COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal for a
COUNCIL DECISION
on the application of principles of a framework agreement on project finance in the field of officially supported export credits

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. The Community is party to the Arrangement on guidelines for officially supported export credits (hereinafter referred to as the "Arrangement") concluded within the framework of the OECD in February 1978 with the aim of regulating government intervention in the area of export credit and establishing fair competition between exporters[1].

2. The Arrangement covers official support for transactions where the repayment risk is on the buyer and where this buyer typically has a number of other economic activities. Presently it is also applicable for so-called project finance transactions. There is no generally accepted and precise definition of project finance, but in OECD discussions reference has been made to "A financing of a particular economic unit in which a lender is satisfied to consider the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan". Since the economic unit is a legally and economically independent project company cash flow from the project must be sufficient during the entire credit period to cover both operating cost and debt service of outside funds.

3. In recent years export credit agencies have reported that it is increasingly difficult to accommodate such project finance transactions within the terms of the Arrangement and that special rules should to be considered which would permit more flexibility for finance of these transactions in order to match the projected cash flow.

4. The absence of special rules for project finance in areas where flexibility is needed means that export credit agencies may be exposed to additional default risks on such transactions which they will seek to offset by requesting additional security, the cost of which will have to be shared among exporters and promoters of the project. The result could also be cancellation of interesting projects where securities are not available.

5. In 1996 the OECD Export Credit Group began discussions on the technical issues associated with introducing more flexibility in the Arrangement for project finance transactions. These technical discussions were concluded in November 1997. Official negotiations in the OECD Participants group began in March 1998. The Commission based its contributions to those negotiations on the negotiating directive which was formally approved by Council on 7 May 1998 and the opinion of an ad-hoc Article 113 Committee. On 11 May 1998 Participants reached agreement on rules for limited flexibility for project finance transactions.

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[1] See Council Decision of 14 December 1992 extending the Decision of 4 April 1978 on the application of certain guidelines in the field of officially supported export credits, OJ L 44, 22.2.1993, p. 1.

6. The agreement provides for flexibility in the timing of the first repayment of principal, the profile of repayment over the duration of the loan and the maximum credit term. Export credit agencies will be able to choose one of two options if the cash flow of a project finance transaction warrants flexibility. The first option permits flexibility on all three aspects provided that the resulting average life of the loan does not exceed 5.25 years. The average life of the loan is the time it takes to repay half the principal of a loan. The second option provides for flexibility within an average life of 7.25 but limits the maximum credit term to 14 years and specifies that the first repayment of principal must be within two years of the starting point of credit. The two options apply equally to projects in all countries except for an agreed list of high-income OECD countries. Korea is excluded from this list until 31 March 2002. This is in view of the special economic conditions it is facing. For these countries only option one is possible and only if the export credit agency is a minority partner in the financing of the project with other financing institutions and has *pari passu* status. This restriction was agreed largely because these countries have well established financial markets to provide the flexibility needed for project finance transactions.

7. The new rules for project finance transactions should enter into force on 1 September 1998. As from 1 April 1999 all export credit transactions, including project finance transactions will be subject to minimum sovereign risk premium rates as agreed by Participants on 20 June 1997. During the period between the entry into force and 1 April 1999 export credit agencies will adjust premium in their national systems to arrive at premium pricing for project finance that reflect the longer average term of the credit.

8. There will be no surcharge to the Commercial Interest Reference Rate for project finance transactions where the credit term is 12 years or less. This is consistent with the current Arrangement guidelines. There will be a small surcharge where the credit period is between 12 and 14 years. This surcharge largely reflects the market.

9. The guidelines for flexibility will operate during a trial period of 2-3 years, after which, Participants will review the experience gained and will decide whether the flexible arrangements should continue and whether the flexibility should be modified or enhanced. The agreement includes provisions for transparency which protect legitimate commercial confidentiality but provide adequate information on which to assess the application of the new rules. If, at the end of the trial period, the flexibility is made permanent, the Arrangement will be amended to incorporate the special rules for project finance transactions. During the trial period the agreement on flexibility will complement but not amend the Arrangement which will continue to apply to all officially supported export credits except where flexibility is permitted for project finance transactions.

10. The Commission therefore recommends that the Council adopt the agreement reached by Participants on flexibility in Arrangement terms for project finance transactions.

Proposal for a

COUNCIL DECISION

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 113(2) thereof,

Having regard to the proposal from the Commission,

(1) Whereas the Community is party to the Arrangement on guidelines for officially supported export credits (hereinafter referred to as the "Arrangement") concluded within the framework of the OECD;

(2) Whereas the Arrangement is the subject of the Council Decision of 4 April 1978, as last amended by Decision 97/530/EC[2]; whereas the Participants to the Arrangement have drawn up a new consolidated text[3] which comprises all the amendments approved by the Participants since the revision incorporated by Decision 93/112/EEC[4];

(3) Whereas the Participants to the Arrangement have decided that there is a need to supplement the Arrangement guidelines with principles affording the flexibility to accommodate the special characteristics of project finance transactions;

(4) Whereas the Participants to the Arrangement do not wish any flexibility to weaken the disciplines provided by the Arrangement guidelines which have been highly successful in regulating government intervention in the field of export credits;

(5) Whereas the Participants to the Arrangement have agreed new principles for the provision of official support for project finance transactions;

(6) Whereas the new principles for project finance transactions should operate during a trial period;

(7) Whereas the Arrangement continues to apply except where the new principles state that flexibility is permitted for project finance transactions;

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2 OJ L 216, 8.8.1997, p. 77.

3 This is awaiting formal adoption by Council Decision.

4 OJ L 44, 22.2.1993, p. 1.

(8) Whereas the Participants to the Arrangement should decide at the end of this trial period whether to continue to apply the new principles for project finance transactions,

HAS ADOPTED THIS DECISION:

Article 1

The principles contained in the framework agreement set out in the Annex shall apply in the Community.

Article 2

The principles referred to in Article 1 shall apply to project finance transactions during a trial period.

Article 3

This Decision is addressed to the Member States.

Done at Brussels,

For the Council
The President

PRINCIPLES OF A FRAMEWORK AGREEMENT ON PROJECT FINANCE

1. **Starting Point of Credit**: no change to the existing Arrangement definition nor flexibility in respect of interpretation.

2. **Description/Criteria**: as at Appendix A (attached).

3. **Transparency/Notification Procedures**: as at Appendix B (attached).

4. **Capitalisation of Interest**: capitalisation of pre-commissioning interest subject to prior notification procedures; capitalisation of post-commissioning interest not permitted.

5. **Trial Period/Monitoring and Review**:

   - the flexibility for project finance transactions to operate during a Trial Period of three years;

   - after two years, a review of the flexible arrangements after which the Participants shall consider the experience gained. The flexible arrangements shall be discontinued at the end of the Trial Period unless the Participants agree upon one of the following:

     - to continue the Trial Period, with any necessary enhancements/modifications, or

     - to cement the flexibility in the Arrangement Guidelines, with any necessary enhancements/modifications;

   - however, if after two years, at least seven Participants agree that there is justification, the Trial Period shall continue for an additional one year;

   - in the event that the Trial Period is not extended, the Participants shall follow the Arrangement rules for the validity of export credits; and

   - the Secretariat shall monitor and regularly report on notifications and the use of flexibility in project finance transactions.

6. **First Repayment, Repayment Profile and Maximum Repayment Term:**

- On a case-by-case basis the option of:

  1. flexibility on the timing of the first repayment of principal, repayment profile and maximum repayment term provided that the average life of the loan[5] supported does not exceed 5.25 years; or

  2. flexibility on the timing of the first repayment of principal, repayment profile and maximum repayment term provided that the average life of the loan supported does not exceed 7.25 years, and subject to the date of the first repayment of principal being within two years of the starting point of credit. This option shall be subject to a maximum repayment term of 14 years.

- In respect of options 1 and 2, it is not expected that the Participants would agree to a single repayment of principal in excess of 25 per cent.

- With regard to "High Income OECD countries" (as defined by the World Bank) in accordance with Article 22 of the Arrangement[6], Option 1 applies only provided that the export credit agencies are providing official support on the basis of co-financing with financial institutions, are a minority partner and have *pari passu* status for at least a significant portion of the life of the credit.

7. **Premium:**

- on the entering into force of this Framework Agreement, premium will be charged on the basis of current systems enhanced to make them consistent with the average weighted life concept as developed by the Working Group of Experts on Premia and Related Conditions.

- as at 1 April 1999, premia shall be charged consistent with the Knaepen Package.

8. **Interest Rates:**

- for repayment terms up to and including 12 years, the normal CIRR regime shall apply; and

- for repayment terms in excess of 12 years and up to 14 years, a surcharge of 20 basis points on the CIRR shall apply for all currencies; the level of the surcharge shall be reviewed at the end of the Trial Period.

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5 The concept of the average life of the loan is based on the time it takes to retire half the principal of a loan. This concept is based solely on the repayment term of the loan and excludes the disbursement/drawdown period.

6 For the purpose of this Framework Agreement on Project Finance, Korea is excluded from the list of "High Income OECD countries" until 31 March 2002.

9. **Implementation:**

- this Framework Agreement will enter into force on 1 September 1998; and

- this Framework Agreement will be expressed in language consistent with the Arrangement and be issued as a TD/CONSENSUS document.

APPENDIX A: DESCRIPTION AND CRITERIA

1. Conforming to both a general description of and essential criteria for project finance transactions could, together with appropriate transparency procedures, be the means to ring-fence any flexibility in the Arrangement to accommodate project finance transactions. The purpose of the Essential Criteria would be to assist decisions on whether or not a specific case could be afforded flexibility.

2. The approach proposed below combines a general description of project finance transactions together with Essential and Indicative criteria. It is suggested that, if Participants were to consider cases which conformed to the general description and met all Essential Criteria, they could then consider whether or not they wished to apply the flexible arrangement. It is expected that the Essential Criteria shall be satisfied; in the event that any individual criterion is not satisfied, justification should be provided. The use of this flexibility would require prior notification of the specific transaction to all Participants together with the appropriate "explanation" [refer to Appendix B].

General Description

- A financing of a particular economic unit in which a lender is satisfied to consider the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan.

Essential Criteria

- Financing of export transactions with an independent (legally and economically) project company, e.g. special purpose company, in respect of "greenfield" investment projects generating their own revenues.

- Appropriate risk-sharing among the partners of the project, e.g. private or creditworthy public shareholders, exporters, creditors, off-takers, including adequate equity.

- Project cash flow sufficient during the entire repayment period to cover operating costs and debt service for outside funds.

- Priority deduction from project revenues of operating costs and debt service.

- No sovereign payment guarantee with regard to the project (not inclusive of government performance guarantees, e.g. off-take arrangements).

- Asset-based securities for proceeds/assets of the project, e.g. assignments, pledges, proceed accounts.

- Limited or no recourse to the sponsors of the private sector shareholders/sponsors of the project after completion.

Illustrative Criteria

- Hard currency revenues; in the case of local currency revenues, additional securities may be required.

APPENDIX B: NOTIFICATION PROCEDURES

1. Participants are required to prior notify 20 calendar days before issuing any commitment where the intention is to allow flexibility under the proposed framework.

2. This procedure would be termed "Permitted Exceptions: Prior Notification With Explanation". The notifying Participant would be expected to provide the information required in the Standard Form of Notification, in accordance with Annex IV of the Arrangement, supplemented to include the following additional information:

   - enhanced description of the project;
   - confirmation of conformity with general description and the essential criteria (including comment, if available, on the illustrative criteria);
   - a full explanation why more flexible terms is required;
   - the date of the first repayment of principal in relation to the starting point of credit, together with details of how this was determined at;
   - for the purpose of notification of anticipated cash flow patterns, the following template shall be used:

     The construction period is _____ years, the repayment period is _____ years for a total term of _____ years. The repayment profile is [front-ended], [back-ended], [variable], [substantially equal], [other, please describe], with ___ per cent of the principal being repaid by the mid-point of the repayment period, and has an average life of _____ years.

   - information on the interest rate charged and the surcharge over CIRR that will be applied, if option 2 is taken;
   - information on any premium surcharge; and
   - an explanation of whether pre-commissioning interest has been capitalised.

3. It would be understood that, although other Participants would have the right to seek further information from the notifying Participant over the rationale for and basis of the proposed support, the notifying Participant would be free to issue a commitment at the end of the 20-day period. It would be expected that the notifying Participant would respond to any questions without delay, whilst recognising the constraints of commercial confidentiality. Where possible, the Participants will provide additional information on the cash flow of projects after financial closure.

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