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Limited Recourse Financing in Project Finance

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ABSTRACT

Project finance has become a popular way to fund large-scale, capital-intensive projects including power plants, oil pipelines, highways, and tunnels, among other things. In a project finance arrangement where the project's lenders have limited access to the sponsoring company's assets, we examine debt capacity and risk selection. We draw a comparison between project finance loans with limited recourse and susceptible financial guarantee loans. We demonstrate the trade-offs between risk and debt capacity using contingent claims analysis in instances where the project's lenders have recourse to the sponsor's assets and in cases where they do not.

Keywords: *finance, lenders, limited recourse, trade-offs, risk, debt, assets.*

I. INTRODUCTION

If a consideration is given towards determining the driving forces behind the current global economy, the development of the industrial and the infrastructure sectors would score very high, probably second only to the global politics. Hence their importance could not be stressed upon any further. However, the major hindrance or issue that arises with these sectors is that: (a) the projects are essentially of a capital intensive nature, and hence it is extremely difficult for an investor to carry out the project single-handedly; and, (b) the risk factor involved is high enough to discourage any investor from venturing into such project development, even if he has the adequate resources. Thus, as a solution to address these issues, project financing as a mechanism to fund large industrial or infrastructure projects has evolved in recent years, and has grown gradually but exponentially.

II. PROJECT FINANCE: THE CONCEPT

Project finance is a technique of financing big, capital-intensive projects with lengthy gestation periods in which lenders use the project's asset(s) as security and the cash flow generated as a source of money to cover their obligations. Simply defined, project finance involves borrowing money against the project's security, with little or no recourse against the project's sponsors or

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other parties engaged in its creation and execution. Because of these unusual aspects of project financing, the lender must accept the borrower's capital or loans based on an assessment of the project's cost and feasibility, as well as the project sponsor's credit rating.

"Project finance may be defined as the collecting funds to finance an economically viable capital investment project in which the fund providers rely on the project's cash flows to service their loans and deliver a return on equity capital invested in the project."[2] Lenders lend money for the development of a project purely based on the risks and future cash flows of that project. "The ability to produce cash flows to assure loan repayment and appropriate returns on equity capital is a crucial aspect of project finance. A revenue stream from the project large enough is a prerequisite for project financing."[3]

III. PROJECT FINANCE VS CORPORATE FINANCE

Project finance should be distinguished from conventional direct finance. Lenders that use the direct financing model look to the full asset portfolio of the company to produce the cash flow they need to repay their loans. Lenders look at each project as a separate legal company under the project financing model. The primary distinction between corporate finance and project finance is that assets are financed separately from the company's balance sheet. "For the purpose of funding an industrial or infrastructural project, project financing entails the formation of a legally separate project company financed with limited-recourse debt (and equity from one or more corporate entities known as sponsoring corporations)."[4]

IV. HISTORY AND TRENDS

If we attempt to trace the history of project finance, we come to the sullen realization that the phenomenon has existed for hundreds of years, but has garnered importance only in the last couple of decades. The earliest example can be traced back to the Roman Empire when risk-averse merchants travelling the Mediterranean Sea sought sea loans from local vendors, repayable only on the successful and profitable return of the fleet.[5] In the past twenty years there has been a new wave of global interest in project finance as a tool for economic investment.[6] In fact, from 1994 to 2013, the sum total project finance investment grew by a

[2] Enzo Scannella, 'Project Finance in the Energy Industry: New Debt-based Financing Models', International Business Research (2012) 5(2) 83
[3] *Ibid*
[4] Benjamin Esty, 'Why Study Large Projects? An Introduction to Research on Project Finance', European Financial Management (2004) 10(2) 213
[5] Denton Wilde Sapte, *A Guide to Project Finance*, (Denton Wilde Sapte International Project Finance Group Publications, 2013)
[6] *Project Finance in Developing Countries*, (International Finance Corporation Publication 1999)

factor of 10 from USD 41.3 billion in 1994 to USD 415 billion in 2013.[7] While the use of project financing for industrial projects such as mines, pipelines, and oil fields have a relatively long history, more recently public-private partnerships have begun to finance infrastructure projects such as toll roads, power plants, telecommunication systems as well as schools, hospitals, and even prisons using project financing arrangements.[8]

V. Types of Project Finance: Extent of Recourse

If we were to attempt to enlist the various types of project finance, we could draw a distinction between categories on the basis of extent of recourse available. The main types of structure that are used in project finance should be examined, albeit briefly. It is to be noted that there are primarily two ways for a commercial venture to raise non-equity money from "outside" sources. These are:

- Conventional "full recourse" borrowing; and
- Receipt of "principal" sum as the price for the use or disposal (sale, lease or otherwise) ofan asset.

Thus, based the parameter of extent of recourse available, project finance may be said to be full recourse or limited or non-recourse financing. Non-recourse project finance is a type of financing in which investors and creditors do not have direct recourse to the project's sponsors, as would be expected in the past.[9] Non-recourse project financing is defined as a loan that can only be repaid using project cash flow and assets. In the case of default, limited-recourse project finance allows the loan to be partially repaid from the sponsor's assets.[10]

VI. Understanding Limited/Non-Recourse Project Financing

The term ‘recourse’ essentially refers to ‘repayment of the loans to the lenders and contractors involved, in the event of the failure of the project’. Based upon this, the model has been categorised into: i) Non-Recourse Model; ii) Limited Recourse Model, depending on the extent of the recourse available.[11] It is pertinent to provide a clarification that, any activity of financing a project is often driven by pure econometrics. Hence, it is extremely difficult to compartmentalise a project into purely a non-recourse model or purely a limited recourse model. Therefore the terms ‘non-recourse financing’ and ‘limited recourse financing’ are

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[7] Source: Capital DATA Project Finance Ware

[8] Robert Bruner, Herwig Langohr, and Anne Campbell, *Project Financing: An Economic Overview* (2008)

[9] *Supra* note 5

[10] Van Son Lai, ‘Project Finance with Limited Recourse: An Option Pricing Approach to Debt Capacity and Project Risk’, The Journal of Structured Finance (2007)

[11] Denton Wilde Sapte, *A Guide to Project Finance*, (Denton Wilde Sapte International Project Finance Group Publications, 2013) 3

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often used interchangeably, with both the models having some elements of each other. The parties to a project often draft the contract in such a manner so as to make it flexible enough for either of the above models being evoked, depending on the scenarios stipulated within the contractual agreement. Before proceeding with the discussion further, it is important to get a brief idea about how the schematics of the project financing work.

VII. NON-RECOURSE PROJECT FINANCING

The practice of '*non-recourse financing*' had been traditionally practiced as one of the major mechanisms for financing projects. However, before proceeding to understand the concept of non-recourse financing, it is pertinent to understand, how the model involving a Special Purpose Vehicle (SPV) works. As suggested in the above schematic representation, the SPV is created with the shareholding of the both the '*Parent Company*' and the '*Government*' of the host state.

These shares are thereafter used as collaterals for raising loans from the various financial institutions who acts as the '*lenders*'. Once the SPV raises enough loans, these loans are then used in the creation of assets and towards completion of the project. Thus, in principle the SPV has no assets of its own. The only assets that it owns are the project's assets, which again are financed by the lenders. Therefore in an event of default, which in the current scenario means if the project fails to take off, then the assets of the SPV are liquidated to pay off the outstanding loans. In project finance, this act is referred to as '*recourse*' as has been mentioned earlier.

The principle of '*non-recourse financing*' essentially suggests that, in any situation if the project is deemed to be a failure, then, the only recourse that the lenders can resort to is the liquidation of the assets of the SPV, thus effectively insulating the Parent Company and its assets from being liquidated.

This model however, after a certain point of time, incurred a lot of criticism. There were primarily two reasons assigned for the same.

(i) First and foremost, from the perspective of the lender was the risk factor. As suggested inthe earlier sections, the mechanism of project finance primarily evolved as a solution to the financing of the projects which were otherwise considered to be involving a very highelement of risk. Thus, when the same was coupled with that of the non-recourse model, the element of risk from the perspective of any lender essentially doubled, thereby leading to a situation of general lack of confidence.

(ii) Secondly, from the perspective of the sponsor company, a point of criticism that could be made out was that the complete insulation afforded to the assets of the parent company essentially led to the creation of a false sense of security. To be put in simpler terms, the sponsor company was aware about the fact that irrespective of the success of the project, its assets would be protected against any action of the lender. This at times, resulted in a lack of impetus for the company to drive forward with the project.

Thus, as a response to the above criticism, the non-recourse model was tweaked ever so slightly with a view to make it more equitable by imposing some amount of liability on the sponsor company, so as to ensure the continuing trust of the lenders and the same time ensure that the burden of risk was not squarely placed upon the sponsor company either. This led to the evolution of the concept of *Limited Recourse Financing.*

VIII. LIMITED RECOURSE FINANCING

The principle of '*Limited Recourse Financing*' was first recognized by the Chancery Division of the English courts way back in 1877.[12] In this instance, a railway company paid an amount of money (the fund) as compensation to a district priest and the incumbent of a papal district in line with an Act of Parliament authorising the railway company to seize a specific church for its purposes. The Act mandated that the funds be used to build a new church and parsonage for the recipients. The fund's recipients hired a builder to construct the church and parsonage, and the project moved forward. In the end, the cost of the construction surpassed the funds available in the fund, and the builder filed a lawsuit to recoup the difference. The Court decided that a proviso to a commitment to pay might be used to restrict personal liability under the covenant, among other things. Despite the fact that the contractual agreements were with people who were at the time trustees of the fund, it was decided that "the aim of the contractual instrument is to bind the fund" rather than the trustees in their individual capacities.

Although, the above instance might be considered as a very crude example, however, it does provide a basic understanding as to how limited recourse financing operates. As against the non- recourse model which essentially insulates the parent company from liability of any nature, in case of the failure of a project, the limited recourse model of project financing on the other hand, as the nomenclature suggests, does put a liability on the parent company albeit of a limited nature in case of a failure on behalf of the SPV to successfully carry out the

[12] *Williams v Hathaway* (1877) 6 CH. D. 544

project. Such a liability is thereafter paid off by the creation of a charge on the assets of the parent company. However, the above discussed limited liability of the parent company including the extent of such liability and the particulars of the assets over which the charge is to be created are often made subject to stipulations that are adequately included within the financing contract itself.

Thus, in principle it could be suggested that limited recourse financing is a more equitable way of financing projects, whereby the burden of risk mitigation is equally imposed upon the lender as well as the borrower (SPV).

IX. FEATURES OF LIMITED RECOURSE FINANCING

Limited recourse model of project financing necessarily includes the formation of a legally separate project company financed by limited-recourse debt or equity from one or more business entities to fund an industrial or infrastructural project.[13] Implementation of a project under the 'limited-recourse model' exhibits certain distinctive features.

- The development of the project is carried through the creation of an 'SPV' (also referredto as the 'project company' or the 'operating company') which is essentially a separate legal entity and formed with the consensus reached upon with the government.
- In such a model, the major portion of the capital and the requisite expertise is provided for by the sponsoring company. The government on the other hand may make certain capital investment, however, it primarily ensures to make available the resources required for establishment of the structural framework and smooth operation of the project in the long run, such as employment guarantees, tax benefits, etc.[14]
- The host government may also make an equity investment in the project company, and may also provide other inputs into the build-up as well as the long-run operation of the project. The government may also give assurances against expropriation, and may support the project in other ways, in return for dividends, employment guarantees, and tax revenues.
- Typically, a banking syndicate provides loan financing: the project usually operates

[13] Benjamin C. Esty, Carla Chavich, and Aldo Sesia, 'An Overview of Project Finance and Infrastructure Finance—2014 Update', [2014] Harvard Business School Background Note 214-083

[14] R. Bruner and H. Langohr, 'Project Financing: An Economic Overview', (1995) Case No. 295-026-6, Universityof Virginia

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with ahigh ratio of debt to equity (high leverage, 60 to 70 percent) with lenders having only limited recourse to the government or to the sponsoring company in the event of default.

- Limited-recourse project financing arrangements are characterized by a series of contracts entered into among the sponsoring company, the host government, lenders, suppliers, and customers that cover their obligations during the build-up as well as the long-term operation of the project.
- The sponsoring company and the government may enter into contracts regarding the long- term ownership and operation of the project: two of the most common contract types are build-own-operate-transfer (BOOT) contracts, where the sponsoring company continues toown and operate the project for a long period of time after building it; and build-operate- transfer (BOT) contracts, where the sponsoring company transfers ownership to the government after a period of temporary operation subsequent to building the project.

However, having discussed both the mechanisms, it would be rather inappropriate to suggest that the limited recourse is a better model of project financing in comparison to the non-recourse financing. As it has been discussed in earlier section, project financing is based more upon econometrics rather on law. Hence, it is important to maintain a certain degree of fluidity during the drafting the contract, so as to ensure that the rigidity of the contract does not affect the potential success of the project.

X. THE INDIAN SCENARIO

A project company known as a special purpose vehicle or project development vehicle is frequently used to route project funding. A limited company, a partnership, and an unincorporated business form are all recognised as appropriate project development vehicles internationally, in addition to a private limited company. In India, however, a private limited company is regarded as an appropriate project development vehicle because it provides limited liability for project developers, allows shareholders to incorporate the various terms and conditions agreed to between them in the project company's articles of association, thereby binding not only the shareholders but also the company to the terms and conditions. Furthermore, a private limited business has more stock and credit funding options than a public limited corporation. Having apprised ourselves with the dynamics of project finance, we shall now move to examine the legal and regulatory framework of the same with respect to India.

XI. Legal and Regulatory Framework

Project finance, and specifically limited recourse financing are not governed by a single unified legislation or set of regulations. Depending on the nature of the project, several legislations may be applicable, as also certain sector specific regulations. For the sake of brevity, we will enlist the applicable laws and regulations without delving too deep into the contents of the same. The following legislation primarily governs rupee denominated project lending by local lenders to borrowers:

- The Banking Regulation Act, 1949
- The Reserve Bank of India Act, 1934
- The guidelines, master directions, notifications and circulars issued by the Reserve Bank of India, being the banking regulator of the nation.

Furthermore, loans obtained from a non-resident lender, known as "external commercial borrowings" (ECBs), are governed by the Foreign Exchange Management Act, 1999, and the rules enacted thereunder, specifically the Foreign Exchange Management (Borrowing or Lending in Rupees) Regulations 2000, the Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations 2000, and the ECB Maste Regulations 2000. The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations 2000 read with the FDI Policy issued by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry manage project funding using equity mechanisms. Moving on to sectoral regulators, there are various government departments, statutory authorities, and autonomous bodies which govern projects, depending on the specifics and stipulations. Barring the sector specific laws and regulations, there are certain generic laws which are applicable regardless of the nature of the project. They are enlisted as follows:

- ❑ Indian Contract Act, 1872 is the primary substantive legislation governing contracts between parties. Thus the loan agreements and security documents, as also any equity or quasi equity arrangements in a scheme of project finance will be governed by this Act.
- ❑ Arbitration and Conciliation Act, 1996 would be applicable if the parties choose to refer any dispute arising out of the contract to arbitration. The Act inter alia provides a mechanism for out of court settlement and the award passed therein is binding on the parties, which thereafter is enforced by the courts.

- Companies Act, 2013 regulated the formation of companies, and inter alia, registration of charges on a company’s assets, conversion of debt securities into equity shares andprocedural compliances in relation to availing of loans and creation of securities bycompanies.
- Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 regulates enforceability of security to recover debts. The benefits under SARFAESI are not available to foreign creditors however, barring the Asian DevelopmentBank and the International Finance Corporation.
- Code of Civil Procedure, 1908 is the principal law governing procedure for civil court proceedings in India. The provisions of the same will apply to creditors seeking initiation of recovery proceedings and for enforcement of security. This Code will also govern the procedural aspects relating to dispute settlement.
- Insolvency and Bankruptcy Code, 2016 is a comprehensive code governing insolvency and bankruptcy proceedings in India and is applicable to companies, partnership firms, as well as individuals.

Having examined the legal and regulatory framework, it is pertinent to get an insight into the practical working of the above financing model. For the purposes of the same, a brief case study of ‘Dabhol Power Company’ is being discussed in the following section.

XII. CASE STUDY OF DABHOL POWER COMPANY

(A) Brief Facts

The Dabhol power project consisted of the development, construction, and operation of a power station, port facilities for the importation of LNG and an LNG regasification facility in Dabhol. The project at the time of its inception was the largest foreign and the largest energy sector project financing in India. The first phase of financing was carried out in 1995 and ended with the foreign companies being allowed into the power sector. Also, the project was the first of its kind, where guarantees against foreign liabilities were provided by the Government of India.[15]

However, the project was severely plagued by the incompetency of the Maharashtra State Electricity Board (MSEB), which was the primary off-taker (purchaser of the product) in the present case. Further, the declaration of bankruptcy by Enron (which was the principal project

[15] ‘India Inks Guarantee for First Phase of Enron’s 2,105MW Dabhol Project’, *Independent Power Report* (23September 1994), p. 12

developer)[16] and default in payments of guarantees by the Government of India and State of Maharashtra essentially acted as the final nail in the coffin of this project, which had otherwise shown immense potential.[17] Post the failure, the entire project was transferred to the lenders. Currently, the project remains as an operational project under the ownership of the Ratnagiri Gas and Power Pvt. Ltd., which is a Government of India undertaking.

XIII. MAJOR REASONS FOR FAILURE OF DABHOL POWER PLANT PROJECT

There are primarily two issues which can be singled out for the failure of the above discussed power project. First and foremost the root cause for the Dabhol fiasco could be attributed to the regulatory framework governing the Independent Power Producers (hereinafter referred to as IPP). As per the requirements under the regulatory framework, Dabhol Power Co. was supposed to sell its electricity only to a state power distribution authority, which in this case was MSEB. Even after the prices stipulated under the Power Purchase Agreement, being very high, became untenable for the State Government, both the Governments were unwilling to change the policy to allow the company to sell power to other entities. Secondly, the faulty projection of usage requirements by the State Government led to surplus power production, in view of which the contract was cancelled, leading to the failure of the project, which in turn resulted in the lenders incurring significant losses.[18]

XIV. LESSONS LEARNT

Two major lessons that could be learnt from the Dabhol fiasco are:

- The MSEB's failure to honour its contractual obligations provides an indication that parties to the contract may fail to honour their contractual obligations when the same are beyond their abilities or fail to cater to their own personal economic interest.
- Dishonouring of their obligations by the Government of India as well as the State Government of Maharashtra can be considered as the most damaging cause leading to the failure of the Dabhol power project. Also, it would also not be improper to suggest that such incompetent decisions may be regarded as 'creeping expropriation'.[19]

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[16] Ben Edwards and Mulul Shukla, 'The Mugging of Enron', *Euromoney* (October 1995), p. 30
[17] Daniel Pearl, 'Dabhol Project Vexes Foreign Firms', *Asian Wall Street Journal*, 6 July 2001, p. 3
[18] Jyoti P. Gupta and Anil I. Sravat, 'Development and Financing of Private Power Projects in Developing Countries: A Case Study of India', *International Journal of Project Management*, 16, p. 2 (1998)
[19] Robin Elsham, 'Dabhol – Enron's USD 2.9 Billion White Elephant in India', *Reuters News*, 23 December 2001

XV. CRITICAL ANALYSIS

Having examined the various forms of project financing with reference to recourse, we shall now critically examine the current state of affairs and propose modifications to the current regime. Before doing so, we would briefly discuss the positive impact of the emerging project finance schemes in our country. With the start of economic liberalisation in the 1990s, the state slowly began to relinquish control of some of the economy's most powerful positions, where governmental responsibility for service supply was equated to state ownership. The new strategy allowed for public-private partnerships in infrastructure and service supply, as well as substantial state regulation to protect customer interests. The command and control governance model, which relied on state ownership of infrastructure services, is gradually giving way to a new regulatory governance model, in which public-private partnerships and private sector participation necessitate the achievement of governmental priorities through independent regulation and contract law.

However, the process of change is still poorly understood. "Regulation may be roughly defined as a state-led endeavour to manage societal risk, market failure, or equitable issues by directing social and individual behaviour according to a set of rules. Economists believe that government regulation is only essential when a natural monopoly exists, when a dominating actor abuses monopolistic power, or when a market failure occurs."[20] Economic regulation is defined as the portion of regulation aimed at ensuring the efficient operation of competitive markets and, in the absence of such markets, simulating competitive market results as closely as feasible. Setting maximum tariffs and enforcing minimum service standards are the two most important regulatory responsibilities in economic regulation.

Infrastructure regulatory frameworks have emerged independently throughout each infrastructure sector, with limited cross-fertilization of ideas. A review of the current statutory and institutional framework reveals that there is no shared regulatory philosophy guiding the growth of regulatory institutions in these infrastructure sectors. In diverse infrastructure sectors, political limitations and ministerial preferences appear to have dominated the reform agenda throughout time. It is time to acknowledge that establishing a strong regulatory philosophy based on a framework with sufficient capacity is a necessary, but not sufficient, condition for infrastructure expansion to be accelerated and sustained.

We understand that different sectors involve different areas of subject matter expertise and

[20] Montek Singh Ahluwalia, Approach to Regulation of Infrastructure, The Secretariat for the Committee onInfrastructure, Planning Commission, Government of India Publication, (September 2008)

having a common or integrated regulatory framework is not possible. However, because of this sectoral strategy, the regulatory environment is unequal. Not only has the establishment of these institutions been delayed, but there have also been concerns raised about the regulator's relationship with the Ministry, the regulatory body's composition, functions, and accountability. In terms of economic growth and welfare, this regulatory evolution model will undoubtedly be highly costly. The guiding concept and administrative concerns relating to the activity of diverse sectoral regulators, however, are two areas where consistency may be attained. A few instances of lack of uniformity may be enlisted as follows:

- The electricity regulators in each state, empowered under the Electricity Act, 2003 enjoy extensive powers including rule making, licensing, enforcement, and imposition of penalties. On the other hand, the Tariff Authority for Major Ports' only role is to set tariffs.
- The Telecom Regulatory Authority of India, inter alia, is entrusted with the responsibility of promoting competition, which is not specifically thrust upon other regulators such as the Petroleum and Natural Gas Regulatory Board or the National Highways Authority of India.
- The tenures of members of regulatory authorities differ significantly. Further, members of some authorities are barred from being re-appointed, while others may be. Further, there exist overlapping roles and responsibilities between regulators, which could be a cause of conflict.

Thus, we propose some standardization or uniformity in these facets of adjective law governing these sectors to ensure a level playing field amongst project financers, and not prejudice them to prefer sectors with favourable terms, or neglect sectors or projects with non-conducive regulatory environments. Furthermore, efficient tax structuring into India is critical, since it has a direct impact on a project's desirability to target investors and the net internal rate of return. As a result, it's critical that foreign investment possibilities are properly organised to account for tax, accounting, regulatory, and legal considerations. With the Specific Relief (Amendment) Act of 2018, a new element for project financing has been included. It stipulates that no injunction shall be issued by a court in a dispute under this Act involving a contract pertaining to an infrastructure project mentioned in the Schedule, if issuing injunction would create obstruction or delay in the development or completion of such infrastructure project.[21] The categories of infrastructure projects included in the Schedule to

[21]Specific Relief (Amendment) Act, 2018, § 20A

the Act include transport, energy, water and sanitation, communication, and social and commercial infrastructure. We could say that this is a new beginning of a legislature with a truly pro-infrastructure mandate and we should look to build on the same. Also, studies have indicated that the role of project finance as a driver of economic growth is crucial, more so for developing nations.[22] The above assertion has been proved to hold good in case of the emerging Asian markets as well as has been substantiated by the findings specific to the Asian economies.[23]

To conclude, in the contemporary economic scenario, infrastructural development and the understanding of a developed economy are almost synonymous. As has been discussed in the foregoing sections, developing of the infrastructure sector without adequate financing mechanism in place is nothing but a cruel joke, hence, the importance of project financing has assumed such grave importance in the last two/three decades. However, irrespective of how central a role is being played by project finance, its lacunas are glaring enough to be completely undermined. Hence, it is rather high time for the global economies to collaborate and converge on some uniform and sector specific guidelines, which can actually be used as a reference points for the others to follow.

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[22] Stefanie Kleimeier & Roald Versteeg, *Project finance as a driver of economic growth in low-income countries,* Review of Financial Economics, 19, 49 (2009)
[23] Ermila Kripa & Halit Xhafa, 'Project Finance and Projects in the Energy Sector in Developing Countries', European Academic Research, 1(2) (2013)

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