

# Project Finance for Infrastructure



# Principles of Project Finance

In recent years, development of infrastructure PPP projects is taking on a larger profile in middle to large size African countries. Under impetus of the PRC government Belt and Road Initiative (BRI), selected countries, PRC government loans are funding major state infrastructure projects. Over time, there is expectation that BRI projects will be more often under the PPP model driven by large financial commitment of PRC-based investors and lenders. African PPP project stakeholders can and will be able to get up the learning curve quickly by review of both recent Africa experience and longer history lessons learned from Asia and the Middle East. In Africa, as in most economies, services such as power generation, transportation – rail, road, ports and airports – water, solid waste, health, and education are seen as essential services, which the economy and population require for sustaining economic growth and development. There are many candidate projects for PPP amongst these sectors so prioritization and selection must be done carefully.



## 3 Key Pain Points for Developing An Efficient Project Finance Programme

An efficient Project Finance programme involves a lot of collaborative efforts in the options available to PPP project developers, contractors and funding sources. Also, early stage identification of critical path items must be resolved for project implementation to prudently proceed. Moreover, Risk-Reward parameters for major stakeholder must be completely defined which factor into overall PPP Risk Allocation Structuring. Following are the key pain points that need to be solved for developing an efficient Project Finance programme:

**Risk Identification,  
Analysis &  
Mitigation**

**How Basel III  
Can Help in Risk  
Mitigation**

**Project Documents:  
PPP Concessions**

# 1. Risk Identification, Analysis, & Mitigation

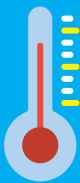
In Public-Private-Partnership (PPP) model, it is of utmost importance to identify, analyse, and mitigate risk. Since large sums are lent, banks come into play. Thus lenders need to understand Basel III provisions and their implementations. Also along with Construction period risk – Delay, Cost Overrun, Performance shortfall, Operating period risk – Revenue decreases, expense increases, force majeure outages etc. are a few things that need to be taken care of. Let's understand in detail how to identify, analyse, and mitigate the risks that come along our way.



In the course of executing construction projects, a lot of risks associated with construction such as delay and cost over-run etc. take place. Let's discuss about them and find out ways to identify and mitigate them.

## A. Delay

### Poor Weather



- i. Rain can turn your excavation project such as a freshly dug hole into a mud pit, which can swallow a machine or an excavator that steps into it.
- ii. High winds can hinder the construction of high rise construction or a roofing job. Also natural disasters such as floods and tornadoes can cause massive damage.
- iii. To protect the project from poor weather conditions, contracts need to include clauses for allowances. Activities like concrete pours need to be rescheduled in accordance with the work schedule.

### Shortage of Budget



- i. The worst scenario is when the construction firm runs out of money while building the project.
- ii. The construction firm should have access to job costing utilities and real-time updates on the firm's financial status.
- iii. The firm should maintain a job costing software for accurately estimating costs and ensuring that each job can bring higher profits.
- iv. The firm should slowly and steadily move to a position where it possesses a lot of collateral so that banks feel flexible to provide loans. This can help pay workers and buy last materials for a project in order to avoid costly delays.

### Substandard Contractors



- i. Many a times due to lack of tools, training, experience, or the required methodology, employees may spend more than required time chatting and in breaks. This hampers productivity.
- ii. Firms should always keep in mind to employ only full-time employees and inform them on what is expected of them. It is also important to inform the employees beforehand that they will be held accountable for producing results.



**31%**

of All  
Projects  
Came Within

**10%**

of The Budget  
in The Past  
3 Years

## B. Cost-Over Run

### Budgeting Error



- i. This can occur due to various mathematical errors like miscalculations or due to transcribing.
- ii. This can also happen due to errors or vague drawings while charting out the construction plans.
- iii. The solution to this problem is that the estimator must double-check the estimate. After this, a competent third party should be assigned to triple check the estimate. In case if there are any doubts, a request to the client for the appropriate documentation should occur in text.

### Cost of Tools & Equipment Exceed Project Allocation

- i. This problem can occur due to inefficient equipment scheduling, poor record-keeping or due to absence of strict punishment at times when people do not return the tools.
- ii. The problem can be mitigated by not allowing rental tools and equipment to stay on a project if they are not required.

### Easily Missed Costly Errors



- i. This can occur due to accounting errors, unchecked deliveries and invoices.
- ii. The manager should check the invoice against the order. If it varies, the invoice should have documentation that imparts a justifiable reason to why it differs.

## 2. How Basel III Can Help in Risk Mitigation

### Financial Stability

#### 1. Minimum Capital Requirements

##### a. Capital Requirements for Credit Risk

- i. Standardised Approach
- ii. Foundation IRB Approach
- iii. Advanced IRB Approach

##### b. Market Risk

- i. Standardised Approach
- ii. Internal VaR Models

##### c. Operational Risk

- i. Basic Indicator Approach
- ii. (Alternative) Standardised Approach
- iii. Advanced Measurement Approaches

#### 2. Supervisory Review Process

##### a. Regulatory Framework for Banks

- i. Internal Capital Adequacy Assessment Process
- ii. Risk management

##### b. Supervisory Framework

- i. Evaluation of internal systems of banks
- ii. Assessment of risk profile
- iii. Review of compliance with all regulations
- iv. Supervisory measures

#### 3. Market Discipline

##### a. Disclosure Requirements of Banks

- i. Transparency for market participants concerning the bank's risk position (scope of application, risk management, information on own funds etc.
- ii. Enhanced comparability of banks

## 1.

**The 3 Main Up Gradations by Basel III**

- a. Incremented the capital for credit risk
- b. The definition of capital has been tightened
- c. The issue of liquidity risk has been addressed

## 2.

It improves on Basel II by introducing a loan loss provisioning system that require banks to set aside specific provisions on newly-originated loans based on individual borrower traits that steers the performance of the loan.

## 3.

By improving the quality of the underlying data that generates provisions buffers, banks will be able to eliminate inaccuracies in current LLP models that produce unnecessarily high (or low) and insufficient buffers and to ensure that data quality on collateral are optimal rather than suboptimal. This guarantees subsequent discretionary increments in provisions for each credit risk category, which would bring provisioning closer to expected loss on each credit risk category.

## 4.

Introduction of through-the-cycle LLP estimates ensures that banks that embrace a through-the-cycle approach for probability of default (PD) estimates and expected losses (EL) can increase their accuracy of LLP estimates and reduce volatility in their estimates.

### 3. Project Documents: PPP concessions

In a PPP project, there are various documents, agreements, guarantees, rights and commitments that one needs to take care of. Some of them are as follows:

**A. Offtake Agreements****B. Force Majeure****C. Termination & Step-In Rights****A. Offtake Agreements**

Offtake agreements are negotiated between buyers and sellers even before the development of the project, and become effective when project development is completed and production comes online. There are a plethora of Offtake agreements such as Take-or-Pay Contracts, Take-and-Pay Contracts, Contract for Differences, Hedging Contracts etc. Let's discuss the benefits it provides to the Project Company and to the Off-taker.

**Benefits to The Project Company:****i.**

In a very large part of the agreement, project Financing was approved due.

**ii.**

For a long time in the future, a substantial part of future production is sold.

**iii.**

Income is guaranteed under the agreement for a long tenure.

**iv.**

For a substantial time, the project company earns a predictable profit.

**Benefits to The Off-Taker****i.**

The offtake agreement allows the offtaker to lock-in a long term supply.

**ii.**

The offtaker receives a guaranteed price along with guaranteed supply.

**iii.**

The contract provides a protection against increase in future prices.

**iv.**

Since the delivery is guaranteed, the off-taker is hedged against shortages in the market.

## B. Force Majeure

In case of occurrence of a Force Majeure event, the Affected Party shall be entitled to relief from its obligations under the PPP Contract if it meets the following requirements:

a. In any event within 7 business days after the Force Majeure Event has caused or is likely to cause breach of an obligation under the PPP Contract, give a notice to the other party of its claim for relief from its obligations including the following:

<b>i.</b> Adequate evidence of the Force Majeure event.	<b>ii.</b> Elaborated details regarding the nature of the Force Majeure event.	<b>iii.</b> Date when it occurred.	<b>iv.</b> How long will it continue.	<b>v.</b> Extent of the event.	<b>vi.</b> Steps taken to mitigate the Force Majeure event.
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b. Express the following things to the other party:

<b>i.</b> Such occurrence could have not been avoided without incurring material cost by the affected party and its contractors.	<b>ii.</b> The affected party could not mitigate the relief claimed, including the recourse to alternate materials and services, without incurring material cost.	<b>iii.</b> To diminish the consequences of the Force Majeure event, the affected party is using all possible and reasonable endeavours.
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c. The affected party should keep in mind that if they obey all the information under the clause, then it shall be excused from the performance of its legal commitments by reason of the Force Majeure Event.

d. The affected party should keep in mind that it shall not be entitled to any relief during the period if the information required under the clause is provided after the dates as mentioned in the clause.

## C. Termination & Step-in Rights

Although lenders are not a contracting party to the PPP Contract but the PPP project cannot be executed without their presence. Thus, lenders seek to obtain comfort by regulating the right of the contracting authority and the private sector. This is achieved by the “Direct Agreement” amongst private partner, contracting authority and the lenders. Under this the lenders often require certain rights:

a. In case of Private Partner default under the PPP contract, lenders require information rights which could allow the Contracting Authority to terminate the PPP Contract.

b. A standstill period, according to which the contracting authority will notify the lenders if it wants to terminate the PPP contract, and will abstain from abandoning the contract for a given period of time

c. For curing any issues that may give rise to the contracting authority’s right to terminate, lenders may demand appointment of an additional obligator to “step-in” and become jointly liable with the private partner.

d. Lenders may demand the right to novate the Private Partner’s rights and obligations under the PPP contracts to substitute a private partner of their choice.

e. As a condition precedent to drawdown under the Senior Finance Documents, lenders may also require Step-in-rights. But jurisdiction in certain places have laws that prevent granting such rights. Thus, it must be thoroughly checked.

Today, there are myriad programmes on Project Finance, but unfortunately, most of them are devoid of tools that can train Project Managers, Project Sponsors, Contractors, Chief Credit officer and Chief Finance Officer on how to develop a sound Project Finance program. This program will train the participants by imparting better understanding of the business and institutional dynamics of each major stakeholder in the PPP Project Development and Finance Process. Also, Prudent Risk allocation and Contractual Framework between Government and Project Developer will be discussed in detail in the program. In our 3 day masterclass, Stephen Wermert, will teach you how to sail your way through the nitty-gritties of Project Finance through presentations, exercises, case studies & group discussions. We urge you not to miss this opportunity, and take home expert skills related to Project Finance.



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