# INTERNATIONAL PROJECT FINANCE

## Law and Practice

EDITED BY

JOHN DEWAR

OXFORD

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UNIVERSITY PRESS

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Great Clarendon Street, Oxford OX2 6DP

Oxford University Press is a department of the University of Oxford.
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Oxford New York

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Kuala Lumpur Madrid Melbourne Mexico City Nairobi
New Delhi Shanghai Taipei Toronto

With offices in

Argentina Austria Brazil Chile Czech Republic France Greece
Guatemala Hungary Italy Japan Poland Portugal Singapore
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Published in the United States
by Oxford University Press Inc., New York

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First published 2011

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British Library Cataloguing-in-Publication Data
Data available

Library of Congress Cataloging-in-Publication Data
Data available

Typeset by Glyph International, Bangalore, India

Printed in Great Britain
on acid-free paper by
CPI Antony Rowe, Chippenham, Wiltshire

ISBN 978–0–19–960144–8

1 3 5 7 9 10 8 6 4 2

# PREFACE

The purpose of this book is to offer a new framework for the law and practice of international project finance.

My colleagues and I at Milbank approached the task with both excitement and a little trepidation. Our aim has been to write a book which analyses the law and practice of project finance from a different perspective from existing books, which have tended to be rooted in a more domestic focus.

Over the last twenty years, modern project financing techniques have spread rapidly from the US market to Western Europe and then on into emerging markets in Asia, the Middle East, Africa, and Latin America. I have felt for some time that there is a place for a book with a truly international focus, responding to the needs of sponsors, lenders, and practitioners for analysis of the legal and documentation issues of core relevance to the practice of international project finance.

Despite a significant knock during the 'credit crunch', and following the collapse of Lehman, the international project finance market has showed remarkable resilience. It has been sustained by the swelling demand for infrastructure, at a time when governments everywhere are seeking to manage burgeoning fiscal deficits. Therefore, in many countries, private sector-led project finance solutions have come to the fore and many governments are seeking to accelerate the introduction or continued growth of Public Private Partnerships.

Whilst economic growth has, and may continue to be, impacted by the effects of the financial crisis, the quest for oil and gas, minerals, and other natural resources continues unabated across the globe. This has led to the sponsoring and financing in the private sector of a number of 'mega' projects in the gas, LNG, gas transportation, refinery, and mining sectors.

The sustained demand for project finance comes at a time when commercial banks—the institutions which have historically provided the preponderance of project debt finance—have found it increasingly difficult to maintain their position as the core providers of capital. In emerging markets, and in some recent cases, even in OECD countries, the financing of many projects has only been possible with the leadership provided by Export Credit Agencies and multilateral and bilateral funding institutions. The last few years have also seen the increasing application of Islamic financing techniques (particularly in the growing Middle East project finance market). Despite the difficulties faced by the international capital markets, there has also been a resurgent focus on the project bond market. In order to tap this diverse pool of potential sources of liquidity, it is important for both commercial principals and practitioners to have a thorough grasp of the structuring and documentation requirements of these very different funding sources.

In conceiving the book, I also concluded that a book on international project finance would not be complete without presenting and analysing the background and issues arising in the context of projects developed in civil law jurisdictions. I was therefore delighted when Antoine Maffei and Jean-Renaud Cazali of De Pardieu Brocas Maffei agreed to write a chapter analysing practice issues arising in France and other jurisdictions whose jurisprudence is based on the civil code. As project financing techniques have spread throughout Francophone Africa, an understanding of the roots of the relevant legal systems, and the particular issues arising in the context of these jurisdictions, is particularly important.

Our long-standing friend and colleague, Martin Benatar, also agreed to assist us in 'de-bunking' the arcane world of project insurance and re-insurance. For project sponsors and lenders, insurance plays a key part in the overall risk management of projects. Even many seasoned practitioners find the topic both complex and bewildering.

Notwithstanding the recent stresses at play across the global financing markets, the relatively low default rate amongst project financed transactions is a testament to the skills of practitioners in analysing and assessing risk, as well as allocating such risk in the most appropriate manner. Alas, some projects do experience financial distress and, in this context, the book includes a chapter analysing the intricacies of restructuring complex projects.

Last, but by no means least, it appeared to me that there was a need for greater understanding and clarity about the management and resolution of disputes, which regrettably do occur, and raise complex legal issues, particularly in the context of cross-border international project financings.

Many authors from different disciplines have been involved in the writing of this book and many other practitioners at Milbank have been involved in supporting the writing process. I am eternally grateful to all who have contributed and the many others who have lent their time, given their advice and insights, and above all, engaged in analysis and debate which has considerably enhanced the knowledge set forth in the pages which follow.

Apart from the invaluable contributions made by all my colleagues, I have also received tremendous support from my unflappable assistant, Josie, who for some time has had to put up with the combined demands of a busy legal practice, as well as the editing of this book. I have also promised to my wife, Geraldine, and my son, William, that the many weeks of nocturnal activity will diminish following the book's publication!

John Dewar
1 March 2011

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# LIST OF CONTRIBUTORS

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# LIST OF FINANCIAL TERMS, ABBREVIATIONS, AND ACRONYMS

| | |
|---|---|
| AAU | Agreement Among Underwriters |
| ALOP | advance loss of profit insurance |
| BIT | bilateral investment treaty |
| BLOU | broker's letter of undertaking |
| BLT | build, lease, transfer |
| BOAD | West African Development Bank |
| BOO | build, own, operate |
| BOOT | build, own, operate, transfer |
| BOT | build, operate, transfer |
| BTO | build, transfer, operate |
| CABEI | Central American Bank for Economic Integration |
| Capex | capital expenditure |
| CASDB | Central African States Development Bank |
| CDB | Caribbean Development Bank |
| CEAR | construction erection all risk insurance |
| CIRR rate | commercial interest reference rate |
| COD | commercial operation date; the date on which the construction phase of a project is completed and the operation phase begins |
| DBFO | design, build, finance and operate |
| DEG | German Investment Corporation |
| DFI | development finance institution |
| DSCR | debt service cover ratio |
| DSRA | debt service reserve account |
| DSU | delay in start up insurance |
| EAC | East African Community |
| EADB | East African Development Bank |
| EBL | equity bridge loan |
| EBRD | European Bank for Reconstruction and Development |
| ECA | export credit agency |
| ECOWAS Fund | Fund for Co-operation, Compensation and Development (Economic Community of West African States) |
| EEA | European Economic Area |
| EIA | environmental impact assessment |
| EIB | European Investment Bank |
| EIF | European Investment Fund |
| EITA | Extractive Industries Transparency Initiative |
| EPCM | engineering, procurement and construction management |
| EPC | engineering, procurement and construction |
| ESMP | environmental and social management plan |

| | |
|---|---|
| EURIBOR | Euro Interbank Offered Rate |
| FCPA | Foreign Corrupt Practices Act of 1977 (15 U.S.C §§ 78dd–1, et seq.) |
| FMO | Netherlands Development Finance Company |
| FONPLATA | Financial Fund for the Development of the River Plate Basin |
| FSA | fuel supply agreement |
| GCC | Gulf Cooperation Council |
| GPA | World Trade Organization's Plurilateral Agreement on Governmental Procurement |
| Hermes | Euler Hermes Kreditversicherungs-AG |
| IACAD | Inter-American Convention Against Corruption |
| IADB | Inter-American Development Bank |
| IBRD (World Bank) | International Bank for Reconstruction and Development |
| ICMA | International Capital Markets Association |
| ICSID | the International Centre for the Settlement of Investment Disputes |
| IDA | International Development Association |
| IDC | interest during construction |
| IDEP | United Nations African Institute for Economic Development and Planning |
| IFAD | International Fund for Agricultural Development |
| IFC | International Finance Corporation, part of the World Bank Group |
| IFRS | international accounting standards within the meaning of IAS Regulation 1606/2002 to the extent applicable to the relevant financial statements |
| IPO | initial public offering |
| IPP | independent power project |
| IRR | internal rate of return |
| ISDA | International Swaps and Derivatives Association |
| IsDB | Islamic Development Bank |
| ISO | International Standards Organisation |
| IWPP | independent water and power project |
| JBIC | Japan Bank for International Cooperation, the international arm of Japan Finance Corporation |
| K-Exim | Export-Import Bank of Korea |
| K-sure | Korea Trade Insurance Corporation |
| LIBOR | the London Interbank Offered Rate (the reference rate for lending in the London interbank market) |
| LLCR | loan life cover ratio |
| LMA | Loan Market Association (London) |
| LME | London Metal Exchange |
| LNG | liquefied natural gas |
| LOI | letter of intent |
| LSTA | Loan Syndications and Trading Association (New York) |
| MAC | material adverse change |
| MIGA | Multilateral Investment Guarantee Agency |
| MRA | maintenance reserve account |

| | |
|---|---|
| NDF | Nordic Development Fund |
| NETA | New Energy Trading Arrangement |
| NEXI | Nippon Export and Investment Insurance |
| NIB | Nordic Investment Bank |
| NPV | net present value (of future cashflow) |
| O&M | operation and maintenance |
| OECD | Organisation for Economic Cooperation and Development |
| OHADA | Organisation pour l'Harmonisation du Droit des Affaires en Afrique |
| Opex | operating expenditure |
| OPIC | Overseas Private Investment Corporation, an agency of the US government |
| PD | property damage insurance |
| PFI | the Private Finance Initiative, a PPP programme promoted by the UK government |
| PIM | preliminary information memorandum |
| PPA | power purchase agreement |
| PPP | public-private partnership |
| PRI | political risk insurance |
| Proparco | Promotion et Participation pour la Coopération Économique |
| PSA | production sharing agreement |
| PWPA | power and water purchase agreement |
| SACE | Servizi Assicurativi del Commercio Estero (SACE SpA) |
| SEC | US Securities and Exchange Commission |
| SFD | Saudi Fund for Development |
| SINOSURE | China Export & Credit Insurance Corporation |
| SPV | special purpose vehicle |
| SWTI | site wide terrorism insurance |
| TPL | third party liability insurance |
| US Exim Bank | Export-Import Bank of the United States |
| World Bank | the International Bank for Reconstruction and Development |

## List of Islamic Financial Terms, Abbreviations, and Acronyms

| | |
|---|---|
| AAOIFI | Accounting and Auditing Organization for Islamic Financial Institutions |
| A.H. | after Hijri |
| *Akhlaq* | moralities and ethics |
| *A'qd* | a bilateral contract |
| *Arbun* | a down payment |
| *Fatwa* | an Islamic legal opinion |
| *Fiqh al Muamalat* | Islamic commercial jurisprudence |
| *Gharar* | the sale of probable items whose existence or characteristics are uncertain or speculative (*maisir*), the risk of which makes it akin to gambling (*qimar*) |
| *Hadith* | each saying, act or approval of the Prophet (PBUH) as complied by the *Sahabah* |
| IFSB | Islamic Financial Services Board |
| IIFM | International Islamic Financial Market |

| | |
|---|---|
| *Ijarah* | lease purchase finance |
| *Ijma* | the consensus of the *Mujtahid* on a particular interpretation of or application of the *Sharia'a* |
| *Ijtihad* | the individual interpretation of *Sharia'a* principles by *Mujtahids* to infer expert legal rulings from foundational proofs within or without a particular *Madhab* |
| *Istisna'a* | commissioned manufacture of a specified asset |
| *Manfa'a* | usufruct or other benefit derived from an asset |
| *Mudarabah* | investment fund arrangement |
| *Mujtahid* | independent Islamic jurists qualified to exercise *Ijtihad* |
| *Murabaha* | cost plus financing |
| *Musharaka* | joint venture arrangement |
| *Musharaka Muntahiya Bittamleek* | Diminishing *Musharaka* |
| *Qard Hassan* | an interest-free loan as permitted by the *Qur'an* |
| *Qiyas* | the interpretation by analogical reasoning where one situation is measured against another by the *Mujtahids* |
| *Qur'an* | Book of Allah (SWT) |
| *Rab al-mal* | capital provider |
| *Rahn* | mortgage or pledge |
| *Riba* | any excess paid or received on a principal amount or an additional return received on the principal which is derived by the mere passage of time |
| *Sahabah* | closest companions of the Prophet (PBUH) |
| *Sharia'a* | Islamic law as derived from the *Qur'an* and *Sunnah* |
| *Sukuk* | trust certificates |
| *Tafsir* | exegesis of the *Qur'an* |
| *Takaful* | *Sharia'a*-compliant insurance |
| *Wa'd* | a unilateral promise |
| *Wakil* | an agent |

# GLOSSARY

| | |
|---|---|
| concession | an authority to develop, construct and operate a project granted to a project company by a host government for a defined period of time |
| construction phase | the initial period of a project during which the plant or other project assets are constructed usually by an EPC contractor |
| drawdown | the borrowing of a loan pursuant to the terms of a facility agreement |
| EPC contract | engineering, procurement and construction contract (i.e. a 'turnkey' construction contract) |
| EPC contractor | strictly, the contractor under an EPC Contract, but commonly used in a generic sense to refer to a construction contractor |
| EPC Delay LDs | the liquidated damages payable by an EPC Contractor to a project company pursuant to an EPC Contract if and when the construction of a project is delayed |
| Equator Principles | the principles described in 'The 'Equator Principles' – A financial industry benchmark for determining, assessing and managing social and environmental risk in project finance' dated July 2006 and available at <http://www.equator-principles./com/Equator_Principles.pdf>. |
| finance documents | the agreements that document the financing of a project |
| Financial Close | the date on which all conditions precedent under a project's finance documents are satisfied or waived |
| Financial Model | a financial model of a project development using a computer spreadsheet program |
| Gearing leverage ratio | the ratio of a company's (consolidated) borrowings to its tangible net worth (or adjusted shareholders' funds) |
| host country | the country in which a project is located |
| multilateral agency | an entity established by a number of countries to promote the development of particular projects around the world or in certain regions by, for example, direct lending or insuring lenders against political risk |
| offtaker | a purchaser of the product(s) produced or manufactured by a project |
| operation phase | the period of a project that follows the construction phase during which the project becomes operational |
| project company | an entity that develops, owns and operates a project which is ultimately owned by the sponsor(s) |
| project documents | the documents that relate to the construction, operation and maintenance of a project |
| security documents | the agreements that document the security taken by the financiers |

| | |
|---|---|
| shareholder | a sponsor which holds the shares in the project company |
| sovereign immunity | a prohibition preventing the seizure of a government controlled entity and its assets that emanates from a law providing that entity immunity in that regard |
| sponsor | an entity responsible for promoting and/or developing a project and usually a direct or indirect shareholder in the relevant project company |

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### UNITED NATIONS COMMISSION FOR INTERNATIONAL TRADE LAW (UNCITRAL)



### UNITED STATES OF AMERICA

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# INTRODUCTION

## The Definition of Project Finance

Whilst many attempts have been made to define project finance, the term has been used in many contexts over the years and its meaning has evolved as the techniques which it embodies have been adapted to macro-economic change. Like describing the 'elephant in the room', it is difficult to define, and perhaps not worth the exercise because inevitably you recognize it when you see it.

Accepted definitions focus on the financing of a specific asset in which lenders look principally to the revenues generated by the operation of that asset for the source of funds from which loans will be repaid. The primary security for the loans consists of the assets of the project including, most notably, the cashflow the project generates and the contracts that assure the stability of both its costs and its revenues.

Project finance is deployed most commonly in the development of large infrastructure projects (e.g. power generation, toll roads, telecommunications), social infrastructure (such as hospitals and schools), and the exploitation of energy and other natural resources, but it can be used to finance a broad range of assets and services.

## Characteristics

Although each financing is specifically designed to meet the requirements of a particular project and the objectives of its sponsors, the following characteristics are common to most project financings:

(1) the project is developed through a separate, and usually single purpose, financial and legal entity;
(2) the debt of the project company is often completely separate (at least for balance sheet purposes) from the sponsors' direct obligations;
(3) the sponsors seek to maximize the debt to equity leverage of the project, and the amount of debt is linked directly to the cashflow potential of the business, and to a lesser extent the liquidation value, of the project and its assets;
(4) the sponsors' guarantees (if any) to lenders generally do not cover all the risks involved in the project;

(5) project assets (including contracts with third parties) and revenues are generally pledged as security for the lenders; and
(6) firm contractual commitments of various third parties (such as construction contractors, feedstock and other suppliers, purchasers of the project's output and government authorities) represent significant components of the credit support for the project.

# 1

# APPROACHING LEGAL ISSUES IN A PROJECT FINANCE TRANSACTION

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## Introduction

Project finance is at its core a form of secured lending. Much of the legal expertise is drawn from the discipline of banking. One who sees the beauty of the perfect covenant, the joy of an all-encompassing event of default, or the elegance of a multi-tiered intercreditor agreement has the capacity to excel in the field. But the inclination to do so comes from never having outgrown the desire to play with big toys (or for that matter machinery and equipment). The reason for this is that project finance lawyers undertake a greater degree of inquiry into the business of the borrower, and into the construction and operation of the facilities that it will construct, than do lawyers involved in other kinds of lending. Project finance transactions entail lenders extending a large amount of credit to a newly formed, thinly capitalized company whose principal assets at the time of closing are not physical but rather merely contracts, licenses, and ambitious plans. Hence the focus on prudent legal analysis. **1.01**

**1.02** Unless a project financing reaches financial close, there are no 'winners'. However, even after the finance documents are signed, the complex relationships among the parties must be sustained through economic, political, and legal change. No matter how comprehensive the legal documentation, virtually every project encounters some form of technical or commercial problem over its life that leads to legal difficulty. Sometimes that difficulty arises because two parties have a legitimate disagreement over the meaning or effect of a few of the words contained within the mountain of documents governing their relationships. In other cases, issues that had not been contemplated at the time of financial close arise with a consequent absence of guidance in the documents as to how to resolve them. Not infrequently, the underlying economics of the project, and the negotiating leverage of the parties, change such that what seemed fair at closing may years later appear to one of the parties as oppressive. In most instances, the parties to a project financing are able readily to resolve such matters, recognizing that their relationships require close cooperation and compromise, but that is not always the case.

**1.03** Disputes cannot be avoided on the playground, nor can they be avoided in project finance. When the stakes are high enough, it may be impossible to secure compromise. The frequency with which disputes arise can, however, be limited by a careful initial assessment of the project so that, at a minimum, all parties enter the deal with a common understanding of the rules of the game.

**1.04** With the expansion of project finance into new industries and regions, the attendant legal issues have become increasingly complex and the ability to predict where difficulties will arise has become more challenging. Ever-shifting market standards, and the absence of agreed-form project documentation, contribute to the extremely varied nature of project finance transactions. Project finance lawyers must patiently consider the technical, political, and legal risks of each individual project in order to enable parties to reach agreement on how contentious issues should be treated. This process requires familiarity with varied disciplines of law, ranging from civil procedure, contracts, property, trusts, torts, equity, and conflicts of laws, and with a range of financial instruments, such as commercial bank loans, capital markets instruments, multilateral, and domestic government-funded loans, guarantees from export credit agencies, and Islamic *Sharia'a*-compliant instruments.

**1.05** By drawing on this variety of disciplines, a project finance lawyer can help the parties structure financings that are robust enough to withstand long-term volatility.[1] There are a range of threshold legal issues and tasks, common to virtually all projects, which must be addressed if the project finance lawyer is to accomplish his or her role effectively.

[1] For a discussion of the approach generally to negotiating project finance transactions, see P. Fletcher, 'Rules for Negotiating Project Finance Deals', *International Financial Law Review*, November 2005.

Among these are: **1.06**

(1) identifying the overall legal risks associated with a project;
(2) assessing the laws and regulations of the host states and of the courts and other institutions that implement them;
(3) addressing environmental and social considerations;
(4) choosing the governing law for the finance and project documents;
(5) drafting and negotiating complex credit agreements; and
(6) developing security packages across a range of jurisdictions.

## Overall Risk Assessment

**1.07** Projects inevitably face risk. Although some risks can be structured, contracted, or insured away, projects, as in the case of all commercial endeavours, are exposed to a wide range of potential challenges that can have an adverse impact on their economic performance and even their viability. As most projects will not have been built or even engineered when their financing is implemented, there will inevitably be differing views on the likelihood and potential impact of future adverse events. The ultimate assessment in any project is whether the risk profile of the deal, taken as a whole, is 'bankable'. This is certainly not a science, and to call it an art is perhaps too kind, but it is a judgment formed by lenders, sponsors, and their advisers every time a deal closes.

**1.08** An essential aspect of the project finance lawyer's role in helping the parties reach a 'bankability' assessment involves reviewing the project, and in particular its underlying documentation, in order to identify its potential and fundamental risks and to determine if, and how appropriately, those risks have been allocated among the parties. In carrying out this diligence effort, a project finance lawyer must liaise with a myriad of advisers, including, among others, technical advisers in respect of the performance of the physical plant, market advisers regarding the availability and cost of inputs and the value of future revenue streams, environmental advisers on the social and environmental impact of the project, insurance advisers on the adequacy of the project's insurance programme, and model auditors to assess the integrity of the financial models. The lawyer also needs to take guidance from the lenders as to their assessment of the credit standing of each party to a material project agreement. The project finance lawyer will work closely with local lawyers in a broad range of relevant jurisdictions, and is often responsible for producing a comprehensive due diligence report that pulls together the key risk assessment and evaluations of each adviser and highlights the potential issues from a documentation perspective.[2]

[2] For a more detailed description of the risk identification and allocation process, see Chapter 4.

1.09 The project's risk profile will inevitably lead to a number of assumptions as to how the overall transaction should be structured. For example, power projects are often awarded to sponsors through a competitive tendering process and are thus structured to give rise to the lowest electricity tariffs possible. The consequence is that the returns available to equity investors may be relatively low, and ensuring that the project is funded to the maximum extent possible through debt (being less costly than equity) and that the average maturity of that debt is as long as possible (thereby reducing the debt service burden in any particular year) takes on great importance. Reduced equity funding and low tariffs combine to result in relatively low debt service coverage ratios. These projects thus have limited ability to absorb the risk of increased costs or reduced revenues, and the parties will therefore focus particular attention on the risk allocation effected through the contracts.

1.10 By contrast, a range of other projects may be designed to produce products sold onto global markets where, for well positioned companies, profit levels may be significant. This is often the case with oil and gas and other natural resource extraction and processing facilities, whose 'base case' revenue projections are generally robust enough to sustain the project through periods of revenue volatility or increased costs. Given market uncertainties, the sponsors may be prepared to fund the project with a greater proportion of equity in exchange for contractual flexibility in the management of the business. In these cases, the relevant contracts may be somewhat less comprehensive in addressing all conceivable risks, but the lenders will generally require more robust overall project economics to mitigate these risks.

## Assessing the Host Country

1.11 One of the key variables in the legal analysis of a project, and certainly the one that can neither be structured around nor wished away, is its location.

1.12 As a threshold matter, the political and social stability of the host country will be of concern to all investors and lenders. At the extreme, structuring a deal in a conflict zone may be impracticable, but the scope of political risk encountered by most projects is generally broader and more subtle than simply physical violence. There are a wide variety of publicly available measures of the ease of doing business in specific countries,[3] and the credit risk associated with the obligations of most countries is rated by leading commercial rating agencies. If the project's lenders and

[3] The World Bank website publishes rankings of economies based on their ease of doing business, currently from 1–183. See <http://www.doingbusiness.org/economyrankings>. A high ranking on the ease of doing business index means the regulatory environment is conducive to the operation of business. The index averages each country's percentile rankings with respect to ten categories, made up of a variety of indicators, giving equal weight to each topic.

investors have particular concerns as to the stability of the host state, they may seek to address that risk though political risk insurance and other mitigants considered in other chapters of this book.

When the project is located in an impoverished or developing country, multilateral and other public sector lenders, in particular, will focus on the developmental impact of the project. They will seek to confirm that the project benefits a broad spectrum of the host population and not just a limited number of well positioned investors and government officials. They may require diligence to be undertaken to confirm the absence of any corrupt payments in the award of the project's licenses and concessions.[4] They may also seek clarity on how the host government will invest the tax and other revenues derived from the project.[5] In addition to ensuring that these public-sector lenders' developmental mandates are adhered to, this sort of inquiry is designed to ensure that the host state will continue to support the project even after the incumbent government is long out of office. **1.13**

In whatever jurisdiction the project is located, the laws and regulations of the host state will affect virtually every aspect of the project company's activities, and its courts and other governmental institutions will have wide discretion in interpreting and implementing that law. In many cases, the project company will itself have to be organized under the laws of the host state, rendering even its control and management subject to local jurisdiction. **1.14**

Among the legal issues arising under the domestic law of the host state that need to be assessed are: **1.15**

(1) corporate governance;
(2) industrial regulation;
(3) environmental, land use, and other permitting;
(4) taxation;
(5) customs and immigration law;
(6) reliability of local laws and courts; and
(7) changes in law.

[4] There is a wide range of international conventions and national statutes to combat corruption. For example, the OECD Anti-Bribery Convention established legally binding standards to criminalize bribery of foreign public officials in international business transactions and provides for a number of related measures that make this effective. See <http://www.oecd.org/document/20/0,3343,en_2649_2017813_1_1_1_1.00.html>.

[5] The Extractive Industries Transparency Initiative (EITI) is a coalition of governments, companies, and others which set global standards for transparency in the oil, gas, and mining sectors that is focused on, among other things, ensuring transparency in the host state's use of revenues derived from major projects. See <http://eti.org>.