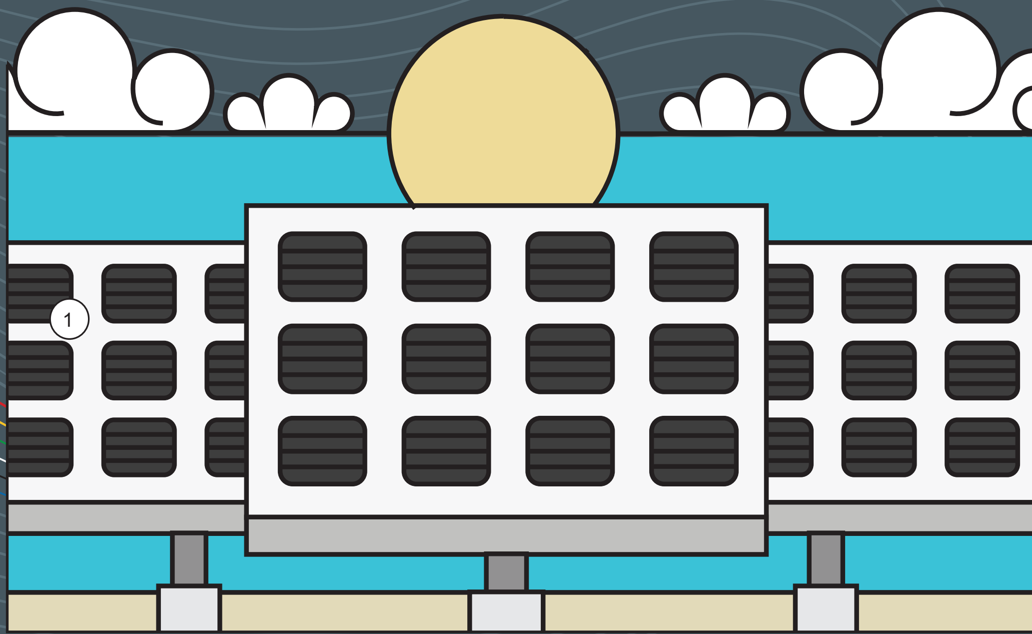

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PROJECT DEVELOPMENT & FINANCE

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Introduction

More and more South African development projects in the infrastructure sector and, more recently, the mining sector are being funded through project finance. Previous projects have included toll roads and prisons, but this means of financing is also being applied to develop Government facilities and mining projects. In cases where commercial and public interests coincide, public-private partnerships usually apply. In other instances banks and project companies employ various strategies, such as combining debt and equity and including a strategic equity partner, to mitigate risk.

Project Financing in South Africa

Project financing involves raising finance for the design, construction and development of a project's infrastructure and the procurement of any equipment and assets required for the operation of that project. This should be done in a way that ensures that the debt, equity capital, interest as well as all returns on the share capital are repaid from future cash flows emanating from the project.

Public-Private Partnership Transactions

The introduction of public-private partnership (PPP) transactions in 2001 caused project financing to come of age in South Africa. Through PPPs, public and commercial entities look to banks to fund infrastructure development – initially prisons and toll roads – which depend on State occupancy payments or traffic volumes (with concomitant toll fees), to service and repay debt over periods of 20 to 30 years.

Treasury Regulations for departments, trading entities, constitutional institutions and public entities, under the Public Finance Management Act, No. 1 of 1999 (the PFMA), were published in Government Notice 225 of 15 March 2005 (Treasury Regulations).

Treasury Regulation 16 specifies detailed processes required by the Treasury in relation to PPPs from project inception through feasibility studies, procurement and contracting, to managing PPP agreements.

Thus, in order to gain prescribed Treasury Approval I, a feasibility study, explaining the strategic and operational benefits of the proposed PPP in promoting the institution's strategic objectives and Government policy, has to be undertaken. A promoting institution may not proceed with the procurement phase of a PPP without written approval for the feasibility study.

To achieve Treasury Approval IIA, a PPP procurement procedure has to be fair, equitable, transparent, competitive and cost-effective, and must include preference for the protection or advancement of persons, or categories of persons, disadvantaged by unfair discrimination.

After the evaluation of bids, but prior to appointing a preferred bidder, the promoting institution has to submit a report demonstrating how the criteria of affordability; value for money; and substantial technical, operational and financial risk transfer (the Criteria), were applied in evaluating the bids. This in order to obtain Treasury Approval IIB.

After the conclusion of the procurement procedure, but before concluding a PPP agreement, the promoting institution has to obtain Treasury Approval that the PPP agreement again meets the Criteria. In so doing, the promoting institution has to set out a management plan (the plan) explaining the capacity of the institution and its proposed mechanisms and procedures to effectively implement, manage, enforce, monitor and report on the PPP. The plan has to be accompanied by a satisfactory due diligence (including a legal due diligence).

The Treasury Regulations also set out a detailed process for managing the implementation of PPP agreements making specific provision for use of State property by a private party in the context of a PPP transaction.

The PPP Unit of the National Treasury has issued Standardised Public-Private Partnerships Provisions that have come to play an important "benchmarking" role in PPP transactions.

PPP mechanisms are now also used to provide Government accommodation and services in respect of offices, schools and hospitals.

Project Finance and Greenfields Resources Projects

An interesting more recent development has been recourse to project financing in relation to funding the development and establishment of greenfields mining, oil and gas, and energy (both thermal and renewable) projects.

When commencing the financing of a new project, many resources or energy companies either do not:

- have a strong balance sheet or the backing of a holding company; or
- want to access their balance sheets for the purposes of financing a new project that can be financed off the strength of cash flows it will generate.

Accordingly, banks lending money to these projects do not have the security of large corporate guarantees or corporate assets. Consequently, any repayment and servicing of debt project finance has to be met solely from project cash flows (ie from product sales generated by the project) which may be subject to market fluctuations.

The ability to use project financing, employing a combination of debt and equity, enhances prospects of making returns to equity providers acceptable and, thus, makes new resources projects more feasible.

Mechanisms reducing risk

Banks need to limit concomitant risks to acceptable levels and, in the case of junior mining companies, may require:

- a larger equity component of overall funding;
- a lower debt to equity ratio than would be the case where a strong balance sheet and/or corporate assets are made available to it;
- a comprehensive hedging strategy in respect of interest rate movements and possibly movements in prices of key supplies and products;
- that equity raised be used prior to any drawdown of debt;
- that cost overrun and working capital facilities be put in place;
- the involvement of a strategic equity partner; and
- committed off-take obligations.

Strategic partners

A third party in need of a resource may be willing to become a strategic equity partner in the development and exploitation of that resource. The strategic equity party may be responsible for:

- providing, or at least contributing to, any necessary additional funding; and
- entering into an off-take agreement with the project company.

An arrangement affords the relevant banks the additional comfort of a committed buyer for the product on the basis of guaranteed minimum prices and for certain minimum quantities (ideally generating adequate cash flows to service debt obligations). However, there may be disadvantages to such an arrangement as it may lock the project company out of participating in surges in the market prices of the resource.

Junior and mezzanine debt

To improve returns to equity shareholders and to reduce the risk to senior debt providers, a project company will often raise a tranche of junior or mezzanine debt. This debt will, in most cases, have a higher return than the senior debt, but rank behind it with respect to security and repayment.

Underlying licences or permits and financing black economic empowerment equity participation

Banks as debt providers are concerned with:

- the status regarding any underlying consents, licences or permits (eg electricity generation permits, casino licences, pipeline permits, mining licences and environment consents); and
- issues of the financing of black economic empowerment equity participation.

In respect of mining projects, banks should require that a new order mining licence is in place. In some cases, this is not possible as the conversion of old order to new order mining rights can take time, generally requiring banks to assess risk on a transaction-by-transaction basis.*

Without the requisite underlying consents, licences or permits, finance (both debt and equity) is difficult to raise. In addition, renewal of such consents, licences and permits are of concern to, and a requirement of, all financiers (both debt and equity).

Conclusion

Investment in South African project development is possible by being party to a PPP or by joining the project as an equity partner. In either case there are regulating bodies, the National Treasury or the relevant banks, that prescribe certain conduct for financing to be approved. This ensures that risk for the investors is mitigated.

** For more information on new order mining licences, please see Chapter 22: Mining And Mineral Law.*

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