DOMESTIC ISSUES IN INFRASTRUCTURE FINANCING

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In the 1880s, Australian public infrastructure was largely financed by sovereign borrowings by colonial governments, particularly borrowings in the London market for railway construction. In more recent years an urgent need to renew or replace much government infrastructure, some of it in fact constructed as long ago as the 1880s, has arisen. At a time of financial stringency for Australian governments, some of which suffered rating drops during the recession, State governments in particular have for some time been seeking ways in which specific infrastructure projects can be undertaken and financed by the private sector without use of a government's credit, or at least without full use of it, and projects have proceeded on this basis.

The financing of infrastructure projects, principally from the perspective of the financier, is the subject of this paper. It commences with some background to the subject, including some fairly arbitrary definitions, and then discusses typical project initiation processes, the overall objectives of the particular parties, and some constraints on them. The paper concludes with some thoughts on project feasibility and the contractual allocation of the risks between the parties, and a brief description of some typical project documentation.

BACKGROUND

Infrastructure projects in the sense used in the paper are projects for the provision of facilities needed by government, for use either by it or its instrumentalities, or by the general public. They are projects which would have traditionally been undertaken by governments and funded by government debt, but which are in fact implemented by the private sector. Thus a power station supplying power into the State grid is "infrastructure" and the subject of this paper, whereas a "private" power station solely dedicated to supplying its owner's aluminium smelter is not. In both cases there may be governmental involvement; in the latter case, the government may provide land or special investor concessions to encourage the industry. Nevertheless, a true infrastructure project is necessarily predicated on the host government's desire for the particular infrastructure to service its own or the public's purposes.

The physical infrastructure in question usually requires to be completely constructed, although there will inevitably be interfaces with infrastructure owned by government or government entities, such as transmission lines or feeder roads. In some cases, such as the Loy Yang B power station in Victoria, the private sector role was to complete a power station which had been

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partially constructed by a government entity. It may also be possible to characterise the sale to the private sector of a facility constructed by government with government funding, at least when the facility or its output is to be used in part for government purposes and the private sector purchaser is required to carry out some refurbishment, as an "infrastructure project" in this broad sense. An example of this was the case with the 1994 sale of the Gladstone Power Station by the Queensland government. In this way, "infrastructure projects" can blend imperceptibly into "privatisation". The distinction between infrastructure projects and privatisations may be one without much of a difference, because many (although not all) of the issues likely to arise will be the same.

Infrastructure projects broadly take two forms. The first is the concession in the strict sense. The government grants a right, usually with an associated lease of land, to a private sector entity to construct or complete a facility such as a toll road, railway, port or airport, and exploit it to derive revenue from the public and others during a finite concession period. The private sector party will have a related obligation to construct and make the facility available as contemplated, and to transfer it to government at the end of the concession period (build, own, operate and transfer). To the extent public use is contemplated, there are likely to be limits on user charges.

The second is an arrangement under which a private sector entity is to construct or complete a facility and sell all or part of the facility's physical output, such as coal or power, to a government or government instrumentality, or operate the facility so as to provide a service, such as access to a gas, communication or other transmission line or water or sewerage treatment, to a government or instrumentality. It often includes an outright sale or long term lease of a government asset, such as unimproved or partly improved land. The supply of output or services to government will typically be under a long term "take or pay" contract, under which government will pay a capacity charge designed to cover the private sector's financing and other fixed costs (payable whether or not the output is taken or the services used) and a usage charge, calculated by reference to output actually taken or services actually used, which covers variable operating costs.

Although not strictly correct, for convenience the paper uses the term "concession agreement" to describe the relevant contractual arrangements with government for both types of project, and in many cases, "government" to cover both a government in the strict sense and a government instrumentality.

The paper is also confined to *project* financing for infrastructure projects. In this regard I use the often quoted definition of a project *financing* by Peter Nevitt of Bank of America:

> "A financing of a particular economic unit in which a 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 collateral for the loan".

A project financing is thus one in which the private sector initiator (sponsor) embarks on a project and raises funds on the basis that it has only a limited degree of financial responsibility to the financiers. In theory a private sector entity could borrow for an infrastructure project on the strength of its own balance sheet, but that would be most unusual, since in most projects the sponsors are seeking to share risk, particularly with the financiers. In any event the issues peculiar to the financing of infrastructure project will not, at least directly, be relevant to financiers who lend on a corporate basis and make a credit decision on the basis of the borrower's balance sheet. It is necessary, in order to consider the issues peculiar to infrastructure financing, to put those issues in the context of conventional project financing techniques, but otherwise the paper endeavours to avoid areas which are common to all project financings.

In a technical Australian sense, "infrastructure financing" might arguably be confined to "infrastructure borrowings" satisfying the requirements of the Development Allowance Authority Act 1992 (Cth) and thereby obtaining income tax benefits as contemplated in the 1992 "One Nation" statement (as revised by the 1994 "Working Nation" statement). The person entitled to interest on "infrastructure borrowings" is exempt from income tax on it or, at its election, may receive a 33% income tax rebate in respect of the interest; the project vehicle, which will be unable to utilise tax deductions for many years (that is, until it has completed construction and

commenced to derive significant revenue) is denied a tax deduction for the interest.[1] The ability of the borrowings for a particular project to constitute "infrastructure borrowings" may be very significant to its commercial viability, and the need to do so can affect the structuring of the project and finance arrangements and documentation. Nevertheless, many "infrastructure projects" have been, and will no doubt continue to be, financed by borrowings which do not satisfy the Act's requirements, because (amongst other things) the Act does not extend to facilities which are undeniably infrastructure in the sense used above, such as dams, coal mines, land, air and transport facilities (such as roads) which the public can use without charge, and gas processing plants. If the former government's announcement in late 1995 is implemented by the present government, urban toll roads will also be excluded.

In the paper, the "sponsor" is the private sector protagonist which essentially "puts together" the project, and its financing, through negotiations with government, debt and any other equity financiers and other contracting parties. As indicated, it will have only a limited level of legal responsibility to the financiers and thus will typically not be the actual borrower, which will usually be the project vehicle in which the equity is invested. The project vehicle may be a corporation, a trust, a partnership or an unincorporated joint venture, according to what is most desirable from the fiscal and accounting standpoint and the viewpoint of minimising the personal liability of the equity holders. It is beyond the scope of this paper to discuss the issues associated with the choice and structuring of the borrower/project vehicle, because in general, these issues are the same for all project financings. Note, however, that only corporations, limited partnerships taxed as corporations, and corporate unit trusts and public trading trusts (which are similarly taxed) may make "infrastructure borrowings".[2]

The sponsor will obviously hold some equity in the project, but will typically have other commercial interests in it. It may be, or have interests in, the construction contractor, the entity operating the project on a contract basis, a supplier of raw material (coal for a power station) or a purchaser of some outputs (some power from a power station, as in the case of the Gladstone Power Station). There may of course be two or more sponsors, which will not necessarily have the same commercial interests or legal involvement. One may be the construction contractor, and one may be the operator or raw material supplier.

The "project financiers" essentially take the credit risk of the project. Their recourse will typically be limited to the project assets and associated cash flows. The most significant of the assets will be the rights of the project vehicle against government under the concession agreement. Also important will be its rights against other contracting parties, such as construction contractors, operators, raw materials suppliers, and offtakers. It may also have rights against banks or insurance companies providing letters of credit, performance bonds or other credit enhancement for obligations of the primary contracting parties. In addition to their indirect rights against the various parties through the security granted by the project vehicle to them, the project financiers will usually have some direct contractual rights against government and the other primary contracting parties, and possibly even against providers of credit enhancement.

The financing structure may also include financiers which do not take project risk. They may lend on the basis of credit enhancement provided by the project financiers, or on the security of specifically dedicated cash deposits, which may have been funded by loans from the project financiers. In some cases such "non-project financiers" may automatically become project financiers at a later stage, for example, once project construction is complete. They will not take the major risk that the facility will never be constructed, but they will take "operating risk".

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1 It is beyond the scope of the paper to deal with the detailed requirements of the Act in relation to "infrastructure borrowings"; see, generally, Loxton, "Infrastructure Bonds - A New Dawn" (1994) 5 *Australian Journal of Banking and Finance Law and Practice*, p 298, and "Infrastructure Bonds" (1994) 38 *Australian Construction Law Newsletter*, p 47].

2 Development Allowance Authority Act 1992 (Cth) s 93I.

Such a "dual debt" structure may be used if the "non-project finance" can be raised in the relevant market at a lower cost than the cost of raising the funds directly from the project financiers, taking into account the amounts payable to the project financiers for providing credit support, or by way of interest on loans to fund the security deposits. This may be because the non-project financiers derive fiscal benefits which cannot be derived by the project vehicle itself, for example under the "infrastructure borrowing" regime. The "non-project finance" may be at a fixed rate of interest, thus avoiding the need to hedge the floating rates typically charged by project financiers, or it may be raised on some other basis which reduces future funding cost risk, for example, where the return on bonds is linked to the Consumer Price Index and matches a revenue stream which is similarly escalated. However, the non-monetary "price" for such finance may be that it can be only be raised in a market which will not accept project construction risk, or project risk at all.[3]

THE PROCESS OF PROJECT INITIATION

If a government decides that it, or the public, needs a particular infrastructure facility and that this should be provided by the private sector, its basic aim will, quite properly, be to see how good and finite a deal the private sector can offer it. This can obviously be best achieved by a tender or similar competitive process. Having completed that process, the government might decide that the best private sector offer is not sufficiently attractive to it, either on substantive grounds or because it is perceived to be too "conditional", for example because it is conditional on obtaining finance and therefore potentially open to renegotiation at the behest of the financiers. That being so, it would obviously like the flexibility not to proceed with the private sector, but to proceed with the project on the basis of government funding, or not proceed with it at all. The government will, or should, also want to reach that decision point at minimum cost to it.

For its part, a private sector entity which is given an opportunity to engage in a tender process must, as with any other tendering opportunity, make a commercial judgment whether or not to take up that opportunity, bearing in mind the very considerable cost associated with the process, the uncertainty as to whether at the end of the day the cost will ever be recouped and it will indeed be a sponsor of a "live" project, and the period during which the uncertainty will continue (which is likely to be quite substantial). It may also have concerns as to whether its own intellectual property will be adequately protected.

I suspect that tendering costs (including management time) associated with project-financed infrastructure projects are likely to be higher than for any other type of project. I say this because of the likely complexity of the arrangements, the involvement with government, the number of parties, and the fact that no reliance (at least legally) can be placed on information provided by, or preliminary work done, by government in relation to the project (see below). The problem will be exacerbated by the natural desire of government to seek maximum certainty before making a final decision. The cost will obviously include the costs associated with the sponsor's own technical consultants and lawyers, bearing in mind that, to achieve that maximum certainty, documentation will need to reach a reasonable degree of finality before the outcome of the tender process is known. In addition, it will probably be necessary to "bring along" the debt financiers as part of the process, and their costs and those of their consultants and lawyers will also need to be taken into account.

In assessing its likelihood of ultimately being an actual project sponsor, the potential tenderer will obviously be concerned with the fairness, as between tenderers, of the tender process. It will also need to take into account the possibility that, even if its tender is the most satisfactory one from the standpoint of government, government will elect not to proceed, either for economic or other

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[3] For a discussion of some issues relating to a dual debt structure, see Furnell, "Combining Project and Bond Debt in Infrastructure Projects: Some Issues" (1996) *Journal of Commercial and Finance Law*, p 51.

rational reasons, or because to proceed with the project in association with the private sector may have become politically unattractive.

The issues relating to cost and uncertainty will not only be of concern for the tenderers to government. If, for the purpose of the tender, a particular degree of commitment is required from, for example, potential financiers or construction contractors, they will equally be concerned with any costs which they incur and which may not be reimbursed to them if the tender is unsuccessful, (and the uncertainty of success). The tenderer may even conduct a tender or similar process in selecting potential financiers or construction contractors, which will increase the overall "cost risk".

The legal position of an unsuccessful tenderer, both in relation to the fairness of the tender process and the right to recover tendering costs, is not particularly strong. Under the general law, an invitation to tender is of course not an offer capable of acceptance by the tenderer so as to give rise to a binding contract to proceed. A tenderer may be able to establish an implied contract with the party calling tenders that all tenders will be considered and assessed in conjunction with all other conforming tenders in accordance with the tender process. Also, a tenderer may be able to establish a "legitimate expectation" on its part of the tenderer requiring procedural fairness to be observed by the principal. In addition, in the case of tenders called by statutory corporations, there might be scope for a tenderer to challenge a decision under section 52 of the Trade Practices Act 1974 (Cth) which prohibits misleading or deceptive conduct.[4] Nevertheless such legal challenges are unlikely in practice to provide worthwhile redress to unsuccessful tenderers, particularly where the government has complied with its own tendering process, albeit one which has been prepared with the view of providing maximum legal protection to the government.

In 1995 a task force appointed by the Economic Planning Advisory Council published interim and final reports on private sector involvement in public infrastructure. In its reports, the Task Force concluded that governments should almost always use competitive tendering to select contractors for major infrastructure projects. However, it echoed many of the above concerns, and made the point that private sector interest in infrastructure projects will be deterred if processes imposed by governments impose an unreasonable burden on tenderers, or if there is a lack of confidence in the tendering process. It concluded that, rather than compensating the private sector for tender costs, governments should work to improve general tendering processes in accordance with its specific recommendations. A recommendation of particular interest to potential project financiers is that where a government requires tenderers to obtain "underwritten bids" from financiers rather than simply "letters of commitment", the government should justify this requirement in the tender documentation.

Another major issue dealt with by the Task Force was the issue of transparency, that is, how to balance the public's right to information about contracts between governments and the private sector with the need to safeguard the latter's commercial information. It concluded that, given the significance of major infrastructure projects, the host government should provide Parliament with a summary of the concession agreement and information on overall distribution of project returns between public and private sectors, and provide its Auditor-General with sufficient resources to exercise his discretion to provide Parliament with his own assessment of (presumably, the full terms of) major infrastructure contracts. The issue of concession agreement disclosure is only likely to be relevant where it has not been ratified by statute and the equity for the project does not include a component which has required the issue of a prospectus. In the former case the agreement will be scheduled in the ratifying legislation or otherwise made public during the legislative process. In the latter case the concession agreement will almost certainly be required to be made available to the public as a material contract.

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4 *ACT Health Authority v Berkeley Cleaning Group Pty Ltd* (1985) 60 ALR 284 and, generally, Shirbin, "Banking Implications of Contracting with Government", *Proceedings, 12th Australian Banking Law Association Conference* (1995), p 289 and the cases there cited.

Even before the Task Force produced its final report, a number of State governments had already published guidelines, in greater or lesser detail, concerning their objectives and proposed procedures in connection with infrastructure projects involving the private sector and the issue of transparency.[5] The procedures contemplated are along broadly similar lines. The Victorian guidelines, for example, contemplate that wherever possible, a four stage tender process will be followed in relation to projects intended by the government to involve the private sector:

(a) A government call to private sector parties for registration of their capability.

(b) An assessment by a government management panel of the registrations, preparation by the panel of a short list of proponents (so as to minimise the number of parties tendering and accordingly overall tender costs), and issue to the short-listed proponents, following formal government approval, of a detailed Project Brief. The Brief may in fact contain pro forma documents for review and comment by proponents as part of their bids.

(c) An evaluation by the parties of the bids in the light of specified criteria and through discussion with proponents. This process typically leads to a determination of a preferred proponent, and a "draft commercial agreement" in plain English including a statement of the risks to be borne by the proponent and by the government.

(d) Final documentary negotiation "within the boundaries" of the commercial agreement.

The intention is that the process remains objective and subject to external scrutiny and formal audit.

The Victorian guidelines contain two specific statements of particular relevance. One is that once the Project Brief is issued, the project will proceed to be implemented without further governmental approval, so long as the requirements in the Brief, including costs to government and achievement of "satisfactory financial arrangements", are satisfied. The other is that non-conforming bids can (only) be considered by government when the non-conforming bidder has also submitted a conforming bid, or no confirming bid has been submitted. The New South Wales guidelines state that the government may consider reimbursing tender costs when the process has been aborted through government action unrelated to any commercial or technical aspect of the proposal.

Such statements obviously will go some way towards satisfying, from a practical viewpoint, the concerns of participants in the tender process. However the effectiveness of the first Victorian statement will obviously depend on how precisely the Project Brief requirements are expressed, and how "satisfactory financial arrangements" are determined. Protection from such statements will in any event be practical rather than legal. At the registration of capability stage, all submissions must under the Victorian guidelines waive any rights to claim costs or to appeal against a decision arising from any aspect of the process. The Western Australian guidelines contemplate a similar waiver, and the New South Wales guidelines contain a specific disclaimer of government liability for loss suffered in consequence of statements contained in the guidelines themselves.

As a lawyer, my only comments on the Victorian process are that if the Project Brief is to contain pro forma documents for the purpose of teasing out the various issues which may be involved, a complete "ambit claim" by government may prove counter-productive. Also, it may not be particularly efficient to start the process with the production of detailed pro forma documents for review by proponents (step (b) above), move to a generally expressed "commercial agreement" (step (c)) and then (necessarily) revert back to detailed documentation (step (d)). I query whether

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5 New South Wales, *Guidelines and Principles for Private Sector Participation in the Provision of Public Infrastructure* (February 1995); Victoria, *Infrastructure Investment Policy for Victoria* (June 1994); South Australia, *Guidelines for Private Sector Provision of Infrastructure* (October 1994); Western Australia, *Investing in Infrastructure* (March 1992).

time and cost might be saved if the issues which the government wishes to expose (presumably principally in relation to risk allocation) were exposed *as* issues, rather than in the form of detailed documentation which may obscure rather than clarify them.

THE OBJECTIVES OF, AND CONSTRAINTS ON, THE PARTIES

It is stating the obvious that if the parties are to reach agreement on the commercial terms applicable to a project, in particular the allocation of risks between them, in a reasonably efficient way, each of them must have a good understanding of the objectives of the others, and the governmental, legal and fiscal constraints on each of them.

The Host Government

To quote the New South Wales guidelines, "Private sector involvement must clearly demonstrate, on a whole of life basis, greater net benefits to Government and the community than the same service funded by the public sector." In assessing the net benefits, the government's basic aim will be to ensure that the required infrastructure is provided, for use by it or its instrumentalities or for the general public, within and during an acceptable time frame.

The government will have turned to the private sector to construct the required infrastructure in part at least to avoid increasing public sector debt, whether that be government debt in the strict sense or instrumentality debt. The government will obviously seek to avoid accepting the general financial risk of the project. The New South Wales guidelines, for example, state specifically that the government will not guarantee private sector borrowings, and will not "assume continuing risk that underwrites the viability of the project". Governments do this as a matter of normal financial prudence, and with a view to ensuring that the project arrangements have minimum impact on their financial statements (consistently with proper accounting treatment). They may also be concerned with the possible adverse impact of the project arrangements on their Loan Council Allocation (LCA) under the 1994 Financial Agreement. Under the LCA system, each jurisdiction is required to nominate a LCA. The LCA of each jurisdiction is then considered by the Loan Council in light of the jurisdiction's fiscal position and capital needs, and overall macroeconomic objectives. Whilst all LCAs have so far been accepted by the Loan Council as nominated, this need not necessarily always occur.

Between 1984 and 1992, a State government's capacity to borrow was determined by the Loan Council by reference to that State's "global borrowing limit", which was an aggregate limit on new borrowings. Under the "global approach", borrowings to finance an infrastructure project were deemed to fall within the global limit if the government assumed the greater part of the financial risks associated with the project, even if it did not hold the majority equity, but not otherwise. In this context, project structures were developed to remove (or to appear to remove) projects from the global limits.

In 1993, a working party of the Heads of Treasury Officials reported that the desire to remove projects from global limits in this way introduced a bias towards private sector involvement which did not always result in the most efficient use of resources, and that the subjective nature of the assessment process created uncertainty for private sector participants and consequently increased transaction costs. In consequence, the Council dispensed with the "all or nothing" approach, and agreed on new guidelines for the treatment of most infrastructure projects of the kind under discussion.[6] The new approach involves estimating the degree of public sector risk exposure, disclosing that estimate, and including it in the host government's LCA. It is designed to quantify the potential liability of the government by reference to the amount it would need to pay to a third party to assume its risk in respect of the project. Estimates of the "value" of the risk

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6 *Guidelines for Loan Council Coverage of Infrastructure Projects with Public Sector Involvement* (March 1994).

are made by weighting the following three factors and applying the weighting to the "government liability" (see below).

(a) The gearing ratio. Government risk is reduced to the extent that project assets have a realisable value in the market place. The higher the ratio of asset values to liabilities, the lower is the likelihood of demand being made on the government. For simplicity, asset values are deemed equal to construction cost less government grants, and project liabilities are deemed equal to construction cost, less equity contributions and government grants. However, in recognition of the fact that infrastructure projects, being driven by governmental requirements, are not necessarily economically viable in an objective sense, (that is, without the specific government need) there is potential for asset values to be discounted where the economic costs exceed the economic benefits of the project.

(b) The volatility factor. The lower the variability of the net liability, the lower is the risk to public funds. For this purpose, project types have been classified into five separate volatility classes based on stock exchange data, ranging from 10% for water and sewerage projects to 30% for communication projects.

(c) Project duration. The longer the life of a project, the greater is the risk to public funds. The minimum term provided in the concession agreement in which no penalties are incurred by government if it does not renew the arrangement is used for this purpose. A 10 year contract with a 5 year renewal option which results in a penalty to government if not exercised is treated as a 15 year project.

Once the three factors have been determined, the risk weighting is calculated from a predetermined set of tables, and multiplied by the "government liability" to generate the LCA impact. What is crucial in this regard is that the "government liability" is the liability (if any) imposed on the government (for example, in consequence of a guarantee to lenders) in the case of private sector default. Accordingly, there will be no LCA impact if the government is able to terminate the project arrangements "for private sector default" without making any payment to the private sector party or to its financiers. This would appear to be so even if the government had significant payment obligations to the project vehicle in other circumstances, for example, if under the agreed risk allocation the government accepted financial liability for "force majeure events". For example, if the concession agreement provides for the suspension of the private sector obligation in consequence of such a "force majeure event", and requires the government to terminate the concession agreement upon making a payment to the private sector party if the event continued for, say, six months, there would at no stage have been a "private sector default".

It is interesting to note that the Victorian guidelines specifically advise proponents that Loan Council status should not be the driving force for any proposal. The New South Wales guidelines, by stating that the State Treasury will work closely with government agencies in preparing an assessment of likely Loan Council impacts, suggest that this may be a significant item in that government's thinking.

A government may also wish to involve the private sector so as to introduce what it perceives to be private sector efficiencies in comparison with the level of efficiency which can be, or currently is being, achieved by government. Private sector efficiency will not only be relevant to the project itself, but may have the potential to improve efficiencies in related areas of activity which are government operated (by way of "competition by comparison").

In addition, in offering what might seem an attractive proposition to a private sponsor to carry out an infrastructure project the government may hope (or specifically bargain for) the carrying out by the sponsor of some purely private project which it is anxious should proceed in the interests of promoting general economic activity and employment.

A particular issue for government is how prescriptive it should be in the requirements it seeks to impose on the project vehicle in relation to the construction or operation of the relevant infrastructure facility, by way of obligations in the concession agreement or statutory regulation. Governments obviously have a responsibility to require minimum performance standards, for

example, the standard of treatment to be achieved by a sewerage plant, or the speed at which vehicles can enter, travel on and leave an electronically tolled freeway.[7] How detailed these standards should be, and in particular what (if any) sanction there should be if those standards are not met (in particular, during construction) is always a matter for debate, as a high level of regulation conflicts with the interests of the debt and equity parties in maintaining the concession on foot, and may possibly even imperil the tax status of the project (see below).

In this context the EPAC Task Force recommended that governments should seek performance or output-oriented solutions to infrastructure needs rather than specifying technology to be used, and that where there is a need to be more prescriptive, provisions should be made during the tender process for submission of non-complying options. The Victorian guidelines also indicate an intention that government should specify the end needs to be satisfied rather than the means of meeting those needs, although this appears to be an indication of what should, and should not, be contained in the Project Brief rather than what should be in the legal documentation.

The Equity Parties

All equity parties will obviously seek a reasonable assurance of an adequate return on their investment over the life of the project. However, the sponsor will, if it has other commercial interests in the project (for example, in the construction contractor), obviously want to maximise its return in its other capacities. To the extent that its interests in those other capacities outweigh its interest in achieving an equity return over the life of the project, there is obviously potential for conflicts of interests as between the sponsor on the one hand, and the "pure" equity holders and the financiers on the other.

For their part, the equity parties will obviously want to confine the performance standards imposed by the government to the minimum. Commercially they will want maximum flexibility in implementing the project both during the construction and operation phase. Further, they, and the financiers, will have a common interest in minimising the risk of premature termination of the concession. The greater the number and scope of the project vehicle's obligations under the concession agreement, the greater will be the risk that the government may be able to terminate the concession (and the financiers' security) potentially without compensation for what might seem to the project vehicle and the financiers to be a relatively trivial breach. Whilst in theory this can be solved by a regime in the concession agreement limiting termination of the concession to "material" breaches of performance standards, experience suggests that this is not often easy to achieve, as the parties will view materiality in this context from very different perspectives.

On the other hand, the project vehicle will obviously want to know at the outset the precise performance standards which it must meet, and not be in a position in the future where new standards are imposed on it which it cannot meet, either at all or at an acceptable cost. This is a practical problem at the moment, because many (if not most) statutory schemes for regulation of the provision of what were previously "governmental" services to the public are in a very incomplete state. Given this, there may be no alternative but to have all regulatory issues settled on a "one off" basis as part of the concession agreement and any related legislation. If the concession agreement is ratified by statute, this will provide some protection against changes in standards of the future (subject to the general issue of "political risk" discussed below).

Section 51AD of the Income Tax Assessment Act (1936) (Cth) must be borne in mind by the private sector parties when considering the issue of performance standards and their "policing" and enforcement, as well as other aspects of the concession agreement. The section denies tax deductions (in particular, depreciation) referable to the ownership of property financed through "non-recourse debt" where, amongst other things:

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7 Melbourne City Link Act 1995 (Vic) Schedule 1, Clause 9.2(a).

(a) the property is to be used in connection with the production, carriage or transmission of goods, or the provision of services;

(b) a person other than the owner (the "end-user"), "effectively controls" that use, or will have or is or will be able to exercise, that degree of control, directly or indirectly; and

(c) either the goods are to be produced, carried or transmitted, or the services are to be provided, for the end user and used by it for a purpose other than to produce income potentially subject to income tax, or the end user is to derive no income potentially subject to income tax from the production, carriage, transmission or provision.[8]

The section potentially covers all infrastructure projects, because the income of governments, and most of their instrumentalities, will of course be exempt from tax; accordingly they are potential "end-users". The tax deductions in question will be crucial to the viability of the project, and accordingly there must be no risk that the government or the relevant instrumentality possesses the necessary degree of "effective control"; the government is most unlikely to accept the risk of the deductions not being available.[9] Because of the complexity of the issue, and the amounts at stake, parties associated with an infrastructure project will normally only proceed if a private tax ruling has been obtained from the Australian Taxation Office as to the non-application to the project of section 51AD, and also Division 16D of Part III of the Income Tax Assessment Act which employs somewhat similar concepts. To obtain such a ruling it is necessary to satisfy the Australian Taxation Office that the arrangements with government, and in particular the performance standards methods of policing them and sanctions for breach of them, will not give it "effective control".

It is beyond the scope of this paper to address all the potential issues which may arise from section 51AD, except to point out that its implications must be carefully borne in mind when project arrangements are being negotiated. In 1990 the Australian Taxation Office issued a public tax ruling[10] which, whilst stressing that the arrangements for each project must be individually reviewed, sets out certain general guidelines in relation to the potential application of section 51AD to privately owned power stations. The ruling points out that the section is concerned with de facto rather than legal control of use by government, and that one must have regard, not only to the formal documents relating to management of the facility, but also to the overall arrangements between the project owner and the government. These overall arrangements include the financial arrangements, because they "may point to a position of economic dependency such that the legal owner may not in reality be capable of operating the station otherwise than in accordance with the wishes or the directions of" government.

The ruling is to the effect that "effective control" must involve government either operating the facility on a day to day basis through its employees or agents, or having "such an immediate supervisory role that enables it to direct others in that day to day operation". It also contemplates that the arrangements may contain a regime which permits government to "step in" to operate the project in circumstances of gross default in operation of the station which threatened the overall supply of power from the State grid, at least where default continued after the station owner has been given reasonable notice and an opportunity to take remedial action. Presumably, a similar regime for "step in" to a water treatment plant to protect public health would be equally acceptable.

Section 51AD has obviously not prevented a number of infrastructure projects proceeding, but its requirements must be borne in mind by all parties, in particular when government is considering the integration of the relevant facility into overall government or public infrastructure. If government representatives seek to adopt the approach that government should be able to

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8 Income Tax Assessment Act 1936 (Cth) section 51AD(4)(b)(ii).

9 For example, the New South Wales guidelines specifically state that the government will not assume any risk associated with the denial of tax deductions.

10 No IT 2602.

regulate and direct the private facility (which may be physically indistinguishable from a government owned facility and serve the same purposes) in the same way, the section clearly has potential to cause significant difficulties.

The "infrastructure borrowing" requirements include two which are particularly relevant to the project contractual arrangements. The first, reflecting the same philosophy as section 51AD, requires, as a condition to the issue by the Development Allowance Authority to the borrower of the necessary certificate, that the borrower intends:

(a) to use the relevant facility to produce income potentially subject to income tax;

(b) "effectively control" the use of the facility; and

(c) not do anything which would cause section 51AD or Division 16D to apply to the facility.

The borrower must in fact also undertake to ensure that its intentions are put into effect. Breach of the undertaking can lead to cancellation of the certificate and, whilst cancellation will not affect the tax status of the current "infrastructure borrowing", it will expose the borrower to a penalty tax.[11] The fact that a private tax ruling is obtained at the outset that section 51AD did not apply will not necessarily protect the borrower in respect of its ongoing undertaking, particularly if the de facto control situation changes over time.

The second requirement is that of section 93O(2) of the Development Authority Allowance Act which prohibits the Authority from issuing a certificate in respect of a direct infrastructure borrowing if there is then in force "a law that the DAA is satisfied will prohibit or restrict the operation of other facilities in competition with the infrastructure facilities concerned". The policy is that, if a State grants a statutory monopoly to a project that project should not be entitled to the relevant tax benefits, but the legislation may arguably have wider scope. Note that the law need not be one specifically passed in relation to the project, but could be a law of general application. The law need not even be a law of the jurisdiction in question. At least in theory, a Commonwealth law could restrict the operation of the "other facilities", even though the concession agreement was with a State government. Equally obviously, if the operation of the other facilities is restricted by purely private contract, the section will not apply.

Leaving aside section 93O(2), the arrangements with government can now potentially breach the general competition provisions (Part IV) of the Trade Practices Act 1974 (Cth). For example, a long term "whole of output" take or pay contract with a government utility can breach section 47 of the Act if it is determined to be an exclusive dealing arrangement and substantially lessens competition, unless of course it has been authorised on a "public benefit" basis by the Australian Competition and Consumer Commission under the Act. Since the 1995 decision of the Commission revoking the authorisation previously granted under the Act in relation to the Cooper Basin natural gas supply arrangements it may be more difficult to obtain such an authorisation.

In the past, the potential problem of long term contracts with government instrumentalities has sometimes been solved by a specific exemption in relation to the contract contained in a State Act.[12] The Commonwealth has always had power to nullify such an exemption, but has rarely exercised it. However, under the recently enacted Hilmer reforms, all such exemptions must be reviewed by the National Competition Council. On receipt of a report by the Council that an exemption should not continue, the Commonwealth Government may, under the Conduct Code Agreement between the Commonwealth and the States and Territories, table in the Commonwealth Parliament a cost-benefit report as to whether the Commonwealth should make regulations nullifying the exemption.

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11 Development Allowance Authority Act 1992 (Cth), ss 93K(1), 93P(1), 93R(1) and 93B and Income Tax Assessment Act 1936 (Cth) ss 159GZZZZE(1A) and 159GZZZZH.

12 Johnston, "The Government as a Vendor - Caveat Emptor" *Proceedings, 11th Annual Banking Law and Practice Conference* (1994) p 238).

The new regime, part of the Hilmer reforms, governing open access to essential facilities has the potential (depending on the circumstances) to be detrimental or beneficial to the private sector participants in an infrastructure project. Under the new Part IIIA of the Trade Practices Act, the Federal Government can declare a "service" provided by means of a "facility"; this covers infrastrcuture facilities such as roads or railway lines, facilities for handling or transporting goods or people, and communications or similar services. Although there are significant constraints and potential time delays inherent in the grant of access to a declared "service", the project vehicle may ultimately be required to give access to a facility the subject of an infrastructure project (for example, a transmission line or pipeline) to all comers, and even to incur capital expenditure to increase the capacity of the existing facility to meet demand, something which is most unlikely to be provided for in the original project financing plan. This could happen notwithstanding anything in the concession agreement or a State Act, although a government offtaker will be entitled to protection for all its rights under a contract executed before 30 March 1995, and all rights under contracts executed after that date to obtain a sufficient amount of the "service" to meet its "actual requirements."[13] On the other hand, if the project involves, for example, the construction of a power station to sell power on a long term basis to a government utility, the new access regime may slightly improve the bargaining position of the project vehicle where the utility terminates the contract for default by the project vehicle or on some other basis (see below).

The Project Financiers

Their security over project assets, in particular over the contractual rights of the project vehicle against the other project parties, will give them an identity of interest in those assets and rights, and the resulting cash flows, with the "pure" equity holders, and they will, in relation to the arrangements with the government and otherwise, be equally concerned with the constraints on equity mentioned above. However as debt financiers they will seek substantially greater certainty than equity of their agreed return in accordance with the agreed amortisation schedule, which will be substantially shorter than the time frame over which the equity return is expected to be achieved (the concession period).

PROJECT FEASIBILITY AND RISK ALLOCATION

As the private protagonist, it will be the sponsor which in the first place endeavours to determine whether the project is feasible from its own viewpoint, and the discussion below focuses on that process. The project financiers and the "pure" equity obviously need to go through similar, but independent, processes from their particular perspectives.

The Factual Situation

The sponsor needs at the outset to satisfy itself that it is aware of the correct factual situation surrounding the project. The government may have a great deal of information relating to the project (for example, historical traffic information in relation to a private toll road) and may make it available to the sponsor and other parties. It may itself have done considerable developmental work in connection with the project. Nevertheless this is an area in which governments are particularly "risk averse" and consequently reluctant to accept any legal responsibility for making the information and development work available to the private sector.[14] In this regard, the position of government is, not surprisingly, often very similar to its position on asset sales, say as part of a privatisation process.[15]

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13 Trade Practices Act 1974 (Cth), s 44W.

14 See, for example, Melbourne City Link Act 1995 (Vic) Schedule 1, Clauses 12.1 and 12.2.

15 Johnston, op cit, pp 239, 240.

The financiers will to a significant degree need to rely on information provided by the sponsor, including the information provided by government. The issue which flows from this is the extent to which the sponsor should give contractual warranties to the financiers (and possibly also to "pure" equity) as to the correctness of the information. A related issue is whether it is appropriate for the sponsor to warrant the reasonableness of the assumptions on which forecasts of cash flows (see below) and other predictions by the sponsor are based, and as to the forecasting process itself. There is a strong argument that sponsors should give such warranties, at least to the project financiers. The latter are being asked to evaluate the possibility of adverse events occurring in the future and thereby to accept risk in that regard. The financiers' argument is that they should, as between them and the sponsor which has done all the initial work, be entitled to assume that the factual material on which that evaluation is based is correct. A similar argument applies to the forecasts, which again are the work of the sponsor. Even if all parties are relying on a particular consultant's report or forecast, the financiers may possibly still take the position that the risk of the consultant getting it wrong should fall upon the sponsor rather than them.[16]

Associated with this issue is the extent to which the project financiers should duplicate the legal and technical "due diligence" carried out or on behalf of the sponsor and/or equity. The sponsor and equity will want to minimise duplication for reasons of cost and time, and accordingly will endeavour to confine the financier's experts to an "audit" role, working in co-operation with the experts engaged by them. Whilst there is clear merit in this approach, it cannot be followed too slavishly, given that the ultimate aims of the different parties are not necessarily the same. Stating the obvious, the sponsor will not be greatly concerned as to whether the concession agreements permits a valid security to be given over the rights of the project vehicle under it, or whether the government has power to enter into direct contractual arrangements with the financiers. Equally, even leaving aside the different aims and time horizons of equity and debt, a due diligence procedure for the purposes of a public float may not of itself be sufficient to satisfy the project financiers. It will to some extent be concerned with ensuring that a process is in place and is implemented so that the lead managers, directors and others have the benefit of the "due diligence" defence under section 1011 of the Corporations Law in connection with the equity issue, whereas the financiers will be concerned with uncovering real threats to their ability to be repaid. The focus is not quite the same.

Feasibility Studies

The fundamental aim of the project feasibility study will be to assess, as accurately as possible, the future cash inflows in the form of revenue, and outflows in the form of operating expenses, capital expenditure, tax and the servicing of debt and equity commitments. This in turn depends on the adoption of realistic assumptions for the purpose. Stating the obvious, cash flow must be assessed in the context of a finance plan which provides for quantified amounts of debt and equity to cover the construction cost and appropriate contingency allowances. The latter should include a "buffer" sufficient to cover debt service for an appropriate period to deal with the unexpected. This will usually be required by the financiers in any event, but is clearly good sense, from equity's perspective, to avoid the risk that a short term cash flow problem will lead to the financiers relying on a failure to pay them to permit acceleration of the project debt and enforcement of their security.

Equally obviously, the cash flow assessment must take into account the effect of servicing the contemplated debt and equity. Before this can finally be determined, the sponsor must decide on the desired mix of debt and equity in their different forms, and whether the projected cash flows are sufficient to attract that debt and equity; what constraints are the project financiers likely to impose on the distribution of surplus cash flow so as to protect their interests, and will these be too restrictive to attract the equity investor? All this has to be assessed when neither debt nor other equity is yet committed to the project and may in fact know little about it, and the outcome

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16 Even if the sponsor does not give a contractual warranty to financiers on a particular matter, it may of course nevertheless have liability to them under section 52 of the Trade Practices Act.

of negotiations with government is not known. The process will inevitably be an iterative and ongoing one.

In assessing cash flows for infrastructure projects, which are almost invariably of a long term nature, the contractual arrangements, particularly with government, will be particularly important. Where, as in a BOOT project, the project vehicle is required to transfer the facility in question to the government at no cost (and free of all security) on the expiry or earlier termination of the concession period, all cash flow is absolutely reliant on the continuance of the concession. Even in the situation where the private sector builds a facility on its own land to supply goods or services to government, the contract is of the same (or almost the same) crucial significance, because on its expiry or early termination it may be very difficult to realise the asset for anything more than land and scrap value, either because the government is the only potential customer for the particular goods or services, say, in the case of a water treatment plant, or because access to a necessary transmission facility is not available, although the latter situation has potential to be improved by the Hilmer access regime. Contrast the situation where a company builds a factory on its own land to supply a particular product to a range of consumers; it will be able to do so indefinitely so long as the market is prepared to pay for the product at a price which results in a profit.

RISK IDENTIFICATION AND ALLOCATION

No matter how carefully the assumptions on which the cash flow forecasts are based have been developed, there are risks (indeed it is certain) that they will not prove to be wholly correct. The whole project evaluation process depends on a systematic assessment of each risk that this will not occur, and if the risk is not to be borne by the project vehicle (and, in consequence, the financiers) the determination, by the sponsor and the financiers, as to which of the other parties involved should have that risk contractually allocated to it. This objective will not necessarily be achieved in negotiation, as risk allocation for infrastructure projects is essentially a compromise. A party (including a government) which wants a better financial deal may have to accept risks which it would otherwise prefer not to accept, as discussed at the 1994 conference of this Association.[17]

Nevertheless, there will be certain risks which must be accepted by the party targeted if the project is to proceed at all. For example, it is unlikely (to say the least) that the private sector parties will proceed with a project if the government is not prepared, for example, to accept the general risk of its own contractual breach.

The process of risk assessment and allocation is likely to involve the following steps:

(a) Each risk which could lead to the assumptions not being satisfied must be identified, something which obviously requires a mix of commercial, technical, legal and other skills.

(b) The commercial significance of each risk must be assessed. High probability risks, such as bad weather during construction, are likely to be commercially significant even if individual incidents have a low time and, in consequence, cash flow impact. Equally significant from a commercial viewpoint will be risks which are very unlikely to occur but which will have a major financial impact, for example, expropriation by government, war or earthquakes.

(c) It must be assessed whether the project vehicle can manage the risk itself at a cost allowed for in the cash flow forecasts. Where, for example, the project is to be operated by the project vehicle itself and not by a contract operator, the debt and equity parties will need to be satisfied that it has the necessary ability and expertise to do so at a cost which does not exceed forecasts. They may, for example, be satisfied because operating expertise of the relevant kind is freely available in the market. In a sense the project

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17 *Proceedings, 11th Banking Law Association Conference*, pp 239 and 248-249.

vehicle can manage risks which are commercially insurable on reasonable terms, assuming that the relevant insurance cover continues to be available in those terms (which may not prove to be correct). However, it is equally appropriate to treat the risk as having been allocated to the insurer.

(d) Having established what risks can be borne by the project vehicle, who should bear, and is likely to be prepared to bear, each other identified risk, either in full or in part, and any consequent effect on the project vehicle's cash flow must be determined. As who should bear risk is essentially a commercial matter, I leave it to the commentators, if they choose, to express their own views as to which party should bear particular types of risks. The following deals only with some very general principles, whilst identifying two particular categories of potential risk bearers and particular ways in which they can contractually bear risk.

The first, and universally quoted, principle of risk allocation is that risks and consequent liability should fall on the party (including government) best able to manage it. The New South Wales guidelines state that its government will consider sharing project risks by assuming the risks it is best able to control and manage and where there are net benefits to government and the community. The Victorian guidelines indicate a governmental intention to allocate risk to those parties which *the government* considers best positioned to assess and manage it, on the basis that the risks associated with design, construction, financing and operation will generally be borne by the private sector.

In this regard two points should be borne in mind. First, the principle is arguably concerned (depending on who is making the argument) with the party which has the legal and commercial power to prevent the risk occurring, rather than the party which is being best placed to *try* to stop it happening. For example, in a federation like Australia a State government (or even its Parliament) cannot in general prevent the passing of a Commonwealth statute which impacts adversely on a project, although the State government is arguably much better placed than the private sector to persuade the Commonwealth not to introduce legislation of this kind. Second, whilst a State government, which by definition has a majority in the lower house, is clearly in a position to prevent State legislation impacting on a project, it may seek to argue in negotiation that it has a responsibility to the general community not to place itself in a position where it cannot initiate legislation affecting the community generally (such as legislation increasing the general rate of payroll tax, or relating to the general environment) without incurring financial liability. It may make similar arguments in relation to State executive acts, and may be reluctant to accept responsibility for acts of local government even though it can ultimately "control" it. On the other hand, the sponsor and the financiers will obviously see in a different light State legislation, or executive acts within State government control, which have a specific effect on the project (either alone or together with similar projects) or discriminate against it.

There will obviously be risks within no one's control in the above sense which the project vehicle and the financiers will accept, on the basis that expert evaluation puts the risk at a commercially acceptable level. An example of this would be "genuine" traffic or market risk associated with a tollway; by way of contrast, the sponsors and the financiers would obviously seek to have the host government accept any increased market risk caused by that government's own action, such as the construction of a freeway serving a similar function.

On the other hand, whilst other risks, such as Commonwealth law change in the case of a State project or uninsurable physical events (earthquakes) are clearly beyond the control of any party, I think it is too sweeping to state that such risks should lie solely with the project vehicle. It will, for example, usually be appropriate for the documents to provide that if such events prevent the project vehicle from performing its obligations to the government under the concession agreement those obligations should be correspondingly suspended; otherwise the government may be able to use the consequent contractual breach as a basis for terminating the concession without compensation. Such a "force majeure suspension" could possibly be linked to a provision that if the effect on the project, and the consequent availability of the relevant facility continues for a sufficiently long period, the government should terminate the concession, and thereby obtain earlier ownership of the facility, on making an appropriate payment.

In determining whether contractual acceptance of a particular risk by another party is sufficient to protect project cash flows, one must take account of the possibility that that party will fail to meet its contractual obligations, in particular its financial obligations. In the case of private sector parties, the risk is eventually one of insolvency and is addressed by normal credit evaluation procedures. It is obviously of particular concern to the financiers, because the party involved (such as a sponsor or construction contractor) will not be concerned to address its own credit. If the credit is assessed as inadequate, the project can obviously only proceed if an appropriate level of credit enhancement from banks or other financial institutions is provided for the relevant obligation.

Whilst there is no equivalent insolvency risk in the case of government, there will almost always be an element of "sovereign risk" that the government's obligations will not be performed, or the rights granted to the project vehicle will be taken away, or both, without compensation, in consequence of later specific legislation. In the case of State projects, this will be so even if the concession agreement is ratified by an earlier statute, because State Parliaments have a clear power to abrogate such obligations and rights without compensation, provided that they make their intention sufficiently clear.[18] In the case of a State government project, the private parties can only proceed if they accept such "sovereign risk", although they may seek to minimise it as a real threat by providing for a broad spread of equity and debt financiers.

The possibility that the obligations of a party accepting risk may not be performed must obviously be taken into account in the course of negotiations. The documents should address this issue of "secondary risk allocation" by stipulating which, amongst the remaining parties, should contractually bear it. For example, if the construction contractor becomes insolvent, should the risk of completing construction be borne solely by the project vehicle, or should the government bear some of the risk, at least by giving the project vehicle an extension of time under the concession agreement for completion of construction to enable it to find a new contractor? The insolvency of the project vehicle itself is another situation where secondary risk allocation directly affects the interests of the financiers, as it is likely to lead to an early breach of the concession agreement. In that event there will be an issue between the government and the financiers as to how long the financiers have to cure the default and keep the concession agreement, and therefore their security, in place (see below).

The principal candidates for acceptance of risk in infrastructure projects are the host government and the construction contractors, although there will obviously be others, such as project operators, insurers, and providers of interest rate hedges. As indicated above, Australian governments are likely to resist accepting financial responsibility for the risk of project vehicle default. On the other hand, on the general principle mentioned above, governments should bear financial risk for their own contractual breaches, and an appropriate degree of liability at least for their own executive or other acts and legislation of their own Parliaments which impinge on the project. For example, if land must be acquired for the project, it seems reasonable for government, which is the only party with power to acquire it compulsorily, to bear the financial risk of the land not being made available in time for construction. Governments may also be prepared to accept financial commitments for some problems, perceived as "low risk", which are essentially governmental in nature even though not entirely within their own control, such as the making or substantiation of native title claims, or an environmental impact statement being required under the Environment Protection (Impact of Proposals) Act 1974 (Cth).

Governments can obviously bear financial risk by agreeing to compensate the project vehicle or the financiers for the effect on cash flow of the relevant event or (more desirably from the

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[18] It is beyond the scope of this paper to deal with the desirability and form of legislative sanction; see Johnston, op cit, pp 232-234, the articles and cases there cited and, more recently, *The Wik Peoples v Queensland* (1996) 134 ALR 637, 689-705). The Commonwealth Parliament does not have the freedom of State Parliaments; see Commonwealth Constitution, section 51(xxxi) permitting acquisition and property only "on just terms", and *Commonwealth v Western Mining Corporation Limited* (unreported, 1996, Full Federal Court) making it clear that abrogation of a concession granted pursuant to statute can be "property" in this sense.

government viewpoint) accepting deferrals of payments otherwise owing to them by the project vehicle. Governments are also more likely to be prepared to accept risks which are clearly outside all parties' control in ways which do not impact on their own cash flow or accounts. They can do this, for example, by accepting that the occurrence of the relevant event suspends the project vehicle's obligations to it (see above) or granting a compensating extension of the concession period (which may be helpful to equity but of little value to the project financiers, whose debt will mature well within the initial concession period). It may also be possible, where the infrastructure is used by the public and the government has imposed limits on the charges which can be made by the project vehicle, for potential redress to include increases or other variations of those limits.

Ultimately, it may be appropriate to provide that if an event for which the government has accepted responsibility, such as a contractual breach by it, continues for a sufficiently long period, the government is obliged to make payment of a pre-agreed termination amount, thus effectively purchasing the concession.

It will normally be appropriate for the construction contractor to accept the risk that the project design and construction will cost more than, or take longer than, the cost and time contemplated in the feasibility study; amongst other things, it is the party with the construction expertise. It will do this by entering into a "fixed price/fixed term" construction contract with the project vehicle. If this course is followed, the only circumstances in which the contractor would be entitled to obtain additional compensation, or an extension of time for performance, are where the project vehicle has equivalent relief from the government which is available to be "passed through" to the contractor (for example, where the government does not provide the land on time) or where the act of the project vehicle itself has caused extra cost or delay.

Obviously the construction contractor will expect appropriate compensation and time extensions where the project vehicle exercises a right to vary the original scope of the work. In this situation, the financiers will be concerned to ensure that this can only occur with their consent, or where the government has called for the variation and under the concession agreement is liable to pay the extra cost involved to the project vehicle and also obliged to allow the project vehicle an equivalent time extension.

The contractor will typically be obliged to meet the requirements for completion under the concession agreement by the time required under that agreement. This will ensure that, if it does so, the project vehicle will be protected from termination of the concession for failure to meet completion requirements. It may however be that in order to achieve the anticipated cash flows, more stringent requirements and a tighter time frame must be met, and in consequence the contractor's contractual obligations to the project vehicle will be more onerous than the equivalent obligations of the latter. The principal sanction for failure on the part of the contractor to meet its completion obligations will be an obligation to pay liquidated damages for the lost cash flow, although ultimately the project vehicle (or their financiers, if enforcing their security) will obviously have the right to terminate the construction contract in consequence of the breach.

The fact that the test for construction completion under the construction contract (incorporating the equivalent test under the concession agreement) has been satisfied is no assurance to the project vehicle, or the government, that construction defects will not appear at some later stage. At that stage, there may in fact be no effective recourse against the contractor. It may then have no legal liability to the project vehicle, because both the defects liability period under the construction contract and the limitation period within which it can be sued have expired. Alternatively, or in addition, the credit of the contractor may have significantly diminished, possibly in consequence of the contract proving to be an unprofitable one in the first place. The risk will primarily lie with the project vehicle, which must (if it can) rectify the defect at its own cost, either because it is necessary in order to maintain cash flow or because the concession agreement with the government requires it to do so, or both (and, if the sponsor is different to the contractor, possibly with it also).

TYPICAL DOCUMENTATION

Because each infrastructure project and its financing will be unique, so will the documentation be. Nevertheless it may be useful to describe, in a very general way, the principal documents which will almost always be required (under whatever name the parties may choose to give them) and their general content.

It is stating the obvious to point out that in the Australian context the structure of an infrastructure project, and the form of the documentation, can be very much influenced by stamp duty considerations.[19] These considerations are not peculiar to infrastructure projects, although when one is dealing with government there is of course an opportunity to negotiate specific duty exemptions or concessions, to be possibly included in the relevant ratifying legislation.

Project Documents

It is logical to commence with the concession agreement between the government and the project vehicle. This will deal with the risk allocation between them, impose a requirement on the project vehicle to construct the relevant facility by a finite time, deal with the performance standards to be met by the project vehicle during operation, and the ability of the government to terminate the concession, particularly in consequence of breach of the project vehicle's obligations or related circumstances.

As indicated above, the issue of termination for default is likely to be hotly debated. Because project value and security is extremely dependent on the concession, neither the project vehicle nor the financiers can contemplate a regime whereby any breach by the project vehicle can lead to "hair trigger" termination of the concession. They will strongly press for the "trigger" events to be limited to major breaches of performance standards, and not extend to breaches of other obligations, or to events other than contractual breaches, such as the project vehicle's insolvency. The financiers will in particular want to avoid a situation in which failure by the project vehicle to make a payment which ranks in point of security after payments to them is a "trigger" for termination, as this will, as a practical matter, require the financiers to make the payment from their own resources in order to protect their security (and in doing so, elevate the payment's priority). It will be equally important to the project vehicle and the financiers to ensure that the former has appropriate opportunities to cure "termination events" before actual termination, without prejudice to the financiers' further opportunity to cure when the project vehicle has not done so and they are enforcing their security and endeavouring to rectify the problem.

The concession agreement can obviously provide for other matters. Typical are provisions for any government "contribution" to the project, whether financial or in the form of land grants or leases or other assistance, provisions (drafted having regard to section 51AD constraints) conferring rights on the government to "step in" to cure breaches of performance standards, and provisions for any payments to made by the project vehicle to government; the commercial arrangement may, for example, be that the project vehicle shares "super profits" with government. By way of separate document, the project vehicle may grant security to the government over its assets to secure amounts payable by it to the government, for example, to reimburse it for "step in" costs.

If the government party is in fact an instrumentality, the government itself may provide contractual credit support in favour of the project vehicle (or possibly the financiers) for the instrumentality's obligations.[20] Such credit support from government itself is particularly

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19 See "Stamp Duty - Infrastructure Financing Case Study", *Proceedings, 12th Banking Law Association Conference* (1995) p 309.

20 See, for example, Gladstone Power Station Agreement Act 1993 (Qld) Schedule, Clause 10 requiring government action if there is a drop in an instrumentality's credit rating.

significant in today's climate of corporatisation and privatisation. It clearly can no longer be assumed that the instrumentality which enters into a long term take or pay contract will stay in the same form, or have the same assets, throughout the life of the contract. All its assets may be transferred by statute to a government owned company, the shares or assets of which are then sold to the private sector. In addition "universal" instrumentalities like the old State Electricity Commission of Victoria or Queensland Electricity Corporation may be split up, with their assets distributed through similar processes.

A vital document from the standpoint of the financiers will be an agreement between the government and them (or their representative) essentially concerned with "secondary risk allocation" in the event of project vehicle insolvency. Such an agreement will regulate the security priority between the security given to the project financiers and that given to the government. It may specifically limit the government's access to project cash flow for, and/or rights to enforce, payments to the government under the concession agreement where those payments do not have agreed security priority as against the financiers; such a provision will typically limit payment to government to funds otherwise available to equity, consistently with the restrictions on the distribution of surplus cash flow agreed between the financiers and the equity parties. The agreement will contain regimes under which the financiers have an opportunity to cure a relevant default under the concession agreement and thereby prevent termination, and under which they can, vis a vis the government, sell the project under their securities. The agreement may also regulate, as between the financiers and the government, the government's right to "step in" to the project, particularly at a time when the financiers are enforcing their security. Whilst the financiers and the government will, for different reasons, be anxious to have the default remedied,[21] the financiers will clearly prefer to be in control of the process.

There will be other "project documents" to which the government is not a party, such as the construction and operating contracts and the "equity" documents. Whether the "equity" documents are simple or complex will depend upon the project vehicle structure chosen. The negotiation and drafting of the other project documents must clearly take into account the provisions and precise language of the government documents, in particular the concession agreement. For example, the construction contract will primarily consist of a re-allocation to the construction contractor by the project vehicle of the "construction risk" accepted by the project vehicle in the concession agreement (see above). Accordingly the language must mesh precisely with the concession agreement in order to achieve a complete "pass through" and avoid what has been called "documentary risk".

Finance Documents

The number and scope of the finance documents which will be required will depend on the number and different interests of the financiers. Where only one group of financiers is providing facilities to the project vehicle on the same terms, there will typically be a facility agreement containing the terms of accommodation, the relevant representations, undertakings and events of default, and "practical" security over the project cash flows, through requirements that project revenue flow into dedicated bank accounts under the control of the project financiers. There will obviously also be security over the project assets.

There will also be agreements between the financiers, or their representative, and non-government parties accepting particular project risks (see above). These may take the form of "completion guarantees" or "peformance guarantees" from sponsors or construction contractors (or both) and performance "guarantees" from operators, suppliers of raw materials or takers of product. Such "guarantees" can take an infinite variety of forms. The most usual form of "completion guarantee" is an undertaking to procure completion of construction in accordance with the agreed arrangements in the construction contract (so that the financiers will have an

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21 Furnell, "Infrastructure Projects - Allocation of Risk" (1996) *Journal of Commercial and Finance Law*, pp 29, 33.

action for damages against the other contracting party in event of breach) or a financial guarantee of the project debt which ceases to be operative on completion of construction.

As indicated above, the financing is quite likely to take a more complex course. There may be a number of separate finance facilities all taking full, or some, project risk and there may well be "dual debt" facilities. In these situations the security and project revenue flow arrangements, and typically common representations, undertakings and events of default, will be in a single document and run for the benefit of all the financiers taking project risk. There will need to be appropriate contractual interface between the different categories of financiers, for example to deal with the provision by the project financiers of credit enhancement to non-project financiers, and the situation where non-project financiers take project risk at a later stage, say on completion of construction. Where, in the "dual debt" situation, non-project financiers are to have security over specifically dedicated cash deposits, this will obviously need to be separately provided for.