

FRAMING THE INQUIRY: THE SOCIAL IMPACT OF PROJECT FINANCE

A COMMENT ON BJERRE

LISSA LAMKIN BROOME*

In *Project Finance, Securitization and Consensuality*, Professor Carl Bjerre compares and contrasts securitizations and project finance transactions, concluding that the differences between the two financing techniques, although distinct, are more differences of degree than of kind.¹ One distinction between the two transactions that Professor Bjerre does find significant, however, is the social impact of project finance transactions.² The impact on third parties as the result of the construction and operation of a power plant in a developing country, for instance, is likely to be enormous. Professor Bjerre also invites us to consider the negative impacts of the project and the more subtle effects it may have on the citizens of the host country, including the impact on what the Nobel Prize-winning economist Amartya Sen has called the population's "capabilities."³ These capabilities include having a political voice, an education, civil liberties, free agency, freedom to live on a family's traditional land without displacement, and maintaining traditional lifestyles.⁴

I second Professor Bjerre's invitation for more analysis of the social impact of project finance transactions, especially on nonconsent-

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* Professor of Law and Director, Center for Banking and Finance, University of North Carolina School of Law. Thanks to Cynthia Collins Mabel for research assistance and to Carl S. Bjerre for enlightening discussion.

1. Carl S. Bjerre, *Project Finance, Securitization and Consensuality*, 12 DUKE J. COMP. & INT'L L. 411 (2002); see also STANDARD & POOR'S, *INFRASTRUCTURE FINANCE: PROJECT FINANCE, UTILITIES AND CONCESSIONS* 20 (2000) (discussing an additional comparison between the two financing techniques), available at <http://www.standardandpoors.com/ResourceCenter/Reference/CorporateFinance/ProjectFinance.html> (last visited Apr. 12, 2002). For additional links to helpful information on project finance, see Harvard Business School's *Project Finance Portal*, maintained by Professor Benjamin C. Esty, at <http://www.hbs.edu/projfinportal/> (last visited Apr. 12, 2002).

2. Bjerre, *supra* note 1, at 428.

3. *Id.* at 429 (quoting AMARTYA SEN, *DEVELOPMENT AS FREEDOM* 14 (1999)).

4. *Id.* at 430.

ing third parties. In addition, I raise some specific questions that I would like to see explored, and for some of the questions, a few very preliminary observations on the issues they raise.

1. *How do the policy considerations relating to project finance transactions differ (if at all) from the policy debate surrounding direct foreign investment in developing nations?*

Professor Bjerre notes that “international project finance transactions are inextricably linked to the longstanding controversies over FDI’s [foreign direct investment’s] effects on developing nations.”⁵ That link should be explored further. The text on economic development, to which Professor Bjerre cites, sets forth seven disputed issues relating to the impact of FDI by multinational corporations in developing countries.

1. International capital movements (income flows and balance of payments)
2. Displacement of indigenous production
3. Extent of technology transfer
4. Appropriateness of technology transfer
5. Patterns of consumption
6. Social structure and stratification
7. Income distribution and dualistic development⁶

Sen’s concerns—political voice, education, civil liberties, free agency, continuing habitation of traditional family land, and maintenance of traditional lifestyles—all seem to be encompassed within item 6 (social structure and stratification).

The debate about the effects of development on poverty in the host country is vigorous and ongoing. A recent study of eighty countries over four decades, for instance, countered the notion that the poor do not take part in or benefit from economic development. The study found that as the economy grows, the income of poor people—defined as the bottom fifth of the population—rises by about as much as the income of everyone else.⁷ If “political empowerment flows

5. *Id.* at 429.

6. MICHAEL P. TODARO, *ECONOMIC DEVELOPMENT* 586 (7th ed. 2000).

7. INTERNATIONAL FINANCE CORPORATION, *PATHS OUT OF POVERTY: THE ROLE OF PRIVATE ENTERPRISE IN DEVELOPING COUNTRIES* 1, 22 (2000), available at http://www.ifc.org/economics/speeches/paths_out_of_poverty.pdf (last visited Apr. 12, 2002) [hereinafter IFC I] (citing David Dollar & Aart Karaay, *Growth is Good for the Poor*, DEVELOPMENT RESEARCH GROUP, WORLD BANK (prelim. draft, Oct. 2000)). The International Finance Corporation is part of the World Bank and its explicit mission is to “foster[] economic growth in the developing world by financing private sector investments, mobilizing capital in the international finan-

from economic empowerment,” as some contend,⁸ then it is possible that many of Sen’s concerns could be addressed by additional economic development, including project finance, in emerging economies. Indeed, project finance transactions may provide direct benefits to the population of developing countries if the project financed is a school or hospital.⁹

2. *Are the policy considerations raised by Bjerre already factored into decisions regarding the viability of a particular project finance transaction? If the project’s sponsors do not specifically consider the policy considerations, do the market and the rating agencies, nevertheless consider them in evaluating the economic viability of the transaction? Are some policy concerns evaluated in this manner, while other, broader-reaching ones, are not considered either explicitly or implicitly by the project’s sponsors, investors, or lenders?*

A 1996 text on project finance exhorts a balancing by the host country of the “social costs” of project finance against the “social benefits.”¹⁰ Notwithstanding the exhortation, the remainder of the chapter chiefly catalogs the expected social benefits of project finance, and fails to highlight any social costs.¹¹ Another text advises that the “feasibility study should consider the degree of public opposition as one factor in the chance for project success.”¹² Are social im-

cial markets, and providing technical assistance and advice to businesses and governments.” *Id.* at ii.

8. *Id.* at 25. As indicated, there is substantial debate on this point. Amy Chua has argued: [M]arketization in the developing world is often destabilizing, fomenting ethnic envy and hatred among often chronically poor majorities. Second, in most developing countries, democracy can proceed only in deep tension with markets. Rather than reinforcing the market’s efficiency and wealth-producing effects, democratization ordinarily will lead to powerful ethnonationalist, antimarket pressures. Third, ethnic division in the developing world cannot be regarded as just another aspect of underdevelopment curable by the universal prescription of free-market democracy. On the contrary, the combined pursuit of marketization and democratization in the developing world is likely to catalyze ethnic tensions, with potentially catastrophic effects, including the subversion of both markets and democracy.

Amy L. Chua, *Markets, Democracy, and Ethnicity: Toward a New Paradigm for Law and Development*, 108 *YALE L.J.* 1, 6 (1998).

9. INTERNATIONAL FINANCIAL CORPORATION, *PROJECT FINANCE IN DEVELOPING COUNTRIES* 3 (1999), available at <http://www.ifc.org/publications/pubs/loe/loe7/loe7.html> (last visited Apr. 12, 2002) [hereinafter IFC II].

10. JOHN D. FINNERTY, *PROJECT FINANCING: ASSET-BASED FINANCIAL ENGINEERING* 188 (1996).

11. *Id.*

12. SCOTT L. HOFFMAN, *THE LAW AND BUSINESS OF INTERNATIONAL PROJECT FINANCE* 161 (2d ed. 2001). Hoffman lists (in rather cursory form) a number of relevant factors, includ-

pacts on the citizens of the host country factored into the evaluation of potential project finance transactions or are these statements merely idealized rhetoric?

Credit rating agencies may be important sources of information about actual practice in this area. These agencies play an important role in evaluating the likely success of a project finance transaction when financing is sought publicly rather than through private funding. Each of the three major U.S. agencies—Standard & Poor's, Moody's Investors Service, and Fitch Ratings—has available, on its website or upon request, extensive and detailed explanations of their rating criteria for project finance transactions.¹³ The role of the rating agencies has gained prominence in this field only in recent years, so it is possible that this information resource may not have previously been fully exploited.¹⁴ The rating criteria suggest that the extent to which these concerns are explicitly considered varies among the credit agencies. Standard & Poor's and Fitch specifically discuss political concerns and public acceptance as crucial to a project's success.¹⁵ Moody's, however, does not discuss these concerns in any detail in its written rating criteria.

Standard & Poor's states in its description of its philosophical approach to analyzing project finance risk that the "legal and political regime in which a project operates can have profound effects on its ability to repay investors."¹⁶ Included in the legal and political aspects are contract enforceability and other aspects of the legal regime of the host country, including sovereign risk such as currency risk.¹⁷ Standard & Poor's specifically considers "site and permitting risks, [as] sometimes synonymous with political risk,"¹⁸ and notes that

ing: environmental impact, impact on plant and animal habitats, aesthetics, historic and cultural significance, and effect on indigenous peoples. *Id.* at 160.

13. See, e.g., STANDARD & POOR'S, *supra* note 1; MOODY'S INVESTORS SERVICE, *Debt Financing of Projects In Emerging Economies: Lessons from Asia*, in MOODY'S PROJECT & INFRASTRUCTURE FINANCE SOURCEBOOK 46 (2001); JOHN C. DELL ET AL., RATING APPROACH TO PROJECT FINANCE (2001); FITCH, REEMERGENCE OF INFRASTRUCTURE FINANCE IN EMERGING MARKETS (2001); but cf., Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999) (reflecting that credit rating agencies and their increasing role in capital markets are not without their critics).

14. Moody's, for instance, assigned its first rating to a project in 1991, and rated its first cross-border transaction in 1994. MOODY'S, *supra* note 13, at 46.

15. Obviously, if the project is halted as a result of public protest, the investment expectations of the project's investors will be totally frustrated.

16. STANDARD AND POOR'S, *supra* note 1, at 20.

17. *Id.*

18. *Id.* at 31.

“[r]egulations and enacting legislation in some jurisdictions, both developed and emerging countries, leave continuous openings for project opponents to stop projects for reasons related, or unrelated, to siting concerns.”¹⁹ The importance of local government, federal government, and public support of the proposed project, garnered through a careful public vetting process, is also emphasized as helping to ensure acceptance of the project by those whom it affects.²⁰ Similarly, even where not required, Standard & Poor’s recommends an environmental impact study that considers potential adverse environmental effects of the project, as well as “[a]rcheological and historical consequences,” and “indigenous peoples or ‘native title’ consequences.”²¹

Fitch has noted in the case of project finance of basic public infrastructure that an impediment to a project’s success can be the “inability of governments to satisfy internal political considerations often associated with privatization,” including “public backlash,” and suggests that public consultation to increase the “awareness of not only the benefits but also the costs of private sector participation” are important.²² Fitch also identifies the selection of “projects that best fit the national, state or local priorities for economic development,” as an important factor in maximizing the project’s success, viewing a “process of public hearings [as] essential.”²³

Moreover, one reason public infrastructure was formerly provided by either “government-owned enterprises . . . or by privately owned utilities subject to rate of return regulation,” was because of the existence of “[e]xternalities whereby benefits and costs are conferred upon those not a party to the transaction.”²⁴ To the extent these projects are now privately funded through project finance, the externalities must still factor in the cost-benefit calculus.

3. *Are the concerns greater or different in less-developed countries than in more developed countries?*

Most project finance during the last two decades has taken place in developed countries.²⁵ By 1997 and 1998, however, project finance

19. *Id.*

20. *Id.*

21. *Id.*

22. FITCH, *supra* note 13, at 2.

23. *Id.* at 3.

24. Darrin Grimsey & Mervyn K. Lewis, *Evaluating the risks of public private partnerships for infrastructure projects*, 20 INT’L J. PROJECT MGT. 107, 108 (2002).

25. IFC II, *supra* note 9, at 5.

transactions in developing countries accounted for an estimated \$184 billion, or a little more than half of the project finance transactions in the world.²⁶ The Asian financial crisis that began in 1997 significantly dampened the increase in flow of investment dollars into developing countries.²⁷ Professor Bjerre is especially concerned about the detrimental effects of externalities in project finance transactions in developing countries,²⁸ and provides several examples of negative effects.²⁹

An additional example of project finance externalities in a developing country involves the now-infamous and failed Enron. In 1995, the newly elected state government³⁰ of Maharashtra in India cancelled an electrical power plant project by Enron, General Electric, and Bechtel.³¹ The reasons stated for the cancellation, including lack of an environmental impact study and allegedly inflated prices to be charged to Indian consumers of the electrical output, explicitly pointed to negative effects of the project on India's population.³² The cancellation occurred after over \$300 million had been spent on the project.³³ The project ultimately went forward after Enron agreed to make the Maharashtra state government a shareholder³⁴ in the single largest foreign direct investment project in India to that date.³⁵ The Maharashtra government, however, later found that its off-take contract was overly burdensome, requiring it to pay for 90% of the plant's capacity when its actual use amounted to less than 30% of the output.³⁶ Following Enron's well-documented collapse, Enron's stake

26. *Id.*

27. *Id.* Moody's reports that project finance transactions have dried up in the Asian market in the wake of the Asian debt crisis. MOODY'S, *supra* note 13, at 45. Further, half of the rated issues for Asian projects have defaulted and only one has an investment grade rating. *Id.*

28. Standard & Poor's adopts the terminology of "developed markets" and "emerging markets." STANDARD AND POOR'S, *supra* note 1, at 7.

29. Bjerre, *supra* note 1, at 430-32.

30. FINNERTY, *supra* note 10, at 48.

31. Eric Weiner, *Canceled Deal Sets Back Reforms in India*, CHRISTIAN SCI. MONITOR, Aug. 11, 1995, at 7.

32. *Id.* Concerns were also expressed about the manner in which the contract was negotiated. Enron executives were accused of doling out bribes and kickbacks. *Id.*

33. *Id.* Another account reports the project as 23% complete with \$600 million having been spent at the time of cancellation. FINNERTY, *supra* note 10, at 48.

34. *Enron to make India's Maharashtra govt partner in Dabhol project*, AFX News, Nov. 13, 1995, LEXIS, Nexis Library, AFX-Asia file.

35. Lola Nayar, *Power Ministry Works Out Scheme for Dabhol*, The Times of India, Dec. 29, 2000, at 1, available at 2000 WL 30944037.

36. *Id.*

in the plant is being sold.³⁷ The 1995 cancellation by the Indian government is frequently cited as an example of the political risks associated with project finance and indicates that subsequent projects have likely been evaluated even more carefully with regard to social impacts and political risks.³⁸

4. *Is there a difference between project finance for public works projects (e.g., Channel Tunnel, other infrastructure projects) and purely private project finance (such as Euro Disney)? If so, what guidelines should be used to help distinguish the two?*

The breadth of the types of projects included under the general rubric of “project finance” is staggering since it is broadly defined to include “the packaging of cash flows from an operating asset.”³⁹ Project finance can, therefore, be utilized for a wide range of assets in a wide range of jurisdictions.⁴⁰ Whether different considerations adhere to different types of project finance transactions is worthy of consideration.

Although there is tremendous demand for private financing (through project finance or other techniques) of basic public infrastructure⁴¹ in developing markets, Fitch’s offers a distinction between what it views as successful project finance to develop “industrial, energy, and telephone capacity,” and what it views as less successful efforts involving project finance of basic public infrastructure systems such as water, sewer, or transportation.⁴² The Fitch analysts conclude that the basic difference between the two types of projects is “the political nature of these basic infrastructure services,” emphasizing the necessity that the basic infrastructure project gains “broad public acceptance for a corporate role in public service.”⁴³

The Channel Tunnel⁴⁴ exemplifies a basic public infrastructure project that is sponsored and financed privately because the govern-

37. *Dahbol Power receives four initial bids for Enron stake*, AFX-Asia, Feb. 1, 2002, LEXIS, Nexis Library, AFX News file.

38. FINNERTY, *supra* note 10, at 48.

39. STANDARD AND POOR’S, *supra* note 1, at 20.

40. *Id.*

41. Australian commentators Darrin Grimsey and Mervyn Lewis note that recognizing infrastructure is easier than defining it. Grimsey & Lewis, *supra* note 24, at 108. Traditionally, infrastructure is thought to provide “basic,” “key,” or “crucial” services and inputs into the economy, while acknowledging that what is “basic” “varies from country to country and from one time to another.” *Id.*

42. FITCH, *supra* note 13, at 1.

43. *Id.*

44. FINNERTY, *supra* note 10, at 288–314 (describing the Channel Tunnel project in detail). His description does not mention, however, the social and cultural impacts of the project noted

ment could not or elected not to finance the project itself.⁴⁵ The Fitch analysis suggests this type of political project will only succeed if there is broad public acceptance of it. In addition to garnering public support, it might also be assumed that an important role for the government is to conduct an explicit or implicit cost-benefit analysis that justifies the project as advancing the welfare of the public.⁴⁶ This analysis could and should include the negative externalities of the project. Indeed, a government is peculiarly situated to evaluate the effects of the projects on all that will be affected by it, whether or not it is an explicit stakeholder in the project. In developing countries, however, especially in nondemocratic regimes, the role of the government in protecting the interests of the populace as a whole may be questionable.⁴⁷

Euro Disney,⁴⁸ on the other hand, exemplifies private project finance (in this case, in the entertainment industry). For projects that fall into this category, it is possible that either the project's sponsors or the host government will have less explicitly considered the interests of nonconsenting third parties. Even for purely private project finance transactions, however, political elements will surely be considered, especially where the project's success is dependent at least to some extent on broad-based public acceptance.⁴⁹ In the case of Euro Disney, public acceptance was part of the calculus explicitly factored into determining whether the project would be financially successful.⁵⁰

by Professor Bjerre. Bjerre, *supra* note 1, at 433. Finnerty describes the cost overruns and economic risks experienced by this project and more generally associated with large transportation projects where alternative forms of transportation (in this case ferries and airplanes) are available. FINNERTY, *supra* note 10, at 314.

45. Such public works projects might include a toll road or bridge, water projects, rail projects, hospitals, or prisons. STANDARD AND POOR'S, *supra* note 1, at 17. Private financing is often sought for such projects for a number of reasons, including the lack of public funds or a market for public debt, the furtherance of a government's privatization strategy, bypassing operation and other risks to the private party financiers, and attempting to achieve greater efficiencies in construction and operation. *Id.*

46. IFC I, *supra* note 7, at 24 ("Government has an important role to play in encouraging or making 'pro-poor' investments that will encourage private enterprise and further development. Examples include backing infrastructure in poor areas, especially transportation, telecommunications, and electricity, as in China's program for poor areas.").

47. See Chua, *supra* note 8, at 86.

48. FINNERTY, *supra* note 10, at 256-87 (providing a detailed description of this project). Finnerty's discussion addresses the failure to foresee the coming recession in addition to failure to adequately account for various social factors that would affect part attendance. *Id.* at 280.

49. IFC II, *supra* note 9, at 7 (stating that "[a]nything that could weaken the project is also likely to weaken the financial returns of investors and creditors.>").

50. The calculation could, of course, be in error, as Professor Bjerre suggests it was in this case. Bjerre, *supra* note 1, at 433 & n.76

Professor Bjerre closes by noting that at some point the externalities may be so strong that project finance transactions cannot continue to be viewed through the lens of consensuality.⁵¹ He asks us to consider placing project finance transaction on a spectrum of consensuality and concludes that these transactions likely fall in the middle range of the spectrum, between clearly consensual transaction and clearly nonconsensual transactions. It seems to me that each project finance transaction is likely to have its own spot on the spectrum of consensuality. The amount of government involvement, the representative and democratic nature of the government, and the public works aspect of the project are among some of the factors that will help to determine placement on the spectrum. At some points on the spectrum, sufficient consensuality may be lacking, putting the project's viability in question. Clearly, Professor Bjerre is correct: the externalities of a project finance transaction and the magnitude of the externalities must be considered and evaluated before undertaking a project finance transaction. Equally clearly, additional study of these policy considerations is warranted.

51. *Id.* at 436.