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EAPS

ENVIRONMENTAL ACTION PROGRAMME SUPPORT PROJECT

THE LESSONS OF PROJECT FINANCE:
PRINCIPLES AND TECHNIQUES FOR ADAPTATION BY
THE CZECH STATE FUND FOR THE ENVIRONMENT

THE ENVIRONMENTAL ACTION PROGRAM SUPPORT PROJECT
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EXECUTIVE SUMMARY

In June and again in August 1995, the Environmental Action Program Support Project commissioned a three-member team to assist the Czech State Fund for the Environment ("SFZP" or "the Fund") in strengthening its lending and financial-management practices. The present report is one of several to be issued by the team.

This report focuses on a specialized lending technique—project finance—designed to deliver debt capital to large infrastructure projects. Originally conceived in the United States, project finance has since been used throughout the world, particularly in developing and transitional economies. The thesis of this report is that the environmental facilities being built with SFZP assistance share many characteristics with the infrastructure improvements that have raised capital through project financing. This similarity suggests that the principles and methods of project finance might be employed in structuring the loans extended by the SFZP.

This is an intriguing proposition, since project-financing techniques may offer insight and at least partial solutions to several problems that have been vexing both the Fund and its borrowers:

- How to ensure that the SFZP and its clients direct their scarce capital to projects that will produce environmental gains commensurate with their cost;
- How to finance worthy environmental improvements, even if the project sponsor is not fully creditworthy; and
- How to improve the quality of the collateral backing the SFZP's loans.

While they exhibit similarities, the investments supported by the SFZP and those funded through project financing also show marked differences. Size is perhaps the most striking. Project financings tend to be large, in the hundreds of millions and even billions of dollars. For the SFZP, on the other hand, a \$1 million loan is large. The financing techniques devised for these huge projects cannot, of course, be applied in all their fullness and without modification to the SFZP's portfolio. Still, particular elements of project financing *can* be adapted, and selected principles and techniques *can* help the SFZP to provide more capital to its clients. This report explains how.

The report begins by defining project finance. It goes on to describe how selected project-financing techniques can help both the SFZP and its borrowers to achieve important goals. Next, feasibility is examined. The feasibility analysis is complemented by two brief case studies. Finally, the report recommends steps that SFZP and USAID can take to capture the potential benefits of project financing.

SECTION I THE NATURE OF PROJECT FINANCE

Project finance is a specialized form of lending used to deliver substantial amounts of debt capital to major investments. The device was used initially by bankers to lend to oil drillers in Texas and Oklahoma during the 1930s. With little available revenue and few marketable assets to offer as collateral, the entrepreneurs, in effect, borrowed against the oil in the ground and the future revenue that it promised. Since the 1930s, the techniques have been refined and their reach has been extended. Project finance is now used to raise capital around the world—especially in new privatizing economies—and in a variety of industries. Toll roads in Hungary, a chemical-waste treatment facility in Indonesia, wastewater-treatment plants in the United States, and an airport expansion in the Czech Republic are among the increasing number of undertakings that are raising capital through project finance. Over a ten-year period, beginning the early 1980s, nearly 150 such infrastructure projects with total costs in excess of \$60 billion have been financed in this manner.¹

Candidates for project finance are typically sizeable, capital-intensive undertakings. Often large in an absolute sense, they are also, more importantly, large relative to their sponsor. They require more capital than the owner could normally borrow. Project finance offers the sponsor a means of expanding its borrowing power, enabling it to finance projects larger than it could through conventional arrangements.

This expanded borrowing power rests on the revenues of the project. Candidates for project finance have a stable and predictable revenue stream. The source of revenue is usually a long-term agreement with the buyer of the project's output. A company seeking finance for a natural-gas transmission and storage facility, for example, might have a long-term contract with a buyer of natural gas. The contract might guarantee that the buyer would take a significant portion of total output over a ten-year period. The contract would set out a formula for pricing, such that the expected revenue would cover operating costs and leave sufficient surplus to compensate the providers of capital. Through such a contract, the gas facility achieves stability and predictability in its cash flows.

The project-finance structure isolates a portion of the cash flow and presents it to the lender as the basis of the project's creditworthiness. The cash flows of the project (as distinct from those of the sponsor) serve as the principal source of loan repayment and often as the collateral security.² Under such an arrangement, the lender is not solely, or even primarily, dependent on the financial strength of the project sponsor. Through the long-term contract, the buyer of gas

¹For a concise description of the project-finance structure and application, see Larry Wynant, "Essential Elements of Project Financing," *Harvard Business Review*, May-June 1980, pp. 165-173. For a listing of the largest project financings currently underway, see "Where, When—and How Much," *Euromoney*, March 1995, pp. 116-120. The figures on the volume of financing are from a survey reported in *Public Works Financing*, October 1993, as cited in The World Bank, *World Development Report 1994* (Oxford University Press: Oxford, 1994), p. 95.

²More precisely, the lender takes a security interest in the contractual obligation of the third-party to purchase output and make payments. Furthermore, while this is often the primary form of collateral, it is seldom the only form. Lenders will seek (and usually obtain) a collateral interest in assets of both the project and the sponsor.

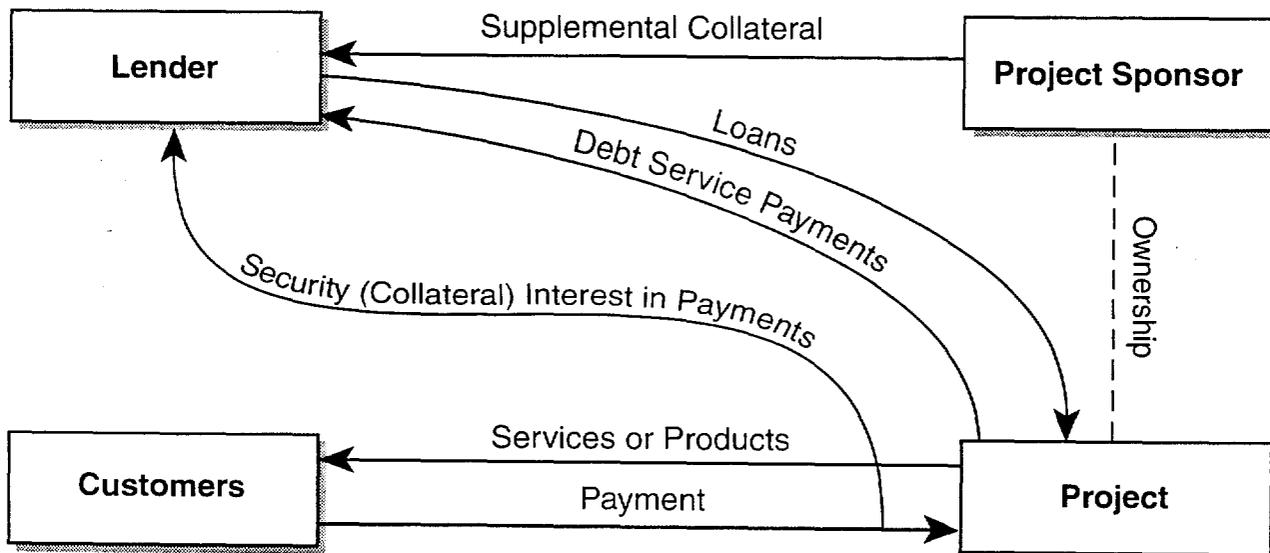
places its financial power behind the project, and though the project-finance structure the borrower gains preferential access to the resulting cash flows. On the strength of the committed cash flows and its assured access to them, the lender is willing to advance more funds than it would through a conventional structure. In the event of default, the lender depends on these cash flows in much the same way that a traditional lender might depend on real-estate collateral.

Table I-1. Sample Project Financings

| Project | Sponsor | Source of Stability in Cash Flows |
|-----------------------------|--|--|
| Wastewater treatment plant. | Municipality. | Household and industrial customers with reasonably predictable usage; stable demographics; rates subject to government control. |
| Aluminum mine. | Mining company. | Long-term contract to sell output to industrial processor of bauxite; the industrial buyer is financially strong; many market uncertainties tied down by contract, e.g., prices subject to formula, minimum volumes agreed, currency risk allocated between the parties. |
| Toll Road. | Private company, with government build-operate-transfer agreement. | Tolls paid by travelers; limited competition from alternative transport modes; favorable demographic and economic projections. |

The isolation of cash flows is normally accomplished by housing the project in a separate legal entity. Such a separate corporate form allows the project's assets, cash flows, and operations to be distinguished from those of the project sponsor. The borrower is often the special-purpose entity that houses the project, and not the project's upstream sponsor (see Figure I).

Figure I. Project Finance Structure



The project-finance structure imposes a strict discipline, on the project, on the sponsor, and on the lender. By isolating the project's cash flows and operations from those of the sponsor, this form of financing lays bare the strengths and weaknesses of a proposed investment. It forces analysis of a project over its lifetime, focusing on operating revenues and expenses and not only on initial construction costs. Project economics must be sound, since the project itself must generate most of the cash flow to cover operations and service debt. Risks must be well understood, because failure of the project to perform as expected may cause financial and other harm to the sponsor and the lender. As one guide to project finance notes,

those providing the senior debt place a substantial degree of reliance on the performance of the project itself. As a result, they will need to concern themselves closely with the feasibility of the project and its sensitivity to the impact of potentially adverse factors.³

This examination will by no means be limited to financial matters. It will additionally cover the project's operations, market, competition, technology, personnel, and management. Often, the lender will require changes in project design to increase the project's creditworthiness, calling for lower capital investment, modifications in pricing, or more efficient operations.

Project financings are most often applied to profit-making ventures. This does not imply, however, that undertakings receiving governmental subsidies cannot qualify. Many public utilities and pollution-control facilities are never intended to fully earn their own way, much less make a profit. They are considered public goods, which the government is willing to provide without fully allocating costs to direct beneficiaries. In project financings of such ventures, the lender cannot rely on project revenues alone and must seek credit enhancement from the project owner, i.e., the government. The benefits of project finance may still be realized, so long as the sum of net operating cash flows, subsidies, and government support are sufficient, and sufficiently predictable, to cover financing costs.

In sum, then, under the right circumstances, project finance can offer three benefits to both the SFZP and its borrowers:

- More disciplined testing of the economic soundness of prospective investment projects, protecting both lender and project sponsor;
- Expanded capacity of the project sponsor to borrow money and to support the resulting debt service; and
- A superior form of collateral, preferable to both the lender and the borrower.

³Manual by Clifford Chance, quoted in "Project Finance: Make Them Pay," *The Banker*, January 1994, p.68.

SECTION II

PROJECT FINANCE AS A MEANS OF PROMOTING THE ECONOMIC ANALYSIS OF INVESTMENT PROPOSALS

In this and the next two sections, we describe how the Fund and its borrowers can employ project-finance concepts to advance their environmental goals and to protect their capital. We organize our discussion around the three benefits identified above. First, in this section, we describe how project finance puts proposed investments to a rigorous test of economic soundness. In the next two sections, we treat, in turn, the expansion of debt capacity and the enhancement of collateral.

A. The Goal

The SFZP and its borrowers have a compelling interest in ensuring that the projects they support represent an economically sensible use of resources—that costs are commensurate with environmental benefits and that the projects can be operated over their lifetime without unduly straining the financial resources of the sponsor. In determining which proposals to put forward and in which to invest, both parties seek an objective, clear and fair means of comparing one project to another and of assessing and ranking their economic merit. Both parties benefit by having a means of detecting proposals that are wasteful, too costly, or inefficient. In short, both the SFZP and its borrowers would like to have processes, methods, and analytical tools to subject proposals to a rigorous testing of economic feasibility and soundness.¹

B. Obstacles

Several factors impede the full realization of these goals.

A focus on the borrower, not on the project. In processing applications, the SFZP's Finance Section currently does not perform a thorough financial analysis of the proposed project. In fact, it does not focus on the project at all; rather, it focusses on the borrower. The foremost question in the Section's analysis is the ability of the borrower to repay the loan, not the economic rationale of the investment. The loan application, for example, calls for five-year cash-flow projections of the borrower but not of the treatment plant or the gas lines. SFZP staff analyze the balance sheet of the municipality or corporation, but they do not compare costs of water lines with fees from sale of water. Nowhere in the analysis is the net present value of the investment computed. The financial evaluation identifies borrowers who can service debt; it is not designed to identify projects that are efficient. The evaluation flags borrowers that will have trouble repaying; it is not designed to flag projects that perhaps should not be built in the first place.²

¹The World Bank referred to a similar goal in describing its own financing of infrastructure projects: "Providing funds to a project is an important objective in itself, but the financing process also serves another important end. Monitoring by financial markets and institutions complements regulation and competition... it provides another mechanism for investors to impose discipline." The World Bank, *World Development Report 1994: Infrastructure for Development*, Oxford University Press, 1994), p.94.

²Conversations with commercial banks reveal that they too devote little attention to the economics of the project being financed.

Weak incentives for self-restraint. When a municipality or a company pays for an improvement with its own funds, it has powerful incentives to economize. Money is limited and has alternative uses; choosing one improvement requires foregoing another. Self-discipline is borne of the need to make choices.

Recipients of assistance from the Fund escape the full measure of this discipline since they rely on the resources of others. Their incentives to economize are weakened to the extent that their capital is subsidized. The applicants will not, on the whole, subject the projects they propose to the Fund to the same discipline—the same weighing, balancing, and paring—that they apply to projects they pay for themselves.

Economic Analysis of Projects at the SFZP

The Fund's Finance Section focuses on the financial strength of the *borrower*, not of the project.

The Fund's Technical Section evaluates the capital efficiency of projects, judging them against standards that relate the volume of pollutant abated to capital cost. See the *Basic Criteria for the Choice of Actions in Particular Fields of the Environment*, which require consideration of the "specific financial requirements calculated from the costs of implementing the provisions and required support from the Fund in relation to units of pollution eliminated."

The district offices of the Department of the Environment rank proposals and make recommendations to the Fund.

Expert opinions required by the Fund specifically exclude analysis of project economics, looking only at the financial condition of the *applicant* and not of the *project*.

The subsidy the Fund offers to municipalities is substantial. In a typical case, 40 percent of project cost is provided by grants, 40 percent by an interest-free loan with a three-year grace period, and 20 percent through the municipality's own funds. Under these terms, the municipality bears, on a present-value basis, only about 40-45 percent of the capital investment.³ The grant and the concessional terms of the loan represent more than half the capital cost. To the extent that these improvements exhibit any price elasticity, this subsidy will stimulate demand with the likely result that some projects will be over-designed and under-utilized.

Missing filters. The purposes for which the Fund may lend are defined in the broadest of terms. *The Basic Criteria for the Choice of Actions in Particular Fields of the Environment/1994*, issued by the Ministry of the Environment, enumerates fully 30 such purposes. Written in such an inclusive manner, the criteria are of little help to the SFZP or to applicants in

discriminating among investments.

³The loan is for 40 percent of capital cost. It is assumed to be repaid in equal installments in years four through seven. Repayment is discounted at 12 percent, approximately the current rate for medium-term debt. The present value of this stream is 22 percent of capital cost. Added to this amount is the sum the municipality has to pay from its own funds (20 percent), arriving at a total of 42 percent.

C. Consequences

With weak incentives for economizing combined with weak filtering mechanisms, the result is predictable. The Fund receives three times as many applications as it can approve. Many have not been rigorously analyzed and tested from an economic perspective prior to submission. The Finance Section of the SFZP does not have the tools or the staff to do so itself.

Of necessity, the Fund delays and rejects a great number of proposals. It has difficulty distinguishing proposals based on sound economics from those that are too costly or inefficient. Some projects may be approved at costs that are not economically justifiable. Others may be approved despite being over-designed.⁴

The high rejection rate is itself probably damaging to the Fund, insofar as many applicants are disappointed. Those rejected are sometimes left uncertain as to the cause of their failure, doubting the objectivity of the decision-making process. When challenged, the Fund has a difficult time defending its decisions on a rigorous and objective basis.

In addition, the Fund's decision-making process causes delay and uncertainty. Although loan queuing may ration scarce capital, the process breeds frustration and delays the implementation of some worthy pollution-abatement projects. Proponents are often forced to put plans on hold while they figuratively stand in line pending the outcome of their application.

D. Project Finance as a Partial Remedy

A project-finance orientation would bring about a shift in the Fund's perspective, sharpening its ability to distinguish sound from unsound proposals. The current focus on the borrower would be equaled by a focus on the project. Often, the two approaches result in the same judgment about proposed investments; where they differ, the project-finance perspective offers valuable insight. Table II-1 illustrates.

⁴Interviews with observers. On a distinct but related note, see also G. Thomas Kingsley, International City/County Management Association Consortium, *Working Paper: Candidate Infrastructure Projects Proposed by Czech Municipalities*, April 1994. In evaluating demand for the Municipal Credit Fund (MUFIS), his team found "a large share of the initial project proposals...were considered to be over-designed in relation to real needs and/or unaffordable to the municipalities proposing them" (page 5).

Table II-1. Alternative Perspectives in Evaluating Applications for Support

| | | PROJECT | |
|--------------------------------------|--------|---------|--------|
| | | Weak | Strong |
| B O R R O W E R | Weak | A. | B. |
| | Strong | C. | D. |

When both borrower and project are either weak or strong (cells A and D), the conclusion remains as it would under a borrower-focused approach. Under the other two scenarios, however, the conclusions will differ:

- When the borrower is strong but the project weak (cell C), a project-finance approach would discourage investment. Even though the borrower could repay a loan, the benefits may not warrant the cost. Here, both the Fund and the sponsor should save their capital.
- Alternatively, when the borrower is weak but the project strong (cell B), the project-finance perspective would lead to a more favorable view. Though the sponsor may have limited financial means, the proposed investment has economic merit. With a strong project but a weak sponsor, the Fund may be able to lend against the cash flows of the project itself, regardless of the cash flows of the sponsor, or choose to support the meritorious project through a grant.

Not only does the project-finance analysis produce good investment decisions, it enables the SFZP to objectively defend its decisions.

Furthermore, the project-finance perspective encourages efficiency in design and operation. By forcing comparison of cash inflows and outflows, the analysis draws attention both to capital costs, encouraging adoption of least-cost technologies, and to operating margins, encouraging cost controls as well as adequate rate structures.

SECTION III
PROJECT FINANCE AND THE EXPANSION OF BORROWING POWER

A. The Goal

Within the limits of its resources, the SFZP attempts to finance all investments that are both environmentally and economically sound. The lack of creditworthiness of some prospective borrowers, however, constrains the Fund's ability to do so. Faced with a strong project advocated by a weak sponsor, should the SFZP follow the dictates of financial prudence and withhold support? Or should it place environmental concerns first, financing the project even if the borrower may not be able to repay the loan?

Where feasible, project finance offers a third alternative. The Fund can rely on the strong cash flows of an economically sound project rather than on the weak or uncertain creditworthiness of the sponsor. Project finance promises to move the Fund a step closer to the ideal state in which no good project need be rejected because of the weakness of the sponsor.

B. Obstacle: Limited Creditworthiness of Municipal Borrowers

Czech municipalities' borrowing capacity is uneven. Some municipal applicants present serious credit risk. Thus, the Fund cannot support all worthy projects within the bounds of prudent risk-taking.

Limited creditworthiness can be linked to three causes: high capital needs, lack of borrowing experience, and uncertain sources of revenue.

High capital needs. The Ministry of Finance reports that a remarkable 39 percent of municipal spending is directed at capital improvements. This represents an extraordinary financial burden, especially for the Czech Republic's many small towns.

Lack of borrowing experience. Czech municipalities are unseasoned borrowers; their willingness and ability to repay their debts has not been tested, and the position of the lender in cases of distress has not been established. This lack of experience limits the flow of debt capital to municipalities.

For the SFZP, loan repayments have not yet come due in appreciable amounts. Indeed, the Fund has not been involved with any borrower through the full cycle of design, construction, disbursement, and repayment. Thus, the relationship between lender and borrower is still at a formative stage.

Uncertain sources of revenue. Municipal revenues have been steady and growing in recent years, a pattern that enhances the municipalities' debt-bearing capacity. At the same time, Czech law narrowly circumscribes municipal taxing powers and leaves the municipality with few levers to increase its revenues. Though 70 percent of municipal revenue is now raised from local taxes (up from 30 percent just a few years ago), the scope and rate of taxation are defined by the

national parliament, with only modest opportunities for local variation.¹ Moreover, the system of municipal finance is in flux, creating uncertainty over future revenues and creditworthiness. While contemplated reforms would generally favor municipalities (giving them a share, for example, of value-added tax and increasing their percentage of the tax on employees), still, change will create uncertainty and thereby constrain municipal borrowing.

C. Consequences

The limited borrowing capacity of the municipal clients distorts the operations of the Fund and of borrowers alike.

Should the Fund exercise caution, many projects that would benefit the environment at reasonable cost will never be undertaken. Should the Fund, on the other hand, allow its environmental mandate to override considerations of financial prudence, it invites collection problems. A high default rate could damage the Fund's reputation, undermining the popular and political support on which it depends. At the same time, defaults rob future projects of recycled loan funds. By offering grants rather than loans, the Fund can avert defaults. However, grants also deplete the Fund's capital and prevent the recycling of funds.

Project sponsors that borrow beyond their means are damaged as well. Their operational flexibility is hemmed-in by burdensome debt repayments. Costs of operating and maintaining new infrastructure may sap resources intended for other uses. Should they default, the borrowers face loss of collateral, cross-defaults on loans from other sources, and exclusion for the credit markets in the future.

D. Project Finance as a Partial Remedy

The sponsor of a project that has strong and predictable revenues may enhance borrowing power through project finance. The project-finance structure isolates and protects the revenue stream and gives the lender preferential access to it. To the extent the lender relies for repayment on utility fees paid by businesses and residents, it is less reliant on the creditworthiness of the municipality. The uncertainties of municipal taxing powers are of less concern and are less limiting. Project financing will, in some cases, allow a loan to go through where otherwise the lender would have had to walk away.

¹Further limiting municipal influence, tax collection is performed by the district offices of the Inland Revenue, which then allocate the collections among jurisdictions. Tax abatements are granted to qualifying local tax payers pursuant to national environmental law with little local involvement.

SECTION IV
PROJECT FINANCE AS A MEANS OF ENHANCING THE
QUALITY OF COLLATERAL

A. The Goal

Both the Fund and its borrowers would like to find more convenient and more workable forms of collateral and rely less on real estate. The ideal collateral would be cheap to post, easy to value, practical to seize in foreclosure, and simple to liquidate.

B. Obstacle: Reliance on Real Estate as Collateral

Despite the rather broad range of assets that the Fund is legally permitted to accept as collateral, the majority of loans are backed by real estate.¹ From the SFZP's perspective, municipal real estate is less than ideal. A recent USAID report cites a number of reasons: difficulty in establishing market value, lack of marketability of specialized facilities, hidden costs of foreclosure, and the political and social impracticality of seizing core municipal assets, among others.²

For many of the same reasons, and also because of administrative costs, municipalities often find the posting of real-estate collateral to be burdensome and undesirable.

C. Consequences

Aware of the economic and practical risks of the collateral backing their loans, the Fund often requires substantial over-collateralization. Perhaps this provides some measure of protection; more likely it compounds the above-cited difficulties. Furthermore, it engenders resistance on the part of the borrowers. The most troublesome consequence of the Fund's reliance on real-estate collateral, however, is that the property may not, in the end, afford the desired protection. Whether because of the vagaries of market value, difficulties in finding an alternative use, or other circumstances that render foreclosure imprudent, the Fund may not realize amounts adequate to cover a loan in default.

¹Nine hundred seventy-five of approximately 1000 outstanding loans are backed by real estate. See Richard J. Lewis, *Collateral Security Backing Loans of the Czech State Fund for the Environment* (USAID, 1995) and *Guideline #8 on Securing Loans Financed by the SFZP*, promulgated by the Fund. In addition to real estate, the Fund may take as security a bank guarantee, a bill of exchange, a guarantee of a third party, or equity shares. While a bank guarantee is "considered to be the best loan security" (Article IV), real property is nonetheless "normally" the collateral taken (Article III). See also Attachment II to the *Instruction of the Czech Ministry of Environment concerning granting of Financial Means from the State Environmental Fund of the Czech Republic for 1994*, which states that "the common form" of security will be real property (Article II).

²Richard J. Lewis, *Collateral Security Backing Loans of the Czech State Fund for the Environment* (USAID, 1995).

D. Project Finance as a Partial Remedy

Project finance offers a form of collateral (i.e., the future revenue stream) unbeset by the shortcomings described above.³ Valuation is, in concept at least, straightforward: it is the value of future cash payments discounted for time and uncertainty. Foreclosure consists of exercising the right to have utility customers make their payments directly to the lender without their passing through the borrower. Liquidation does not require conversion from physical to monetary form, saving some uncertainties and expenses. Overall, as compared to real estate, such collateral can be valued with less risk and foreclosed upon and liquidated at lower risk and lower cost.

³More technically, as noted above, the lender takes a security interest in the contractual rights of the borrower to receive the cash flows.

SECTION V FEASIBILITY

Having established that project finance could help the SFZP and its borrowers to achieve important goals, we turn to the question of feasibility. We look first at the general characteristics of SFZP-supported investments, comparing them to more typical candidates for project-finance candidates. Next we look at selected aspects of Czech law. Finally, we consider the ability of the Czech banking system to support project financing.

A. Suitability of SFZP-supported Undertakings for Project Financing

A1. Similarities

Many of the infrastructure improvements undertaken by SFZP clients match, in broad outline, the profile for project finance. This is particularly true of sewer lines and wastewater treatment plants, water systems, and gas-distribution networks. These are capital-intensive undertakings, involving substantial sums relative to the size of the typical Czech municipality. Few sponsors can finance the improvements through cash on hand (or equity) and so they turn to debt. For small companies and municipalities, however, the capital costs often over-stretch debt capacity.

Like the typical candidate for project finance, wastewater, water, and gas systems have identifiable and separable assets and revenues. Operationally, they can be segregated from the other affairs of the sponsoring municipality or company.

Many project-finance entities achieve stability and predictability of cash flows through long-term contractual sales to a dominant customer. For the Czech utilities, sales are made to numerous, small consumers and are not generally governed by long-term contract. Nonetheless, the existing reliable patterns of consumption, set fee boundaries, metered consumption, and prompt payments, fostered by both national custom and an effective collection mechanism, also create conditions for stable cash flows.

A2. Differences

The two major differences between SFZP-supported investments and more traditional candidates for project finance, as previously noted above, are:

- Many SFZP-supported projects are not fully intended to recover costs without government subsidy; and
- SFZP investments are comparatively small.

Table V-1. Characteristics of Candidates for Project Financing

| Traditional Candidates | SFZP-supported Investments |
|---|--|
| The scale of the project is large relative to the sponsoring entity. | Projects are small in an absolute sense. Municipalities are, however, investing vast sums relative to their operating budgets. |
| The project requires substantial capital. | Projects are capital-intensive. |
| Much of the financing is debt. | Municipal budgetary surpluses are far from adequate to finance the facilities. Debt or grants are the only answer. |
| The project can be cordoned off, legally and operationally, from the activities of the sponsor. | Utilities can operate on a stand-alone basis. Municipalities have the legal right to house the utility in a wholly-owned subsidiary. |
| Long-term relationships with third parties (generally customers) dampen market and operating risk and promise stable and predictable cash flows | Utilities do not generally have long-term contracts. Demand is often predictable. Prices are often stable, due both to competitive conditions and government regulation. |
| Cash flows are sufficient to cover debt service and to provide an adequate buffer. | Cash flows are often inadequate. Credit support is often required from municipal sponsor. |

A3. Conclusions

Projects supported by the SFZP share many characteristics with those that have raised capital through project financing, suggesting that the technique holds promise. However, the SFZP projects also differ from these other projects in significant ways, suggesting the need for considerable tailoring. In particular, there are probably few SFZP-supported investments that could support the full burden of debt service on project cash flows alone. Most will require supplemental credit support from the sponsor. Given their small size, the SFZP-sponsored investments cannot afford the cost of the elaborate legal structuring that goes into a typical project financing.

B. Legal Feasibility¹

The legal system must provide for certain powers and rights if the project-finance structure is to function correctly.

B1. Segregation of Cash Flows and Operations

Under Czech law, municipalities and business corporations have the right to establish subsidiary corporations, which they can own in whole or in part. This right provides the means of segregating the operations and finances of the project from those of the sponsor.

B2. Pledge of Revenues

Under Czech law, municipalities and business corporations have the right to pledge cash flows they will receive in the future. Specifically, in the case of municipalities, the lender may be offered a security interest in cash receipts arising from the operation of water, wastewater, gas, or other utilities. However, this right applies to future receipts only to the extent that they are due and payable. Thus, for example, the amounts that residents and businesses owe for water during the *current* billing period can be pledged, but the receipts expected in *future* billing periods cannot. This is a severe limitation since the amount of taxes and fees currently due at any time is normally quite small relative to the amount the municipality would be borrowing from the Fund. Fortunately, several solutions are possible.

A municipality can establish a corporate subsidiary to hold and operate the project (sometimes called a “development corporation,” though that term has no legal significance). The municipality can then enter a long-term agreement with the subsidiary under which the subsidiary agrees to pay a rent or fee to the municipality in exchange for the right to operate the project and to collect revenues from service users. The amount of the rent or fee must be sufficient, or nearly so, to service the SFZP debt. The municipality can in turn offer the SFZP a security interest in these rents or fees (see Figure V on the next page).

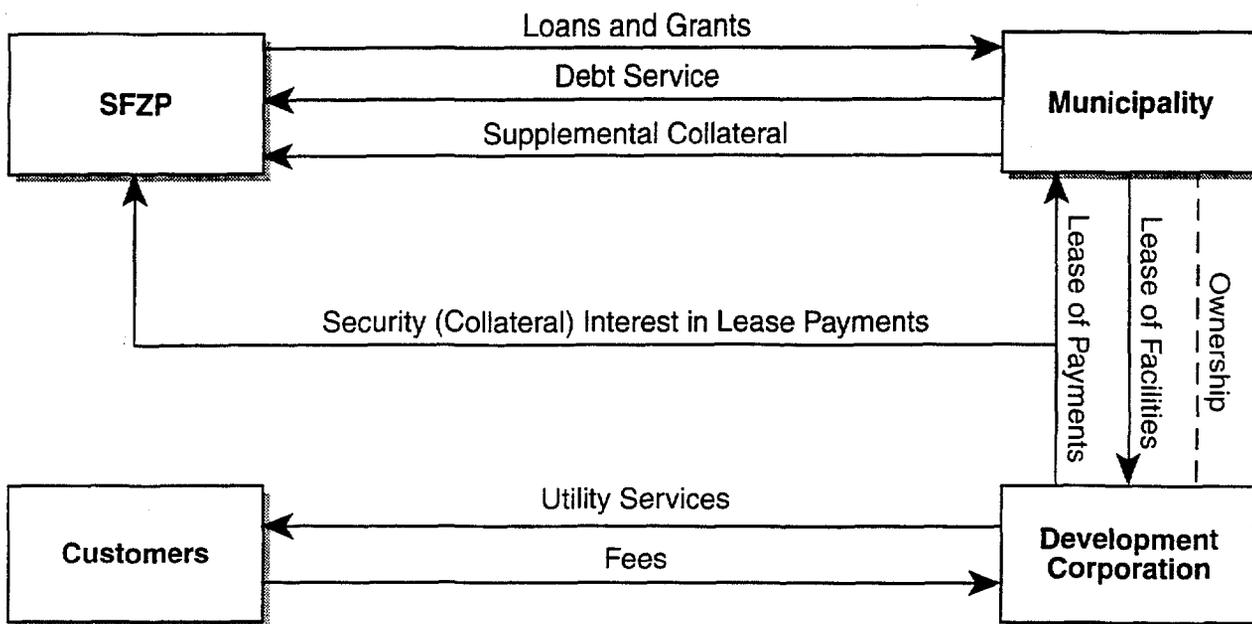
Alternatively, a municipal or business borrower could agree contractually (but not as a pledge or assignment) to pay certain revenues received by it into a blocked bank account or into a sinking fund.

For its part, the SFZP appears to have the authority to accept a future revenue stream as collateral, though the pertinent rules are somewhat ambiguous.²

¹We base our discussion largely on a memorandum by the law firm of Hogan & Hartson, which appears as Annex A.

²The ministerial instructions read in part as follows: “The common form [of collateral] will be security based on real property. However, other forms are also not precluded—freezing of outstanding debts, guarantee from third parties, etc.” See Attachment II to the *Instruction of the Czech Ministry of the Environment concerning Granting of Financial Means from the State Environmental Fund of the Czech Republic for 1994*.

Figure V.
SFZP Project Finance Structure Using Development Corporation



B3. Enforcement of Security Rights

Two obstacles confront the parties to a project financing. First, municipalities are not subject to Czech bankruptcy law. Should the municipal borrower default, the lender’s rights are not clearly defined. Second, a lender’s claim that is secured by a revenue stream does not, in any event, have priority over general unsecured creditors.

Again, solutions are available. A development corporation formed to house the investment, though wholly or partially owned by the municipality, would itself be subject to bankruptcy law. Priority over general unsecured creditors could be established by supplementing the security interest in the cash stream with other (tangible) collateral.

B4. Supplemental Collateral

The development corporation also provides the vehicle for posting supplemental collateral, which is often required in project financing. The development corporation can offer a security interest in its own assets. The municipality can do the same with municipal assets. Furthermore, the municipality can offer the shares it holds in the development corporation.

B5. Conclusion

One clearly cannot characterize the Czech legal system as “hospitable” to project financing. Yet, it is possible, with some ingenuity, to surmount the various obstacles.

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C. The Financial System

Just as the feasibility of project finance depends on the adequacy of project cash flows, proper corporate form, and a facilitating legal system, so too does it depend on a supportive financial system. This report identifies three requirements of the financial system: the availability of long-term credit, a store of experience in technical and market evaluation of projects, and skills on the part of bankers in structuring financings.

C1. Long-term Credits

Loan maturities of ten or more years are needed to finance the long-lived capital assets normally involved in project finance. Since debt is serviced from current earnings, most projects cannot accommodate large principal payments in early years. Financial systems offering only short and intermediate maturities make debt financing of any capital equipment difficult, and they eliminate the possibility of project finance altogether. Long-term financing is, however, rather limited in the Czech Republic. The SFZP is permitted to lend up to ten years, including a grace period, though average maturities are typically closer to seven. Ceska Sporitelna, the leading commercial lender to municipalities, reports that of its 550 outstanding municipal loans, only about 30 have maturities greater than four years. MUFIS and the Czech-Moravian Guarantee and Development Bank offer longer terms, though they have limited funds available. The bond market, which several municipalities have tapped, does offer longer-term funds, though only to the larger cities.

C2. Expertise in Project Evaluation

Project finance also demands distinctive skills and experience on the part of the lender. Lenders must understand the project in depth and on a technical level. An effective loan officer is technically trained and has substantial experience in the industry from which the project arises. The SFZP staff possess some of this experience. The chief credit officer, for example, ran a municipal landfill earlier in his career. The staff generally lack, however, the formal financial training to complement the technical knowledge of urban infrastructure. Neither do the commercial banks generally employ experts in municipal infrastructure in their municipal lending corps.

C3. Expertise in Structuring

Project financing demands legal and tax skills. Here again, experience is scarce. The SFZP staff has had little opportunity for work on these matters, while Ceska Sporitelna has had some. The latter has recently begun, for example, to explore alternatives to real estate and other fixed assets as collateral, and today they have some Kč 500 million of outstanding loans for which revenue and cash balances provide some dampening of credit risk.³ Even among the commercial banks doing the bulk of municipal lending, however, the experience is thin. Neither Ceske

³The structure is one that U.S. bankers would call "controlled collateral." It is used only with customers who maintain deposits at the bank. The bank does not have a lien on specific revenues or balances and it has no legal right to seize funds. Rather, it monitors the customers' account activity, analyzes the health of its business operations, and seeks early warning of the need to intervene.

Sporitelna nor Komerčni banks, for example, has designed an effective means of taking a security interest in revenue streams.⁴

C4. Conclusion

The Czech financial system is immature with respect to project finance. The basic structures have not yet been worked out, and the banking community does not possess abundant technical knowledge regarding municipal infrastructure or the requisite legal, tax and corporate skills. Expertise is growing as municipalities search for new vehicles to supply their great appetite for capital. In the meanwhile, foreign expertise can supplement that of the Czech specialists. Additionally, a rather modest supply of long-term financing is available in the Czech Republic. This pool must expand. For the moment, of course, demand for project financing is limited.

D. Summary

The picture that emerges from our analysis of feasibility is understandably mixed. The SFZP projects possess many, though not all, of the hallmarks of project-financè candidates. Neither the legal nor the financial systems can be said to be very accommodating, though neither poses insurmountable barriers. Arranging project financings will not be simple. Yet the benefits are very powerful. As the financial system matures and legal points are clarified, the SFZP and its borrowers may well determine that the potential rewards of project finance justify tackling the obstacles.

⁴Neither, in fact, believes that is legally possible to do so, a position at variance with the legal advice we have received.

SECTION VI CASE STUDIES

In this section, we present two case studies from the Czech Republic to illustrate the potential benefits of project finance and probe the extent of its feasibility. One of the case studies is of a small village that made substantial capital investments; the other, a joint venture between a municipality and an industrial firm to supply gas-generated heat. (The names have been altered to protect confidentiality.)

A. The Village of "A"

The Village of "A" is a trim community of several hundred households in a picturesque rural setting. During the past six years, the village built two sewer lines, a sewage-treatment plant, water lines, and a residential gas-distribution system, all with substantial assistance from the SFZP.¹

The environmental benefits of this aggressive construction program have been impressive and most welcome. The residents and the mayor are justifiably proud. The financial consequences are, however, less fortunate. The village has in fact become greatly over-indebted, and may have difficulty meeting its financial obligations. Further investment—certainly further borrowing—will be problematic.

The capital required for the village's improvements vastly exceeded the municipality's resources. Table VI-1 (see next page) shows capital spending of nearly Kč 70 million over the past six years, or Kč 11 million per year.² By comparison, the village's annual operating budget is only Kč 4 million. Nearly half of the capital was supplied through grants, while a substantial portion came from the village's operating surpluses. Only one-seventh was borrowed, and this on highly concessional terms. Even so, the village will be hard-pressed to repay the loan. With a four-year repayment term following a several-year grace period, the village will face annual debt service of about Kč 2.6 million. This represents more than 60 percent of its current operating budget. Though the first principal repayment is not due for several years, the village has already sought and received a deferral from the SFZP.

The village did not use project-finance methods to raise capital. The question we ask is: had it done so, would conditions be different today?

A project-finance orientation would have imposed greater discipline on the village, forcing it to project into the future the associated revenues, expenses of its improvements, along with the source of cash to repay the debt. Such analysis would have revealed a serious cash-flow deficiency, foreshadowing the strain that these investments would place on municipal revenues. Subjected to the discipline of project finance at the planning stage, the village would have felt severe pressure to economize. It very well may have made the same improvements, but on a

¹It should be noted that the SFZP's loans and grants to the Village of "A" were extended before the advent of the credit-analysis unit and the recent improvements in risk-management procedures.

²The table omits figures for the water lines as these are not available. It also omits those for the home heating systems as the work was performed by the homeowners rather than the municipality.

smaller scale or slower rate. It may also have insisted on higher user fees and lower operating costs, or it may have dropped one or more of the projects altogether.

Table VI-1

| Infrastructure Improvements in The Village of "A", 1989-1995 (Kč in millions) | | | | | |
|---|-------------------|---------------|--------------|----------------------|--------------|
| | <i>Total Cost</i> | <i>Grants</i> | <i>Loans</i> | <i>Village Funds</i> | <i>Other</i> |
| Sewer Line A | 30.8 | 22.8 | | 4.5 | 3.5 |
| Sewer Line B | 17.5 | 7.0 | 7.0 | 3.5 | |
| Gas | 9.2 | 3.5 | 3.5 | 1.7 | 0.5 |
| Sewage Treatment | 12.0 | | | | 12.0 |
| Total | 69.5 | 33.3 | 10.5 | 9.7 | 16.0 |

One might be tempted to argue that environmental needs are paramount and that any financial considerations that might impede investment should be given little heed. In the long run, however, it is not clear that the environment is served when financial discipline is relaxed. The Village of "A" now finds that any further environmental investment will be difficult to finance. The SFZP is faced with having to reschedule the loan and, more seriously, carries the risk of default. Moreover, the capital consumed by the Village of "A" is unavailable to other needy communities.

B. The Joint Venture "B&C"

The joint venture "B&C" pairs a small city and a major industrial concern in an enterprise that will supply gas-generated heat to apartment dwellings, permitting the retirement of coal-fired boilers. The reduction in air emissions due to the project will be considerable.

The joint venture has taken the form of a separate corporation, with 50 percent ownership by each party. To finance the construction of hot water and steam transmission lines, the city is seeking loans and grants from commercial and government sources. The city will build the improvements, then lease them to the joint venture, which will operate them. Lease payments from the joint venture to the city will be approximately equal to the municipality's debt service. The joint venture will buy heat from the industrial concern and sell it to apartment residents. "B&C" is expected to meet all operational costs plus lease payments from the revenues it earns on the sale of heat.

The municipality will probably try to raise some of its capital through project financing. This approach will offer several benefits over conventional financing. Though a considerable amount of money will be borrowed, the capacity of the municipality to borrow more in the future will remain undiminished. Lease payments from the joint venture to the municipality will fully cover the municipality's debt service. Thus, the project-finance structure will enable the city to finance more environmental investments than it otherwise could.

The lender (an application will be made to the SFZP) will face lower risk than it would under a conventional loan. The source of repayment will be clearly identified and the cash flows isolated and dedicated to debt service. Rather than relying on unmarketable pipes and transmission equipment as collateral, the lender will take a security interest in a lease-payment stream that is contractually defined and that is backed by the utility payments of the apartment dwellers.

The project-finance structure will put pressure on the sponsors and the joint venture to economize. "B&C" will have to earn sufficient revenue to meet operating costs and to make lease payments. It will have an incentive, therefore, to control capital expenditures and associated borrowings, hold down operating costs, and charge rates for service that fully cover cost. Such rates, in turn, will encourage rate-payers to conserve energy, contributing to beneficial environmental effects.

C. Conclusion

The two case studies support the contention that project finance can serve a real need of both the SFZP and its borrowers by increasing borrowing power, improving collateral, and—most importantly—encouraging a disciplined balancing of project costs and benefits and a judicious use of capital.

Variations on Corporate Form

In the Village of "A," the municipality owns and operates the utilities itself. What happens when things aren't so simple?

Sale to an operating company. In a common arrangement (formerly mandated by law), the gas-supply company pays book value to the municipality for the purchase of the lines. It then takes over operations, collects customer payments, and has no further financial obligation to the town. The prospect that such a sale may take place in the future need not render project finance impractical at the outset. So long as the acquisition price paid by the gas works exceeds the principal value of the debt, the municipality will receive sufficient funds to repay its loans.

Lease to an operating company. Here the operating company pays the municipality rent for use of the facilities. The rent may be a function of capital cost, often equal to depreciation. In such a case, the rent payments would typically not be sufficient to support the full burden of unsubsidized project-finance debt service. The long-lived assets generate depreciation charges at a rate well below prevailing Czech interest rates, and as a result rental income would be less than interest charges.

Profit-seeking utility companies. Many of the village's neighbors have transferred their water systems to a regional sewer and water association. This entity is half-owned by a profit-seeking utility. The participation of profit-making firms in utility operation offers encouragement to those attempting to structure project-financing, as it suggests that these firms have found a formula for earning revenues in excess of operating and capital costs.

SECTION VII NEXT STEPS

Project finance presents many opportunities for both the SFZP and its borrowers. Seizing the opportunities will require overcoming a number of obstacles. The Fund should proceed incrementally: it should neither forego the improvements that project finance could bring, nor should it dissipate its energy in a headlong rush to embrace innovation.

The recommended action plan consists of three steps:

Step #1 Apply a rigorous economic analysis to each new project, complementing the current analysis that focusses on the creditworthiness of the borrower.

Step #2 Identify and isolate cash flows as the source of repayment and as collateral.

Step #3 Fight the root limitations on the feasibility of project finance and apply project finance to an expanding the number of projects. The Fund can realize material benefits by taking just the first step, or by taking the first two steps. Benefits accumulate with each move forward. The proper sequence must be followed because achievements in early steps are prerequisite to success in the latter.

A. Step #1: Project Analysis

The first step, while ambitious, is the most modest of the three. It calls for no change in lending procedures (i.e., analysis of the municipalities' or corporations' credit is unaltered; traditional hard assets continue to serve as collateral; and repayment comes from general municipal or business revenues). In addition to these activities, however, the Fund begins to perform a rigorous economic analysis on the proposed sewer line or water system to determine whether the investment: (1) will represent an efficient use of resources, and (2) will generate a reasonable return when adjusted for externalities and subsidies. This analysis supplements the credit appraisal of the borrower. It differs from the credit appraisal in that the object of the analysis is the project itself and not the borrower. The focus is on the efficient use of capital and not of the ability to repay.

The economic analysis will flag proposals that are too big, too costly, or inefficient. It will highlight the degree to which subsidies distort costs, prices, and returns on capital. Performed and communicated sensitively, an analysis revealing inefficiency will encourage the proponent to redesign the project. For those projects that are not or cannot be redesigned, the analysis provides the rationale for the Fund to reject the application and to support its decision before ministry officials and disappointed mayors.

Ideally, the applicants would perform the analysis themselves, with the Fund reviewing the results. This would encourage the applicants to burnish their proposal before its submission, allowing the Fund to escape the role of distant and heavy-handed critic.

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Table VII-1. Step #1: Project Analysis

| Goal | Purpose | Obstacles | Actions | USAID Assistance |
|--|---|--|---|--|
| Economic analysis performed of each project. | Establish greater discipline in the design and evaluation of projects, increasing efficiency in use of capital. Create an objective basis for accepting and rejecting applications for assistance. | Methodology not adopted by the SFZP. SFZP not trained. Applicants not trained. | Adopt analytical standards and procedures. Express standards and procedures in forms and built into application process. Train SFZP staff. Train applicants. | Previous studies like <i>Approach to Project Selection and Guidelines for Project Preparation and Seminars on Capital Budgeting</i> . EAPS study setting out basic economic standards for infrastructure. EAPS training. |

B. Step #2: Cash Flows as Source of Repayment and Collateral

Step #2 calls for the Fund to achieve greater specificity in identifying a source of repayment for its loans. It also requires the Fund to move away from its near-exclusive reliance on real estate as collateral. In many cases, both the Fund and the borrower would prefer to use a pledge of cash flows as the first line of security, supplemented, if necessary, by hard assets. Both would benefit by avoiding the cost and uncertainty in appraising the value of the collateral and in perfecting the pledge, and, in the event of default, the impracticality of foreclosing on core municipal assets. The cash flows pledged need not be only those of the project; they could be any amounts contractually owed to the borrower that meet the standards of Czech law.

Table VII-2. Step #2: Cash Flows as Source of Repayment and Collateral

| Goal | Purpose | Obstacles | Actions | USAID Assistance |
|---|--|--|---|---|
| Identify and isolate cash flows as a source of repayment and as collateral. | Reduce risk of loans. Expand borrowing power. Improve the quality of collateral. | Legal position not established. MOF approval needed for some municipal pledges. | Devise the legal documentation. Seek MOF approval. Arrange procedures to verify and monitor cash flows. Explain advantages to borrowers. | Hogan & Hartson research and opinion. Richard Lewis' report on collateral. EAPS training of the SFZP. Training of borrowers by Urban Institute and others. |

C. Step #3: Expanded Application of Project Finance

If its experience with project financing is favorable, the Fund may wish to pursue a widespread, rather than selective, application of the technique. If so, under Step #3, it will have to directly confront obstacles to feasibility. The most limiting of these, as we have seen, are the weak economics of many projects, the legal difficulties in using cash flows as collateral, and the short supply of long-term capital.

Project analysis (Step #1) will identify and strengthen projects that are economically sound, but better analytical procedures can only help so much. Ceilings on utility rates and other price distortions will continue to make it difficult for many municipal infrastructure projects to generate cash flows sufficient to support their capital costs. Drawing on its considerable and growing experience with project finance, the SFZP could demonstrate to policy makers the crippling effects of rate limitations on the utilities' rate of return and, consequently, on their ability to raise capital. The Fund will be able to argue persuasively that capital is denied to municipal infrastructure and that environmental improvement is being slowed as a result.

With respect to legal obstacles, the Fund could promote legislation clarifying the use of security that would benefit both lenders and borrowers. The Hogan & Hartson report in Annex A sets out concrete recommendations.

Finally, with respect to the short supply of long-term credits, the SFZP could consider lengthening the repayment term of its loans.

Table VII-3. Step #3: Expanded Application

| Goal | Purpose | Obstacles | Actions | USAID Assistance |
|--|---|--|---|--|
| Attack obstacles to the widespread use of project finance. | Demonstrate feasibility. Improve efficiency in use of capital. Expand clients' borrowing power. Improve the quality of collateral. | Poor project economics. Inadequate legal foundation for collateral. Short supply of long-term credits. | Illustrate the dampening effect of subsidies and price ceilings on investment. Promote new legislation. Offer longer repayment periods. | Policy studies. Economic modeling. Training of borrowers through EAPS. |

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ANNEX A

LEGAL MEMEORANDUM ON COLLATERAL SECURITY, HOGAN & HARTSON

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HOGAN & HARTSON L.L.P.

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To: Chemonics International Inc.
From: Hogan & Hartson L.L.P.
Prague Office
Date: August 29, 1995
Re: State Environmental Fund of the Czech Republic (Question 1)

To follow up on our memorandum of August 16, 1995, set out below are our comments regarding the ability of the Czech State Environmental Fund (the "Fund") to obtain security to cover the financial assistance provided by the Fund to Czech municipalities and/or other entities within the framework of supporting environmental projects in the Czech Republic.

I. SOURCES OF MUNICIPAL REVENUES

A. Relevant Legislation

The principal relevant legislation in this area is set forth below:

1. The Budget Guidelines of the Czech Republic and Municipalities (Act No. 576/1990 Sb., as amended) (the "Guidelines"), which provide for various sources of revenues to the municipal budget of Czech cities and towns, including (i) revenues ("subsidies" and "grants") from the state budget of the Czech Republic and from various state funds, such as the Czech State Environmental Fund (Section 23(i)), and (ii) credits, loans and other forms of repayable financial assistance (Section 23(g)).

2. The annual Act on the State Budget. The current law is Act No. 268/1994 Sb., on the State Budget of the Czech Republic for the year of 1995, which, in accordance with the Guidelines, provides for state subsidies to be transferred to the Czech municipalities through District Offices (in Czech "Okresní úřady") (Section 2).

3. Act No. 388/1991 Sb., on the State Environmental Fund of the Czech Republic (as amended), which allows the Fund to provide financial

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support for environmental projects in the form of "subsidies, grants, loans, assumptions of obligations and other assistance to legal entities and individuals" (Section 3(2)).

4. Act No. 410/1992 Sb., on Municipalities (Municipal Establishment) (as amended), which, among other things, empowers the municipalities to borrow funds.

B Sources of Municipal Revenues

Pursuant to Section 18(1) of Act No. 410/1992 Sb., on Municipalities (Municipal Establishment), the property of the municipalities comprises the "res (i.e. tangibles) and rights of economic value determined by special laws". Accordingly, as noted above, the Act on the State Budget of the Czech Republic, the Guidelines, and the Act on the State Environmental Fund, provide for various sources of municipal revenues.

Municipal revenues consist of, among other things, the following:

- proceeds from the municipal property (e.g., rental income, interest from deposit accounts, etc.)
- revenues from the activities of legal entities and establishments created by the municipalities within the scope determined by special laws, and revenues from the municipality's own activities of an economic nature,
- proceeds from real estate property taxes with respect to the property located on the territory of the municipality,
- subject to certain exceptions, personal income tax paid by individuals conducting business activities as a sole proprietor and living within the territory of the municipality,
- a portion of 55% of the District-wide revenues resulting from personal income tax payable by employees and emoluments (the 55% share of the District-wide tax revenues is allocated to each municipality in proportion to the ratio of its population to the population of the District as a whole),
- local fees and administrative charges,
- credits, loans and repayable financial assistance,
- subsidies from the state budget and the state funds of the Republic,
- subsidies from the District budget,

- fines imposed by the municipality, other fines accruing under special laws into the budget of the municipality, as well as other revenues under law.

II. SECURITY INTERESTS GENERALLY UNDER CZECH LAW

A. Liens

As a general comment, Czech law does not recognize a "lien" in the common law sense of the word. The Czech analogy for this legal term is the right to retain (or to seize) and applies strictly to tangible assets (res) where (i) the holder of the retention right already has physical possession of the tangible assets in question, and (ii) the monetary claim of the creditor is due and payable (Section 151s et seq. of the Civil Code). Since physical possession is a prerequisite, the retention right under Czech Civil Law does not include retention (i.e., seizure) of intangible assets, receivables or other financial claims (e.g., claims of municipalities arising from various municipal revenues).

B. Pledges

1. General

A critical aspect of the pledge concept under Czech law is that the pledged asset (regardless of the nature of the asset) must be in existence at the time the pledge is granted in order to be effective. In principle, receivables and other financial claims may be used as collateral. It is not possible to pledge assets to be acquired in the future. For this reason, a pledge of future receivables is highly problematic under Czech law, since a new pledge agreement must be entered into at the time each future receivable later comes into existence. Thus, in the case of a pledge of term deposits, for example, a new pledge agreement will be required each time the term deposit is rolled over on maturity.

2. The Pledge Agreement and Registration

In general, pursuant to Section 151a et seq. of the Civil Code, a pledge is created by an agreement between the creditor and the debtor (pledgor). The pledge agreement must clearly describe the pledged item and the secured claim as well as the reason for the pledge and its monetary value.

In general terms, subject to two exceptions, there is no registration system under Czech law under which the pledge can be recorded as a matter of public record. The two exceptions relate to:

(i) pledges of real estate, where the pledge becomes effective by its registration with the Land Records Office, and

(ii) pledges of shares in joint stock companies and certain other types of securities where the shares (or other securities) are in the form of "book entry"

securities registered with the Czech Securities Center, in which case the pledge becomes effective upon its registration with the Czech Securities Center. Shares and other securities which are in the form of (or evidenced by) physical certificates are pledged through physical delivery of the certificate evidencing the shares or other securities.

3. Pledge of Tangible Assets

In the case of tangible assets, the pledge becomes effective by physical delivery of the pledged asset to the secured creditor, or by noting the pledge in the certificate of title to the asset (such as title certificates for aircraft and vessels). In the latter case, the title certificate serves as proof of the pledgor's ownership of the pledged item, which is essential for using or disposing of the thing being pledged, and noting the pledge in the certificate of title is the equivalent of constructive delivery of the asset. If the parties agree, the pledged tangible asset may, alternatively, be deposited with a third party for safekeeping.

C. Pledge of a Claim

Under Section 151h et seq. of the Civil Code, it is possible for a debtor to pledge a claim owed to the debtor (such as a receivable) by a "subdebtor" where the object of the claim's performance consists of a thing (res), right or some other item of monetary value. Thus, for example, it is possible to pledge rental income due under an existing lease agreement, since although the future rent is not yet due, the debtor has an existing claim to receive the future rent.

The pledge of the claim against the subdebtor becomes effective only when either (i) the pledgor notifies the subdebtor in writing of the existence of the pledge, or (ii) the pledgee is able to prove to the subdebtor the existence of the pledge (for example, by producing the pledge agreement). If either of these two alternative requirements are met, the subdebtor is then bound to perform his obligation in favor of the pledgee. If the substance of the subdebtor's performance is a thing (res) (where, for example, a buyer has pledged goods to be delivered under a sale of goods contract), a pledge upon the thing arises by its delivery to the pledgee, and the pledge upon the claim terminates. The pledgee is obligated to notify the pledgor of the subdebtor's performance of his obligation. In this context, a pledge of a debt also expires upon a written notification of the pledgee to the subdebtor that the claim secured by the pledge has been satisfied or if the pledgor proves to the subdebtor that the claim secured by the pledge has been satisfied (Sections 151i and 151j of the Civil Code).

D. Assignment of Claims

It is possible under Czech law to assign a claim, such as a receivable, provided the claim is in existence and quantified and notice has been given to the subdebtor. The essential difference between the assignment of a claim and a pledge of a claim is that, under an assignment, the subdebtor is obligated to pay

the amount due to the creditor regardless of the relationship between the creditor and the assignor. In the case of a pledge of a claim, the subdebtor's obligation to pay the creditor will terminate when the pledgor/debtor satisfies the secured claim owed to the creditor.

Similar in concept to a pledge, it is not possible under Czech law to assign a claim to be acquired in the future (such as future receivables).

E. Bankruptcy Issues

Under Czech bankruptcy laws, in general terms, only claims which are secured by a pledge of real estate or tangible assets will be treated as "secured claims" having priority over general unsecured creditors. Consequently, a pledge of a receivable, for example, would not be treated as a secured claim for bankruptcy purposes under Czech law. However, in the context of the Fund taking a pledge over assets of a municipality, it should be noted that Czech law specifically excludes municipalities from the Czech bankruptcy laws.

F. Development Corporations

It is possible for a municipality to own all or part of the share capital of a joint stock company (or, indeed, own or form any other type of legal entity recognised under Czech law). This situation originally arose in the context of privatisation, where the municipality would sometimes receive a small percentage of shares in newly privatised state enterprises located within the municipality. However, some municipalities have also formed "development corporations" for the purposes of developing particular projects outside of the municipal framework. (Please note that the term "development corporation" is not a term of art under Czech law and does not denote any special form of legal entity.) One reason municipalities may wish to adopt this approach would be to move the decision making process regarding the project away from the full city council to the directors of the development corporation.

In the context of the Fund providing financial assistance, the Fund could therefore either finance the municipality or finance the development corporation. The financial assistance could be linked to a security package which could include any or all of the following: (i) a pledge of the corporation's assets, (ii) a pledge of the municipality's assets (including the shares owned by the municipality in the development corporation), and/or (iii) a guarantee granted by the municipality. Please note that the protection afforded to municipalities under the Czech bankruptcy laws does not extend to the corporation in which the municipality owns shares and the corporation can be put into bankruptcy. However, the corporation's bankruptcy would not affect the validity of any security granted to the Fund directly by the municipality, such as a guarantee or pledge of the corporation's shares.

III. SECURITY INTERESTS OVER MUNICIPAL REVENUES

In response to your specific questions, set out below are our comments regarding the ability of the Fund to take a perfected pledge over certain types of municipal revenues.

A. Is the Fund legally able to have a perfected pledge on revenues transferred to a municipality from the state budget?

1. General

As a general comment, borrowing by the Czech municipalities is not a long-established practice; indeed, the Czech legislation which empowered municipalities to borrow was only passed in 1992. Until recently, Czech municipalities were not considered independent legal entities and, as such, were not permitted to enter into commercial dealings such as loan transactions. Municipal budgets were highly regulated and did not allow for creating debts and other forms of financial obligations. Czech municipalities were essentially state administrative bodies formed to serve as an "extended arm" of the central government. As a result, there are few, if any, specific examples of secured borrowings on the part of Czech municipalities (other than loans secured by real estate). Moreover, Czech banks maintain a very conservative approach to the issue of securing loans through pledges of certain types of assets (for example, some domestic banks are very reluctant to accept a pledge of shares).

2. Pledge of Tax Revenues and State Subsidies

As a technical matter, the municipality can pledge its claim against the State with respect to certain types of revenues to the extent the claim exists and is quantified. As noted above, notice of the pledge would need to be given and the municipality cannot pledge future claims against the State. The municipality's ability to pledge "revenues" will, however, depend very much on the specific nature of the revenues and, as a practical matter, may prove both problematic and, in some cases, of little real value.

Revenues received by the municipalities from the state are essentially either in the form of taxes or state subsidies as noted below:

(a) Tax Revenues

Under Czech law, personal and corporate income taxes and real estate taxes are collected by the local Finance Office (which is a subdivision of the Ministry of Finance). Depending upon the nature of the tax, the Finance Office will then pay the amounts collected either to the state or directly back to the municipality.

(i) Real estate taxes with respect to the property located within the municipality are paid by the taxpayer to the Finance Office and then the Finance Office pays the collected amounts directly back to the municipality on a monthly basis. The Finance Office's obligation to pay the municipality arises at the end of the calendar month, after the Finance Office has determined how much it has collected in, and the collected amount must be paid within five days thereafter. Technically, the municipality could pledge this receivable as it arises at the end of each month. However, real estate taxes may not generate significant amounts for individual municipalities and this may have little practical value, given that the receivable will be paid within five days and a new pledge agreement will be required at the end of each month as each new receivable arises.

(ii) Subject to certain exceptions, the municipality is entitled to receive 100% of the personal income tax paid to the Finance Office by individuals conducting business activities as a sole proprietor and living within the territory of the municipality. These amounts are payable quarterly and the principles set out in Paragraph (i) above apply.

(iii) The municipality is entitled to receive a proportionate share of 55% of the District-wide revenues resulting from personal income tax payable by employees and emoluments. (The 55% share of the District-wide tax revenues is allocated to each municipality in proportion to the ratio of its population to the population of the District as a whole.) Again the same principles apply as set out in Paragraph (i) above.

(b) Subsidies.

There are two sources of subsidies granted by the "state": (i) subsidies from the state budget and state funds (such as the Fund), and (ii) subsidies from the District budget. Regardless of the source, subsidies are of two types: either project specific subsidies or general subsidies. It is not possible, under Czech law, for the municipality to pledge a project specific subsidy.

Conceptually, it is possible under Czech law for the municipality to pledge a general subsidy, which has been approved in the annual Act on the State Budget (regardless of whether the funds are paid directly by the state or channeled through the District Office). The criteria necessary to create a valid pledge must also be satisfied, namely, that the claim to the subsidy exists and is quantified and that notice of the pledge has been delivered to the state or District Office (as the case may be). However, unlike the case of tax revenues, the window period between the date the obligation to pay the subsidy arises and the date the subsidy is actually paid could be as long as one year.

3. Alternatives to a Pledge of Tax Revenues and Subsidies

Given the problematic nature of pledges of tax revenues and subsidies, alternative approaches which the Fund could consider are:

(a) The Fund could require the municipality contractually (and not by way of assignment) to pay revenues received by it into a blocked bank account. This could take the form of a blocked account requiring joint signatures of the Fund and the municipality for any withdrawals, although there could be an attendant administrative burden with respect to day-to-day withdrawals. Alternatively, the municipality could be required to pay only certain types of revenues into a blocked account, while other categories of revenues could be left in the municipality's control to cover day-to-day expenditures.

(b) As a variation on point (a) above, the municipality could assign certain types of revenue to the Fund, which could be paid into a "sinking fund" to be used for debt service generally or only in a default situation. This would, however, involve new assignment agreements as each future receivable later comes into existence.

(c) To the extent a development corporation is involved in the relevant project, the Fund could obtain a security interest in those assets of the corporation capable of being pledged under Czech law, or a secured guarantee from the municipality (if the corporation is the debtor).

B. Is the Fund legally able to have a perfected pledge on tax revenues of a municipality (e.g., real estate taxes, personal income taxes) ?

Please see our comments above regarding the municipality's ability to pledge this source of revenue.

C. Is the Fund legally able to have a perfected pledge on user fees from municipal services (e.g., heat, waste-water treatment) ?

As noted above, the ability of the municipality to pledge user fees, rental income, and the like will depend on the nature of the revenue. The claim must be in existence and quantified. In addition, the subdebtor will need to be notified of the pledge so that the Fund may be paid directly by the subdebtor. In this context, although the municipality cannot grant a pledge over future claims, to the extent that the "claim" represents future receipts under an existing contract (such as a rental agreement) then the whole amount of the rental income, for example, can be pledged at the outset, even though the rent is not yet due.

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IV. CONCLUSION

A. The Current State of Czech Law Regarding Pledges

As a general matter, pledging claims such as receivables is technically possible under Czech law but very problematic in the context of municipal revenues. In addition, it is not possible under Czech law to pledge or assign claims coming into existence in the future and it is therefore necessary to enter into new pledge (or assignment) agreements each time the future claim later comes into existence.

Given the problematic nature of pledges of tax revenues and subsidies, an alternative approaches which the Fund could consider are:

1. The Fund could require the municipality to pay all or certain types of revenues received by it into a blocked bank account. (This would be a contractual obligation and not an assignment.)

2. The municipality could assign certain types of revenue to the Fund, which could be paid into a "sinking fund" to be used for debt service generally or only in a default situation. This would, however, involve new assignment agreements as each future receivable later comes into existence.

3. To the extent a development corporation is involved in the relevant project, the Fund could obtain a security interest in those assets of the corporation capable of being pledged under Czech law, or a secured guarantee from the municipality (if the corporation is the debtor).

B. Suggested New Legislation

Changes in the law in this area would clearly benefit both lenders (in terms of gaining greater security) and borrowers (in terms of widening credit availability). Set out below are some suggested areas where changes in current legislation could be beneficial:

1. Czech bankruptcy laws regarding what constitutes a secured claim could be amended to include all forms of pledges and not be limited to pledges of real estate and tangible property.

2. In order to give the general public notice of the existence of the pledge of tangible and other types of assets, a central register for recording all types of pledges could be created.

3. The requirement under Czech law that a pledge of tangible assets must be effected through physical delivery of the pledged asset is an obstacle to secured debt financing. We would suggest that this legal requirement be removed.

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4. The prohibition against pledges or assignments of future claims is a further obstacle to secured debt financing and we would suggest that this restriction be removed.

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