

## Straight Talk Appearances

### Project Finance India 2005 - Overcoming Hurdles to Growth

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#### **I. INTRODUCTION**

Good morning ladies and gentlemen. It is my pleasure to address this distinguished gathering among such eminent speakers. I take this opportunity to thank you all for participating in this important event. I also wish to extend a special thanks to our honorable guests from the Government of India for gratifying us with their presence and providing us all with an opportunity to exchange views and provide them with our inputs.

My address consists of a brief analysis of some of the current trends and innovative transactional structures in project finance in India. Many of you are probably familiar with much of what I will address. However, it is important that we have a well-rounded view of the current scenario vis-à-vis project finance in India's developing infrastructure.

#### **II. BACKGROUND**

The demand for project finance in India has grown by leaps and bounds in the past decade. The impressive economic growth registered by the Indian economy, owed mainly to the series of reforms initiated by the Government of India since the early 1990s, has provided the impetus for progress in the Indian infrastructure sector. As the Indian economy flourishes, India's already grossly inadequate and severely antiquated infrastructure is further overburdened to the point that it threatens to disturb the entire momentum of economic progress.

Traditionally, the Government of India has been expected to be the sole investor in the country's infrastructure facilities. In this regard, the Government of India financed and implemented the bulk of its infrastructure outlays and also managed the attendant risks thereto. Infrastructure financing historically was relatively simple. However, it also was quite inefficient and lacking accountability. Domestic funds were raised primarily through public sector banks and insurance companies, budgetary outlays as well as the issuance of bonds linked to infrastructure projects. Foreign loans and project-specific aid also were raised from multilateral financial institutions such as the Asian Development Bank and the World Bank.

Notwithstanding, a growing budgetary deficit and the capital constraints of the Government of India led to a crisis situation in the early 1990s. As a result, the Government of India was forced to open the infrastructure sector to the private sector. This action constituted the first wave of liberalization of the Indian economy. Today, the public sector is moving towards privatization. It is increasingly looking towards the private sector to deliver through market-based mechanisms, corporate efficiency and viability-based practices. Since the Indian capital markets lack the sophistication of the similar markets in developed countries, foreign investors also have had an increasingly more important role to play in the development and financing of India's infrastructure.

In a bid to increase the participation of the domestic private sector as well as foreign investors, the Government of India has relaxed regulations, reduced foreign investment restrictions, and introduced a number of tax, customs and other incentives for companies engaged in infrastructure-based activities. These incentives include, but are not limited to, the following:

- Increased foreign equity participation (or foreign direct investment ("FDI")) of up to 100% through the "automatic approval" route by removing the ceilings on project costs and the percentage/amount of FDI in most sectors of infrastructure, except for a small negative list. "Automatic approval" means that foreign investors need not first obtain the Government of India's Foreign Investment Promotion Board's ("FIPB"'s) approval. Instead, they simply may apply to the Reserve Bank of India, India's Central Bank, for clearing their investment.
- Tax deductions in respect of profits and gains from industrial undertakings or enterprises engaged in infrastructure development under Section 80-IA of the Indian Income Tax Act, 1961.
- Tax exemptions against income for an infrastructure capital fund or a company under Section 10(23G) of the Indian Income Tax Act, 1961.

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This year's India Union Budget 2005-06, issued on February 28, 2005, also has lowered the corporate income tax rate from 36.6% to 33.6% for domestic companies. A lower tax rate, among other factors, should further encourage investments in India. The corporate income tax rate on foreign companies has remained at 40%.

### **III. REQUIREMENTS FOR FOREIGN INVESTMENTS IN CERTAIN INDIAN INFRASTRUCTURE**

The requirements for foreign investment in certain infrastructure sectors include many positive changes.

#### A. Power

The Government of India permits FDI up to 100% in the power sector, without any limit on project cost, under the automatic route in respect of the projects relating to electricity generation (including coal, gas and liquid fuel-based thermal power projects, hydro-power projects, wind power, solar power, and biomass-to-cogeneration power, projects), transmission, distribution and power trading. Further, there is no limit on the project cost and the percentage/amount of foreign direct investment in these projects.

#### 1. Indian Electricity Act, 2003

The new Electricity Act, 2003, effective June 10, 2003, consolidated all previous electricity laws in India. The enactment of this new statute was a welcome step for foreign investors, as well as for private domestic players, for a number of reasons including but not limited to, the following:

- A power generating company has been allowed to establish, operate and maintain power-generating stations without obtaining a license on fulfillment of certain conditions.
- The Act allows private participation in transmission and distribution facilities subject to licensing by the Central Electricity Regulatory Commission ("CERC").
- Licensors are to provide non-discriminatory open access to their transmission and distribution systems for use by any licensee, generating company and consumer, subject to the payment of certain charges.
- Independent Power Producers ("IPPs") and captive power generators have been allowed to sell directly to any licensee or consumer on terms and conditions agreed to between the parties, subject to the payment of certain charges.
- The Appellate Tribunal for Electricity ("Tribunal") has been established for hearing appeals from decisions from the CERC and State Electricity Regulatory Commissions ("SERC"s). The Tribunal will have powers similar to that of a civil court.
- The Act provides for re-organization of State Electricity Boards ("SEB"s) through corporatization and unbundling.

#### 2. India Electricity Policy, 2005

In early 2005, the Government of India unveiled its new Electricity Policy "Electricity Policy". Through this new Electricity Policy, it hopes to secure Rs. 891,750 crore (approximately US \$205 Billion) of investments required for power generation, transmission, distribution and rural electrification projects through 2012.

The new Electricity Policy sets rules covering the purchase of electricity by power suppliers through long-term contracts or power purchase agreements ("PPAs") of over seven (7) years and medium-term contracts extending for periods of one (1) year to seven (7) years. These PPAs must be secured through open bidding processes. Three (3) regulators determine the charges for power generation, transmission, wheeling and retailing after public hearings examining whether the "tariff has been determined through transparent process of bidding."

Previously, long-term PPAs have ranged between 15 years for gas-fired projects to 30 years for coal-fired projects. The shorter terms for these PPAs could cause project financing issues, such as higher interest rates on debt and increased security requirements by lenders.

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The new Electricity Policy also provides that some power sales will continue to be subsidized. This politically-inspired requirement provides that power should be supplied at below the actual cost to many consumers. Such practices has left the SEBs financially - crippled and reliant on government subsidies for decades.

The new Electricity Policy marks a departure from the prevailing practice. In this regard, the regulatory authorities establish SEB tariffs after accounting for the direct subsidy support available from the particular state government. They gradually reduce the subsidy in tariffs between different categories of consumers with a view to ultimately eliminating all cross-subsidies. The poor, thus, will continue to benefit from subsidies at the expense of commercial and industrial consumers, who still will pay more for their power than warranted by electricity production costs.

Today, some 45% of India's households of over a billion people are currently without electricity. Similarly, per capita electricity consumption is under 400 kWh per annum. Meanwhile, electricity shortages are rampant. In this regard, a 10% gap exists between peak demand and supply in the April to November 2004 period, when overall shortages exceeded 6%.

Power quality and reliability is also poor. These situations are a direct result of the weak transmission and distribution network, leading to supply failures even in the main cities. Second tier cities and the rural areas, which suffer daily from extended, albeit scheduled, power cuts are in more difficult straits. The severe financial straits of SEBs, which act as power off-takers from private generators, have caused poor capital inflows from domestic and foreign private investors.

Experts concede, however, that improvement has occurred since the establishment of quasi-independent power regulators, now operating in most states. The new Electricity Policy also should result in a better deal for consumers. In this regard, it should both promote competition and establish an ombudsman, charged with redressing the consumers' grievances, within the next six (6) months.

The new Electricity Policy also requires that, within six (6) months, the Central Electricity Authority ("CEA") must launch its first National Electricity Plan ("CEA Plan"), covering through 2017. The new Electricity Policy requires that the CEA Plan provides for adequate generation capacity by 2012 based on 85% availability, and including reserves of at least 5%.

The new Electricity Policy retains the open access provisions of the 2003 Electricity Law. There, market participants, such as generators, traders and consumers, may use the transmission and distribution networks of the state-owned utilities. The new Electricity Policy requires that the state regulatory authorities "will provide a facilitative framework for open access at the earliest including technological upgrading of state load dispatch centers by June 2006 to ensure data acquisition capability on real time basis."

The new Electricity Policy also boosts renewable and non-conventional energy sources. In this regard, it states that distribution companies must purchase a percentage of renewable power, to be specified by the state regulatory authorities. This requirement is similar to the requirements of the US Public Utility Regulatory Policy Act of 1980. There, the US Congress requires electric utilities to purchase power at their "avoided-costs" from small power producers, such as renewable energy producers.

### 3. Historic India Power Problems

Historically, since its commencement of economic liberalization in 1991, India's increasingly insatiable power needs, along with its general trend toward economic liberalization, led to much interest among foreign investors in establishing IPP projects in India. While dozens of projects were approved, and the foreign and Indian private sectors constructed several such power plants between 1992 through 2004, most of the largest projects have been stalled by considerable payment risk issues. A number of factors in the power sector hampered IPPs from attaining financial closure. These factors include, but are not limited to, the following:

- Lack of credit worthiness of the SEBs;
- Substantial cross-subsidies and politicized tariff setting;
- Inadequate offtake and payment guarantee mechanisms; and

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- Inadequate fuel supply and transportation agreements, with the significant issues involving how to cover risks between the SEBs, Coal India/Gas Authority of India (“GAIL”) and the Railways/GAIL).

### 4. Risk Mitigation Security Mechanisms

Traditionally, a major issue has been to mitigate the risks associated with the SEBs through widespread SEB restructuring and improvement in the security and payment mechanisms in arrangements with the IPPs.

#### a. Irrevocable LOCs

In a typical “PPA”, the generating company submits an invoice within an agreed timeframe. The invoice is generally payable through an irrevocable revolving letter of credit (“LOC”), issued by the concerned SEB through its banks. However, in case of a default, the bank may simply refuse to renew the LOC, and the generating company may end up facing the same risk.

#### b. Escrow Accounts

An escrow arrangement is another mechanism to protect against the SEB credit risk. It is usually a complex arrangement, whereby an escrow agent is appointed for the specific project. The escrow agent establishes escrow accounts, an SEB account and a generating company account. Such agent also creates a charge and hypothecation over the SEB receivables. In the event of a default in payment, the escrow agent transfers an equal amount of receivables from the SEB escrow account to the generating company’s account. It is advisable to retain some amount as security in the escrow account in order to provide effective security to the generating company.

However, there are a number of difficulties involved in the escrow account security mechanism. One such problem is the simple failure of an SEB to fund the escrow account. In such case, a hypothecation agreement can be protective, as it would shift payments of power purchasers from the SEBs directly to the electricity generator.

#### c. SEB Reforms

In the long run, reforms must concentrate on how the SEBs may collect more revenues through more efficient collection mechanisms, power theft control and market-linked tariff regimes, as well as through the privatization of the electricity distribution sector. Few SEBs of states, such as Orissa, Delhi, Haryana, Karnataka and Andhra Pradesh, already have taken positive steps towards (i) unbundling power generation, transmission and distribution assets into new entities and (ii) corporatizing those entities with leadership less subject to political whims. Distribution of electricity in the states of Orissa and Delhi has been privatized.

#### d. PTC Power Purchases

Innovative structures, wherein agencies such as the Government of India-owned Power Trading Corporation (“PTC”) are intermediate buyers of power, and effective offtake risk mitigation measures, also have enhanced the potential of new projects to achieve financial closure and better ensure success. Many of these projects simply would not have reached financial closure and achieved commercial operation within a single buyer model.

Recently, the PTC has short-listed 35 power projects (with generation capacity exceeding 2300MW) for long term power purchases. The PTC also will acquire up to 15% equity in each such project.

In a milestone in the evolution of India’s power sector, the Hyderabad-based Lanco Group’s 300 MW thermal power project in the State of Chhattisgarh will become the first power company to achieve financial closure on the strength of a PPA with the PTC. To date, all Indian private sector projects have secured financing from banks and financial institutions on the basis of executing sophisticated PPAs with SEBs.

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The debt-equity ratio for the Lanco project is 70%:30%. The financial closure of the Lanco power project will occur shortly. The process of achieving Lanco's financial closure has accelerated following the creation of an inter-institutional group ("IIG") of lenders. The IIG consists of the IDBI Ltd, State Bank of India, ICICI Bank and Power Finance Corporation.

Over a dozen projects have achieved financial closure in India, since the IIG was established in January 2004. Similarly, at least another dozen projects await the commitment of similar funds. Many of these projects, financially closing on "all – India finance" (i.e., no foreign lenders) basis, have reached such closings, only because project sponsors, unlike previously, have agreed to accept fuel and other project risks.

### 5. Continuing Indian Power Finance Problems

Notwithstanding, substantial foreign private sector equity and finance will not stream into the Indian power sector, until the major twin albatrosses, known as the Dabhol Power Project and Tamil Nadu power-tariff issues, around the neck of Indian infrastructure, are finally settled. Foreign investors and financiers require sanctity of contracts (including the purchase of, and full payment for, contracted power), honored-payouts for purchased power under binding guarantees (i.e., payment (i.e., counter guarantees) and debt (i.e., sovereign guarantees) security mechanisms), and the knowledge that invoices will be paid in full and regularly without requiring litigation to ensure each payment.

### B. Roads

#### 1. General Provisions

The Government of India permits FDI up to 100% in the construction and maintenance of roads, highways, vehicular bridges, toll roads and vehicular tunnels under the automatic route. The private sector can develop commercial retail service and rest areas along the roads on which they have secured operation and maintenance contracts. The National Highways Authority of India ("NHA") is permitted to participate up to 30% in the equity in Build, Own and Transfer ("BOT") projects. The Government of India provides a 10-year corporate tax holiday for road project developers. It provides a 100% income tax holiday for the first five (5) years and 30% for the next five (5) years. The Government of India also provides a 100% customs duty exemption.

#### 2. Financing Problems

The major constraints for this sector, however, are problems in acquiring land and obtaining environment and forest clearances, each of which requires the assistance of state/local governments. Other issues for consideration involve toll fixation problems and traffic projections for toll roads. These issues historically have made the private funding of roads (and also railways) commercially problematic or untenable. Without resolving these issues, investors cannot hope to realize their contemplated returns on their investments.

#### 3. Shadow And Annuity Tolling Arrangements Versus Off-Road Real Estate Development

Roads will attract little private investment until a model is developed to enable investors to earn an adequate return in the absence of assured tolls being paid.

The Government of India attempts to solve the tolling problem through "Annuity Tolling" and "Shadow Tolling" arrangements. Under "Annuity Tolling," the Government of India, to avoid situations where citizens do not use the toll road because of the need to pay tolls, actually pays the contractor a fixed annuity irrespective of the income. Under "Shadow Tolling," the Government of India keeps track of the use of the toll road and pays the contractor based upon the volume of road use. These tolling arrangements hopefully will assist in financing India's road projects with private sector funds.

An alternative model was to allow the developers to also develop real estate in the vicinity of the roads and, thus, not have to charge tolls. This idea has not taken off.

### C. Civil Aviation

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The Government of India permits foreign equity participation, including investments by foreign airport authorities, in airport infrastructure of up to 74% under the automatic approval route, and further up to 100% FDI with FIPB permission. In the domestic air-transport services sector, the Government of India permits FDI of up to 40% under the automatic approval route, and Non-Resident Indian investment of up to 100% after first obtaining FIPB approval.

However, the Government of India imposes several restrictions on foreign investors, specifically foreign airlines, including, but not limited to, the following:

- No direct and indirect equity participation by foreign airlines is allowed in domestic air-transport services.
- Foreign investors are allowed to hold only up to 33% of the representatives on the Board of Directors of domestic airlines.
- The minimum fleet size for a scheduled operator was raised from the existing three (3) aircraft to five (5) aircraft.
- A management contract with a foreign airline is not permitted.

Since the Government of India recently has permitted domestic airlines to fly international routes, and has initiated on "Open Skies" policy with foreign airlines, the sector has seen considerable increase in interest, including the planned establishment of new airlines. This interest will spur new opportunities for equipment and project finance such as the purchase and finance of aircraft; modernization and upgradings of existing airports (such as the installations of state-of-the-art air traffic control systems); construction of new domestic and international airports; the privatization of such airports; and, over time, possibly the privatization of the current Government of India-owned airlines - - Air India (for international operations) and Indian Airlines (for domestic operations).

The Indian Minister of Civil Aviation, Praful Patel, recently advised US Transportation Department Secretary, Norman Mineta, that India will require the modernization or new construction of at least 30 airports in the short term. These immense undertakings will require significant capital outlays with sophisticated equipment finance and project finance structures.

### D. Marine Ports

The Government of India permits FDI of up to 100% in the construction and maintenance of marine ports and harbors and in project services for water transportation, such as the operation and maintenance of piers, loading and discharging of vessels, etc. The Government of India permits FDI of up to 51% on an automatic basis in commercial support services for the operation and maintenance of the piers and loading vessels at a marine port. It provides a 10-year tax holiday for port developers.

The most common problems in this sector include high taxation and inadequate facilities. The Ports Act, 1908, too is significantly outdated in many respects for the present scenario. Further, the area of marine port development requires a change in the existing law and the establishment of an independent regulatory authority.

As is the case with many of India's statutes governing infrastructure development, these laws are quite antiquated vis-and-vis the similar laws of developed countries. As such, in this area as in other infrastructure areas, the Government of India and Indian Parliament must structure and enact new laws which provide the increasingly sophisticated-provisions necessary to develop and finance these important sectors. Then, the Government of India must create the necessary regulatory structures, with independent regulatory authorities, to implement such new laws. The absence of such modern laws severely hampers growth of India's infrastructure buildout and modernization.

In addition, the revenue-sharing regime continues to be unfavorable in the marine ports sector.

### E. Telecommunications

#### 1. General Provisions

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In February 2005, the Government of India cleared the proposal to raise the FDI limit from 49% to 74% for telecommunications' investments under the automatic approval route. The Government of India has stated that it requires at least Rs. 87,000 crore (approximately US \$20 Billion) in private equity over the next three (3) years in this sector. Foreign investors (including non-resident investors, foreign institutional investors, and American and Global Depository Receipt holders) now cumulatively may hold up to 74% ownership, in companies engaged in telecommunications activities. For internet service providers ("ISP"s) with gateways, radio-paging and end-to-end bandwidth, the Government of India permits FDI of up to 74%, with FDI beyond 49% requiring FIPB approval.

No equity cap is applicable to communications manufacturing activities. In manufacturing, the Government of India permits FDI of up to 100% subject to the condition that such companies would divest 26% of their equity in favor of the Indian Public in five (5) years, if these companies are publicly-listed in other parts of the world, for the following activities in the telecommunications sector:

- ISPs not providing gateways (both for satellite and submarine cables);
- Infrastructure providers providing dark fiber;
- Electronic Mail; and
- Voice Mail.

### 2. Restrictive Riders

The Government of India's policy announcement last month contained certain "riders", or restrictive conditions, including but not limited to, the following:

- the disqualification of foreign nationals from holding top positions in telecommunication companies;
- the requirement that a minimum of 10% equity be held by an Indian promoter;
- prohibition of remote access to any equipment manufacturers outside of India for maintenance and repair;
- the telecommunications provider must provide traceable identity of their customers;
- indirect foreign investment may be counted within the 74% ceiling;
- at least 50% of the Board of Directors must be resident Indians;
- calls between subscribers within India cannot be routed out of the country; and
- licenses may be cancelled if conditions are breached.

These riders may prove to be difficult generally and sector financing issues. However, companies have begun structuring ways around them.

For example, the new policy prohibits foreign nationals from holding key management positions, such as CEO, COO, CTO, etc., notwithstanding that such positions in India telecommunications companies frequently and often already are held by foreign nationals. Thus, to by-pass these restrictions, such companies' managements have reissued such titles as Deputy-CEO, Deputy-COO, etc., without filling a new position over such person. Therefore, they effectively have maintained the current leadership.

### F. Oil and Natural Gas

The Government of India permits foreign investment of up to the following levels:

- in exploration and production, 100% FDI in small and medium-sized fields under the automatic approval route through competitive bidding;
- 60% FDI for unincorporated, and 51% for incorporated, joint ventures;
- 100% FDI under the automatic route for the Natural Gas/ LNG/ petroleum products pipeline sector;
- 74% FDI in infrastructure related to marketing and marketing of petroleum products;

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- 100% FDI in a corporate subsidiary for purposes of market study and formulation;
- 100% FDI in a corporate subsidiary for purposes of investment/ financing; and
- for actual trading and marketing, a minimum of 26% of Indian equity is required over five (5) years.

Pipelines for oil and gas are still a monopoly of the government enterprises. When private parties are allowed to invest as seems likely, the sector will require the independent regulation of tariffs, licensing, access, etc. to secure investment and financing. Tariff regulation is not in the functions of the gas regulator in the draft regulatory legislation currently before the Indian Parliament. Private investment will enter, but with some caution.

### G. Real Estate Development

The Government of India recently permitted FDI up to 100% through the automatic approval route in the development of real estate. It allows these investments in townships, housing, built-up infrastructure and construction-development projects (including housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional infrastructure, among other applications).

The Government of India permits foreign investors to develop plots of 25 or more acres (in lieu of the previous requirements of 100 or more acres and a minimum of 2,000 dwelling units). For commercial development, the Government of India requires a "built-up" area of at least 50,000 meters. In the case of a combination of these two types of projects, either of the two conditions will suffice.

Some of the requirements for investments include, but are not limited to, the following:

- The minimum capitalization required for investing in companies engaged in such projects is Rs. 43.5 crore (approximately US \$10 Million) for wholly-owned subsidiaries and Rs. 21.75 crore (approximately US \$5 Million) for joint ventures with Indian partners.
- The funds must be brought into India within six (6) months of the commencement of the business of the wholly-owned or joint-venture company.
- The Government of India requires a "lock-in" period of three (3) years for the original investment. Thus, the original investment may not be repatriated before three (3) years from the completion of the minimum capitalization. Notwithstanding, the Government of India may relax this exit norm on a case-to-case basis.

## **IV. TRANSACTIONAL STRUCTURES**

### A. Infrastructure Participants

Typically, the main participants in an infrastructure project would involve:

1. Government (Central/State)- represented either through a Ministry or a government-owned entity. The government (a) grants (i) concessions, (ii) leases and (iii) permits/clearances/authorizations for the project and (b) enters into off-take agreements with the project company.
2. Sponsors- A consortium of interested groups usually are invited by the government to prepare a proposal or bid on a project with pre-specified parameters and selection criteria.
3. Financiers- A syndicate of banks provides debt to the sponsor and also may provide a stand-by loan facility for any cost overruns. They usually require a first security over the infrastructure created.
4. Contractors- Construction ("EPC"), and Operation and Maintenance ("O&M") Contractors
5. Project Vehicle- At present, a private limited company is the most suitable form of ownership for a project vehicle, or a special purpose vehicle ("SPV"). The advantages of forming a private limited company include the following:

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- protects developers of the project from liability; and
- enables shareholders to incorporate terms and conditions mutually agreed by them, binding the shareholders and the company to such requirements

Partnerships or unincorporated entity structures, on the other hand, are not effective, because:

- liability would be general and, thus, could be unlimited (India presently does not recognize a limited liability partnership);
- the tax benefits may not be available to such structures; and
- partnerships have limited sources of financing, as they have member number restrictions.

6. Regulator- The Government of India entity vested with the authority to regulate the development of a particular sector. For example, the Telecommunications Regulatory Authority of India (“TRAI”) regulates companies within the communications industries. The regulator typically involves users and consumers through open or public hearings.

7. Other Authorities- For example, the NHAI is in charge of the development, operation and maintenance of roads and highways in India, but is not necessarily a government regulator.

### B. Risk Mitigation

The mitigation and allocation of risks are vital considerations in project finance. Typically, sponsors and other interested parties seek to segregate, or ‘ring-fence’, their obligations pursuant to each specific project. This action is in line with the very nature of project finance, as opposed to balance sheet finance.

In non-recourse financing, lenders rely on a combination of the economic and technical viability of the project, rather than on the value of the sponsor’s credit rating. However, a completely non-recourse arrangement may create some discomfort for the lenders. As such, it eventually may result in raising the cost of debt to compensate for the risk exposure.

In certain cases, it, therefore, may make sense to use a limited recourse financing structuring. There, lenders primarily rely on the cash flows from the relevant project to repay the debt. However, they also may create obligations on the owners of the borrowing entity in the event of certain events of default. Where the financing is limited recourse, the sponsor’s credit rating will assume greater importance.

The creation of a SPV, in the form of a private limited liability company, is the common practice in India to develop, finance, construct, own, operate and maintain an infrastructure project. Such a SPV owns only the assets of the particular project, thus limiting the liability of the sponsors and interested parties.

In certain cases, one might create a complete recourse project finance structure during the construction phase of the project to protect against the risks of project non-completion. In such instances, lenders often would require guarantees from the project developers.

The extent of recourse to the project developers is usually provided in the sponsor support agreement. The sponsor support agreement may include the following obligations:

- Direct Equity Obligations- These obligations are requirements placed upon the project sponsors to inject certain amounts of equity into the project at project development commencement.
- Contingency Obligations- These obligations are requirements placed upon the project developers to provide equity funds to the project company on the occurrence of certain contingent events, such as shortfalls in the project revenue receipts or loan servicing amounts.
- Equity Locks or Negative Liens on Shares- These obligations are requirements placed upon the project developers not (i) to sell their shareholding in the project company for a specified period of time or (ii) create any third party interest other than that of a pledge of the SPV shares as security to the lenders.

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### C. Certain Accepted Indian Project Finance Structures

#### 1. Public-Private Partnerships Finance Model

##### a. General Structures

Public-Private Partnerships or PPPs, as they are known, are increasingly becoming an accepted model for developing and financing infrastructure projects in India. While the public sector faces budgetary constraints and lacks required expertise, the private sector faces problems in (i) acquiring land, (ii) obtaining environment and forest permits and other such clearances, (iii) securing approvals from local authorities and (iv) overcoming inordinate delays caused by Central, State and local government authorities. A partnership between the public and private sector to a large extent can help mitigate these often daunting project impediments.

Some of the structures under the PPP Finance Model include, but are not limited to, the following:

- BOO (Build Own and Operate i.e. without any obligation to transfer)
- BOT (Build Own and Transfer)
- BOOT (Build Own Operate and Transfer)
- BOR (Build Operate and Renewal of concession).
- BLT or BRT (Build Lease or Rent and Transfer)
- BT (Build and Transfer immediately)
- BTO (Build Transfer and Operate)
- DBFO (Design Building Finance and Operate)
- DCMF (Design Construct Manage and Finance)
- MOT (Modernize Own / Operate and Transfer)
- ROO (Rehabilitate Own and Operate)
- ROT (Rehabilitate Own and Transfer)

##### b. BOO Finance Structure

The Bangalore International Airport Limited (“BIAL”) initiative is a good illustration of a PPP. The BIAL is a Rs. 1400 crore (approximately US \$320 Million on a Rs. 43.5 to US \$1 currency conversion basis), 26%:74% public-private joint venture. It plans to build a state-of-the-art greenfield/development airport on a BOO basis. The Karnataka State Government will lend Rs. 350 crore (approximately U.S. \$80 million) as an interest free loan for a period of 10-years to the BIAL. The BIAL and Karnataka State Government already have executed the concession agreement, state support agreement and land lease agreement. Moreover, the airport is awaiting financial closure to commence the construction work.

##### c. BOT Finance Structure

Large scale Indian infrastructure projects, such as those under the National Highway Development Program (“NHDP”), India’s largest-ever highway project with an estimated cost of Rs. 54,000 crores (approximately US \$12.4 Billion), usually use the BOT model to access direct private sector funds.

Under such a model, a consortium of private sector parties agrees with the government to invest in a public infrastructure project. A concession agreement is signed to commence the project development. Such agreement includes a description of the project, the terms of the concession (including the actual grant or award and terms of license), the terms of the construction and operation of the facility, the provisions of the equity structure and restrictions, if any, on foreign ownership, and other requirements.

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The project vehicle then seeks and secures financing and constructs, owns, maintains and manages the facility for an agreed concession period. During that period and thereafter, the SPV investors recover their investment through project tolls or other designated charges. After the concessionary period, the ownership and operation of the facility is transferred to the Center, State or local government or relevant governmental authority.

Advantages of BOT projects include, but are not limited to, the following:

- The government receives the benefit of the private sector to mobilize finances and to use the best management skills in construction and O&M.
- Private participation ensures efficiency and quality by using the best available technology and equipment.
- Projects are conducted in a fully competitive bidding situation. Thus, they are completed at least theoretically, if not actually, at the lowest possible cost.

BOT projects have had varying degrees of success in India. BOT toll road projects, such as the Delhi-Noida toll road project, at times have run into revenue generation difficulties due to inaccurate traffic projections. However, the scenario is set to improve, as user reluctance towards toll payments has reduced considerably over the past few years.

### 2. Take-Out Finance

Another problem that arises in infrastructure projects, due to the long gestation periods they involve, is the maturity mismatch between revenue flows from the project and the debt tenor required by infrastructure projects. It is usually difficult to obtain financing from banks and other financial institutions for a tenor exceeding 5-10 years. However, the project needs realistically could require between 15-20 years for adequate revenue flows. The mismatch has resulted in greater risks and higher interest rates.

There are various ways to obtain the necessary debt financing while simultaneously addressing the problem of this revenue flow-debt maturity mismatch. One of the more innovative techniques is "take-out financing." Take-out financing refers to the transfer of the project loan liability from one lending agency to another in order to receive better financial benefits and a suitable allocation of risks between different lenders.

Under this approach, the debt tenors can be structured in a way, so that separate lender syndicates finance the project during different stages. For example, one lender syndicate may agree to provide the debt only during the construction period. It will require the return of its funds at construction completion. This group will be interested in evaluating the commensurate construction risks. Another lender syndicate, which is entirely averse to bearing the perceived construction risk, may agree to provide debt financing during the project's operation and maintenance stage. Thus, in such case, borrowings will occur in two (2) stages covering the entire span of the project life, during which time debt finance was required.

### 3. Bond Finance

Increasingly, sponsors and developers have begun approaching the Indian bond markets for their borrowing needs. As the Indian capital markets mature, bond financing mechanisms could lower the cost of capital by creating the desired financing flexibility through different debt instruments. One may further reduce the cost of bonds, where a credible source, such as the government, acts as a guarantor of the bonds.

For example, the Maharashtra State Road Development Corporation ("MSRDC"), in 2004, originally targeted a bond issuance for Rs. 400 crore (approximately US \$92 Million) in order to fund the Rs. 2203 crore (approximately US \$506 Million) Mumbai-Pune expressway, Mumbai expressway overpass (or flyover) and Mumbai expressway railway bridges in the State of Maharashtra. The bonds were guaranteed by the Maharashtra State Government. In this finance, the MSRDC offered four (4) bond instruments: two (2) fixed-rate bonds of five (5) years and 10 years maturity and two (2) floating-rate bonds of 10 years and 12 years maturity. The bond offering, when held, was oversubscribed by more than 100%, or by Rs. 450 crore (approximately US \$103 Million). Thus, the total raise of funds by this bond offering was Rs. 850 crore

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(approximately US \$195 Million).

The Mumbai-Pune expressway project was the first toll road project in the State of Maharashtra requiring more than Rs. 2100 crore (approximately US \$483 Million) for construction. It was awarded as a BOT project for 30 years to the MSRDC. The project did not receive any government grant or funding. Instead, the MSRDC entirely financed the project through debt raised on an equity base of a mere Rs. 5 crore (approximately US \$1.15 Million).

#### 4. Securitization

The MSRDC is seen as somewhat of a market leader when it comes to innovations. In 2004, it executed a significant securitization deal with respect to the same Mumbai-Pune expressway project. In that transaction, it raised Rs. 1348 crore (approximately US \$310 Million) through securitization, of which Rs. 918 crore (approximately US \$211 Million) was provided up-front to the project.

The MSRDC invited bids from private companies for a period of 15 years for securitizing the future cash inflows from the expressway and the 111 km stretch of NH4 that runs parallel to it. The MSRDC acted in this particular case as a "Project Incubator" by developing, constructing and initially operating a high risk project and turning its revenue stream over at a price to free-up its investments for subsequent projects.

Securitization may become a significant financing tool in the future in India. However, as of now, it is still not a common method for the mobilization of financial resources. Nevertheless, companies are beginning to realize its potential benefits.

For example, Larsen & Tuobro ("L&T") raised Rs 409 crore (approximately US \$94 Million) from banks, foreign investors and mutual funds to finance the construction of a 2X45 MW gas turbine-based, captive co-generation power plant at the Gandhar complex in the State of Gujarat. The power project was to be leased to Indian Petrochemicals Corporation Limited ("IPCL").

L&T structured a SPV company, called India Infrastructure Developers Ltd ("IIDL") for the implementation of this power project. L&T was to act as the EPC contractor to IIDL. IIDL was to own the power plant and lease it to IPCL. The lease rentals, receivable by IIDL from IPCL, were securitized to raise funds for the construction of the power plant.

#### 5. Viability Gap Funding

In a welcome and recent initiative, the Government of India has established a special financing facility, called "Viability Gap Funding" under the Department of Economic Affairs, Ministry of Finance, to provide support to PPP infrastructure projects that have at least 40% private equity committed to each such project. The Government of India has set certain criteria to avail this facility under formal legal guidelines, issued in August 2004, to support infrastructure PPPs.

Viability Gap Funding can take various forms such as capital grants, subordinated loans, O&M support grants and interest subsidies. It will be provided in installments, preferably in the form of annuities. However, the Ministry of Finance guidelines requires that the total government support to such a project, including Viability Gap Funding and the financial support of other Government of India Ministries and agencies, must not exceed 20% of the total project cost as estimated in the preliminary project appraisal, or the actual project cost, whichever is lower. The Government of India has allocated Rs. 1500 crore (approximately US \$345 Million) for Viability Gap Funding for infrastructure projects in the Union Budget 2005-2006.

#### 6. Infrastructure SPV

The Union Budget 2005-2006 also provides for the establishment of a SPV to finance infrastructure projects in specified sectors such as roads, ports, airports and tourism ("Infrastructure SPV"). The projects will be appraised by an inter-institutional group of banks and financial institutions. The SPV will lend funds, especially long-term debt, to eligible projects. The Government of India has allocated Rs. 10,000 crore (approximately US \$2.3 Billion) for the Infrastructure SPV for Financial Year 2005-06. Some major foreign financiers, however, have complained that this amount is actually quite small when considering (i) that India's Foreign Exchange Reserves currently exceed Rs. 598,100 crore (approximately US

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\$137.5 Billion), (ii) its abysmal infrastructure, and (iii) its tremendous infrastructure needs (in order to retain and further expand its burgeoning economic growth).

### 7. Infrastructure Development Finance Corporation

The Government of India earlier had established a specialized infrastructure finance institution, called the Infrastructure Development Finance Corporation (“IDFC”), in 1997 to attract private investment in infrastructure projects. The IDFC provides infrastructure projects credit enhancement to and extends long-term loans and guarantees that existing public and private financing institutions may not be able to provide. Some advantages of using IDFC financing consist of the following:

- its favorable terms and conditions, so far as maturity and interest rates are concerned; and
- the quasi-governmental nature of the finance provides credit enhancement, while mitigating political risk.

However, the inherent delays in securing such funds may discourage project sponsors from seeking IDFC financing.

In any event, it is important to secure the Government of India’s involvement and interest in some manner, and particularly at an early project state. This involvement can occur through government financing or guarantees to provide coverage for political, regulatory and financial risks associated with investing in India.

### D. Emerging Project Finance Fundamentals

One key development in India project finance over the last several years is that the lenders themselves are now more focused on project fundamentals rather than on “guarantee mechanisms”. In India, sovereign guarantees and counter guarantees at the Government of India and State government levels have been found to be woefully inadequate and difficult to implement in a range of infrastructure projects. Moreover, the respective Central and State governments have refused to burden their balance sheets with these security mechanisms.

As lenders become more comfortable with the nature of infrastructure project risk and the appropriate risk mitigation measures to address such concerns, a whole range of financing opportunities are likely to open-up. Additionally, the earlier divide between private and public projects and financing thereto is now becoming blurred. The joint venture of the private and public sectors in the financing and construction of these many and massive infrastructure project undertakings required throughout India will permit the successful execution and completion of several projects that perhaps would not have succeeded independently as either private or public projects.

## **V. CONCLUSION**

India is entering a new era in project financing and infrastructure project development. Many lessons have been learned from the unfortunate errors of the mid-1990’s, India-infrastructure “gold-rush” that never materialized into a significant number of completed and fully operating projects throwing off substantial rates of returns to the investors. Hopefully, India is finally positioning itself for the dawn of a true infrastructure growth. Its recent tremendous economic growth is the result of an economic engine running on a mere half of its capacity through technology services export revenues. The use of the remaining capacity in India’s economic engine not only will safeguard India’s current brightening economy, but will fuel an economic growth never before seen in India. Hopefully, such additional use will power it for the years to come.