Project Finance, Public Utilities, and Public Concerns: A Practitioner’s Perspective

Nagla Nassar*
Project Finance, Public Utilities, and Public Concerns: A Practitioner’s Perspective

Nagla Nassar

Abstract

Because of the lack of competition regulation, certain contract provisions attempt to substitute for such vacuum. In an era when private ownership of infrastructure projects is gaining grounds, the need for elaborated competition regulation is more pressing than ever. Private ownership does not necessarily mean personal funding. The more common mode of funding involves a syndicate of banks, which brings a third competing interest to this type of transactions, rendering the need for competition law an essentiality to avoid confusion. The involved interests, while diversified, are not always conflicting. For instance, the continuity of public service is a major concern of all contracting parties, but for different reasons. This unity of goals justifies a unity of solutions in form of uniform legal reforms.
PROJECT FINANCE, PUBLIC UTILITIES, AND PUBLIC CONCERNS: A PRACTITIONER'S PERSPECTIVE

Dr. Nagla Nassar*

INTRODUCTION

Historically, infrastructure projects have been undertaken by public utilities or services, run by the state or entities with a special national mandate, and financed by taxpayers. In the welfare state, the function of running a public utility—be it a sewer system or a telephone communication service—was regarded as one of the services traditionally provided by the state. This is not to say that the private sector was totally excluded from participating in operating public infrastructure services. In fact, the notion of public utilities or services has evolved differently in different countries. In some countries, the private sector participation in such sectors was not totally prohibited but took the form of a regulated license, franchise, or concession. Here, private sector investment in infrastructure was allowed upon government authorization and on the assumption that the service provided was a public service requiring certain regulations.

This situation, which prevailed throughout most of the twentieth century, was not always the case. We must not forget that it was the private sector that, during the nineteenth century, developed the world's railway, electricity, and telecommunications systems through investing substantial amounts of money in then-granted concessions. As public services expanded, necessitating large scale funding not available in the relatively limited capital market, however, the governments undertook the task with the help of public funds or international financial institutions.

Deficits along with budgetary and financial constraints recently experienced by most governments have forced both developed and developing countries to search for alternative means to develop an ever-expanding need for infrastructure. With the

* Hague Academy, Diploma of Private International Law; Ph.D., Geneva University; LL.M., Harvard Law School; M. Lit., Trinity College. Lecturer of Private International Law, and Partner at Zaki Hashem & Partners, Cairo, Egypt.
start of the Margaret Thatcher era in the United Kingdom and
the victory of right wing or center-right parties in Europe in the
late 1970s and the 1980s, the situation took a 180° turn. Public
utilities were sold to the private sector, with the United Kingdom
playing a leading role in this endeavor. Deregulation was the
name of the game. I remember how, as a Ph.D. student in the
late 1980s and early 1990s, I must have been the only student not
writing about the deregulation of one of the sectors. Privatiza-
tion and deregulation meant more developed competition law,
which was a goal undertaken by the European Community fol-
lowing the lead of the United States.

Parallel to this change, the capital markets were strength-
ened and commercial lending became available for larger scale
projects. No longer were the financial markets limited. There
were funds available to finance five hundred or even eight hun-
dred million dollar projects. Coupled with the budgetary and
financial constraints faced by governments, it made very little
sense to finance infrastructure projects through public funding,
thus putting the ultimate burden on taxpayers. Accordingly,
while sectors were deregulated and existing projects privatized,
using private financing to modernize, expand, or develop new
infrastructure projects became the norm rather than the excep-
tion.

These are usually long-term complex transactions requiring
special financing techniques, globally known as project finance,
that involve a multiplicity of parties and different project forms.
They may take the form of Build-Operate-Transfer ("BOT"),
Build-Own-Operate ("BOO"), Build-Own-Operate-Transfer
("BOOT"), Build-Own-Lease-Transfer ("BOLT"), or Build-Rent-
Transfer ("BRT"), to name only a few. These transactions are
constantly evolving and every project’s documents accommodate
the specific needs of the concerned project and country involved
and, accordingly—although they have common features—the
forms of transactions vary considerably. For these reasons, I pre-
fer to use the term “privately financed infrastructure transac-
tions” or “project finance” to refer to all forms of developing
infrastructure projects, be it a BOOT or any other form.1

1. See generally, Privately-Financed Infrastructure Projects: Draft Chapters of a Legislative
Guide on Privately-financed Infrastructure Projects Report of the Secretary General, U.N. GAOR,
Under this transaction form, there are two competing interests, that of the private financier\(^2\) and that of the public utility. Concerns of each participant are reflected in the project documentation in certain ways. This fact is particularly true with respect to competition law issues, which necessitate separating the discussion of each of these concepts. Before dwelling on elucidating the contractual provisions geared towards protecting each of the contracting parties and addressing their concerns, it is important to define the set of contracts constituting a project finance agreement.

I. PROJECT FINANCE

"Project finance" is a term used to reference a model of private financing, where the repayment of financing funds is mainly dependent on the financed project itself. It is the financing of a particular economic unit in which the lender is satisfied to look initially to the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as a collateral for the loan.\(^3\)

The finance is usually divided into two portions, debt capital and equity, in the ratio of seventy to thirty percent or eighty to twenty percent, or any range in between. The difference between debt and equity ratios is usually significant in favor of debt since it is the cheaper form of finance.

The sponsors or developers of the project participate in equity. These participants are usually a group of investors taking a stake in the project company, which is normally a one-purpose vehicle. It is common that one of the sponsors is a local partner, which may, or may not, be a governmental entity. The debt is raised from capital markets of commercial banks and other fi-

---


nancial institutions and export credit agencies. Due to the large amount required to finance infrastructure projects, debt is usually obtained in the form of syndicated loans with participation of more than one bank. Commercial banks prefer medium-term tenures, while multilateral financial institutions and export agencies are more willing to take long-term risk and, hence, their tenures are longer.

Most of the more recent project finance are the projects put up for bid. No longer is the route of direct negotiations taken. A bid is more transparent; it guarantees the lowest pricing and awards the project to the most competitive bidder. All in all, it is regarded as the most efficient way of guarding the public interest and ensuring a fair chance to all competing sponsors. Once the bid is won, the successful consortium transfers its joint venture agreement, which is normally sufficient for purposes of the bid, to a project company incorporated under the laws of the country where the project is located. Based on the information of the project company, several contracts are entered into.

The type and number of contracts concluded depends on the users and the end product. Where the end product is capable of being directly consumed by its potential end consumer without the need for any further process, the contract entered into is a contract for sale of such end product. Electricity, water, and liquified natural gas are good examples. Where the product needs further processing to be ready for consumption, however, the contract is often a concession. Oil exploration and production, as well as lumber contracts, are the classical examples. In a concession, the agreement is always concluded between a private party, i.e., the project company, and the host government, its agent, or another instrumentality of the host government. This situation is not always true with respect to contracts of sale of end products, which may be directly consumed. In the latter instance, since the project is designated for commercial users, the off-taker may be a private party, and, hence, the government may or may not be a party to the deal. Accordingly, the two parties to the sale-purchase contract may be private parties.

Bearing this fact in mind, the discussion to follow is pertinent mainly to agreements involving a government or a public party and would rarely apply to purely private transactions. In addition to sale or concession contracts, there must be a site use contract—be it a lease or a usufruct of a building or land. De-
pending on the type of project, transportation, retail sale, fuel supply, or a management contract may be concluded. In addition, there is an operation and maintenance (or “O&M”) agreement as well as an Engineering, Procurement, and Construction (“EPC”) contract based on a fixed price and comprising a completion guarantee.

On the finance side, the project normally reflects several agreements, including subscription, equity support, and finance agreements. Under the latter category, all agreements are aimed at providing the project company with the necessary liquidity to execute the project. These agreements may include bank loans, underwriters, bonds, note-holders, export agencies, or multilateral institutions. To guarantee the repayment of these borrowed funds, several collateral are executed.4 The collateral documents grant the project creditors security interest in all its rights and assets. These may take the form of a mortgage, pledge, and/or assignment of revenues. Regardless of the details of the finance deal, which is not our main concern, all lenders, as a group, are particularly concerned with the project’s economic viability and the commercial deal incorporated in the project documents. In project finance, as opposed to traditional corporate/bank finance, there is a lack of, or limited recourse to, personal/corporate guarantees, which makes lenders rely heavily on the project’s cash flow and assets. Since the physical assets of infrastructure projects are not—in most cases—of independent significant value and their potential markets are limited, lenders to projects of this sort are exposed to very high risk. Not only does the guarantee of a constant cash flow becomes a crucial issue, but the continuous operation of the project also becomes an essential contractual goal.

In this context, the relationship with competing projects—either existing or potential ones—becomes of critical importance, especially with respect to the pricing of the goods or serv-

---

ices that constitute the main revenue source. In many developing or emerging markets, due to market limitations, more projects mean less revenue, and, hence, less resources to satisfy the lenders. Similarly, because of the lack of a regulatory framework for competition, it is not uncommon that competing projects engage in unfair practices, which ultimately may push competitors out of the market.

The banks' two main objectives are a constant cash flow and a continuous operation of the project. To realize these goals, the lenders must use contractual documents to guard against any potential threats. In other words, in the absence of market regulations, private contracts attempt to provide a substitute, which in most cases is more concerned with individual interests and not those of a class, e.g., consumers or the market as a whole.

This situation is further complicated by the public nature of infrastructure projects. It must never be forgotten that these projects, regardless of how they are financed, render a public service. Supply of water, electricity, telecommunications, or even transportation—these services are of public concern and politically sensitive. Cutting off any such service or providing it for an exaggerated charge is not a politically desirable situation for any government, be it a developed or developing country.

These tensions and conflicts of interest reflect themselves in the contractual documents of project finance. It is only natural that each of the contracting parties looks to protect its own interest. The project finance group of contracts usually reflects the compromise position that reconciles conflicting interests. Still, some of the provisions lend themselves more to the protection of one of the contracting parties. The following sections review some of the more relevant contract provisions from a competition law perspective.

II. SPONSORS/CREDITORS CLAUSES

The interests of sponsors developing the project and creditors are not always identical. On the whole, however, both these interests are opposite to those of the government. The following discussion not only concentrates on clauses that reflect the common interests of both sponsors and creditors, but also highlights points of divergence.
A. Access Provisions

One of the main concerns of both sponsors and creditors of a BOOT project is access to markets and market share necessary to preserve the project’s viability and payment capacity. Ensuing from this reality, many of the BOOT contractual documents directly or indirectly attempt to ensure exclusivity/most favored treatment clauses. Exclusivity is a concern in technology edge projects or where potential markets are limited.

In either case, the real issue is that the BOOT project is capital intensive, the recapture of which needs a guaranteed minimum return. Therefore, allowing new competitors to the market would simply disrupt the calculated returns rendering the project non-viable. One of the means of guaranteeing a minimum return to such projects, without actually obtaining a government guarantee in one form or another, is an exclusivity clause. Under such clauses, a project is granted exclusive access to the market for a specific period of time. Many project agreements would require that:

The licensor agrees that no (other) license will be issued for a period of four years from the date of signing of this license, unless for reasons only depending on licensees, the number of (those) on waiting lists exceeds 10% of the (already existing consumers) for longer than two months. After this period, the licensor might decide to issue a tender in view of selecting a (new licensee) and the granting of the applicable license. In this respect the licensor undertakes (i) to inform beforehand the licensee of the possibility of the issuance of a new license (ii) that the terms and conditions of new license shall be substantially and materially similar from financial, legal and technical standpoints to the ones applicable pursuant to the present license.

_De facto_ exclusivity clauses, similar to the one set forth above, eliminate competition from the marketplace for the agreed upon period and, hence, prices are determined by the only player in the market. To avoid abuse of either a monopoly or a quasi-monopoly, project finance agreements containing such exclusivity clauses also provide for a price control or review mechanism. In either case, a regulatory body or a government agency—in a very rare case, a public/private board—is entrusted with determining the price of the service or commodity, or at least reviewing such pricing after it is determined by the project.
In the latter case, the reviewing body or agency would normally have veto power over any determined price. This price control or review mechanism is aimed at counterbalancing/restraining price fixing by a single or few providers. Whether such mechanism is an effective substitute to market competition and competition law is doubtful. There is no proof that the reviewed or controlled price and the quality of the provided service or commodity is the same as that which would have been provided in a free market regulated by competition laws.

Although the interests of the sponsors/creditors do not always or necessarily coincide with that of the regulatory body, it may sometimes be in their mutual interests to fix prices at a high level so long as it is not excessively appalling to cause public discontent. This example is especially so where the project finance agreements provide for payments of royalties or for splitting charges, or any other similar mechanism, where increased pricing kicks back in one form or the other to the government. It is not uncommon that a government-run utility will charge high prices and provide less quality. It is exactly because of this reason that privatization of most public utilities occurred. Therefore, the mere existence of a regulatory body is no real guarantee of competitive pricing, especially in the absence of actual competition and/or competition laws. This type of agreement, providing for exclusivity/price control or review mechanism, is very close in its model to the more classic monopolistic public utility model.

The same end, i.e., guaranteeing a certain return or overcoming market limitations, is better provided for by most favored treatment clauses. Such clauses provide for non-discriminatory treatment among projects in the same field. A standard most favored treatment clause is set forth below:

The (government or its successor) shall treat the (project) on a non-discriminatory basis compared with other projects. The licensor agrees that the licensee shall enjoy the same nondiscriminatory treatment as it shall grant companies performing similar activities with a contractual relationship between either party. The licensor will not grant similar licenses to any other party with any terms more favorable than granted to the Company within this license.

Clauses similar to the example above do not eliminate potential competitors but merely guarantee current projects equal
treatment. It is well known that once markets become developed, operating conditions get better, thus allowing new corners and edge on older projects. In the absence of a developed competition law, it is necessary for pioneer projects to guard themselves against such an eventuality. Contrary to exclusivity clauses, most favored treatment provisions fill in for a competition law vacuum. It is a private regulation substituting legislative powers and, therefore, it is not necessarily contrary to the principles of free markets and open competition.

This, however, carries with it the risk of tying the government’s hands and eliminating new entries, which would not get established in a market unless granted better operating conditions than the existing ones. The market access issue is of major importance in project finance since the main security for repayment to creditors is the project itself. Its viability, therefore, becomes a prime concern. It is in the interest of all creditors and sponsors to keep such projects operating even if it means eliminating competition or maintaining an uncompetitive project. To guarantee a continuous cash flow and satisfy creditors, the project must be kept afloat by all means possible. This goal has prompted several other contractual arrangements, which collectively may be referred to as creditors provisions aiming at securing creditors’ right of timely repayment, as discussed hereunder.

B. Creditors’ Provisions

The creditors’ major interest, as stated above, is to preserve the project’s payment capacity. Before examining how this reality reflects itself on project finance agreements and to allow for a clear understanding of the creditors’ interest, it is first necessary to understand the security package accompanying such projects. Since project finance is carried out on non-recourse, or at least a limited recourse, basis and the one purpose, the special vehicle project company, lacks is the credit history necessary for creditworthiness, it is important for the creditors to obtain collat-

---

eral that would secure the project's debt. This collateral includes a mortgage on real property, pledge or lien over personal property of the project (including intangibles), and the assignment of the project's potential revenues. The details of obtaining and perfecting security interest in the project company's assets does not square with the main theme of this Essay.

It must be borne in mind, however, that because of the difficulty or failure to perfect securities under the relevant and applicable laws, the need to provide for alternative protection under the project finance agreements emerges. An applicable law that does not allow for a security interest in accounts or other intangibles or one that restricts establishing offshore accounts to which the project company's revenues may be transferred, will definitely lead creditors to seek alternative means of controlling the project. In lieu of, or in addition to, revenue control, creditors normally ensure that sponsors' rights to a continuous cash flow is secured as well. This statement represents the creditor's own step in, and substitution rights to secure the project viability when, and if, needed.

Many of these clauses, if operable within a developed competition legal framework, would be inconsequential insofar as markets are concerned. Because of the absence of competition law and lack of actual competition, however, creditors' provisions may disrupt and adversely affect the relevant product market, especially with respect to new entries. For instance, the type of available remedies in cases of default, force majeure, or lenders' step-in and substitution rights have more than one effect. First, they influence the availability of the concerned product or service in the market, depending on whether the defaulting party is the only provider. Second, they determine the plausibility of new project entries to provide the same or substitute services. Therefore, creditors' provisions examined below are those believed to be most relevant to competition law, and their effect thereon is examined in the course of the discussion.

1. Events of Default

The need to maintain the cash flow of the project for purposes of debt repayment necessitates two requisites. First, any non-payment other than by the project company under the revenue contract will trigger default almost instantaneously. Second,
non-performance by the project company will not trigger default until after a relatively long cure period lapses and the lender banks relinquish their step-in and substitution rights. This distinction between project events of default and other (or government) events of default extend to buyout price, which differs depending on the triggering event of default. These opposing legal solutions reflect the conflicting interests of the contracting parties in project finance agreements. While continuous cash flow and payment capacity is the focal point for creditors and sponsors, governments are more concerned with the continuity of public service at reasonable charges and the elimination of monopolistic risks. These conflicting concerns are better explained by elaborating on the relevant contractual provisions.

a. Government Events of Default

A standard default provision will protect against all, and any, risk of dryness of funds. This provision would include not only cases of non-payment under the revenue contract, but also instances of dissolution, winding up, voluntary or non-voluntary bankruptcy, liquidation or appointment of liquidator, lack of foreign reserves, and adverse change of law affecting the profitability of the transaction. In addition to these fact-specific events of default, there is a catch-all provision allowing for termination buyout, which is set forth below:

Any material breach by Government of this Agreement that is not remedied within (45) days after notice from the Company identifying the material breach in question in reasonable detail, and demanding remedy thereof; provided, however, that for material breaches of this Agreement that can be cured only in more that (45) days, Government may have such additional time to cure any material breach under this Agreement as it estimates may be necessary to cure such material breach if, prior to the end of the (45) day period, Government provides satisfactory evidence to the Company that (i) it has commenced and is diligently pursuing a cure and (ii) that more than (45) days is required in order to effect such cure and provides a good-faith estimate of when the material breach will be cured.

A catch-all provision like that provided above is meant to protect the company against any unpleasant risk affecting the performance of the government. It also allows for the continua-
tion of the project if such risk does not represent a serious threat. This clause is meant to create a balance among the competing interests of the parties without allowing either party a greater leverage.

For this reason, the identical clause appears under company's event of default. In practice, this provision, while leading to a potential disagreement as to its exact implementation, nonetheless, serves as an effective pressure tool for either party. The party whose interest is at risk would require the other party to provide a remedy or otherwise terminate the agreement if the latter solution is a better one. The project and its creditors may use the threat of termination, available under this provision, to pressure for quick remedies in unsatisfactory situations. From a competition law perspective, this device may be undesirable, especially where the project enjoys a *de jure* or *de facto* monopoly or dominant position. In these cases, the project company will have an extra leverage over the government, which allows it to tighten its control over the market, especially in absence of competition law.

b. Company Events of Default

Company events of default are usually very specific and limited to instances where the project company and the banks are no longer capable or interested in operating the project company. Rarely is it acceptable to the sponsors or the creditors to accept the catch-all provision, discussed above, in connection with government events of default. Here, the conflicting interests of the contracting parties reflect themselves in the negotiations and find their way to contractual documents. Reproducing duplicate clauses for both government and company with respect to the catch-all provision requires prudent contractual drafting and policy.

In reality, including such a mirror clause in the party's agreement may prove difficult and unacceptable to creditors. Longer cure periods and step-in and substitution rights are necessary in case of company default. It is beyond acceptable limits that the banks will suffice themselves with a forty-five day cure period. Nor will they allow a triggering of termination upon a basis as wide as the ones stated above. Even with these limitations, a catch-all provision imposed on the company may prove
useful to the government because it provides for some maneuvering powers where a project does not abide by the agreed upon terms.

The infringing conduct does not have to be an overt breach of a contractual undertaking. These catch-all provisions are meant to cover instances that cannot be squared with one of the events of default. This situation usually occurs when the project is the only provider of the service or has a dominant position in the market. In these cases, there is a great temptation to cash in on such a position even if doing so would violate the agreement or its spirit. In practice, this violation may take the form of relaxing the standards or quality of service in order to gain a financial advantage. In these cases, the government may use such provisions to protect the public interest. This case is equally applicable where competition law policy considerations are at stake.

Long cure periods and lenders' step-in and substitution rights are a main characteristic of all company events of default. Sponsors and their creditors, through such techniques, attempt to secure their interest in the project for the longest period possible even where they are in default. Any government right to terminate will not occur unless and until the lenders decide to relinquish the project. An example standard step-in rights clause might read as follows:

From and after the occurrence of the Financial Closing, no rescission or termination of this Agreement by government shall be valid or binding upon the lenders without such notice, the expiration of such cure period, and the expiration of the lenders' cure period, if any, as may be available. The lenders may make, but shall be under no obligation to make, any payment or perform any act required to be made or performed by the company, with the same effect as if made or performed by the company. Upon termination of the cure period provided to the company and pursuant to written request from the lenders to government, the lenders shall be granted a further period of up to 90 days, during which the lenders shall evaluate the condition of the project and other matters relevant to the actions to be taken by the lenders to take possession of the project and cure the event of default. If prior to then end of such 90 day period, the lenders have delivered to government a notice that the lenders have elected to pursue their remedies under the financing agree-
ments and to attempt diligently to cure the company event of
default, the lenders shall be granted an additional period of
120 days to cure any such company event of default (the
"lenders' cure period"). So long as the lenders diligently at-
ttempt to cure such company event of default, government
shall not terminate this agreement in respect of such com-
pany event of default.

The provision above is usually supported by a substitution
clause, under which lenders' step-in rights are confirmed by pro-
viding for the mechanism to be followed for replacing the pro-
ject company by another, if necessary. Such substitution rights
are structured as follows:

during any lenders' cure period . . . the lenders shall be enti-
tled, whether by exercise of their rights under the financing
agreement or otherwise, to substitute a company (the "nomi-
nated company") for the company under this Agreement in
accordance with the provisions of the following
paragraphs. . . . [A] notice (a "substitution notice") may be
given to government by or on behalf of the lenders. The sub-
stitution notice shall indicate the nominated company.

Upon receipt by government of a substitution notice,
government and the relevant lenders shall consult for a pe-
riod of up to 60 days as to the company, which is to be the
nominated company. On or before the expiry of that consul-
tation period, government shall have the right to reject the
company for specific reasons concerning the nominated com-
pany's financial and technical capability to continue the con-
struction and/or operation of the project. Except as afore-
said, government shall not reject a company nominated
under this section.

At the end of the period(s) specified in the above para-
graph: (i) government, the company and the nominated
company shall forthwith execute novations of this Agreement
and the nominated company shall expressly assume in writing
the ongoing rights and obligations of the company under this
Agreement; and (ii) the company shall procure and govern-
ment shall, if necessary, use its good offices to facilitate a
transfer of the company's rights to the site to the nominated
company.

It is clear from the provisions above that standard project
finance practice requires long cure periods and step-in and sub-
stitution rights. Providing for such rights, in most cases, does
not promote public interest or competition. Long cure periods simply mean interruption of production or service, which, needless to say, is a major concern where a public utility is involved. Interruption of business means that the public shall not receive the expected service, which, as previously pointed out, is a politically undesirable situation.

For these reasons, the government normally would attempt to prescribe short cure periods, after which the contract is terminated and the government is allowed to run the project. Here, the stepping stone is creating a balance between the government's concern not to cut off a public service, especially if the project company is the only provider for such service, and the private party's desire to be allowed sufficient time to remedy and avoid termination. The agreed compromise reflects not only the bargaining powers of either party, but also political and economic concerns. A vulnerable government is less likely to make aggressive compromises, as is the private party from investing in a fragile country.

On the other hand, step-in and substitution rights overtly contradict the principles of transparency and open competition. The right of the lenders to replace the existing project company with another operating company is according to the lenders' sole discretion. It does not permit an open offer where the credentials of more than one prospective operator are considered. In this respect, much reliance is placed upon the lenders' self-interest to choose the best possible operator. It would be self-defeating for the lenders not to elect the most efficient and competent operator. This case may very well be true, yet in practice there are many considerations, other than the public interest, that may influence such decision. Acknowledging this reality, governments occasionally succeed in carving out contractual exceptions to protect the public interest and to guarantee the continuity of service. It remains true, however, that the clauses set forth above do not further equal opportunities or fair competition.

2. Buyout and Transfer

The risk of termination of the project during the term of the loan is one of the main concerns of the lender. Any such termination will affect the cash flow of the project and the con-
comitant ability to pay back the creditors. Ensuing from this fact, and despite the above detailed cure periods and step-in and substitution rights, sponsors and creditors insist that no termination of the project may occur except upon payment of the buyout price. Such buyout price is paid without set-off or counterclaim and free from all taxes, duties, or any form of levies. The buyout price itself is determined by a formula, which normally would provide for a different calculation method depending on whether the termination of the project occurs before the terms of the loans expire. The banks and other creditors will insist that the buyout price is at least equivalent to the outstanding loans. This is the case even if the termination occurs upon a company event of default. Where termination is triggered because of a government event of default, the sponsors will normally require payment for equity.

Calculation of the buyout price does not in any way attempt to base itself on or take into consideration the market value of the project. Whether the calculated buyout price is representative of the real value of the project is actually irrelevant. Pursuant to competition law criteria, this pricing mechanism is neither reflective of public interest nor is it in accordance with market standards. In most cases where both sponsors and lenders fail or opt not to continue with the operation, the matter is pretty serious and the project is probably not viable. It is rather contrary to prudent practice to require a government to pay for a worthless project.

This case is even more outrageous where it is the company's actions that give rise to the critical situation. These clauses, similar to those previously discussed, are mainly concerned with the financial needs of the sponsors and creditors, and not with the competition requirements. This rationale is partly justified by the fact that the only security for the creditors is the project itself. They have limited or no recourse other than the project. Hence, the inclusion of such clauses is imperative, or otherwise proper finance may prove difficult if not impossible to obtain. Some of the inadequacies of the creditors' provisions are partly mitigated by counter provisions imposed by the government to promote its main and more important interests from a competition law perspective as discussed hereunder.
III. GOVERNMENT CONTRACTUAL CLAUSES

A major concern of governments entering into utility related contracts is the continuity and price of services provided under such contracts. As pointed out earlier, these matters are politically sensitive and, in the majority of cases, are strictly regulated. The situation is further complicated if the private operator of the public utility enjoys a de jure or de facto monopoly.

Even when the private project is the major, although not the only, provider of the public service, the matter is still a sensitive one. Here, the government is more cautious to accept long cure periods or high buyout prices. To balance contractual clauses protecting creditors’ interest, the government, during negotiations, will insist on an allocation of contractual risks, which does not adversely affect its main interests. Contractual clauses are executed to guard the government against the risk of interruption of public service/tariff manipulation. These two major contractual undertakings are examined separately hereunder.

A. Tariff Control

In the absence of actual competition and lack of competition law, the risk of price fixing by the only or major provider of service is a real threat. In monopolistic or quasi-monopolistic markets the government negotiates project finance deals, in addition to the previously referenced regulatory boards or pricing committees, employs a cost-sharing approach or a tariff formula, or a combination of both. Under a cost-sharing approach, the government requires the project company to install a cost control accounting system and to open its books for the inspection and verification of the government representatives.

Here, the tariff to be charged by the project is determined on the basis of cost plus. The project company agrees that the charged tariff would represent its costs plus a certain return. This situation is normally subject to certain limitations beyond which extra costs are neglected and not taken into consideration when calculating the tariff. These limitations are to discourage projects from inflating their costs or at least acting in reckless disregard of incurred costs.

Projects normally resist this costs plus approach, which ties their hands in order to minimize costs for purposes of increasing
the profit margins. This concern is a real one and represents the main disadvantage of the cost plus approach. There is no real motivation for a project to reduce its incurred costs since this reduction will not be reflected in its profit margin, but will be reduced from its charged tariff.

To overcome these disadvantages, many of the project finance agreements allow one form or another of kickback to the company. Sometimes the company is allowed to retain the cost savings as an increase in profitability margins, where such savings do not exceed a certain percentage. In other agreements, any cost savings are split among the project and the government, and it is the latter’s share that is used to reduce the charged tariff. There are many techniques of sharing cost savings used to motivate the project to reduce costs in spite of a cost plus tariff basis.

To avoid the complications of cost plus calculations, which need a permanent and elaborated inspection and verification mechanism, many project finance agreements use a tariff formula upon which the tariff is calculated at any given time. The components of the tariff formula are normally laid out in an annex, which forms part of the party’s agreement. Some of these components are variables, while others are constant inputs. It is through such variable inputs that the tariff adjustment occurs.

Any such adjustment may not be carried out without being first negotiated and agreed to by the government. *De facto*, this may result in price stabilization if the government does not consent to the suggested tariff adjustment. Accordingly, a government is guaranteed that the end consumer will never pay non-politically correct prices for public services. For the same reasons, and because of monopolistic concerns, the government would normally request a finance and performance bond or bonds, which normally take the form of a letter of credit or guarantee. Such bonds may adversely affect the tariff negotiated and agreed upon with the government. Withdrawing the deposited bond is a real likelihood if the tariff adjustment, introduced to reflect lenders’ requests, is not acceptable to the government.

B. *Service Continuity*

The efficient and continuous operation of the project is the
bottom-line necessity for guaranteeing the continuity of public service. To attain this goal, the government retains to itself a supervisory role over implementation aspects affecting the provision of service.

One main relevant area is the operating and maintenance contract. In most cases, this contract is concluded after the conclusion of the main project contracts, i.e., revenue, concession or sale, etc. In most project agreements, however, the approval of the future operation and maintenance contractor by the government is a condition precedent for the effectiveness of the main project contracts. The identity of the operator and manager of the project greatly influences the proper operation of the project and the continuity and quality of provided services.

This issue is particularly relevant in monopolistic or quasi-monopolistic markets, where the project company is the only or main provider of the public service. It is a standard practice in such cases for the government to have a contractual veto power over the appointment or change of the project operator and manager. It is not sufficient that the government sets out the standards according to which operator or manager is selected. Here, unlike the case of competitive markets where there is more than one supplier of the same service, governments insist that the operation of the project shall not be contracted out unless, and until, it has approved the potential operator. Realizing that the sponsors developing the project may not necessarily possess the necessary know-how for operation and maintenance, governments never go as far as totally prohibiting the appointment of an O&M contractor. In most cases, however, the delegation of this task is contractually regulated.

The degree and extent of such regulation depends on the market in which the project is located, its structure, and the significance of the project production to the whole market production. In all cases, governments prefer to place responsibility for O&M with the project company, regardless of the entity actually entrusted with such task. A standard clause regulating the O&M of the project is set forth below:

The company has the right to operate and maintain the complex, as required to promote its best interests, and shall operate and maintain the complex in a manner that maximizes its output and minimizes unnecessary costs provided, however, that the company may contract with the operation
and maintenance contractor to operate and maintain the complex; and provided, further, that the appointment of the operation and maintenance contractor by the company shall not relieve the company of any of its obligations or potential liability regarding the insuring, operation or maintenance of the complex or any liability whatsoever resulting from a breach of any term or condition of this agreement.

In addition to the placement of liability with the original contracting party, i.e., the project company, there is an operating committee comprised of representatives of either contracting party overlooking the operation of the project and ensuring that it is properly executed. The government may ensure, through an operating committee, that the project is not abusing its market position and is not engaging in restrictive practices, e.g., price fixing, which adversely affect the market. The role of the operating committee is both crucial and sensitive in markets where there is no competition law or where such law is not sufficiently developed to provide effective conduct standards.

Another related aspect, which directly secures the proper operation, continuity, and quality of provided service is the government right of entry. Pursuant to such right, the government is guaranteed the option to operate the project itself where it decides that such course of action is necessary. The purpose of this clause is to allow the government at any time, if necessary, to step in and take over the operation of the public utility. This right is not an absolute one but is qualified by several conditions, the nature of which varies from one transaction to the other. A standard clause would read as follows:

If, after the commercial operations date, without the prior written consent of the government the company shall have abandoned or refused to operate the project, then the government shall (i) be entitled but not obligated to operate it until the company demonstrates to the reasonable satisfaction of the government that it can and will resume normal operation, and (ii) as soon as is practicable, send written notice of such action to the lenders in accordance with the procedure set forth in this agreement; provided that, in the case of abandonment by the company, the government right to operate the project hereunder shall be subject to any first of lenders to operate the project pursuant to the financing agreements.
Unless abandonment is defined in another contractual clause in reference to a specific duration, the government right of entry clause determines it. How long or short the period depends on how badly the service provided by the public utility is needed. The abandonment period is usually defined in terms of hours where a project enjoys a monopoly or a quasi-monopoly and provides an essential public service, e.g., gas, electricity, water, etc.

In other cases, especially where there are more than one provider of the same service, a few days are allowed before the government may seize and operate the project. It must be noted that the government rights in this respect are subordinate to that of the lenders. Thus, if the company abandons the project but any of the lenders step in and—either personally or via a substitution—operate it, then the government may not use its right of entry. This case means that the government right of entry is that of last resort, designated to avoid interruption of production.

The clause set forth above is generally worded, allowing for entry and operation of the project under any circumstances, even where the government itself is at default. For instance, should the government fail to pay its monthly invoices and in retaliation the project suspends production, the government may still enter and operate the project. This exact scenario had actually happened in respect to electrical utility in the Caribbean.

A powerful multinational electricity-generating project suspended production as a mean of twisting the government’s arm and obliging it to pay its bills. Unfortunately, the applicable power purchase agreement had no similar provision as the one set forth above. Therefore, the government, faced with a cut of the electrical power in the concerned country, must enter the power station using armed force and operate it. This case is a very unfortunate situation, which must be avoided, and therefore, carefully drafted project finance agreements would grant the government the right of entry and operation for purposes of protecting the public interest. It is not to say that such rights must be absolute. In fact, the sponsors and lenders, if they can, insist on carve-outs for specific events, e.g., force majeure or change of law.

Once the government enters and operates the project, it
does so at its own risk and expense. An example contractual clause granting a government such right of entry would state in addition the following:

During any period that the government shall operate the complex pursuant to this agreement, the government shall bear all costs of such operation, and shall be relieved from making payments to the company under this agreement, provided, that to avoid foreclosure under the financing agreements during operation by government, government shall continue to pay to the company the debt service portion of the capacity payment as the company would otherwise be entitled to during such period, less actual damages (other than operation and maintenance expenses) incurred by government.

Notwithstanding any other provision in this Agreement to the contrary, government shall operate the project in accordance with the operating limits, prudent utility practices and the applicable laws and shall indemnify and hold the company harmless from any loss or damage to the project incurred, suffered or sustained by the company by reason of government's negligence or willful misconduct in the operation of the project during such period, but only to the extent that such loss or damage is not covered by insurance.

The provision above represents a middle-ground solution for the thorny problem of payment for production or service during the government operation period. A project company not operating the public utility and, hence, not providing the public service, may not claim payment for works not done. In practice, however, the world is not that simple. Lenders have a right of foreclosure. In addition, a provision must be entered to reflect the fact that the failure of the company to operate the project properly may not be always due to its own mismanagement or default. If such a contingency is not provided, then it must be reflected in the payment arrangements.

The conditions and circumstances under which a company gets paid even if not operating the project usually present a very difficult negotiating point. Because the government right of entry is subordinated to that of the lenders, the latter may agree to excuse, in cases of default, the debt service payment. In such circumstances, however, the government right of entry clause is tied to the buyout provision. Once the government starts run-
ning the project, it shoulders all responsibility in respect of such operation, which must be carried out according to the contractually agreed upon standards. It is clear from the above examination that although the main goal of government entry rights is to ensure the continuity of a public service, private considerations and interests interfere to limit the full realization of such goal.

An issue relevant to the continuity of service and allocation of business interruption risk, especially in absence of competition law, is the duty to restore a damaged project. Who should shoulder such a duty? Pursuant to the general principles of property law, the owner of the plant bears the risk of injury and, hence, the duty, or—more accurately—the option, to restore it. It is an option, not a duty because the general principles of law do not oblige an owner to restore his/her damaged property unless he/she voluntarily does so. Therefore, the simple answer to the above question is to identify the owner of the project with whom the option to restore lies.

In the world of project finance, matters are not that simple, and the damaged project may affect parties other than the owner. Many interests are at stake here. Putting aside the inquiry into the ownership of the project, there are the creditors and the government who may not own the project, but who may be directly injured as a result of the loss of the project. The creditors will lose their revenue-generating source from which they are to be repaid. This loss leaves them with no option, and even the right of foreclosure is emptied from all its content in such circumstances, since there is nothing on which to foreclose. The government might not be the owner of the project, but yet it has much to lose from the discontinuity of the service. Not only is the matter politically undesirable, but it is also socially unacceptable.

In fact, in such situations the government is the biggest loser, especially where the project is the only or major provider of a given public service. In a competitive market, where more than one provider competes and provides the same service, the withdrawal of any one project—for whatever reason—does not need to adversely affect the market as a whole. Even if it does, the existence of a well-developed legal structure for competition would facilitate new entries, substituting for the old ones or providing alternative services.
In the absence of such legal regulation and actual competition, the government's interests are severely undermined, if not totally lost, as a result of the discontinuity of service because of the damage to the project. It is because of these reasons that most project finance agreements attribute great significance to the restoration issue. No longer do the parties regard it as an owner's option. It adversely affects all interests at stake, be it those of the creditors or the government. Therefore, the answer to the question of who shoulders the burden of restoration is dependent on who caused the damage or injury.

According to general principles of contract law, damage ensuing from either contracting party's breach or default, or the breach or default of those for whom they are responsible, is to be restored by the breaching or defaulting party causing the damage. The issue becomes complicated in respect to a damage or loss that does not ensue from either party's action or inaction. This contingency arises in respect of force majeure events and is the one more commonly addressed and provided for in project finance agreements.

As was pointed out, the solutions provided by the application of the general principles of contract law are not satisfactory in this context. Rarely would a project finance agreement give the project's owner an absolute discretion whether to restore. This matter is not subject to the sole discretion of the owner, but is contractually regulated in great detail. The content of such regulation depends on the negotiation powers of either contracting party and the vested interests at stake.

A standard restoration clause would prescribe the following minimal requirements:

(a) In the event that the project or any part thereof is damaged as a result of any force majeure event, the company shall within thirty days thereafter, prepare and deliver a restoration report to the government.

(b) Within fifteen business days of the delivery of a restoration report to the government or such further time as the parties may agree, the parties shall meet to discuss the restoration report and any action(s) to be taken. In connection with the review by the government of a restoration report, the company shall provide promptly to the government such additional financial and related
information pertaining to the restoration report and the matters described therein as the government may reasonably request.

(c) If the estimated costs of restoration, as indicated in the restoration report as agreed to by the parties, are (i) recoverable (subject to applicable deductibles) from insurance required to be carried by the company in accordance with this agreement, or (ii) less than a certain percentage of the engineering, procurement, and construction contract price, then, subject to the rights of lenders under the financing agreements, the company shall effect the restoration as soon as practicable.

If it is not possible to proceed with restoration, then either party may terminate this agreement according to its own terms setting forth the date for transfer of the project, in accordance with the transfer annex, whereupon, subject to the provisions of this annex, this agreement shall terminate on the transfer date. The threshold for restoration may not always be a percentage of the engineering, procurement, and construction contract. Many other formulas can be adopted, depending on the parties involved and the type of the project. The more important issue is that there is always a dividing line beyond which the project has no option but to restore. This division should be reasonable enough to allow the project to suspend its operation if restoration is too costly, impracticable, or unfeasible. Because of the previously detailed public concerns, however, projects should not be let off the hook easily. The public interest here is far more important than any financial burden, especially if a substitute or alternative provider is not readily available because of a particular market structure.

Here, contract provisions attempt to substitute market regulation and competition law. If these two considerations are well developed in any relevant market, then the need for detailed restoration clauses of the sort set forth above is less pressing. Projects operating in such markets are rarely monopolistic and new entries are always available.

CONCLUSION

It is clear from the above analysis that, because of the lack of competition regulation, certain contract provisions attempt to
substitute for such vacuum. In an era when private ownership of infrastructure projects is gaining grounds, the need for elaborated competition regulation is more pressing than ever. Private ownership does not necessarily mean personal funding. The more common mode of funding involves a syndicate of banks, which brings a third competing interest to this type of transactions, rendering the need for competition law an essentiality to avoid confusion. The involved interests, while diversified, are not always conflicting. For instance, the continuity of public service is a major concern of all contracting parties, but for different reasons. This unity of goals justifies a unity of solutions in form of uniform legal reforms.