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Project Finance and Infrastructure Development

The impact of tax on project bankability

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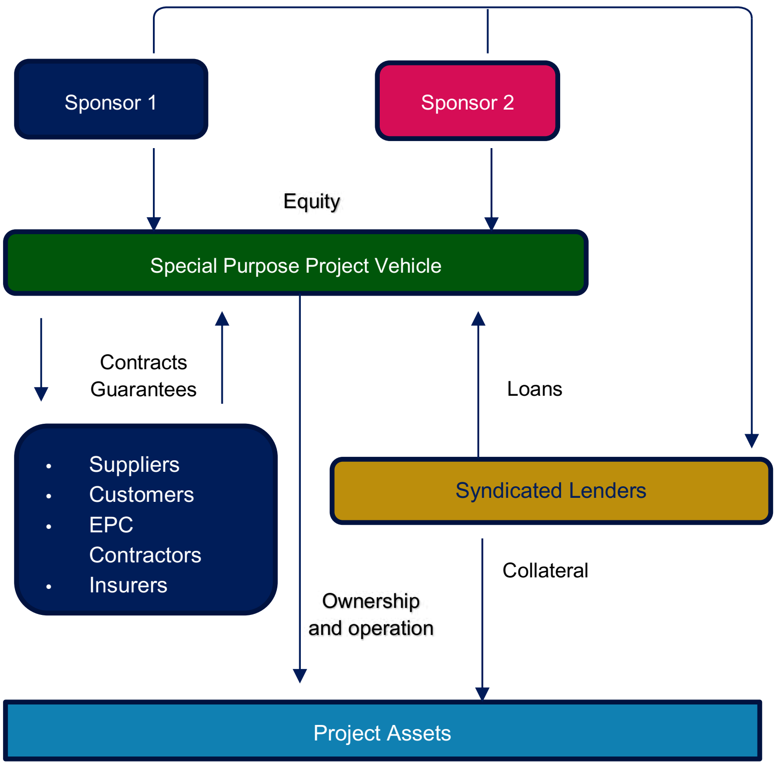
1. Introduction

Project finance (also referred to as limited or non-recourse financing) represents the long term financing of capital projects relying largely on the future project cash flows as the means of servicing the loans advanced for the project development. Project finance contrasts with regular corporate financing that relies on the strength of the project company or sponsor balance sheet in determining whether to lend to the project under consideration.

Project finance is an important means of financing capital projects such as roads, airports, power stations, crude oil production facilities, pipelines and refineries. Projects generally need to have long-term, stable and predictable cash-flows to be financeable under this arrangement. In 2015, Uganda passed the Public Private Partnership (PPP) Act that established the framework for the participation of the private sector in public infrastructure projects providing legislative clarity which is key in the closure of project finance transactions. The ongoing procurement, funding and financing of the Kampala-Jinja Expressway (projected to cost over a billion United States dollars) is being undertaken under the provisions of the PPP Act.

The impending commercialisation of Uganda's crude oil discoveries that will involve the construction of production facilities and associated infrastructure, an export pipeline and a refinery and is expected to be funded at least in part by way of project finance.

Simplified Project Finance Structure



Given that project cashflows are the principal means of servicing loans, sponsors and lenders are sensitive to any aspects of the legal, tax and operational framework that can contribute to cost escalation potentially rendering a project commercially unviable. Future changes to the tax and related fiscal laws can also erode the commercial value of the project as previously anticipated. If there are disruptions to the project as a result of operational problems or disputes with the government and major customers, the project special purpose vehicle may be starved of cash required for debt servicing and operations. Project sponsors and lenders therefore carefully review the project risks and can abort participation in project development if the risks cannot be optimally allocated (to the party best suited to manage the risk) or mitigated.

This publication examines some issues related to the use of project finance in the initiation, development, commissioning and operation of capital projects and how tax and related fiscal issues can impact project bankability.

2. Evaluation of project finance

When considering whether to use project financing, several critical issues are considered, interalia:

a) Project finance enables participants to share in the project risks which are allocated to the party best able to absorb the perils at hand. Multilateral and bilateral agencies can be co-opted to provide financing but also managing sovereign or political risks. In suitable cases, customers can be asked to enter into long term agreements committing to buy/off take the output of the project giving comfort to the lenders of assured cash flows to meet operational costs and debt servicing debt. Other risks can also be allocated to the other project participants based on their capacity to handle the same.
b) By keeping the project financing and liabilities off their balance sheet, project sponsors maintain favourable debt to equity ratios retaining their ability to take on more debt based on their balance sheet strength when required. Project finance also enables sponsors to orbit loan covenants that may place limits on the amount of additional corporate debt that they can take on.
c) Sponsors are able to take part in a range of projects enabling diversification, which is a time tested strategy of mitigating project risks. Diversifiable risks represent perils that can be mitigated by holding smaller stakes in several projects as opposed to one large stake. Political and project development risks can be mitigated by diversification.
d) Project financed transactions are carefully evaluated and assessed. Robust economic and technical reviews are undertaken to enable parties to arrive at bankable projects that they are all comfortable to take part in because of the reasonable expectation of project success.
e) Project financed transactions are usually big capital infrastructure projects which may require incentives from the host government. Given the strategic importance of some of these projects to a country's development agenda, governments are often amenable to providing incentives (such as tax holidays and targeted exemptions) to enable them meet commercial thresholds.
f) The above notwithstanding, project finance is complex and costly to implement because of the several participating parties with diverging and sometimes conflicting interests. The cost of capital is also much higher in contrast with corporate debt because of the limited recourse to non-project cashflows to service debt. There is also a higher level of control that may be exercised by the commercial lenders sometimes in conflict with the sponsor objectives.

3. Project finance participants

There are several players (both local and international) in project finance transactions. These include the project vehicle, sponsors, commercial lenders, host governments and contractors among others.

a) The project sponsor represents the entity or investors economically interested in the project. The sponsors set up a special purpose entity that develops and maintains the project under development. This special purpose entity contracts with the lenders, operators, contractors, customers and suppliers. The type of entity established depends on the legal, tax and commercial objectives of the sponsors.
b) Commercial lenders include but are not limited to banks, insurance companies, pension funds and credit corporations that extend loans to the project. The arranging bank organises the cooperation between the syndicate of lenders that comes together to pool the project funds. The agent bank coordinates loan draw downs in the syndicate and monitors covenant compliance by the borrower.
c) The security agent holds security interests as agent of the project lenders, monitoring lien filings and other steps necessary to protect the security interests of the lenders.
d) Multilateral agencies like the World Bank, the International Finance Corporation, regional development banks and bilateral bodies such as export credit agencies also participate in project financing. They provide seed funding and are sometimes used as a hedge against political risk.
e) Rating agencies are also involved to provide credit rating for the underlying debt based on which the cost of capital that reflects the investment return sought by the sponsors and lenders is computed.
f) The suppliers of project inputs are also key. Sponsors and lenders are keen to ensure that the underlying contractual arrangements are realistic and that the suppliers are able to perform the roles they have contracted to undertake.

g) Sometimes customers can enter into long-term agreements committing to purchase the output of the project providing credit support for the underlying financing. The long-term commitment to purchase output addresses market risks giving comfort to commercial lenders as there is assured cash flow for debt servicing once the project is commissioned.
h) There is also the Engineering, Procurement and Construction (EPC) contractor that is responsible for the activities relating to the design, procurement, construction and commissioning of the project facilities to the project special purpose vehicle.
i) There are often several technical consultants and other specialist advisors that are retained to advise the lenders and sponsors on highly technical project matters.
j) Host governments sanction the project under development by issuing permits, licenses, authorizations and concessions. In some instances, host government are asked for sovereign commitment not to revise laws that may affect the project or if such laws are revised, they may be asked for an undertaking that the economics of the project agreement may be renegotiated to restore the investor or government to their previous economic standing at the date of signing the project agreements.
k) Insurance providers work closely with the project sponsors and lenders to provide an insurance package that mitigates risks at an economical price. This is the commercial practice and sometimes a regulatory requirement.

4. Project bankability and the impact of tax

A project is bankable if it has sufficient collateral, ascertainable future cash flows and a high probability of success. Project finance participants scrutinise carefully the risks to the project and how these can be optimally allocated to secure commercial viability. The risks are wide-ranging covering credit, construction or completion, market, finance, politics, legislative and environmental matters amongst others.

Completion or commissioning risks arise if the construction of the project facilities deviates from specification or there are significant cost overruns along the way. Political risks include changes to legislation that explicitly expropriate investments or increased tax and related fiscal impositions that can erode the commercial value of the project as evaluated at final investment decision. How tax and fiscal issues can affect project bankability is further discussed below.

a) Stability of the tax and fiscal regime

Project financed ventures are generally long term, large scale and require upfront investment before revenue generation commences. This raises concerns for investors with regard to the future legal and fiscal changes that can dilute the value of their investments. A common safeguard is the inclusion of stabilisation clauses in project agreements.

Stabilisation clauses can restrain a government from unilaterally amending the terms of the project agreements. They aim at ensuring that the fiscal terms of the agreement executed are not altered to the disadvantage of the investor during the duration of the project. While stabilisation clauses can seem attractive to the government in the short run as an inexpensive way of minimising investor risk, they may have costs in the long run by limiting government’s ability to modify tax and legislative policy.

The stability of the country’s taxation regime is a key concern for project sponsors and lenders who are sensitive to future tax changes at investment appraisal stage. Future tax changes can erode the economic value of the project as previously evaluated reducing the cashflows available for debt service, operational costs and investment returns.

b) Taxing investments or profit

It is important for countries to find a fiscal balance that enables optimal tax revenue collections but also maintain a competitive business environment. Front loaded tax impositions not linked to profitability can adversely impact the commercial viability of capital projects because of the long lead time from final investment decision to commissioning.

There are three broad types of taxes and related fiscal charges levied in Uganda. These are presence-based taxes that arise as soon as a business entity is established and before any revenue is forthcoming. Stamp duty is an example. Revenue-based taxes arise on the commencement of operations regardless of whether a project is profitable or not such as royalties for the extractive sector and indirect taxes. Profit based taxes as the name suggests are charged on profits by whatsoever means determined such as corporation income tax on taxable company profits.

An ideal taxation regime is one that taxes profits arising from production as opposed to investment activities that are being undertaken to facilitate project commissioning. If not, it can be the case that some of the funds earmarked for project development have to be allocated to tax payment even before the project is commissioned.

c) **Value Added Tax**

The development of capital projects can abort as a result of the Value Added Tax ("VAT") regime. Given the long lead time between the investment and production, the VAT regime can significantly affect the commercial viability of capital projects if normal VAT principles are applied without modification.

VAT is charged on most finished items and is principally borne by the final consumer. VAT registered persons can claim VAT incurred on their inputs for business operations but registration for VAT is normally possible if the business has commenced production or trading unless the law is varied to permit voluntary registration during the investment stage.

Most project financed ventures have long lead times between investment and production and would have to wait for years to register for VAT when they start revenue generating activities if the normal VAT rules are applied. The cost of the non-recoverable VAT incurred during the investment phase significantly escalates project costs potentially affecting commercial viability.

Even if special consideration is made for projects at investment stage to register for VAT, there are often delays with processing the VAT refunds in developing countries. It is therefore the position in many countries that some capital projects are provided with exemption and zero rating mechanisms at investment stage and Uganda has a deemed VAT paid system that mirrors the VAT zero rating system for the extractive industry and donor funded projects.

d) **Customs duties**

Most of the inputs used in the development of capital projects in developing countries are imported. Duties at importation raise substantial tax revenues for developing countries. Though tax revenues may be foregone, it is usually necessary to exempt capital project inputs from import duties as duty imposition can escalate project costs making it more difficult to meet the investment hurdle criteria.

e) **Project incentives**

Many countries need these capital infrastructural projects to realise their development goals. Given the strategic significance of some of these projects to countries, incentives in the form of tax exemptions or reduced tax rates may be given to enable them to meet the commercial thresholds for investment.

f) **Withholding taxes**

Withholding tax ('WHT') applies on specified payments to the local and non-resident vendors. In capital projects, WHT applies on payments for technical, management, civil works and interest amongst others. Non-resident vendors and lenders to project financed capital ventures often demand that their service fees or interest payments are paid net of taxes. The WHT component ends up being borne by the project company thereby escalating project costs. It is common for interest on project finance loans for strategic projects to be exempted from WHT.

g) **Capital gains**

Investors in capital projects can exit or dilute their interests in projects during the implementation period with new investors on boarding. Exit or dilution can be a strategy for investors to recoup their investment and a return for participation in the project development, or of reducing project risk. Project finance participants therefore pay close attention to the capital gains tax ("CGT") regime applicable if they are to exit from the project.

CGT is imposed on profits realised on the sale of non-depreciable and non-inventory assets that are acquired at a cost amount lower than the amount realised on sale. Some countries do not tax capital gains at all or only tax a limited range of gains. Some countries provide exemption from CGT provided the gains arising from the sale are re-invested in the country. It is important for a government which wishes to promote major investments to consider this in shaping an appropriate fiscal policy.

h) **Local content**

There are concerns that the economic benefits from capital project development are not inclusive with local companies excluded given that most of the project inputs and services are imported. To address this, some countries have enacted local content rules prescribing the extent to which local goods and services must be used in local project development. This is particularly common in the extractive industries. If local content rules are excessively prescriptive and oblivious of the available local capabilities, they can breed inefficiency hence increasing the project development costs. The locally sourced goods and services need to be competitive in terms of price, quality and timely delivery.

i) **Government participation**

Capital projects are usually of national strategic importance and governments are keen to participate in their development with the private sector as a means of asserting greater operational control in the investment. A high level of government participation is however not popular with private companies for a variety of reasons including the potential of reducing entitlement to the project profits and unwarranted government sway in technical and working committee meetings.

5. Conclusion

The importance of the tax and regulatory regime in influencing project bankability and thus encouraging and stimulating new investments cannot be overstated. A project is bankable if the various participants reasonably expect it to succeed earning investment returns consistent with the risks assumed. Front loaded tax regimes that impose taxation during the investment phase of capital projects can escalate project costs and these adversely affect the principal project evaluation measures of payback period, Net Present Value ('NPV') and Internal Rate of Return ('IRR') that are widely used to inform investment decisions.

Payback period is the amount of time it takes to recover the capital including return incurred on the project development. NPV is the difference between the present value of future cash inflows and outflows for a period of time. It is determined by calculating the costs (cash outflows) and benefits (cash inflows) for each period of an investment. Future cash inflows and outflows are discounted with the cost of capital reflecting the risk undertaken to invest in the project. IRR is a metric used in capital budgeting to estimate the profitability of potential investments. IRR is a discount rate that makes the NPV of all cash flows from a particular project equal to zero.

Taxation and regulatory regimes applicable to capital projects must therefore take into account country settings and other trade-offs to retain competitiveness with other countries that are also contending for the same project capital. It is also important to recall that an overly generous tax and regulatory regime erodes the country's tax base and can cause political problems yet again a very tough one can stifle the incentives for investors to take up capital projects.

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At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

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Bill is a Senior Advisor with Cristal Advocates. He has concentrated on working with energy companies with a particular focus on cross border transactions and M&A since 1989 and is a leading global energy and tax practitioner with wide international experience. Between 1986 and 1998, he worked in London with the UK tax authorities and Big Four accounting firms. From 1998 to 2004, he was based in Kazakhstan working across the Caspian region with Deloitte. He was in the region at the time it was developing its infrastructure for crude oil production with international investment following the collapse of the Soviet Union.

From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

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John leads the public policy and advocacy practice at the firm and combines unique public and private sector experience.

Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

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Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

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