

Project Finance—Living with Uncertainty

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FLEXIBILITY IN PROJECT FINANCING

The title of this section is really a contradiction in terms. Project financing by its limited or non-recourse nature cannot be particularly flexible. The writer will illustrate from his recent experience how it could be made to respond more to the real world. His exposure to project finance is through managing the documentation, and the subsequent modification under the stress of events of a deteriorating market, of two major resource projects. The first, the Tiwest Titanium

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Joint Venture in Western Australia, costing over \$500 million, was financed in 1988-1989. The second, the Minproc Sodium Cyanide Project, costing approximately \$100 million, was financed in 1989. The writer's background is more from general and project management, and he has only become a finance manager by circumstance and geography. The views expressed are the writer's and not necessarily the company's.

THE NON-RECOURSE BORROWER

Before discussing specifics on project finance documentation, it is worth examining a few of the background issues about the borrower and its attitudes.

First, there is an inherent flaw in the logic of non-recourse project financing that is guaranteed to cause difficulties if the project enters rough waters. Traditionally, the lender will be looking to the ultimate parent of the borrower until its project has met its performance tests. Once it has met them, the risk has theoretically been reduced and the strength of the parent is no longer relevant. This means that companies without a strong corporate base are the ones that need project financing the most, but which are the least likely to find it. BHP does not really need project financing but can find it at any time. A Minproc needs it but can only find it when banks, commodities and the share market are all at peaks of enthusiasm. Given construction times and the length of cycles, this almost guarantees that commissioning will take place as prices hit new lows and the good guys will have been retrenched from the banks.

In effect, this means that there is a very limited field for whom project financing really makes sense. It should be confined to small resource companies that are attempting to finance a bonanza type ore-body whose intrinsic value outweighs the lack of other assets in the parent. A major would appear to get the worst of both worlds when they use project finance judging by the recent experience of MIM. They have the increased margins but are still expected to support the project.

Another problem that contributes to the problems of the borrower is that very few executives live through more than two projects as the manager. The service groups, such as lawyers and engineering groups, repeat the experience throughout their careers, but that is quite distinct from managing the whole project. Their exposure is usually in the early stages and not the early production experience. The feasibility stage takes usually a minimum of two years, plus two more post-commissioning, making the usual project a six- or seven-year stint. After two of those experiences the lucky executive tends to look for a quiet advisory role or recycling as a winegrower, etc. It is made more difficult because the project managers are engineers and usually have little contact with fund raising. The fund raisers or treasury staff are unlikely to be very familiar with the evolution of projects.

The effect of this is that only the very largest companies have the lessons of previous projects as part of their conventional wisdom. From

experience it would appear that banks are even worse in this respect, particularly in Australia where many of the banks are relatively new and staff are continually changing.

A third problem that is almost ubiquitous in projects is that within the company there is always a project champion or promoter. Without one it would not have got as far as the banks. The champion has a few universal characteristics, such as optimism, enthusiasm and belief in the project; qualities that the banks come to share, but which are not the usual hallmarks of successful bankers.

The end result of these factors is that the people who negotiate documents that are purely project-based frequently do not have a clear understanding of what could happen. The resulting documents clearly reflect this.

PROJECT RISKS

The above discussion is necessary background to have in mind when looking at the way in which borrowers and lenders treat the risks of projects and the finance documentation. Both parties at the time of writing the documents have a very different perception of the risks they are exposed to. The writer's views are as follows in order of decreasing importance.

Commodity price

This is the single largest risk and the one that sinks more projects than any other. It cannot be separated from sales volume as you can always sell the full production if you reduce the price far enough. To illustrate, the figures below show the experience of Minproc.

Tiwest Commodity Prices

	\$/T Actual 1988-1989	\$/T Actual 1992	Feasibility Forecast 1992
Rutile	613	500	774
Ilmenite	78	85	98
Zircon	430	200	543
Synthetic rutile	491	450	619
Pigment	2469	2078	3117
NaCN	2500	1600	3062

The exchange rate risk is part of the price risk and can, to some extent, be protected against.

The banks' reaction to commodity risk is to insist on sales contracts. The borrower dutifully signs up the contracts, the banks' lawyers vet them and the banks obtain a nice warm feeling. The lawyers point out that they contain a "market price or force majeure" clause which really says that this contract will only be followed if market conditions are the same as today. If it is worse we will tear it up. This applies to virtually all minerals. What this means is that all project finance has commodity risk built into the project from day one for both lender and borrower. The documents do not reflect this.

Ore reserves

The calculation of ore reserves is, unfortunately, not an exact science. Before a project is started the accuracy of the reserves is usually $\pm 10\%$ even for easy minerals, such as iron or coal. For something like gold, where you are estimating values of the order of 2 or 3 parts per million, the accuracy is usually $+5\%$ to -40% . The record in gold mining is not impressive but this is perhaps the one issue that banks have come to terms with. Armed with very extensive reports, compiled at the borrower's expense, they usually make exactly the same mistakes as the borrower.

Commissioning/completion

This is the area that is consistently underestimated by both owners and lenders. For the reasons given in the preamble, owners have not done enough projects to have learned the lesson. When they have recent memories there are always enough special circumstances that they consider it a "one-off". The record suggests otherwise. Hard data is difficult to come by but one private study of 75 major projects worldwide gave the following results for the time taken to reach 100 per cent of design.

Projects	Best Case	Worst Case	Average
Mines	10 months	90% at 4 years	18 months
Mills	10 months	80% at 3 years	2 years
Smelters	19 months	50% at 4 years	4 years

The reasons for these figures are very varied but some of the commonest would be:

- poor sample of the ore-body for metallurgical testing
- unsuspected mineralogical difficulties
- poor process choice
- inadequate training of operators
- economies during construction phase that eliminated essential equipment.

At the root of most of the above problems, one usually finds a flawed project management structure. Every project built is a compromise between operators who want the perfect plant, and the construction engineers who are trying to complete it on time to a budget and make a profit at the same time. It is the owners who have to choose where that compromise is drawn through the project manager. If the balance of personalities and experience is wrong, the line will be drawn in the wrong place, with lender and borrower paying the price.

There is another compromise that is perhaps easier for lenders to control, that occurs even earlier. This is the level of knowledge acquired before the project is financed. There is a simple balance between the level of design before project commitment, and the accuracy of the final cost estimate. If your plant designs are conceptual only you are going to need a lot more contingency.

Capital cost

This is greatly feared but much more rarely found. The average overrun on most projects is around the 10 per cent level. Most such overruns are due to the owner changing her or his scope rather than poor estimates.

Title and legal

The issue that is exhaustively explored and dissected, usually in the shape of the infamous (at least to the borrower) conditions precedent to first drawdown, are the legal ownership and title situation. Projects virtually never fail because of these risks but they are much more tangible to the lender. Their experience and philosophy is clearly coloured by their property lending experience. If the dollars spent on these issues are compared to the market aspects, the reasons for failure are more understandable.

Environmental

This risk is clearly moving up in the table of priorities, not because it will stop the project, but more because it will increase the capital and operating cost. At the financing stage, the broad conditions of the environmental licence will be known. Translating those release conditions into specific plant can cause considerable scope changes in the capital cost. In the Minproc Tiwest project we adopted long-term solutions that added some \$20-30 million to the capital cost.

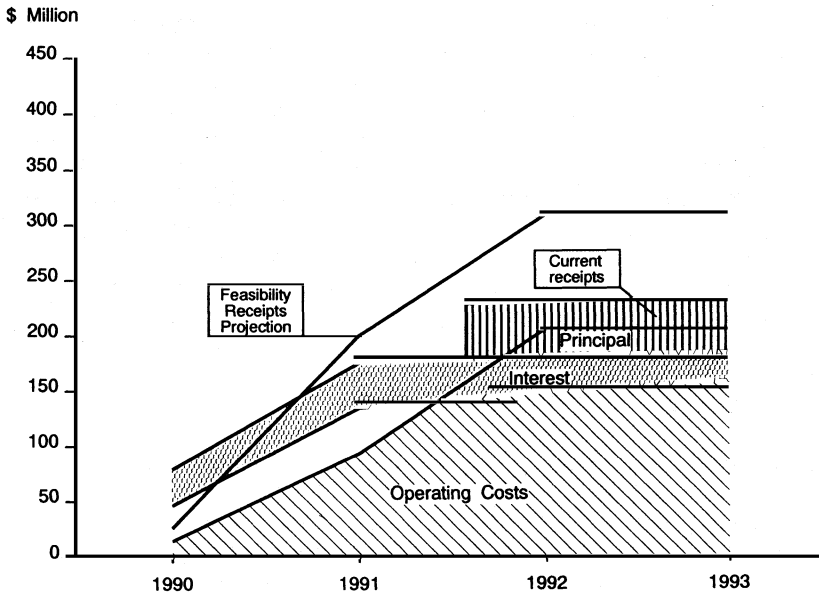
IMPACT OF RISKS ON PROJECTS

The risks of the project manifest themselves in one final equation—“What is the income level during the early years of the project when it is vulnerable, compared to operating and financial costs?” In the

standard feasibility study the borrower estimates the capital cost, makes an allowance for working capital, adds in some contingency and hopes for the best. The banks ask the borrower to put up her or his 30 or 40 per cent first and then (conditions precedent permitting) allows the borrower to draw the other 60 per cent. Very few financial models go on to analyse the scenarios that would result from a very slow start-up combined with a trough in commodity prices. The Minproc experience with Tiwest is a good example.

The following graph has been prepared without the capital cost included. This was essentially as per budget and obscures the real issue.

Tiwest Joint Venture: Current Revenue/Feasibility Study Costs



Our experience was compounded because we were building three separate plants coming on-stream at six-monthly intervals, but each contributing cashflow to the remainder of the project from sales. The net effect of a 40 per cent drop in sales price with slow commissioning increased working capital on the project by over \$100 million. Neither banks nor borrowers foresaw this and the models used tended to take a static approach, that is: fix the start-up date and measure sensitivities one by one. This will not calculate the maximum funding that may be required. We now model as a matter of course on any evaluations, varying start-up scenarios with low selling prices. This, at least, calculates the amount of funding that might be necessary.

DOCUMENTARY PROBLEMS

The impact of the extra funding needed on the facility in both of our projects highlighted weakness in the documents and syndicate structure

that could and should be avoided. In many cases, it is in the interests of the lender just as much as the borrower that, when the documents are written, they can handle all eventualities without reverting to the credit committees on every minor point. Some of the points discussed below are probably unobtainable in the present climate, but lawyers acting for banks are not winning points for their clients if they succeed in negotiating them out. They are creating problems.

Start of debt repayment

Banks don't like long repayment periods; they need a good reason to look beyond five years. They should however be prepared to allow a longer period for the start of repayments if the cashflows are not adequate. To have the first repayment period triggered by events other than plant performance and receipts is self-defeating. If the ultimate borrower is not a major company, demands for principal before the project generates it is almost certainly going to lead to a series of waivers and deferments. Granted that the lender wants the right to call the loan if he or she wants to, the document should provide for deferments of the first repayment period if the cashflows are not yet up to the required level. Two years from the date the plant is available until the first repayment is by no means unreasonable. This repayment should be tied in to the performance tests.

Level of repayment

Documents inevitably lay down the higher of x per cent of the loan or y per cent of the available cashflow, depending on frequency and duration of payments. As with the start of repayments, flexibility should be built into these clauses. Again calling on the parent is fine if it is a BHP but if it is unlikely to have the funds this guarantees an increase in the workload of the banks. The project cashflows should determine the level of repayment and it would not be difficult to define a formula that will increase as the economics improve. This would take all cash available over interest, operating and capital as the amount of principal repayment until it reached the desired level.

Voting rights

In an 11-member syndicate, to make voting on virtually all issues unanimous is an invitation to disaster. If we take the experience of joint ventures as relevant (and a bank syndicate is precisely a joint venture to lend to a single borrower), you can accept the following rules as being almost universal.

- relatively minor decisions by simple majority;
- major decisions by majority of some 75-85 per cent depending on the participants' equity;

- unanimous decisions confined to issues such as changing the object of the joint venture, commercial development, etc. Where one party dissents from these major decisions there is usually some method of “sole risking”.

Clearly there are differences in banking in that the crucial decisions are usually ones taken under duress of some kind but to give a minority partner the right to say no to the will of the majority is giving that partner a loaded gun. Experience in some of the recent entrepreneurial meltdowns suggests that such minority partners will threaten to pull the trigger. Again, lawyers acting for the banks should contemplate where their clients’ best interests lie before winning another Pyrrhic victory.

Bank syndicates are certainly like joint ventures in that they work best when all have the same objectives and philosophies. None, however, work without a degree of give and take.

Meetings

Any decent joint venture document incorporates some serious provisions for running meetings. The minimum would include the following:

- procedure for calling meetings
- agenda-setting mechanism
- minimum quorum
- chairperson
- consequences of non-attendance on voting
- proxies
- minutes.

I have, so far, failed to find a single reference to meetings in finance documents but I have attended many, many meetings. All these clauses are doing is putting a discipline into the syndicate so that it can carry out its business. If a bank has \$20 million invested in a project but cannot justify enough staff to supervise it, they should either reconsider the size and number of its loans or its staffing budget.

It would make good practical sense to tie the voting procedures to the meetings. This would provide, say, three weeks’ notice for calling for a meeting with the necessary submission, by either borrower or individual lenders, with voting compulsory at the meeting.

I am told that bank syndicates don’t put these provisions in the documents because they expect that it will be paid down without problems and meetings are unnecessary. This is difficult to reconcile with the volume of pages on defaulting, representations and warranties, undertakings, etc.

Role of agent

It is perhaps unnecessary, or even tactless, to remind AMPLA that we live in a litigious age. Within a bank syndicate this is having a less-than-welcome effect. The usual bank document contains so many limitations

and disclaimers of responsibility for the agent that he or she is reduced to the role of an unpaid letterbox. The agent fees are derisory and tend to cover the operational side only. When problems arise the agent is obliged to handle them but feels almost as much a victim as the borrower. The writer believes very strongly that the role should be that of lead bank with reimbursement related somehow to the workload and with the ability to effectively manage the syndicate without looking over her or his shoulder for a lawsuit. Again transferring the experience of resource joint ventures, can you seriously imagine Santos, for example, trying to run the Cooper Basin Joint Venture without the right to call a meeting, a vote, or making a recommendation, all for \$50,000 per year.

The formula to adopt in the documents is preferably that discretion is provided to the agent, not "as advised by the majority participants". A good agent does not need a dozen other banks looking over her or his shoulder on routine matters.

Role of banks' lawyers

Although this is a sensitive subject within a forum like AMPLA, the role of banks' lawyers needs to be debated with some vigour. The usual client-lawyer relationship does not operate within syndicate lending. The agent is not a client in the normal sense; the limitations of the role mean that the agent cannot take short cuts or give strong direction. He or she can only pass the legal comments on to the syndicate. Even more to the point, the fees are passed on to the borrower, leaving the law firm without its normal balancing forces.

This means that the policy becomes that of the lowest common denominator in the syndicate. If the lawyer diagnoses any weakness in the bank's position he or she can expect one participant at least to insist on plugging the gap no matter how unrealistic the circumstances. The solution, in the absence of a stronger agent's role, is that firms working for banks should give a better sense of perspective and more commercial realism in their advice. If you offer a smorgasbord of legal possibilities to a syndicate you can expect at least some of them to make pigs of themselves at the borrower's expense.

Representations and undertakings

The average project finance document seems to have taken an extreme position in the black letter versus fuzzy law debate. If we take the Tiwest example we have the following:

Representations and warranties	7 pages
Undertakings and covenants	17 pages
Events of default	6 pages

These 30 pages of closely packed "thou shalt nots" could probably be defined in a couple of pages of fuzzy principles tied to "material adverse effect" which all borrowers bar the professionally dishonest respect

anyway. The drawback to the 30 pages is that they are so precise and detailed that they are almost continuously causing waivers, deferrals and changes. They all seem to be predicated on the borrower being completely crooked, devious, and with no thought in her or his mind except cheating the banks out of their money. In a changing economic scene they become a potential source of irritation to the banks and borrowers, not to mention the amount of legal work they generate. My preferred fuzzy solution, working with the strengthened role of the agent discussed above, would make it easier for all to manage without weakening the banks' position. It is idle speculation whether the lawyers who are currently protesting about the proposed additions to the Companies Law as being too detailed are guilty of constructing these legal jungles for their own clients.

Default

The default mechanism itself would also seem to require revision. As normally written, if the borrower should break any one of the 450-odd commandments, he or she is automatically in default. The fact that this breach may be by events entirely outside of her or his control is not relevant; the borrower is guilty as charged. If business is to continue the banks are obliged to address it as a matter of urgency to give a waiver. A much more sensible approach that would lessen the workload of all concerned is if the declaration of a default requires a positive vote. The actions open to the lender would then include giving a waiver, more time for a cure, or the ultimate sanction of calling the loan. This would allow the borrower to continue trading without cross-defaults anywhere else while the credit committees around the world worked out where their best interests lay. This would not weaken the banks' position but would certainly avoid some desperate situations.

COMPLETION TESTS

In many respects, completion tests should be one of the main clauses in the finance document, at least if we assume that the parent guarantee is worth something in the first place. This is one of my starting points—if the parent has nothing to give you the completion tests are meaningless. If the parent is BHP/MIM is the company going to financially disown the project because it has jumped a particular technical hurdle and subsequently runs into economic difficulties?

For the purpose of the following I ignore the subject of value of the parent guarantee but discuss the completion tests only in how they relate to the project and the loan facility. It is perhaps relevant to first define the various significant events that take place at the start of a project.

- **Mechanical completion (sometimes practical completion):** This is when the contractor hands over the plant to the operator. At this point only 85-90 per cent of the cost has been paid. This is a very precise date because a certificate is issued.

- **Start-up:** Usually some 1-2 months after mechanical completion.
- **Practical completion:** In a lump sum contract this is where the plant is handed over to the operator after passing its performance tests.
- **Costs paid:** The date when all the costs of construction are paid in full, other than genuine disputes. This is usually nine months after mechanical completion but is a rather nebulous date for any certification—some minor contractual matters can take over a year to settle.
- **Achievement of design output:** Referring back to the study quoted this can be anything up to four years. The average would be 1-2 years from start-up for large plants.
- **Cash break-even:** The point where the sales equals the operating costs plus the inevitable capital fix-up spending during commissioning. It also has to cover interest and principal. This is unlikely much before two years from mechanical completion.

If the completion tests were logical they would be simply the point at which this last milestone is achieved. It could be the result of very high prices but a lousy plant. Equally, it could be achieved by a brilliant plant with very average prices. The banks should not care as they have support from the guarantor until it is achieved.

In practice this is not what is written. Performance tests for completion tend to be a purely physical plant test to be run at any time. If they have any economic test in conjunction, it is likely to be one of debt coverage ratio for the life of the loan. In the experience of the two major projects that we have completed these kinds of tests are a complete waste of time. They do not protect the banks, neither are they related to the project cashflows and hence help the borrower trigger repayments. The results are quoted below:

Values of Product

Plant	Design t/d	Test t/d	Value \$/t F. Study	Value \$/t Test Date	Value \$/day F. Study	Value \$/day Today Test	Variance %
Tiwest							
Dry	583	525	202	126	117,766	66,150	40.0
Synthetic							
Rutile	356	320	619	450	220,364	144,000	34.7
Pigment	150	134	3,117	2,078	467,550	278,452	40.5
Total	—	—	—	—	805,680	488,602	39.4
Cyanide	54.8	49.3	2,500	1,600	137,000	78,880	42.5

This shows that each project could have passed its test with flying colours but still be well below paying interest let alone principal. Cash

receipts are 40 per cent below prediction but the project can go non-recourse. I would suggest that these tests are unrelated to the project events as defined above.

It is clear that a 90 per cent of design test is a rather low hurdle. Given the conservatism of design engineers and their tendency, when in doubt, to add a bit more for safety, most designs finish up around the 110-120 per cent mark once the owners have learnt how to make it work. As a borrower, I would always be happy to accept 90 per cent, but if the tests don't correspond to some economic reality it will just create more work for all concerned.

The question of grade of ore in a completion test is quite complex. I would not be prepared, in most ore-bodies, to tie completion to 100 per cent of grade. Ninety per cent is a difficult hurdle in most cases. If it is a gold mine, recovered ounces of gold is the only acceptable criteria for a borrower.

In one of our projects the completion test involved an economic test. This was the achievement of a minimum gearing ratio over the life of the loan. This is fair enough from the banks' point of view because it virtually guarantees that the loan will never go non-resource. Because of the timing of financings referred to in the preamble to this paper, this test will be applied when the markets hit bottom and using the figures of the day it will be lucky to meet the magic threshold of 1.6. The weakness in this whole type of test is that you are going to have a forecast for the future of a whole range of things; inflation, prices, exchange rates, etc. No self-respecting bank will ever allow its borrowers to think that they can count on things improving in the future.

I would suggest that the whole question of non-recourse and performance tests should be settled more along the following lines:

- physical performance should be 100 per cent of design not 90 per cent
- the economic test is achieving debt coverage for two successive quarters
- the repayment schedule is triggered by achieving a surplus above costs and interest but the parent guarantee to top up only comes in after two years
- the amount of principal is calculated by cash surplus but with catch-up provisions if it takes more than two years to start any repayments
- the loan remains subject to parent guarantee until debt coverage is achieved but it should require a positive vote to require top-up not just an automatic obligation of the parent.

With this kind of flexibility it should be possible to handle all but the most disastrous scenarios within the terms of the document.

WORKING CAPITAL

The cash required during the late construction and commissioning period is working capital in its nature of expenditure but is really part of

the cost of building the plant, that is, capital. There is, however, a need in project finance to somehow build in a true working capital facility for the ongoing operations. If you analyse the cash receipts of a project like Tiwest they can come in very irregular amounts. Mineral shipments can be bunched within a few months, leaving several months without receipts.

The operating costs are very regular, and so are principal and interest payments. This is recognised by the requirement to collect two quarters' interest and principal in the proceeds account controlled by the banks, but it does not recognise that working capital can be at least one month's operating cost, if not more.

Once the project facility is in place with its charges, it is difficult to negotiate any security to back up a working capital facility. It is usually made more complex by the operation of the joint venture cross-charges. Main bank documents should provide for this even if it is not made available as part of the loan itself.

CROSS-CHARGES

Few, if any, joint ventures are written today without cross-charges being fundamental to the documentation. If they are not in place when the finance documents are first drafted it is a certainty that the banks' lawyers will attempt to obtain parity with them at least. If their true security lies only in the project and not in the parent guarantee, this, once again, is not in their best interests. It will create more work, more friction with the borrower and, if there are any unreasonable syndicate members, a true risk to the value of the asset.

Most joint ventures are between unequal partners. Assume that one is a basket case and the other is a BHP. If the weak partner defaults on its operating payments the usual mechanism is that the BHP equivalent will put in the cash, collect all future sales receipts, charge interest and, if the banks decide to put the defaulter out of its misery, eventually co-operate in a rational sale procedure. Meanwhile, the project operator pays its bills on time, the project runs properly and value is maintained. If a bank syndicate is in equal ranking it raises a whole string of issues that will usually be resolved by waivers, etc. to give the same result as the above scenario. Banks would find it difficult, for credit reasons, to put in the cash so why take a position that might discourage the non-defaulting venturers from putting it in.

BANKING RELATIONSHIPS

The change in the world economic scene has had almost as dramatic an effect on the attitudes and management of the banks as it has had on the cashflows of the borrowers. While it would be unfair to say that we, the

remaining borrowers, are paying for the sins of the departed entrepreneurs, the banks are certainly installing more rigid procedures into their credit management. The levels of decision making on credit issues appear to have moved further up the banks' hierarchies and closer to head office.

This effect is compounded in resource project finance where the bulk of lenders are foreign banks. If they gained market share in the late 1980s by aggressive lending, their head offices are now more concerned with reducing their book rather than making concessions. The pricing of the loans in that period now looks over-generous to the borrower, but the workload is increasing, leaving banks complaining that they are losing money on the loan.

A simple calculation shows that this is not far from the truth for a bank with a small participation in a large and complex loan. (If total fees and margins on a \$10 million participation add up to 0.8 per cent this does not pay for one full-time manager.) Far be it for a borrower to shed tears for the banks' margins, particularly in view of their habit of increasing them every time a concession is requested, but it strongly suggests that too many small participants in a loan will increase the aggravation in times of hardship. Unless their participation is large enough they will not have enough profit to pay for the required supervision.

What would clearly seem logical in lending to large projects is that the facility is layered. The smaller participants would take their equity from the larger underwriter or lead banks without having direct involvement with the borrower. It should be possible to draft the documents and securities so that their positions are not diminished in a liquidation. This already happens in effect with committees. These have been used on the major reconstructions and liquidations to limit the number of banks around the table. Why not incorporate this into the documentation from the start?

CONCLUSIONS

If it was possible to write an ideal project financing in some far-off, perfect banking world, it would have the following characteristics:

- An arranger and agent who had many years of project financing behind it in the commodities of the project. It would have professional project managers within the bank structure to call on for advice and a list of well tried technical consultants for specialist roles.
- An upper tier of senior banks who would also be experienced project financiers. They would underwrite the facility completely with the arranger.
- A second tier of participating banks who never see or deal with the borrower and who derive their rights entirely from the underwriters.
- A principal repayment schedule that was triggered in both time and amount by cashflows from the project.

- Performance tests that were based on plant performance and cashflows, not life of loan debt coverage ratios.
- Would include a working capital facility that would stay with the project beyond the life of the project loan.
- An agent armed with extensive powers that allowed him to manage the loan and the borrower's behaviour within broadly defined principles.
- Voting on facility issues taking place at duly convened meetings within clearly defined voting rules. Underwriting first tier banks only participating in meetings.

I would suggest that such a facility would be less likely to fall into default, would involve much less unnecessary work and repay the lenders as fast as the project would allow. Bearing in mind the commodity cycle the banks should be in the right frame of mind for this by 1995, aiming at production starting up in the next trough.