In order to engage with our readers and simplify the legal complexities of the infrastructure sector, EPC World has partnered with Rajani Associates, a full-service law firm for a series of legal Q&As. Through this Legal Q&A column, **SHISHAM PRIYADARSHINI**, Partner, Rajani Associates and **AMISH SHROFF**, Associate Partner, Rajani Associates, will endeavour to address the queries and challenges faced by our readers.

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What are the sources of debt finance for infrastructure projects?

The level of investments required to be done in the infrastructure projects such as highways, railways, aviation, power and renewable energy, shipping, water, solid and waste management is increasing over the years to meet the demand of the growing population. Government estimates the total infrastructure investment requirement to the tune of ₹ 31 trillion (USD 454.83 billion) for infrastructure development over the next 5 years, with 70 per cent of funds needed for power, roads and urban infrastructure segments. Sustaining this trend of investment does require systematic flow of investment.

Given the large investment requirement for undertaking the infrastructure projects in India and the limited resources of the Government, it is rather difficult that public funds would be adequate to meet the needs in this context. Hence, support of a private player, financial institutions and banks play a critical role to finance and implement the infrastructure the projects.

It is estimated that PPP infrastructure projects to an extent of 65-70% are financed by debt. Out of this commercial banks are the major source of debt and constitute 72% of all debts, while the second group of institutions are the development finance institutions like IDBI, IDFC, IIFCL, HUDCO, PFC and IL&FS which constitute the balance 28% of debt. There are also bilateral and multilateral institutions which can offer innovative financial products like political risk insurance, currency risk insurance, etc, but their participation in lending to PPP projects is India is insignificant as of now. Funding from insurance, pension and provident funds, besides raising external debt, including from multilateral development banks like the World Bank and the Asian Development Bank are other alternative sources which need to be fully tapped. Bond market is also another option for project financing. In fact, the Indian bond market is estimated to be one of the largest in the Asia. The bonds includes issuances by the central and State Government or other Government bodies, public sector undertakings, financial institutions and banks. With several reforms being implemented by the Government, the infrastructure bond market is likely to develop over a period of time and can play an important role as an alternative means of financing.

What is nonrecourse and limited recourse financing?

The term project finance in common parlance means the long term financing of capital intensive industry like infrastructure, industrial projects and public services based on a nonrecourse or limited recourse financial structure, in which project debt and equity is used to finance the project are paid back from the cash flow generated by the project itself. Project finance is generally used to refer to a nonrecourse or limited recourse financing structure. Nonrecourse financing depends purely on the merits of the relevant project. The credit appraisal undertaken by the lenders of such projects are based on the anticipated cash flow from the project, and is independent of the creditworthiness of the project sponsors. In case of nonrecourse financing, the project sponsor has no direct legal obligation to repay the project debt or make interest payments and the assets of the facility, including any revenue-producing contracts and other cash flow generated by the facility act as collateral for the debt. In fact, there is no recourse to the assets of the project sponsor for the debts or liabilities in relation to the relevant project. In most project financings, however there are certain limited obligations and responsibilities of the project sponsor and this is called limited recourse financing. The lenders generally perceive substantially high risk during the construction period of a project and in order to mitigate this risk they may require that the project sponsor infuse additional equity in the event the risk actually materializes. The lenders are conscious that the security and/or guarantees offered by the sponsors may not fully secure the risk. However, the intent is to simply implicate the involvement of the sponsor sufficiently and deeply in order to fully incentivize the sponsor to ensure the successful completion of the project. In certain cases, the lender would have recourse to the assets of the project sponsor until the risk is reduced or construction is completed and thereafter the loan may become nonrecourse.

What are the essential features of a nonrecourse or limited recourse financing?

Infrastructure projects are often financed through special purpose vehicles and are structured on a limited/nonrecourse basis. The approach to such projects is to properly identify and allocate various elements of the project risks to the entities participating in the project. Ideally, in a nonrecourse or limited recourse financing, there is requirement of a very stringent security structure and this includes a registered mortgage/ hypothecation of all assets, besides pledge of sponsor holdings in the special purpose vehicles and an assignment in favour of institutions of all the project contracts and documents as also charge on the future receivables. In addition to the assets of the company, the lender would have the security over the cash flows of the special purpose vehicles under a Trust Retention Account arrangement. This allows the appropriation of all cash inflows of the special purpose vehicles by an independent agent acting on behalf of the security trustee which is then allocated in a pre-determined manner to meet the various requirements including debt servicing. It is only after all these requirements are met that the residual cash flow is available to the project company. Further, in a limited or nonrecourse financing structure, it is quintessential that the sponsor group commits to provide standby support for cost-overrun in the project. In case the overrun exceeds the amount of such support committed by the sponsor, considering that there is no obligation on any party, all the players may negotiate the quantum, terms and conditions of additional funding requirement.

What are the measures taken by the lenders to minimize the risk associated with nonrecourse or limited recourse financing?

Considering the huge risk that the lenders undertake in case of a nonrecourse or limited recourse financing, the lenders take various steps to mitigate the same like conducting an extensive SWOT analysis to evaluate the strengths, weaknesses, opportunities, and threats to a project in order to ascertain bankability of the project and whether or not the project risk allocation protects the project and the special purpose vehicle company sufficiently. Every risk associated with the project is carefully studied by the lenders before any type of financing is provided to the project company. Besides, creating security interest on all the assets of, and TRA arrangement for the fund inflow to the project company, the lenders adopt a number of other control mechanisms such as limitations on what the project company can do and cannot do without approval of the lender. These include "reserve discretions" whereby the project company may undertake not to take certain actions without the prior written approval of the lender, or without intimation to the lenders. There may be certain rights and discretions vested in the lenders. The project company may be required to covenant to the lenders that it will not (amongst other things) change the project plan, project contracts, capital expenditure program or debt program without lender consent. These are the key elements of the project, which the lenders will want to control in order to restrict the changes in the underlying risk profile, which is either done through appointment of a nominee director on the board or through negative and positive covenants.

The lenders will also require the project company to provide warranties and representations concerning the financial, legal and commercial status of the project company, the performance of the work, construction and operation of the project. The warranties and representations may be used by the lenders not so much as a basis for claiming damages but rather as potential events of default which will then permit the lenders to suspend drawdown, accelerate the loan, seek additional security or enforce security. In some cases, the lenders will also want the project company to repeat certain warranties and representations with each drawdown and periodically throughout the term and tenure of the loan, to ensure continued compliance. In the event there is termination of the concession agreement by the authority, the lenders may enforce security over the project assets. However, since the project assets are unlikely to be worth the value of the outstanding debt, the lenders often require some form of right to take over the project and step into the management of the project company.

What is step-in rights of the lender in project financing?

The step in right forms an integral part of the project financing agreement between the lenders, the grantor of the project (which is the authority) and the project participant. Step in rights is a contractual understanding between the project company and the lenders, whereby the lenders have the right to "step in" to the project company's position in the contract and to take control of the infrastructure project where the project company is not performing and/or where the authority intends to terminate the concession agreement. In such eventuality, the step-in rights provisions give lenders an opportunity to step in to the project and to ensure that the project is completed. While there are certain prohibitions in the law on lenders directly stepping-in, in the project, the lenders also face limitations due to absence of domain knowledge and therefore direct agreements are entered into by the lenders with key sub-contractors to enable them to step into and continue the contractual relationships in such eventualities. The financing arrangement generally provides to the lenders different levels of intervention in the project wherein, the lenders have cure rights, step in rights and novation or substitution rights. EPC World