Main Financing Mechanisms for Infrastructure Projects

Full Description

Government Funding

The Government may choose to fund some or all of the capital investment in a project and look to the private sector to bring in expertise and efficiency. This is generally the case in a so-called Design-Build-Operate project where the operator is paid a lump sum for completed stages of construction and will then receive an operating fee to cover operation and maintenance of the project. Another example would be where the Government chooses to source out the civil works for the project through traditional procurement and then brings in a private operator to operate and maintain the facilities or provide the service.

Even where Governments prefer that financing is raised by the private sector, increasingly Governments are recognizing that there are some aspects of the project or some risks in a project that may be easier or more sensible for the Government to take. This is discussed in Government Support in financing PPPs.

Corporate or On-Balance Sheet Finance

The private operator may accept to finance some of the capital investment for the project and decide to fund the project through corporate financing – which would involve getting finance for the project based on the balance sheet of the private operator rather than the project itself. This is typically the mechanism used in lower value projects where the cost of the financing is not significant enough to warrant a project financing mechanism or where the operator is so large that it chooses to fund the project from its own balance sheet.

The benefit of corporate finance is that the cost of funding will be the cost of funding of the private operator itself and so it is typically lower than the cost of funding of project finance. It is also less complicated than project finance. However, there is an opportunity cost attached to corporate financing because the company will only be able to raise a limited level of finance against its equity (debt to equity ratio) and the more it invests in one project the less it will be available to fund or invest in other projects.

Project Finance

One of the most common - and often most efficient - financing arrangements for PPP projects is “project financing”, also known as “limited recourse” or “non-recourse” financing. Project financing normally takes the form of limited recourse lending to a specially created project vehicle (special purpose vehicle or “SPV”) which has the right to carry out the construction and operation of the project. It is typically used in a new build or extensive refurbishment situation and so the SPV has no existing business. The SPV will be dependent on revenue streams from the contractual arrangements and/or from tariffs from end users which will only commence once construction has been completed and the project is in operation. It is therefore a risky enterprise and before they agree to provide financing to the project the lenders will want to carry out an extensive due diligence on the potential viability of the project and a detailed review of whether the project risk allocation protects the project company sufficiently. This is known commonly as verifying the project’s “bankability”. For more, go to Risk Allocation, Bankability and Mitigation.

Related Content
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Sources of Financing and Intercreditor Agreement
Project Finance – Key Concepts
Key Issues in Developing Project Financed Transactions
Risk Allocation Bankability and Mitigation in Project Financed Transactions

Risk Mitigation Mechanisms (including guarantees and political risk insurance)
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Government Risk Management
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Additional Resources
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