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Privately financed infrastructure projects: draft chapters of a legislative guide on privately financed infrastructure projects

Report of the Secretary-General

Addendum

II. Project risks and government support

Contents

Legislative recommendations

For host countries wishing to promote privately financed infrastructure projects it is recommended that the following principles be implemented by the law:

Project risks and risk allocation (see paras. 8-29)

Recommendation 12. No unnecessary statutory or regulatory limitations should be placed upon the contracting authority's ability to agree on an allocation of risks that is suited to the needs of the project.

Government support (see paras. 30-60)

Recommendation 13. The law should clearly state which public authorities of the host country may provide financial or economic support to the implementation of privately financed infrastructure projects and which types of support they are authorized to provide.

Notes on the legislative recommendations

A. General remarks

1. Privately financed infrastructure projects create opportunities for reducing the commitment of public funds and other resources for infrastructure development and operation. They also make it possible to transfer to the private sector a number of risks that would otherwise be borne by the Government. The precise allocation of risks among the various parties involved is typically defined after consideration of a number of factors, including the public interest in the development of the infrastructure in question and the level of risk faced by the project company, other investors and lenders (and the extent of their ability and readiness to absorb those risks at an acceptable cost). Adequate risk allocation is essential to reducing project costs and to ensuring the successful implementation of the project. Conversely, an inappropriate allocation of project risks may compromise the project's financial viability or hinder its efficient management, thus increasing the cost at which the service is provided.

2. In the past, debt financing for infrastructure projects was obtained on the basis of credit support from project sponsors, multilateral and national export credit agencies, Governments and other third parties. In recent years, these traditional sources have not been able to meet the growing needs for infrastructure capital and financing has been increasingly obtained on a project finance basis.

3. Project finance, as a method of financing, seeks to establish the creditworthiness of the project company on a "stand alone" basis, even before construction has begun or any revenues have been generated, and to borrow on the basis of that credit. Commentators have observed that project finance may hold the key to unlocking the vast pools of capital theoretically available in the capital markets for investment in infrastructure. However, project finance has distinctive and demanding characteristics from a financial point of view. Principal among these is that, in a project finance structure, financing parties must rely mainly upon the project company's assets and cash flows for repayment. If the project fails they will have no recourse, or only limited recourse, to the financial resources of a sponsor company or other third party for repayment (see also "Introduction and background information on privately financed infrastructure projects.", paras. 54 and 55).

4. The financial methodology of project financing requires a precise projection of the capital costs, revenues and projected costs, expenses, taxes and liabilities of the project. In order to predict these numbers precisely and with certainty and to create a financial model for the project, it is typically necessary to project the "base case" amounts of revenues, costs and expenses of the project company over a long period—often 20 years or more—in order to determine the amounts of debt and equity the project can support. Central to this analysis is the identification and quantification of risks. For this reason, the identification, assessment, allocation and mitigation of risks is at the heart of project financing from a financial point of view.

5. Among the most important, yet difficult, risks to assess and to mitigate are "political risks" (risks associated with adverse actions of the host Government, its agencies and its courts, in particular in granting licences and permits, adopting regulations applicable to the project company and its markets, taxation and the performance and enforcement of contractual obligations) and "currency risks" (risks related to the value, transferability and convertibility of the local currency). In order to guard against such risks, in particular,

project finance structures have often incorporated insurance or guarantees of international financial institutions and export credit agencies as well as guarantees of the host Government.

6. Section B of the present chapter (paras. 8-29) gives an overview of the main risks encountered in privately financed infrastructure projects and contains a brief discussion of common contractual solutions for risk allocation, which emphasizes the need to provide the parties with the necessary flexibility for negotiating a balanced allocation of project risks. Section C (paras. 30-60) sets out policy considerations the Government may wish to take into account when designing the level of direct governmental support that may be provided to infrastructure projects, such as the degree of public interest in the execution of any given project and the need to avoid the assumption by the Government of open-ended or excessive contingent liabilities. Section C considers some additional support measures that have been used in governmental programmes to promote private investment in infrastructure development, without advocating the use of any of them in particular. Lastly, sections D (paras. 61-71) and E (paras. 72-74) outline guarantees and support measures that may be provided by export credit agencies and investment promotion agencies.

7. Other chapters of this *Guide* deal with related aspects of the host Government's legal regime that are of relevance to the credit and risk analysis of a project. Depending upon the sector and type of project the emphasis will, of course, vary. The reader is referred in particular to chapters IV, "Construction and operation of infrastructure"; V, "Duration, extension and termination of the project agreement"; VI, "Settlement of disputes"; and VII, "Other relevant areas of law".

B. Project risks and risk allocation

8. As used in this chapter, the notion of "project risks" refers to those circumstances which, in the assessment of the parties, may have a negative effect on the benefit they expect to achieve with the project. While there may be events that would represent a serious risk for most parties (for example, the physical destruction of the facility by a natural disaster), each party's risk exposure will vary according to its role in the project.

9. The expression "risk allocation" refers to the determination of which party or parties should bear the consequences of the occurrence of events identified as project risks. For example, if the project company is obliged to deliver the infrastructure facility to the contracting authority with certain equipment in functioning condition, the project company is bearing the risk that the equipment may fail to function at the agreed performance levels. The occurrence of that project risk, in turn, may have a series of consequences for the project company, including its liability for failure to perform a contractual obligation under the project agreement or the applicable law (for example, payment of damages to the contracting authority for delay in bringing the facility into operation); certain losses (for example, loss of revenue as a result of delay in beginning operating the facility); or additional cost (for example, cost of repair of faulty equipment or of securing replacement equipment).

10. The party bearing a given risk may take preventive measures with a view to limiting the likelihood of the risk, as well as specific measures to protect itself, in whole or in part, against the consequences of the risk. Such measures are often referred to as "risk mitigation". In the previous example, the project company will carefully review the reliability of the equipment suppliers and the technology proposed. The project company

may require its equipment suppliers to provide independent guarantees concerning the performance of their equipment. The supplier may also be liable to pay penalties or liquidated damages to the project company for the consequences of failure of its equipment. In some cases, a more or less complex chain of contractual arrangements may be made to mitigate the consequences of a project risk. For instance, the project company may combine the guarantees provided by the equipment supplier with commercial insurance covering some consequences of the interruption of its business as a result of equipment failure.

1. Overview of main categories of project risk

11. For purposes of illustration, the following paragraphs provide an overview of the main categories of project risk and give examples of certain contractual arrangements used for risk allocation and mitigation. For further discussion on this subject, the reader is advised to consult other sources of information, such as the *UNIDO BOT Guidelines*.[1]

(a) Project disruption caused by events outside the control of the parties

12. The parties face the risk that the project may be disrupted by unforeseen or extraordinary events outside their control, which may be of a physical nature, such as natural disasters—floods, storms or earthquakes—, or the result of human action, such as war, riots or terrorist attacks. Such unforeseen or extraordinary events may cause a temporary interruption of the project execution or the operation of the facility, resulting in construction delay, loss of revenue and other losses. Severe events may cause physical damage to the facility or even destruction beyond repair (for a discussion of the legal consequences of the occurrence of such events, see chap. IV, "Construction and operation of infrastructure", paras. 131-139).

(b) Project disruption caused by adverse acts of Government ("political risk")

13. The project company and the lenders face the risk that the project execution may be negatively affected by acts of the contracting authority, another agency of the Government or the host country's legislature. Such risks are often referred to as "political risks" and may be divided into three broad categories: "traditional" political risks (for example, nationalization of the project company's assets or imposition of new taxes that jeopardize the project company's prospects of debt repayment and investment recovery); regulatory risks (for example, introduction of more stringent standards for service delivery or opening of a sector to competition) and "quasi-commercial" risks (for example, breaches by the contracting authority or project interruptions due to changes in the contracting authority's priorities and plans) (for a discussion of the legal consequences of the occurrence of such events, see chap. IV, "Construction and operation of infrastructure", paras. 122-125). In addition to political risks originating from the host country, some political risks may result from acts of a foreign Government, such as blockades, embargoes or boycotts imposed by the Governments of the investors' home countries.

(c) Construction and operation risks

14. The main risks that the parties may face during the construction phase are the risks that the facility cannot be completed at all or cannot be delivered according to the agreed schedule (completion risk); that the construction cost exceeds the original estimates (construction cost overrun risk); or that the facility fails to meet performance criteria at completion (performance risk). Similarly, during the operational phase the parties may face

the risk that the completed facility cannot be effectively operated or maintained to produce the expected capacity, output or efficiency (performance risk); or that the operating costs exceed the original estimates (operation cost overrun). It should be noted that construction and operation risks do not affect only the private sector. The contracting authority and the users in the host country may be severely affected by an interruption in the provision of needed services. The Government, as representative of the public interest, will be generally concerned about safety risks or environmental damage caused by improper operation of the facility.

15. Some of these risks may be brought about by the project company or its contractors or suppliers. For instance, construction cost overrun and delay in completion may be the result of inefficient construction practices, waste, insufficient budgeting or lack of coordination among contractors. Failure of the facility to meet performance criteria may also be the result of defective design, inadequacy of the technology used or faulty equipment delivered by the project company's suppliers. During the operational phase, performance failures may be the consequence, for example, of faulty maintenance of the facility or negligent operation of mechanical equipment. Operation cost overruns may also derive from inadequate management.

16. However, some of these risks may also result from specific actions taken by the contracting authority, by other public authorities or even the host country's legislature. Performance failures or cost overruns may be the consequence of the inadequacy of the technical specifications provided by the contracting authority during the selection of the concessionaire. Delays and cost overruns may also be brought about by actions of the contracting authority subsequent to the award of the project (delays in obtaining approvals and permits, additional costs caused by changes in requirements due to inadequate planning, interruptions caused by inspecting agencies or delays in delivering the land on which the facility is to be built). General legislative or regulatory measures, such as more stringent safety or labour standards, may also result in higher construction or operating costs. Shortfalls in production may be caused by the non-delivery of the necessary supplies (for example, power or gas) on the part of public authorities.

(d) Commercial risks

17. "Commercial risks" relate to the possibility that the project cannot generate the expected revenue because of changes in market prices or demand for the goods or services it generates. Both of these forms of commercial risk may seriously impair the project company's capacity to service its debt and may compromise the financial viability of the project.

18. Commercial risks vary greatly according to the sector and type of project. The risk may be regarded as minimal or moderate where the project company has a monopoly over the service concerned or when it supplies a single client through a standing off-take agreement. However, commercial risks may be considerable in projects that depend on market-based revenues, in particular where the existence of alternative facilities or supply sources makes it difficult to establish a reliable forecast of usage or demand. This may be a serious concern, for instance, in tollroad projects, since tollroads face competition from toll-free roads. Depending on the ease with which drivers may have access to toll-free roads, the toll revenues may be difficult to forecast, especially in urban areas where there may be many alternative routes and roads may be built or improved continuously. Furthermore, traffic usage has been found to be even more difficult to forecast in the case of new tollroads, especially those which are not an addition to an existing toll facility system, because there is no existing traffic to use as an actuarial basis.

(e) Exchange rate and other financial risks

19. Exchange rate risk relates to the possibility that changes in foreign exchange rates alter the exchange value of cash flows from the project. Prices and user fees charged to local users or customers will most likely be paid for in local currency, while the loan facilities and sometimes also equipment or fuel costs may be denominated in foreign currency. This risk may be considerable, since exchange rates are particularly unstable in many developing countries or countries whose economies are in transition. In addition to exchange rate fluctuations, the project company may face the risk that foreign exchange control or lowering reserves of foreign exchange may limit the availability in the local market of foreign currency needed by the project company to service its debt or repay the original investment.

20. Another risk faced by the project company concerns the possibility that interest rates may rise, forcing the project to bear additional financing costs. This risk may be significant in infrastructure projects given the usually large sums borrowed and the long duration of the project, with some loans extending over a period of several years. Loans are often given at a fixed rate of interest (for example, fixed-rate bonds) to reduce the interest rate risk. In addition, the finance package may include hedging facilities against interest rate risks, for example, by way of interest rate swaps or interest rate caps.

2. Contractual arrangements for risk allocation and mitigation

21. It follows from the above that the parties need to take into account a wide range of factors to allocate project risks effectively. For this reason, it is generally not advisable to have in place statutory provisions that limit unnecessarily the negotiators' ability to achieve a balanced allocation of project risks, as appropriate to the needs of individual projects. Nevertheless, it may be useful for the Government to provide some general guidance to officials acting on behalf of domestic contracting authorities, for instance, by formulating advisory principles on risk allocation.

22. Practical guidance provided to contracting authorities in a number of countries often refers to general principles for the allocation of project risks. One such principle is that specific risks should normally be allocated to the party best able to assess, control and manage the risk. Additional guiding principles envisage the allocation of project risks to the party with the best access to hedging instruments (that is, investment schemes to offset losses in one transaction by realizing a simultaneous gain on another) or the greatest ability to diversify the risks or to mitigate them at the lowest cost. In practice, however, risk allocation is often a factor of both policy considerations (for example, the public interest in the project or the overall exposure of the contracting authority under various projects) and the negotiating strength of the parties. Furthermore, in allocating project risks it is important to consider the financial strength of the parties to which a specific risk is allocated and their ability to bear the consequences of the risk, should it occur.

23. It is usually for the project company and its contractors to assume ordinary risks related to the development and operation of the infrastructure. For instance, completion, cost overrun and other risks typical of the construction phase are usually allocated to the construction contractor or contractors through a turnkey construction contract, whereby the contractor assumes full responsibility for the design and construction of the facility at a fixed price, within a specified completion date and according to particular performance specifications (see chap. IV, "Construction and operation of infrastructure", para. 70). The construction contractor is typically liable to pay liquidated damages or penalties for any

late completion. In addition, the contractor is also usually required to provide a guarantee of performance, such as a bank guarantee or a surety bond. Separate equipment suppliers are also usually required to provide guarantees in respect of the performance of their equipment. Guarantees of performance provided by contractors and equipment suppliers are often complemented by similar guarantees provided by the concessionaire to the benefit of the contracting authority. Similarly, the project company typically mitigates its exposure to operation risks by entering into an operation and maintenance contract in which the operating company undertakes to achieve the required output and assumes the liability for the consequences of operational failures. In most cases, arrangements of this type will be an essential requirement for a successful project. The lenders, for their part, will seek protection against the consequences of those risks, by requiring the assignment of the proceeds of any bonds issued to guarantee the contractor's performance, for instance. Loan agreements typically require that the proceeds from contract bonds be deposited in an account pledged to the lenders (that is, an "escrow account"), as a safeguard against misappropriation by the project company or against seizure by third parties (for example, other creditors). Nevertheless, the funds paid under the bonds are regularly released to the project company as needed to cover repair costs or operating and other expenses.

24. The contracting authority, on the other hand, will be expected to assume those risks which relate to events attributable to its own actions, such as inadequacy of technical specifications provided during the selection process or delay caused by failure to provide agreed supplies on time. The contracting authority may also be expected to bear the consequences of disruptions caused by acts of Government, for instance by agreeing to compensate the project company for loss of revenue due to price control measures (see chap. IV, "Construction and operation of infrastructure", para. 124). While some political risks may be mitigated by procuring insurance, such insurance, if at all available for projects in the country concerned, may not be obtainable at an acceptable cost. Thus, prospective investors and lenders may turn to the Government, for instance, to obtain assurances against expropriation or nationalization and guarantees that proper compensation will be payable in the event of such action (see para. 50). Depending on their assessment of the level of risk faced in the host country, prospective investors and lenders may not be ready to pursue a project in the absence of those assurances or guarantees.

25. Most of the project risks referred to in the preceding paragraphs can, to a greater or lesser extent, be regarded as falling within the control of one party or the other. However, a wide variety of project risks result from events outside the control of the parties or are attributable to the acts of third parties and other principles of risk allocation may thus need to be considered.

26. For example, the project company could expect that the interest rate risk, together with the inflation risk, would be passed on to the end-users or customers of the facility through price increases, although this may not always be possible because of market-related circumstances or price control measures. The price structure negotiated between the project company and the contracting authority will determine the extent to which the project company will avoid those risks or whether it will be expected to absorb some of them (see chap. IV, "Construction and operation of infrastructure", paras. 36-46).

27. Another category of risk that may be allocated under varying schemes concerns extraneous events such as war, civil disturbance, natural disasters or other events wholly outside the control of the parties. In traditional infrastructure projects carried out by the public sector, the public entity concerned usually bears the risk, for example, of destruction of the facility by natural disasters or similar events, to the extent that those risks may not be insurable. In privately financed infrastructure projects the Government may prefer this

type of risk to be borne by the project company. However, depending on their assessment of the particular risks faced in the host country, the private sector may not be ready to bear those risks. Therefore, in practice there is not a single solution to cover this entire category of risk and special arrangements are often made to deal with each of them. For example, the parties may agree that the occurrence of some of those events may exempt the affected party from the consequences of failure to perform under the project agreement and there will be contractual arrangements providing solutions for some of their adverse consequences, such as contract extensions to compensate for delay resulting from events or even some form of direct payment under special circumstances (see chap. IV, "Construction and operation of infrastructure", paras. 131-139). Those arrangements will be supplemented by commercial insurance purchased by the project company, where available at an acceptable cost (see chap. IV, "Construction and operation of infrastructure", paras. 119 and 120).

28. Special arrangements may also need to be negotiated for the allocation of commercial risks. Projects such as mobile telecommunication projects usually have a relatively high direct cost recovery potential and in most cases the project company is expected to carry out the project without sharing those risks with the contracting authority and without recourse to support from the Government. In other infrastructure projects, such as power-generation projects, the project company may revert to contractual arrangements with the contracting authority or other public authority in order to reduce its exposure to commercial risks, for example, by negotiating long-term off-take agreements that guarantee a market for the product at an agreed price. Payments may take the form of actual consumption or availability charges or combine elements of both; the applicable rates are usually subject to escalation or indexation clauses in order to protect the real value of revenues from the increased costs of operating an ageing facility (see also chap. IV, "Construction and operation of infrastructure", paras. 50 and 51). Lastly, there are relatively capital-intensive projects with more slowly developing cost recovery potential, such as water supply and some tollroad projects, which the private sector may be reluctant to carry out without some form of risk-sharing with the contracting authority, for example, through fixed revenue assurances or agreed capacity payments regardless of actual usage (see also chap. IV, "Construction and operation of infrastructure", paras. 48 and 49).

29. The risk allocation eventually agreed to by the contracting authority and the project company will be reflected in their mutual rights and obligations, as set forth in the project agreement. The possible legislative implications of certain provisions commonly found in project agreements are discussed in other chapters of the *Guide* (see chaps. IV, "Construction and operation of infrastructure", and V, "Duration, extension and termination of the project agreement"). Various other agreements will also be negotiated by the parties to mitigate or reallocate the risks they assume (for example, loan agreements; construction, equipment supply, operation and maintenance contracts; direct agreement between the contracting authority and the lenders; and off-take and long-term supply agreements, where applicable).

C. Government support

30. The discussion in the preceding section shows that the parties may use various contractual arrangements to allocate and mitigate project risks. Nevertheless, those arrangements may not always be sufficient to ensure the level of comfort required by private investors to participate in privately financed infrastructure projects. It may also be

found that certain additional government support is needed to enhance the attractiveness of private investment in infrastructure projects in the host country.

31. Government support may take various forms. Generally, any measure taken by the Government to enhance the investment climate for infrastructure projects may be regarded as governmental support. From that perspective, the existence of legislation enabling the Government to award privately financed infrastructure projects or the establishment of clear lines of authority for the negotiation and follow-up of infrastructure projects (see chap. I, "General legislative and institutional framework", paras. 23-29) may represent important measures to support the execution of infrastructure projects. As used in the *Guide*, however, the expression "government support" has a narrower connotation and refers in particular to special measures, in most cases of a financial or economic nature, that may be taken by the Government to enhance the conditions for the execution of a given project or to assist the project company in meeting some of the project risks, above and beyond the ordinary scope of the contractual arrangements agreed to between the contracting authority and the project company to allocate project risks. Government support measures, where available, are typically an integral part of governmental programmes to attract private investment for infrastructure projects.

1. Policy considerations relating to government support

32. In practice, a decision to support the implementation of a project is based on an assessment by the Government of the economic or social value of the project and whether that justifies additional governmental support. The Government may estimate that the private sector alone may not be able to finance certain projects at an acceptable cost. The Government may also consider that particular projects may not materialize without certain support measures that mitigate some of the project risks. Indeed, the readiness of private investors and lenders to carry out large projects in a given country is not only based on their assessment of specific project risks, but is also influenced by their comfort with the investment climate in the host country, in particular in the infrastructure sector. Factors to which private investors may attach special importance include the host country's economic system and the degree of development of market structures and the degree to which the country has already succeeded with privately financed infrastructure projects over a period of years.

33. For the above reasons, a number of countries have adopted a flexible approach for dealing with the issue of governmental support. In some countries, this has been done by legislative provisions that tailor the level and type of support to the specific needs of individual infrastructure sectors. In other countries, this has been achieved by providing the host Government with sufficient legislative authority to extend certain types of assurance or guarantee while preserving its discretion not to make them available in all cases. However, the host Government will be interested in ensuring that the level and type of support provided to the project does not result in the assumption of open-ended liabilities. Indeed, over-commitment of public authorities through guarantees given to a specific project may prevent them from extending guarantees in other projects of perhaps even greater public interest.

34. The efficiency of governmental support programmes for private investment in infrastructure may be enhanced by the introduction of appropriate techniques for budgeting for governmental support measures or for assessing the total cost of other forms of governmental support. For example, loan guarantees provided by public authorities usually have a cost lower than the cost of loan guarantees provided by commercial lenders. The difference (less the value of fees and interests payable by the project company) represents a

cost for the Government and a subsidy for the project company. However, loan guarantees are often not recorded as expenses until such time as a claim is made. Thus, the actual amount of the subsidy granted by the Government is not recorded, which may create the incorrect impression that loan guarantees entail a lesser liability than direct subsidy payments. Similarly, the financial and economic cost of tax exemptions granted by the Government may not be apparent, which makes them less transparent than other forms of direct governmental support. For these reasons, countries that are contemplating establishing support programmes for privately financed infrastructure projects may need to devise special methods for estimating the budgetary cost of support measures such as tax exemptions, loans and loan guarantees provided by public authorities that take into account the expected present value of future costs or loss of revenue.

2. Forms of government support

35. The availability of direct governmental support, be it in the form of financial guarantees, public loans or revenue assurances, may be an important element in the financial structuring of the project. The following paragraphs briefly describe forms of governmental support that are sometimes authorized under domestic laws and discuss possible legislative implications they may have for the host country, without advocating the use of any of them in particular.

36. Generally, besides the administrative and budgetary measures that may be needed to ensure the fulfilment of governmental commitments throughout the duration of the project, it is advisable for the legislature to consider the possible need for an explicit legislative authorization to provide certain forms of support. Where government support is found advisable, it is important for the legislature to bear in mind the host country's obligations under international agreements on regional economic integration or trade liberalization, which may limit the ability of public authorities of the contracting States to provide support, financial or otherwise, to companies operating in their territories. Furthermore, where a Government is contemplating support for the execution of an infrastructure project, that circumstance should be made clear to all prospective bidders at an appropriate time during the selection proceedings (see chap. III, "Selection of the concessionaire", para. 67).

(a) Public loans and loan guarantees

37. In some cases, the law authorizes the Government to extend interest-free or low-interest loans to the project company to lower the project's financing cost. Depending on the accounting rules to be followed, some interest-free loans provided by public agencies can be recorded as revenue in the project company's accounts, with loan payments being treated as deductible costs for tax and accounting purposes. Moreover, subordinate loans provided by the Government may enhance the financial terms of the project by supplementing senior loans provided by commercial banks without competing with senior loans for repayment. Governmental loans may be generally available to all project companies in a given sector or they may be limited to providing temporary assistance to the project company in the event that certain project risks materialize. The total amount of any such loan may be further limited to a fixed sum or to a percentage of the total project cost.

38. In addition to public loans, some national laws authorize the contracting authority or other agency of the host Government to provide loan guarantees for the repayment of loans taken by the project company. Loan guarantees are intended to protect the lenders (and, in

some cases, investors providing funds to the project as well) against default by the project company. Loan guarantees do not entail an immediate disbursement of public funds and they may appear more attractive to the Government than direct loans. However, loan guarantees may represent a substantial contingent liability and the Government's exposure may be significant, especially in the event of total failure by the project company. Indeed, the Government would in most cases find little comfort in a possible subrogation in the rights of the lenders against an insolvent project company.

39. Thus, in addition to introducing general measures to enhance the efficiency of governmental support programmes (see para. 34), it may be advisable to consider concrete provisions to limit the Government's exposure under loan guarantees. Rules governing the provision of loan guarantees may provide a maximum ceiling, which could be expressed as a fixed sum or, if more flexibility is needed, a certain percentage of the total investment in any given project. Another measure to circumscribe the contingent liabilities of the guaranteeing agency may be to define the circumstances under which such guarantees may be extended, taking into account the types of project risk the Government may be ready to share. For instance, if the Government considers sharing only the risks of temporary disruption caused by events outside the control of the parties, the guarantees could be limited to the event that the project company is rendered temporarily unable to service its loans owing to the occurrence of specially designated unforeseeable events outside the project company's control. If the Government wishes to extend a greater degree of protection to the lenders, the guarantees may cover the project company's permanent failure to repay its loans for the same reasons. In such a case, however, it is advisable not to remove the incentives for the lenders to arrange for the continuation of the project, for instance by identifying another suitable concessionaire or by stepping in through an agent appointed to remedy the project company's default (see chap. IV, "Construction and operation of infrastructure", paras. 147-150). The call on the governmental guarantees could thus be conditional upon the prior exhaustion of other remedies available to the lenders under the project agreement, the loan agreements or their direct agreements with the contracting authority, if any. In any event, full loan guarantees by the Government amounting to a total protection of the lenders against the risk of default by the project company are not a common feature of infrastructure projects carried out under the project finance modality.

(b) Equity participation

40. Another form of additional support by the Government may consist of direct or indirect equity participation in the project company. Equity participation by the Government may help achieve a more favourable ratio between equity and debt by supplementing the equity provided by the project sponsors, in particular where other sources of equity capital, such as investment funds, cannot be tapped by the project company. Equity investment by the Government may also be useful to satisfy legal requirements of the host country concerning the composition of locally established companies. The company laws of some jurisdictions, or special legislation on infrastructure projects, require a certain amount of participation of local investors in locally established companies. However, it may not always be possible to secure the required level of local participation on acceptable terms. Local investors may lack the interest or financial resources to invest in large infrastructure projects; they may also be averse to or lack experience in dealing with specific project risks.

41. Governmental participation may involve certain risks that the Government may wish to consider. In particular, there is a risk that such participation may be understood as an

implied guarantee by the Government, so that the parties, or even third parties, may expect the Government to back the project fully or eventually even take it over at its own cost if the project company fails. Where such an implied guarantee is not intended, appropriate provisions should be made to clarify the limits of governmental involvement in the project.

(c) Subsidies

42. Tariff subsidies are used in some countries to supplement the project company's revenue when the actual income of the project falls below a certain minimum level. The provision of the services in some areas where the project company is required to operate may not be a profitable undertaking, because of low demand or high operational costs or because the project company is required to provide the service to a certain segment of the population at low cost. Thus, the law in some countries authorizes the Government to undertake to extend subsidies to the project company in order to make it possible to provide the services at a lower price.

43. Subsidies usually take the form of direct payments to the project company, either lump-sum payments or payments calculated specifically to supplement the project company's revenue. In the latter case, the Government should ensure that it has in place adequate mechanisms for verifying the accuracy of subsidy payments made to the project company, by means, for example, of audit and financial disclosure provisions in the project agreement. An alternative to direct subsidies may be to allow the project company to cross-subsidize less profitable activities with revenue earned in more profitable ones. This may be done by combining in the same concession both profitable and less profitable activities or areas of operation, or by granting to the project company the commercial exploitation of a separate and more profitable ancillary activity (see paras. 48-60).

44. However, it is important for the legislature to consider practical implications and possible legal obstacles to the provision of subsidies to the project company. For example, subsidies are found to distort free competition and the competition laws of many countries prohibit the provision of subsidies or other forms of direct financial aid that are not expressly authorized by legislation. Subsidies may also be inconsistent with the host country's international obligations under international agreements on regional economic integration or trade liberalization.

(d) Sovereign guarantees

45. In connection with privately financed infrastructure projects, the term "sovereign guarantees" is sometimes used to refer to any of two types of guarantee provided by the host Government. The first type includes guarantees issued by the host Government to cover the breach of obligations assumed by the contracting authority under the project agreement. A second category includes guarantees that the project company will not be prevented by the Government from exercising certain rights that are granted to it under the project agreement or that derive from the laws of the country, for example, the right to repatriate profits at the end of the project. Whatever form such guarantees may take, it is important for the Government and the legislature to consider the Government's ability to assess and manage efficiently its own exposure to project risks and to determine the acceptable level of direct or contingent liabilities it can assume.

(i) Guarantees of performance by the contracting authority

46. Performance guarantees may be used where the contracting authority is a separate or autonomous legal entity that does not engage the responsibility of the Government itself.

Such guarantees may be issued in the name of the Government or of a public financial institution of the host country. They may also take the form of a guarantee issued by international financial institutions that are backed by a counter-guarantee by the Government (see paras. 61-71). Guarantees given by the Government may be useful instruments to protect the project company from the consequences of default by the contracting authority or other public authority assuming specific obligations under the project agreement. The most common situations in which such guarantees are used include the following:

(a) *Off-take guarantees.* Under these arrangements, the Government guarantees payment of goods and services supplied by the project company to public entities. Payment guarantees are often used in connection with payment obligations under off-take agreements in the power-generation sector (see chap. IV, "Construction and operation of infrastructure", para. 50). Such guarantees may be of particular importance where the main or sole customer of the project company is a government monopoly. Additional comfort is provided to the project company and lenders when the guarantee is subscribed by an international financial institution;

(b) *Supply guarantees.* Supply guarantees may also be provided to protect the project company from the consequences of default by public sector entities providing goods and supplies required for the operation of the facility—fuel, electricity or water, for example—or to secure payment of indemnities for which the contracting entity may become liable under the supply agreement;

(c) *General guarantees.* These are guarantees intended to protect the project company against any form of default by the contracting authority, rather than default on specifically designated obligations. Although general performance guarantees may not be very frequent, there are cases in which the project company and the lenders may regard them as a condition necessary for executing the project. This may be the case, for example, where the obligations undertaken by the contracting authority are not commensurate with its creditworthiness, as may happen in connection with large concessions granted by municipalities or other autonomous entities. Guarantees by the Government may be useful to ensure specific performance, for example, when the host Government undertakes to substitute for the contracting entity in the performance of certain acts (for example, delivery of an appropriate site for disposal of by-products).

47. Generally, it is important not to overestimate the adequacy of sovereign guarantees alone to protect the project company against the consequences of default by the contracting authority. Except when their purpose is to ensure specific performance, sovereign guarantees usually have a compensatory function. Thus, they may not substitute for appropriate contractual remedies in the event of default by the contracting authority (see chap. IV, "Construction and operation of infrastructure", paras. 140-150). Different types of contractual remedies, or combinations thereof, may be used to deal with various events of default, for example, liquidated damages in the event of default and price increases or contract extensions in the event of additional delay in project execution caused by acts of the contracting authority. Furthermore, in order to limit the Government's exposure and to reduce the risk of calls on the guarantee, it is advisable to consider measures to encourage the contracting authority to live up to its obligations under the project agreement or to make efforts to control the causes of default. Such measures may include express subrogation rights of the guarantor against the contracting authority or internal control mechanisms to ensure the accountability of the contracting authority or its agents in the event, for instance, of wanton or reckless breach of its obligations under the project agreement resulting in a call on the sovereign guarantee.

(ii) Guarantees against adverse acts of Government

48. Unlike performance guarantees, which protect the project company against the consequences of default by the contracting authority, the guarantees considered here relate to acts of other authorities of the host country that are detrimental to the rights of the project company or otherwise substantially affect the implementation of the project agreement. Such guarantees are often referred to as "political risk guarantees".

49. One type of guarantee contemplated in national laws consists of foreign exchange guarantees, which usually fulfil three functions: to guarantee the convertibility of the local earnings into foreign currency, to guarantee the availability of the required foreign currency and to guarantee the transferability abroad of the converted sums. Foreign exchange guarantees are common in privately financed infrastructure projects involving a substantial amount of debt denominated in currencies other than the local currency, in particular in those countries which do not have freely convertible currencies. Some laws also provide that such a guarantee may be backed by a bank guarantee issued in favour of the project company. A foreign exchange guarantee is not normally intended to protect the project company and the lenders against the risks of exchange rate fluctuation or market-induced devaluation, which are considered to be ordinary commercial risks. However, in practice, Governments have sometimes agreed to assist the project company in cases where the project company is unable to repay its debts in foreign currency owing to extreme devaluation of the local currency.

50. Another important type of guarantee may be to assure the company and its shareholders that they will not be expropriated without adequate compensation. Such a guarantee would typically extend both to confiscation of property owned by the project company in the host country and to the nationalization of the project company itself, that is, confiscation of shares of the project company's capital. This type of guarantee is usually provided for in laws dealing with direct foreign investment and in bilateral investment protection treaties (see chap. VII, "Other relevant areas of law", ___).

(e) Tax and customs benefits

51. Another method for the host Government to support the execution of privately financed projects could be to grant some form of tax and customs exemption, reduction or benefit. Domestic legislation on foreign direct investment often provides special tax regimes to encourage foreign investment and in some countries it has been found useful expressly to extend such a taxation regime to foreign companies participating in privately financed infrastructure projects (see also chap. VII, "Other relevant areas of law", __).

52. Typical tax exemptions or benefits include exemption from income or profit tax or from property tax on the facility, or exemptions from income tax on interest due on loans and other financial obligations assumed by the project company. Some laws provide that all transactions related to a privately financed infrastructure project will be exempted from stamp duties or similar charges. In some cases, the law establishes some preferential tax treatment or provides that the project company will benefit from the same favourable tax treatment generally given to foreign investments. Sometimes the tax benefit takes the form of a more favourable income tax rate, combined with a decreasing level of exemption during the initial years of the project. Such exemptions and benefits are sometimes extended to the contractors engaged by the project company, in particular foreign contractors.

53. Further taxation measures sometimes used to promote privately financed infrastructure projects are exemptions from withholding tax to foreign lenders providing loans to the project. Under many legal systems, any interest, commission or fee in connection with a loan or indebtedness that is borne directly or indirectly by locally established companies or is deductible against income earned locally is deemed to be local income for taxation purposes. Therefore, both local and foreign lenders to infrastructure projects may be liable to the payment of income tax in the host country, which the project company may be required to withhold from payments to foreign lenders, as non-residents of the host country. Income tax due by the lenders in the host country is typically taken into account in the negotiations between the project company and the lenders and may result in a higher financial cost for the project. In some countries, the competent organs are authorized to grant exemptions from withholding tax in connection with payments to non-residents that are found to be made for a purpose that promotes or enhances the economic or technological development of the host country or are otherwise deemed to be related to a purpose of public relevance

54. Besides tax benefits or exemptions, national laws sometimes facilitate the import of equipment for the use of the project company by means of exemption from customs duties. Such exemption typically applies to the payment of import duties on equipment, machinery, accessories, raw materials and materials imported into the country for purposes of conducting preliminary studies, designing, constructing and operating infrastructure projects. In the event that the project company wishes to transfer or sell the imported equipment on the domestic market, the approval of the contracting authority usually needs to be obtained and the relevant import duties, turnover tax or other taxes need to be paid in accordance with the laws of the country. Sometimes the law authorizes the Government either to grant an exemption from customs duty or to guarantee that the level of duty will not be raised to the detriment of the project.

(f) Protection from competition

55. An additional form of governmental support may consist of assurances that no competing infrastructure project will be developed for a certain period or that no agency of the Government will compete with the project company, directly or through another concessionaire. Assurances of this sort serve as a guarantee that the exclusivity rights that may be granted to the concessionaire (see chap. I, “General legislative and institutional framework”, paras. 20-22) will not be nullified during the life of the project. Protection from competition may be regarded by the project company and the lenders as an essential condition for participating in the development of infrastructure in the host country. Some national laws contain provisions whereby the Government undertakes not to facilitate or support the execution of a parallel project that might generate competition to the project company. In some cases, the law contains an undertaking by the Government that it will not alter the terms of such exclusivity to the detriment of the project company without the project company’s consent.

56. Provisions of this type may be intended to foster the confidence of the project sponsors and the lenders that the basic assumptions under which the project was awarded will be respected. However, they may be inconsistent with the host country’s international obligations under agreements on regional economic integration and trade liberalization. Furthermore, they may limit the ability of the Government to deal with an increase in the demand for the service concerned as the public interest may require or to ensure the availability of the services to various categories of user. It is therefore important to

consider carefully the interests of the various parties involved. For instance, the required price level to allow profitable exploitation of a tollroad may exceed the paying capacity of low-income segments of the public. Thus, the contracting authority may have an interest in maintaining open to the public a toll-free road as an alternative to a new tollroad. At the same time, however, if the contracting authority decides to improve or upgrade the alternative road, the traffic flow may be diverted from the tollroad built by the project company, thus affecting its flow of income. Similarly, the Government may wish to introduce free competition for the provision of long-distance telephone services in order to expand the availability and reduce the cost of telecommunication services (for a brief overview of issues relating to competition, see "Introduction and background information on privately financed infrastructure projects", paras. 24-29). The consequence of such a measure, however, may be a significant erosion of the income anticipated by the project company.

57. Generally, it may be useful to authorize the Government, where appropriate, to give assurances that the project company's exclusive rights will not be unduly affected by subsequent changes in governmental policies without appropriate compensation. However, it may not be advisable to adopt statutory provisions that rule out the possibility of subsequent changes in the Government's policy for the sector concerned, including a decision to promote competition or to build parallel infrastructure. The possible consequences of such future changes for the project company should be dealt with by the parties in contractual provisions dealing with changes in circumstances (see chap. IV, "Construction and operation of infrastructure", paras. 121-130). It is particularly advisable to provide the contracting authority with the necessary power to negotiate with the project company the compensation that may be due for loss or damage that may result from a competing infrastructure project subsequently launched by the contracting authority or from any equivalent measure of the Government that adversely affects the project company's exclusive rights.

(g) Ancillary revenue sources

58. One additional form of support to the execution of privately financed infrastructure projects may be to allow the project company to diversify its investment through additional concessions for the provision of ancillary services or the exploitation of other activities. In some cases, alternative sources of revenue may also be used as a subsidy to the project company for the purpose of pursuing a policy of low or controlled prices for the main service. Provided that the ancillary activities are sufficiently profitable, they may enhance the financial feasibility of a project: the right to collect tolls on an existing bridge, for example, may be an incentive for the execution of a new toll bridge project. However, the relative importance of ancillary revenue sources should not be overemphasized.

59. In order to allow the project company to pursue ancillary activities, it may be necessary for the Government to receive legislative authorization to grant the project company the right to use property belonging to the contracting authority for the purposes of such activities (for example, land adjacent to a highway for construction of service areas) or the right to charge fees for the use of a facility built by the contracting authority. Where it is felt necessary to control the development and possibly the expansion of such ancillary activities, the approval of the contracting authority might be required in order for the project company to undertake significant expansion of facilities used for ancillary activities.

60. Under some legal systems, certain types of ancillary source of revenue offered by the Government may be regarded as a concession separate from the main concession and it is

therefore advisable to review possible limitations to the project company's freedom to enter into contracts for the operation of ancillary facilities (see chap. IV, "Construction and operation of infrastructure", paras. 100 and 101).

D. Guarantees provided by international financial institutions

61. Besides guarantees given directly by the host Government, there may be guarantees issued by international financial institutions, such as the World Bank, the Multilateral Investment Guarantee Agency and the regional development banks. Such guarantees usually protect the project company against certain political risks, but under some circumstances they may also cover breach of the project agreement, for instance, where the project company defaults on its loans as a result of the breach of an obligation by the contracting authority.

1. Guarantees provided by multilateral lending institutions

62. In addition to lending to Governments and public authorities, multilateral lending institutions, such as the World Bank and the regional development banks, have developed programmes to extend loans to the private sector. Sometimes they can also provide guarantees to commercial lenders for public and private sector projects. In most cases, such guarantees provided by those institutions require a counter-guarantee from the host Government.

63. Guarantees by multilateral lending institutions are designed to mitigate the risks of default on sovereign contractual obligations or long-maturity loans that private lenders are not prepared to bear and are not equipped to evaluate. For instance, guarantees provided by the World Bank may typically cover specified risks (the partial risk guarantee) or all credit risks during a specified part of the financing term (the partial credit guarantee), as summarized below. Most regional development banks provide guarantees under terms similar to those of the World Bank.

(a) Partial risk guarantees

64. A partial risk guarantee covers specified risks arising from non-performance of sovereign contractual obligations or certain political *force majeure* events. Such guarantees ensure payment in the case of debt service default resulting from the non-performance of contractual obligations undertaken by Governments or their agencies. They may cover various types of non-performance, such as failure to maintain the agreed regulatory framework, including price formulas; failure to deliver inputs, such as fuel supplied to a private power company; failure to pay for outputs, such as power purchased by a government utility from a power company or bulk water purchased by a local public distribution company; failure to compensate for project delays or interruptions caused by government actions or political events; procedural delays; and adverse changes in exchange control laws or regulations.

65. When multilateral lending institutions participate in financing a project, they sometimes provide support in the form of a waiver of recourse that they would otherwise have to the project company in the event that default is caused by events such as political risks. For example, a multilateral lending institution taking a completion guarantee from the project company may accept that it cannot enforce that guarantee if the reason for failure to complete was a political risk reason.

(b) Partial credit guarantees

66. Partial credit guarantees are provided to private sector borrowers with a government counter-guarantee. They are designed to cover the portion of financing that falls due beyond the normal tenure of loans provided by private lenders. These guarantees are generally used for projects involving private sector participation that need long-term funds to be financially viable. A partial credit guarantee typically extends maturities of loans and covers all events of non-payment for a designated part of the debt service.

2. Guarantees provided by the Multilateral Investment Guarantee Agency

67. The Multilateral Investment Guarantee Agency (MIGA) offers long-term political risk insurance coverage to new investments originating in any member country and destined for any developing member country other than the country from which the investment originates. New investment contributions associated with the expansion, modernization or financial restructuring of existing projects are also eligible, as are acquisitions that involve the privatization of state enterprises. Eligible forms of foreign investment include equity, shareholder loans and loan guarantees issued by equity holders, provided the loans and loan guarantees have terms of at least three years. Loans to unrelated borrowers can also be insured, as long as a shareholder investment in the project is concurrently insured. Other eligible forms of investment are technical assistance, management contracts and franchising and licensing agreements, provided they have terms of at least three years and the remuneration of the investor is tied to the operating results of the project. MIGA insures against the following risks: foreign currency transfer restrictions, expropriation, breach of contract, war and civil disturbance.

(a) Transfer restrictions

68. The purpose of guarantees of foreign currency transfer extended by MIGA is similar to that of sovereign foreign exchange guarantees that may be provided by the host Government (see para. 49). This guarantee protects against losses arising from an investor's inability to convert local currency (capital, interest, principal, profits, royalties and other remittances) into foreign exchange for transfer outside the host country. The coverage insures against excessive delays in acquiring foreign exchange caused by action or failure to act by the host Government, by adverse changes in exchange control laws or regulations and by deterioration in conditions governing the conversion and transfer of local currency. Currency devaluation is not covered. On receipt of the blocked local currency from an investor, MIGA pays compensation in the currency of its contract of guarantee.

(b) Expropriation

69. This guarantee protects against loss of the insured investment as a result of acts by the host Government that may reduce or eliminate ownership of, control over or rights to the insured investment. In addition to outright nationalization and confiscation, "creeping" expropriation—a series of acts that, over time, have an expropriatory effect—is also covered. Coverage is provided on a limited basis for partial expropriation (for example, confiscation of funds or tangible assets). Bona fide, non-discriminatory measures taken by the host Government in the exercise of legitimate regulatory authority are not covered. For total expropriation of equity investments, MIGA pays the net book value of the insured investment. For expropriation of funds, MIGA pays the insured portion of the blocked funds. For loans and loan guarantees, the Agency insures the outstanding principal and any

accrued and unpaid interest. Compensation is paid upon assignment of the investor's interest in the expropriated investment (for example, equity shares or interest in a loan agreement) to MIGA.

(c) Breach of contract

70. This guarantee protects against losses arising from the host Government's breach or repudiation of a contract with the investor. In the event of an alleged breach or repudiation, the investor must be able to invoke a dispute resolution mechanism (for example, arbitration) under the underlying contract and obtain an award for damages. If, after a specified period of time, the investor has not received payment or if the dispute resolution mechanism fails to function because of actions taken by the host Government, MIGA will pay compensation.

(d) War and civil disturbance

71. This guarantee protects against loss from damage to, or the destruction or disappearance of, tangible assets caused by politically motivated acts of war or civil disturbance in the host country, including revolution, insurrection, *coup d'état*, sabotage and terrorism. For equity investments, MIGA will pay the investor's share of the least of the book value of the assets, their replacement cost or the cost of repair of damaged assets. For loans and loan guarantees, MIGA will pay the insured portion of the principal and interest payments in default as a direct result of damage to the assets of the project caused by war and civil disturbance. War and civil disturbance coverage also extends to events that, for a period of one year, result in an interruption of project operations essential to overall financial viability. This type of business interruption is effective when the investment is considered a total loss; at that point, MIGA will pay the book value of the total insured equity investment.

E. Guarantees provided by export credit agencies and investment promotion agencies

72. Insurance against certain political, commercial and financial risks, as well as direct lending, may be obtained from export credit agencies and investment promotion agencies. Export credit agencies and investment promotion agencies have typically been established in a number of countries to assist in the export of goods or services originating from that country. Export credit agencies act on behalf of the Governments of the countries supplying goods and services for the project. Most export credit agencies are members of the International Union of Credit and Investment Insurers (Berne Union), whose main objectives include promoting international cooperation and fostering a favourable investment climate; developing and maintaining sound principles of export credit insurance; and establishing and sustaining discipline in the terms of credit for international trade.

73. While the support available differs from country to country, export credit agencies typically offer two lines of coverage:

(a) *Export credit insurance*. In the context of the financing of privately financed infrastructure projects, the essential purpose of export credit insurance is to guarantee payment to the seller whenever a foreign buyer of exported goods or services is allowed to defer payment. Export credit insurance may take the form of "supplier credit" or "buyer

credit" insurance arrangements. Under the supplier credit arrangements the exporter and the importer agree on commercial terms that call for deferred payment evidenced by negotiable instruments (for example, bills of exchange or promissory notes) issued by the buyer. Subject to proof of creditworthiness, the exporter obtains insurance from an export credit agency in its home country. Under the buyer credit modality, the buyer's payment obligation is financed by the exporter's bank, which in turn obtains insurance coverage from an export credit agency. Export credits are generally classified as short-term (repayment terms of usually under two years), medium-term (usually two to five years) and long-term (over five years). Official support by export credit agencies may take the form of "pure cover", by which is meant insurance or guarantees given to exporters or lending institutions without financing support. Official support may also be given in the form of "financing support", which is defined as including direct credits to the overseas buyer, refinancing and all forms of interest rate support;

(b) *Investment insurance*. Export credit agencies may offer insurance coverage either directly to a borrower or to the exporter for certain political and commercial risks. Typical political and commercial risks include war, insurrection or revolution; expropriation, nationalization or requisition of assets; non-conversion of currency; and lack of availability of foreign exchange. Investment insurance provided by export credit agencies typically protects the investors in a project company established overseas against the insured risks, but not the project company itself. Investment insurance cover tends to be extended to a wide range of political risks. Export credit agencies prepared to cover such risks will typically require sufficient information on the legal system of the host country.

74. The conditions under which export credit agencies of member countries of the Organisation for Economic Cooperation and Development (OECD) offer support to both supplier and buyer credit transactions have to be in accordance with the OECD Arrangement on Guidelines for Officially Supported Export Credits (also referred to as the "OECD consensus"). The main purpose of the Arrangement is to provide a suitable institutional framework to prevent unfair competition by means of official support for export credits. In order to avoid market-distorting subsidies, the Arrangement regulates the conditions of terms of insurances, guarantees or direct lending supported by Governments.

Note

[1] See "Introduction and background information on privately financed infrastructure projects", footnote 1.