, usually 12 months, exceed the debt service requirement. The Loan Life Coverage Ratio (LLCR) compares the net present value of the future revenues during the agreed term of the loan with the debt outstanding on the day in question. The debt to equity (DTE) ratio seeks to ensure that project sponsors on a continuing basis are also taking agreed risk in the project.

Financial covenants are meant to protect the interest of the lenders by ensuring that the project company or promoters do not prioritise dividends or other operational expenses before meeting debt obligations. Failure to adhere to the financial covenants may see the financier taking over the project by exercising step-in rights which may include instituting management and board changes in order to secure repayment in the future.

Conditions Precedent

These refer to conditions that should be met prior to lender authorising a drawdown of the requested facility. Common conditions precedent include regulatory approvals, RBZ Exchange Control Approvals, and execution of any of the contacts depicted in figure 1.

Availability period,

Availability period is an important component of the financing agreements as it specifies the period the lender is obligated to disburse the funding. Funders need to have liquidity available to meet loan disbursement and as such this clause partly enables planning the lender's cash flows so that they do not hold the funds indefinitely but rather deploy them to other projects once availability period expires. Failure to utilise funding within the given availability period may also point to challenges in project implementation or failure to meet conditions precedent.

Representations and warranties

The representations and warranties are the statements of fact made by the borrower to the lender at the time the financing agreement is signed hence the borrower signifies that they fully understand that the lender is relying on the truth of those representations. Usually a breach of representations and warranties is an event of default. Common representation and warranty include compliance with laws, director's powers to execute the facility agreements and that necessary operating regulations and license are available for the business to commence operations.

Concession Agreements

Public Private Partnerships ("PPP") entail an entity granting a private company the right to develop and operate a facility or system for a certain period. The Concession Agreements form the main documentation to be executed between the private and public entity which could be Government of a Municipal Authority.

The exact nature of the Concession Agreements, depend on the particular outcome desired by the project promoters. These outcomes relate to mechanism of delivering the project and the desired mechanisms for compensation to the private party in the PPP arrangement.

Some of the various types of Concession Agreements include the Build Operate Transfer (BOT), Build Own Operate Transfer (BOOT) Build Own Operate (BOO); and Rehabilitate Own Operate Transfer (ROOT). The basic tenet of PPPs is that the Project procurement requires that the concessionaire provides a certain set of deliverables before they can own or operate a project.

The concession period which typically could be a period of ten to thirty years should be long enough to fully amortize the investment in the project and earn a return from the investment.

The pricing of the end product to recoup the investment is an important aspect in a PPP agreement. In most instances, the pricing mechanism is such that the private entity recovers revenue from the public entity in the event that certain revenue thresholds are not achieved.

Off-take Agreements

An off take agreement in project finance transactions ensures that there is a ready market to utilise the resultant product or service delivered by the project. As discussed above, a project finance transaction is principally hinged on the ability of the project's cash flows to meet future repayment obligations to lenders of the project. This ability is however drawn from the nature of the project's off-take. In power projects, security of an offtaker for energy generated by a project is normally in the form of a Power Purchase Agreement (PPA). The PPA will define the project's output to be bought and the tariffs to be charged. Particular attention will be given to the impact of the proposed pricing or tariffs on the project's financial model. It is therefore important to ensure that the tariffs agreed to in an off-take agreement provide positive cash flows that will enable the project company to repay debt and provide a return to investors.

Supply Contracts

In instances where the project will require feedstock or raw materials for it to operate, long term supply contracts are of paramount importance. Typically, in energy projects such as power plants which are fired by coal, diesel or other forms of fuels, the project financing process will concentrate on putting in place long term feedstock supply contracts that match the general terms of the corresponding off-take contracts such as the output required, length of the contract, failure to deliver because of supervening events beyond the control of the supplier.

Conclusion

Successful project finance transactions are hinged on the quality of relationships created in the development stage of the transaction. It is therefore vital to ensure that sufficient work by a team of advisors notably, legal, financial, and technical is done in the drafting, review and execution of project finance agreements. These agreements will govern relationships in a project and give remedies to other parties whilst ensuring minimum disruption to the project delivery schedule. Project finance is considered document intensive as various agreements are drafted and reviewed professionally and thoroughly, often to achieve project deliverables and provide sufficient legal cover and remedies in the case of disputes.

Richard Mangi is Deputy Divisional Director, Investment Banking, CBZ Holdings Limited. He writes in his personal capacity and is reachable on rmangi@cbz.co.cw