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USING PROJECT FINANCE TO FUND INFRASTRUCTURE INVESTMENTS

Richard A. Brealey, Ian A. Cooper, Michel A. Habib

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Abstract

For much of the past century, there has been an increased tendency for large infrastructure projects to be funded and operated by governments. Since the early 1980s, however, private-sector financing and management of such projects have experienced a dramatic revival. In some cases, this revival has taken the form of the "privatization" of an entire industry. But another, increasingly common, form has been the use of project finance to fund instrastructure investments. Besides being widely used in infrastructure investments like telecommunications and power generation in developing countries, the use of project finance has recently been extended by the U.K.'s Private Finance Initiative to fund public enterprises as diverse as the construction and operation of prisons, hospitals, subway cars, and the National Insurance computer system.

In a project financing, the project is managed by a separate company that is owned by a project sponsor (or sponsors) who usually takes an active role in the management of the project. The project company enters into a complex series of contracts with multiple parties, including the host government, the project's customers and suppliers, and the banks that typically provide most of the debt financing.

This paper argues that the equity investment by the project's operators works together with high debt ratios and the web of contractual arrangements to reduce "agency" problems in the management of large projects. It also shows how the contracts shift the various project risks to those parties best able to appraise and control them. Finally, it discusses why most project financing takes the form of limited recourse bank loans to the project company rather than, say, public bonds with full recourse to the sponsors.