RISKS ANALYSES OF THE PROPOSED SECURITISATION OF THE PHILIPPINE GOVERNMENT'S PRODUCTION SHARE IN MALAMPAYA[1]

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I INTRODUCTION

Hailed as 'one of the most important financing vehicles in the United States,'[2] 'a technology that is fundamentally altering traditional forms of fund-raising,'[3] and a 'boon to every participant in the capital markets,'[4] asset securitisation has swept both public and private sectors in search of cheap project financing. The Philippine government was no exception as it has made it intentions clear that it will leave no stones unturned in its effort to privatise its share from the proceeds of the Malampaya natural gas production, easily the biggest infrastructure project ever undertaken in the country.[5] Finance and energy officials see securitisation as a replacement for traditional lending, which will reduce the cost of capital for the country through direct access to the financial markets.[6] Furthermore, demand for securitisation securities by institutional investors has increased greatly as they tend to be attracted to the high credit quality and rating, high yield, and relatively short maturity of these securities. Already, legal and financial commentators have closely examined the device to either dissect its attractiveness or debunk the myth surrounding its popularity as a scheme to reallocate the risk of a business enterprise.[7] Some authors have even described it as 'alchemy'[8] where securitisation creates value where non existed before.

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[1] Project Finance Research Paper for University of Melbourne LLM 18 February 2002
[2] Steven L. Schwarcz, 'The Alchemy of Asset Securitisation' (1995) 1 *Stan. J. L. Bus. & Fin.* 133, 133.
[3] James A. Rosenthal & Juan M. Ocampo, 'Securitisation of Credit: Inside the New Technology of Finance' (1988) 3.
[4] Joseph C. Shenker and Anthony J. Colletta, 'Asset Securitisation: Evolution, Current Issues and New Frontiers' (1991) 69 *Tex. L. Rev.* 1369, 1371.
[5] 'Malampaya to Raise $500M for Government', *BusinessWorld (Philippines)* (Manila, Philippines), 21 January 2002. According to the report, the Philippine Secretary for Finance has received proposals from investment bankers ING Barings, Lehman Brothers, Credit Lyonnaise and Morgan Stanley to underwrite the securitisation.
[6] In Standard & Poor's Sovereign Ratings List as of 25 January 2002, the Philippines rated BBB+ for long-term rating, negative outlook and A-2 for short-term rating of local currency. For foreign currency, the long-term rating was BB+, negative outlook and the short-term rating was B. This explains the high cost of capital for the country. The rating was last accessed through S&P's web site at http://www.standardandpoors.com on 31 January 2002.
[7] Christopher W. Frost, 'Asset Securitisation and Corporate Risk Allocation' (1997) 72 *Tul. L. Rev. 101*, 106. The question advanced by Frost is whether the value that the firms seeking to privatise is due to some real advantage to a particular risk allocation or to the exploitation of an opportunity to foist

Two intractable realities explain the demand for alternative project finance transactions: the enormous amount of money required for infrastructure projects, and the difficulty that developing economies face in mustering that money via general public revenues. While securitisation is a mainstay in 'project-financing' transactions to help meet the current demand for infrastructure development and improvement, it has also been argued that it can be applied as well in the refinancing of previously constructed and operational infrastructure projects. The question that comes to our mind then is should the Philippine government embrace this structured finance scheme with breathless euphoria. Given the potential size and scope of this non-traditional and relatively undeveloped source of financing for the country, the rewards for pursuing cross-border securitisation must of course be weighed against perennial political risks which include country and sovereign risks,[9] risks inherent in oil and gas financing,[10] as well as problems related to dealing with a legal system that may be relatively unsophisticated in asset based finance. A critical examination of the reasons why the government should embark on asset securitisation instead of the more traditional methods of raising capital[11] must be undertaken thoroughly.

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uncompensated risk unto other creditors. He used the Modigliani and Miller argument that under an assumption of perfect markets, the capital structure of a firm (particularly the mix of debt and equity) does not affect the firm's overall value, and therefore should not change its investment decisions. In essence, their 'irrelevance hypothesis' recognises the common-sense idea that the size of a pie is the same regardless of the way in which it is sliced. Thus, while asset securitisation should result in a reduced interest rate on loans to the special purpose entity itself, it is not obvious why the device should lower that firm's overall cost of capital. The reduction in risk faced by the asset securitisation investors might be offset by a corresponding increase in the risk facing the firm's general creditors. If the inherent risk of the company (as measured by its variability of returns) remains unchanged, these transactions might simply reallocate risk, rather than eliminate it.

[8] Scwarz, above n 1, 154. ('Securitisation, in short, brings to financial technology what the sought-after philosopher's stone promised to bring to base metals -- the ability to turn them into gold!')

[9] Country risk primarily concerns situations in which the host country is not economically positioned to permit transfers of its currency for payments of interest and principal on foreign debt to lenders, or returns on equity to foreign investors. On the other hand sovereign risk refers to the risk of a lender or investor extending credit to a foreign sovereign nation and is particularly important if some portion of credit enhancement is to be provided by the sovereign nation.

[10] These are: production/reserve risk, price risk, operator/management risk, and currency and foreign exchange risk.

[11] Oil and gas financings have been implemented using one of three structures or a combination thereof: reserve-based financings, project financings and direct equity investments. Financing of reserves is based on the collateral value of the underlying oil and gas reserves and has generally been accomplished through production term loans or revolving borrowing base loans. Project financing is non-recourse financing that is not entirely dependent on the creditworthiness of the sponsor of the project or the particular borrower, or the sponsor's physical assets, but depends on the expected performance of the project itself. In direct equity investments, the vehicle typically employed by an operating company seeking investor equity capital to explore for, or acquire and develop, an oil and gas reserve is a resources joint venture.

This paper is structured as follows: Part II focuses on the use of asset securitisation for the generation of funds. It begins with a definition of the term, the enumeration of the parties involved, and an outline of the basic model of a securitised transaction. This part not only seeks to cite the advantages but also explains the criticisms as well. Part III is directed toward a discussion of the securitisation of future receivables commonly transacted in economies dependent on the export of commodities. This discussion is set against the background of the specific experience of the petroleum industry and cites as an example the securitisation transacted by Mexico's state oil company. Part IV surveys the distinction between civil and common law systems in the context of securitisation and explains the relative difficulty of civil law countries in undertaking structured finance. Part V then examines in more detail the preliminary legal impediments to the proposed securitisation of the Philippines' production share in the newly commissioned natural gas project by initially looking at the general framework of the petroleum upstream industry. It continues with a brief description of the Malampaya project including a discussion of the sovereign guarantees undertaken by the Philippine government. This part discusses the various risks identified by the author, which include quasi-commercial risks of the government-created special purpose entity which will own and service the securitised assets. The author then concludes that the proponents first analyse the risks arising from the legal implications of the transaction before they rush headfirst into what may be a normative and doctrinal quagmire.

II ASSET SECURITISATION – THE NEW KID IN THE BLOCK

Various legal and economic stimuli, including legal and regulatory rules, taxes, technological improvements, increased efficiencies in collecting and processing information, and increased interest rate volatility attributed to the surge in financial innovation.[12] Modern technology has propelled information as the key to creating wealth and has encouraged the invention of computing power, allowing for the manipulation of massive amounts of information. Financiers may now very accurately predict the behaviour of pools of assets because computers enable

[12] Shenker and Colletta, above n 3, 1370

researchers to store and retrieve extensive data about the historical performance of such assets.

The case usually is that when a corporation needs funds for working capital, inventory, or general operations, it resorts to either one of two financing approaches: right hand side (RHS) balance sheet funding or left hand side (LHS) balance sheet funding.[13] RHS funding methods include a firm's issuance of traditional debt (secured and unsecured) and equity obligations, which are backed by the general credit of the issuer. In contrast, when a firm uses an LHS funding approach, it raises capital based upon a specific asset pool's cash flow and value examples of which include asset leasing,[14] project finance,[15] factoring,[16] and the most recent financial innovation, the securitisation of financial assets.[17]

The use of asset securitisation was formerly the domain of large, stable companies and banks, which were governed by a regulatory structure. While, doctrinal analysis of asset securitisation is limited by the fact that courts have yet to consider the device, asset securitisation covers a gamut of legal issues pertaining to securities, bankruptcy, tax, banking and in cross-border transactions, international law. Furthermore, the legal and regulatory issues that arise will depend upon a variety of factors, including (1) the type of asset being securitised, (2) the type of credit enhancement provided, (3) the nature of the issuer, (4) the type, place and manner of the securities offering, and (5) the type of accounting and tax treatment that is

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[13] Lois R. Lupica, 'Asset Securitisation: The Unsecured Creditor's Perspective' (1998) 76 *Tex. L. Rev.* 595, 596.

[14] Asset leasing involves the 'transfer of the right to possession and use of goods for a term in return for consideration.' *Uniform Code of Commerce* (UCC) § 2A-103(1)(j)(1994).

[15] Project finance refers to a method of raising funds that relies on the value of the project being financed and the revenues generated. Typically, the project developer or borrower is a 'single purpose entity whose only asset is the project being financed.' Jonathan Birenbaum, 'Credit and Related Documentation for Project Finance Transactions' (1993) *PLI Commercial Law & Practice Course Handbook Series No. 672* at 269, 271.

[16] Factoring originated in England in the fourteenth century as a way for textile manufacturers to liquidate their accounts receivable. Holders of accounts receivable sold them at a discount and without recourse to a 'factor.' In most cases, the factor accepted the account receivable's credit risk and took control of the accounts' collection. This benefited the manufacturer in two ways: (1) the manufacturer did not have to review the credit of its customers, and (2) it enabled the manufacturer to liquidate assets quickly so that it was able to purchase more raw materials. Peter H. Weil, 'Factoring' (1988) *PLI Commercial Law & Practice Course Handbook Series No. 443* at 41.

[17] The term 'asset securitisation' is used interchangeably with the terms 'structured finance transactions,' 'asset-backed arrangements,' 'asset-backed financing,' 'asset securitisation,' and structured securitised credit.'

sought.[18] Doctrinal analysis of asset securitisation is also made complicated by the fact that it combines elements of sales, secured financing transactions, and intercorporate/intra-enterprise transactions between members of a commonly controlled corporate group.[19]

A *Definition*

Although securitisation is widely discussed in legal and financial literature, no uniform definition has emerged that satisfactorily describes it.[20] The U.S. Securities and Exchange Commission defines asset-backed securities as: '…securities that are primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders.'[21] Asset-backed securitisation is defined as the 'sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structure to reduce or reallocate certain risks inherent in owning or lending against the underlying assets.'[22] The definition of an executory future flow securitisation may be extrapolated from this definition by replacing all references to 'asset' with 'executory future flow.'[23]

Securitisation transactions normally involve the following parties: (1) the initial owner of the asset (the 'sponsor');[24] (2) the issuer of the debt or equity instruments; (3) the investment bankers who assist in structuring the transaction and who underwrite or place the securities; (4) the rating agencies, who assess the credit quality of certain types of instruments and assign a credit rating; (5) a credit enhancer, possibly a bank, surety company, or insurer, who provides credit support through a

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[18] Shenker and Colletta, above n 3, 1406-1407.
[19] Frost, above n 6, 108.
[20] Shenker and Colletta, above n 3, 1373.
[21] General Instruction I(b)(5), Form 33, *Securitisation Act 1937.*
[22] Ibid 1374.
[23] Thomas J. Gordon, 'Securitisation of Executory Future Flows as Bankruptcy-Remote True Sales' (2000) 67 *U. Chi. L. Rev.* 1317, 1320.
[24] The term 'sponsor' is usually used to refer to the economic owner of the asset who desires to securities it; the entity that created the asset, the 'originator,' may be a distinct entity. For example, in some arbitrage collateralised mortgage obligation issuances, or UK 'repackaging,' the sponsor may be an investment bank that buys the assets (e.g., mortgage loans) from their originator (e.g., a thrift).

letter of credit, guarantee, or other assurance that there will be a source of funds available for payments as they become due on the securities; (6) a servicer, usually the sponsor or affiliate, who collects payments due on the underlying assets and, after retaining a servicing fee, pays them over to the security holders; and (8) legal counsel, who participate in the structuring of the transaction and who may provide advice to the rating agencies or other parties in the form of legal opinions.[25]

The basic model of a securitised transaction using the parties numerated above can be outlined as follows: First, the asset to be securitised is an income-producing asset, and the cash flow produced by the asset is used as the source of funds for the payments to be made to the purchasers of the debt or equity instruments. Most transactions involve large numbers of homogenous assets pooled together.[26] Assets most suitable for securitisation are those with standardised terms, delinquency and loss experience that can support an actuarial analysis of expected losses, and uniform underwriting standards and servicing procedures satisfactory to rating agencies and investors.

Second, the asset being securitised generally must be segregated from the sponsor's other assets in order to insulate the securitised asset from certain risks associated with the sponsor – principally, the risk that their owner or an affiliate may become subject to a bankruptcy proceeding[27] – and to help ensure that the transaction is treated as a sale for tax or accounting purposes or both, if such treatment is desired.[28] Segregation is usually accomplished by transferring the assets to a distinct entity, frequently referred to as a 'special purpose entity,' (SPE) that is restricted from engaging in any activity other than owning, and perhaps servicing, the securitised assets.[29] In addition, various steps must be taken to ensure that the transfer will be

[25] Shenker and Colletta, above n 3, 1376.
[26] Assets are typically pooled for three reasons: (1) to achieve a sufficiently large asset value to make securitisation economically feasible from a transaction cost viewpoint, (2) to reduce certain risks inherent in the assets through diversification, and (3) to create a large enough dollar volume to make a secondary market in the asset-backed securities feasible.
[27] Creditors of an entity that becomes subject to a proceeding under the *Bankruptcy Reform Act of 1978,* 11 U.S.C.A. § § 101-1330 (1979 & Supp. 1990) [hereinafter Bankruptcy Code], are unlikely to receive full and timely payment of their claims due to various provisions in the Bankruptcy Code.
[28] For various economic, legal, and regulatory reasons, many securitised transactions are structured so that the asset is treated as being sold by the sponsor for accounting purposes.
[29] Although the special purpose entity is the most common means, other methods of segregating the securitised asset may be possible e.g. placing the asset in an insurance company separate account.

effective as against third parties, including creditors of the sponsor or its affiliates.[30] The special purpose entity is the actual issuer of the instruments, most often, a trust or a corporation, meaning that either trust interests or typical corporate securities are issued by the entity. Under current *Statement of Financial Accounting Standard 125 ('FAS 125')*,[31] to be a qualifying SPE, it must be a trust, corporation, or other legal vehicle whose activities are permanently limited to: (1) holding title to transferred assets; (2) issuing beneficial interests; (3) collecting and reinvesting cash proceeds from assets and servicing assets; and (4) distributing cash proceeds. The SPE must also have a standing at law distinct from the transferor.[32] These requirements have been substantially amended, however, by the *amended FAS 125*, issued during the fourth quarter of 2000, which states that the qualifying SPE must be a trust or other legal vehicle that has (1) standing at law distinct from the transferor; (2) significant limits placed on its activities and its permitted activities specified in its formative documents; (3) holdings that are restricted to financial assets transferred to it and other assorted types of assets; and (4) restrictions on when it can distribute or sell transferred assets to parties other than the transferor or its affiliates.[33]

Third, the instruments sold in a securitised transaction may be either debt or equity[34] and will usually, though not necessarily, constitute 'securities.'

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[30] Although the special purpose vehicle is structured so that it is not likely to become subject to a proceeding under the *Bankruptcy Code* (i.e. it is 'bankruptcy remote'), there are several ways in which the asset may nevertheless be exposed to bankruptcy risk: (1) the assets of the special purpose vehicle are 'substantially consolidated' with those of its parent or another entity in a bankruptcy proceeding involving the parent or other entity, (2) the transfer from the sponsor is not treated as a 'true sale,' but rather is treated as a pledge of collateral so that the asset becomes part of the sponsor's bankrupt estate in the event the sponsor becomes subject to a bankruptcy proceeding, or (3) the transfer from the sponsor is treated as fraudulent or preferential transfer subject to avoidance.

[31] See *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Statement of Financial Accounting Standards No. 125 P 1* (Financial Accounting Standards Board. 1996) [hereinafter *FAS 125*]. Financial Accounting Standards are published by the Financial Accounting Standards Board (FASB) and for the most part constitute generally accepted accounting principles (GAAP). The GAAP outlines the conventions, rules, and procedures used in accounting practice. The FASB is a standards institute recognised by the U.S. SEC and the American Institute of Certified Public Accountants; it also works closely with the Federal Reserve Board. Its mission is to develop accounting standards for business, industry, and finance.

[32] *FAS 125 P 26.*

[33] *FAS 125 P 5.*

[34] In the case of mortgaged-backed securities, 'pass-throughs' – where the security holders receive undivided interests in the securitised asset and the cash flow generated by the assets is 'passed-through' to the security holders – are examples of equity securities. 'Mortgaged-backed bonds' and 'pay-through' securities, on the other hand, are examples of debt obligations of the issuer secured by the securitised asset or pool of assets.

Fourth, in addition to the steps taken to minimise risks associated with a bankruptcy proceeding, a securitised transaction is structured either to reduce or reallocate certain risks inherent in the underlying assets,[35] such as prepayment risk and concentration risk.[36] With reduced or reallocated risks and greater liquidity, the securities will be more appealing to a wider range of purchasers and, consequently, the yield required to sell them will be lower.

B *Advantages*

Firms securitise their assets for the same reasons firms borrow money: to raise money for either special projects or working capital. Firms choosing to securitise their assets rather than use them as collateral for a secured loan conclude that securitisation's net benefits exceed the benefits of other possible financing alternatives.[37] These benefits include improving liquidity, increasing diversification of funding sources, lowering the effective interest rate, improving risk management, and achieving accounting-related advantages.

The process of securitisation transforms future payments into instant cash, and this transformation allows entities to recognise immediately the value of these assets for a variety of uses, including current business needs. The sale of assets, even at a discount, results in a lump sum cash payment to the originator. Positive consequences of a firm's increase liquidity include the permitting of a more fluid cycling of inventory for originators with trade creditors increasing the firm's chance of paying its suppliers' invoices as they become due. In many cases suppliers of inventory are unsecured trade creditors and the cash infusion improves their chances of repayment. The transformation of a future payment stream into immediate cash also enables the originator to pursue a potentially profitable project or meet its regular obligations, as

[35] Risk reduction and reallocation measures include (1) over collateralisation or other issuer credit support, (2) third-party credit enhancements, such as monoline guarantees, and (3) alteration of the income stream produced by the asset through liquidity facilities, swaps, or risk segmentation devices, such as senior/subordinated and collateralised mortgage obligation structures.

[36] 'Prepayment risk' is the risk that the obligors of the underlying…loans repay their loans [faster] than expected…and therefore reduce the yield on the securities. 'Concentration risk' refers to the degree to which the pool of mortgages or other securitised assets is geographically concentrated.

[37] Meredith S. Jackson, 'Leap of Faith: Asset-Based Lending to Asset-Backed Securitisation – A Case Study (1996) *Stan. J. L. Bus. & Fin.* 193.

cash is needed by businesses to invest in research and development, to pay dividends to shareholders, and to engage in other long-term investments.[38]

Diversification of funding sources may also improve the originator's overall credit rating; a firm with a diversity of funding options generally has somewhat higher credit quality than a firm that solely utilises commercial lending financing sources. Credit ratings reflect the livelihood that investors will be repaid their investments, plus interest, on time and on the terms described in the transaction's offering documents, and provide investors with a means to compare a variety of investment products. The lower a security is rated, the higher risk it is deemed to be and thus the higher return paid. A firm may find it financially prudent to engage in a securitisation in order to improve its credit rating and then to return to the traditional commercial finance market as a better credit risk.[39]

A successful securitisation is dependent upon investors' satisfaction with the quality of the assets backing the securities, not the credit quality of the originator. In a traditional lending arrangement, the same institution originates the loan, structures the terms, bears the credit risk, provides the funds, and services the collection of principal and interest. The lender thus absorbs whatever 'event risks' the borrower offers such as: the possibility that the value of the collateral will decline, the potential for non-payment or late payment of the underlying collateral, the prospect of the borrower becoming subject to unexpected (or expected liability), the uncertainty of interest rate fluctuation, any fallibility associated with the borrower's previous borrowing record, the uncertainty associated with a limited borrowing history, and the potential of borrower's bankruptcy. Asset-backed securities investors, in contrast, do not bear all of the risks associated with the originator and its business and instead rely upon risk-containing measures that are made a part of the transaction. For example, credit enhancement allows the party providing the letter of credit or guaranty to bear a portion of the risk of non-payment or late payment, in exchange for a fee. Also, when an originator securitises its highest quality assets it minimises the investors' risk. Because there are no unknown or uncertain events in the future that could alter the quality of the investors' investment, the investors are not subject to the vagaries of the

[38] Lupica, above n 12, 609-610.
[39] Ibid 611.

originator's business behaviour, and their risk of exposure is limited to the obvious risks associated with the assets in the pool.[40]

Securitisation enables most firms to fund their operations at a lower effective interest rate than through a secured borrowing arrangement because originators can better manage 'event risks.' An originator can obtain this lower effective rate because the capital markets do not consider its creditworthiness in pricing the rate of return for the securitisation of a firm's receivables and it is the quality of the underlying assets, which determines the rate. In cases where the originator's credit rating is deficient, the capital markets, through the rating agencies, may give a higher credit rating to the asset-backed securities issued by the special purpose vehicle than to the securities issued by the originator directly. This translates into a lower effective interest rate. Because the quality of the asset-backed security issued depends upon the quality of the payment stream of the underlying assets, it is the character and quality of the assets that are under the rating agencies' intense scrutiny.[41]

Securitisation further allows a firm to isolate a pool of financial assets and match them with liabilities with similar maturities, tenor and price. If a firm decides to take advantage of this financing option as part of its overall financing strategy, it reduces the necessity to hedge its funding obligations to eliminate a mismatch in asset and liability term and interest rate. This arrangement may prove to be advantageous to customers and other creditors because the credit risk of the securitised asset pool is segregated from the rest of the firm's assets, thus decreasing the risk of interest rate fluctuation and a resulting disruption in the firm's cash flow.[42]

C. *Accounting for Securitisation*

An equally important reason to engage in securitisation transactions is for favourable accounting treatment, known as off-balance-sheet financing. These rules allow the transferor to increase the liquidity of the balance sheet and lower its debt to equity ratio because the transferor immediately recognises income and possibly gains

[40] Ibid 611-612.
[41] Ibid 613-614.
[42] Ibid 614-615.

from the sale of the accounts but recognises no corresponding liability. This advantage, however, is contingent upon the transferor relinquishing control of the assets and the transaction being labelled a 'true sale.'[43]

The proper accounting for a securitisation transaction depends upon whether the transfer from the transferor to the SPE is a 'true sale.'[44] The drafters of *FAS 125* considered making the key determinant of a 'true sale' the transfer of risk of loss. Nonetheless, they chose to focus on control, making it the cornerstone of the new statement.[45]

FAS 125 states that a 'transfer of financial assets in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange.'[46] According to paragraph 9 of *FAS 125*, control has been surrendered only if the following three conditions have been met:

> a. The transferred assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership…
>
> b. Either (1) each transferee obtains the right – free of conditions that constrain it from taking advantage of that right…to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity…and the holders of beneficial interests in that entity have the right – free of conditions that constrain them from taking advantage of that right… to pledge or exchange those interests.
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> c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets that are not readily obtainable…[47]

[43] Jessica L. Debruin, 'Recent Developments in and Legal Implications of Accounting for Securitisations' (1999) 199 *Ann. Surv. Am. L.* 367, 371.
[44] G. Larry Engel & Andrew B. Koslow, 'Securitisation Advice for Asset-Based Lenders' in *Asset Based Financing, Including Securitisation and Acquisition Financing* 473, 479.
[45] James Johnson, 'Accounting Issues' in *Securitisation of Financial Assets,* 19-7.
[46] *FAS 125, P 9.*
[47] Ibid.

Paragraph 9 is thus the key paragraph for all accounting and legal considerations concerning the proper treatment of securitised assets as controlled by the transferor or by the SPE.[48]

If the transfer is considered a sale, then after it has occurred, the transferor may retain certain interests in the transferred assets, including servicing interests, beneficial interests, and retained undivided interests.[49] These retained interests must be carried on the balance sheet and the carried amounts must be allocated between the assets sold and the retained interests based on fair value at the date of transfer.[50] More specifically, when a securitisation is treated as a sale, a snapshot of the balance sheet must be taken before and after the transaction.[51] To begin with, the transferor must identify all financial components arising out of the transaction.[52] Under *FAS 125*, each financial component must be evaluated separately; different accounting treatment may be applied to different components.[53] Cash and any other sale proceeds must then be added to the assets of the seller, and the sold accounts must be removed from the balance sheet.[54] The seller must then recognise a gain or loss if the value of the assets sold differs from the proceeds of the sale.[55]

If the transaction does not meet the requirements of paragraph 9 and is not considered a true sale, it will be considered a secured financing arrangement and the receivables and associated debt will remain on the balance sheet of the transferor. Article 9 of the *Uniform Commercial Code (UCC)* will govern the transaction.[56] There is little case law addressing bankruptcy issues raised by securitisation, which is

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48 Debruin, above n 42, 374.
49 *FASB Statement No. 125, P 10.*
50 Ibid.
51 James Johnson, 'Accounting Issues' in 2 *Securitisation of Financial Assets* 19-1, 19-28.
52 Tommy Moores & Anthony F. Cocco, 'Audit Considerations Under SFAS' (1997) 125 *Ohio CPA J.* 21, 21.
53 Ibid.
54 Johnson, above n 50, 19-5.
55 Ibid.
56 Where a transaction falls within the scope of Article 9, the rights and obligations of the parties upon default are clear and straightforward. If a transferee of assets in an Article 9-governed transaction has complied with Article 9's attachment and perfection rules, the transferee is deemed secured and is therefore entitled to priority over all of the debtor's unsecured creditors, as well as to priority over subsequent judgment creditors, secured parties and lien creditors with competing claims to the assets. Conversely, if a transferee fails to perfect its interests in transferred assets, a subsequent, competing transferee may defeat its interest. Paul M. Shupack, 'Making Revised Article 9 Safe for Securitisations: A Brief History, 73 *Am. Bankr. L.J.* 167.

likely due to the market's relative youth, and there have not been many bankruptcies of securitising originators.[57] What assets are included in a securitising originator's bankruptcy estate is the central concern of parties to securitisation transactions. As a practical matter, if securitised assets are deemed part of the originator's bankruptcy estate, the transferee is a 'party in interest' in the originator's bankruptcy, and as such, the transferee is required to participate in the proceedings. Furthermore, as a party in interest, the transferee is subject to collateral substitution, reduction in priority of payment and other alteration of rights. The assets that the transferee has an interest in are accessible to the debtor-in-possession as cash collateral, with only 'adequate protection' offered the transferee as compensation of the possibility of a depletion of its interest. In contrast, if transferred assets are not deemed included in the debtor's bankruptcy estate, the transferee is not required to participate in its originator's bankruptcy in any way.[58]

An offsetting liability will correspond with the increase in assets from the sale proceeds.[59] It is important that both the transferor and the SPE account for the same transaction using the same principles: true sale or secured financing.[60]

However, the accounting profession and the regulators object to classifying a transaction in which sellers retain credit risk after a sale. For accountants, who are in charge of a true picture of the financial position of issuers, the removal of the loans from the sellers' books is misleading if a significant degree of risk from the loans remains with the sellers. For regulators in charge of safety and soundness of regulated institutions, retention of the risks from assigned loans does not justify reduction of capital requirements or loan loss reserves.

D *'True Sale' as a Legal Issue in Securitisation Transactions*

'Securitisation' covers a wide spectrum of transaction[61] where at one end, there is clearly a release of control and the transaction is accounted as a 'true sale' because

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[57] Lois R. Lupica, 'Revised Article 9, Securitisation Transactions and the Bankruptcy Dynamic' (2001) 9 *Am. Bankr. Inst. L. Rev.* 287, 293.
[58] Lupica, 'Revised Article 9', above n 56, 298-299.
[59] Johnson, above n 50, 19-41.
[60] Michael H. Trager, 'Is Securitisation in Your Future?' (1998) in *The Secured Lender,* 74.

the transferor sell its assets outright, retain no interest or control whatsoever, and sever all ties with the SPE. At the other end is where the transferor creates a secured loan transaction in which the assets will serve as collateral for the loan thus, the transferor retains full control and a 'sale' has not been made. This type of transaction is clearly a loan for the transferor and will be accounted as such. At both extremes, the transactions are simple because their accounting will follow their form.[62]

What complicates the matter is where the transaction is done in the middle of the spectrum where the form is ambiguous because the transferor desires to retain some control over and interest in the SPE. In order to address transactions that fall within this middle range, *Appendix A to FAS 125* requires a careful evaluation of the facts and circumstances of the securitisation transaction.[63] A transferor cannot conclude that financial assets have been sold unless 'the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates…'[64] The pivotal paragraph in *FAS 125* is paragraph 9(a), which states that control of transferred assets has only been surrendered if three conditions have been met, the most important of which is that '[t]he transferred assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership…'[65] There is yet no definitive judicial authority analysing the issue of true sale in relation to securitisation transactions. *Uniform Commercial Code § 9-504 Official Comment 4* leaves the 'determination whether a particular assignment constitutes a sale or a transfer for security' to individual courts.[66]

One problem in examining how the courts have treated securitisation transactions is that no decisions have been issued since the effective date of *FAS 125*. Under *FAS 77*,[67] the grant of sale accounting treatment depended mostly upon a

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[61] Debruin, above n 42, 380.
[62] The Asset securitisation Handbook 30 (Philip L. Zweig ed., 1989), 250-251.
[63] *FAS 125, P 23.*
[64] Ibid.
[65] *FAS 125, P 9(a).*
[66] Ibid.
[67] *FAS 77* governed securitisation transactions throughout the 1980s and early 1990s. Over time, the appropriate rule-making bodies became increasingly concerned that accounting results were the driving force behind securitisation transactions, and that the economic substance of the transactions was only

declaration of the parties to that effect, which meant that courts could look to accounting treatment to determine whether the assets were remote for bankruptcy purposes. If the parties called the transaction a sale, it was a sale; if they called it a loan, it was a secured borrowing. It is unclear whether the courts will change their analysis based on the changes in accounting treatment.[68]

In analysing securitisation transactions, some courts have looked solely to the intention of the parties;[69] this method has advantages but is problematic. The method fits well with *FAS 77* in that both the bankruptcy and the accounting treatment depended upon the parties' intention. The method creates problems of proof, however, and can be easily manipulated by the parties. As such, truly accurate accounting based on the legal ownership of the assets will not be achieved by looking solely to the parties' intent.[70]

Some courts have regarded intent as only one of several factors to be considered in determining whether the securitisation transaction constitutes a true sale or a secured loan.[71] Attributes these courts have analysed include: (1) the existence of recourse for the investors in the SPE; (2) who holds the benefits of ownership; (3) irrevocability; (4) whether there is any commingling of funds; and (5) which party maintains and services the financial assets. Unfortunately, another factor these courts often consider is the accounting treatment of the transaction. Under *FAS 125*, using accounting treatment to determine whether a true sale has occurred would make the rule entirely circular and would provide no guidance to attorneys evaluating whether assets are remote for bankruptcy purposes.[72]

In *Major's Furniture Mart, Inc. v. Castle Credit Corp.*,[73] the court relied on two actions by the transferor: warrants that the sold accounts were legally enforceable and fully collectible, and a provision indemnifying the purchaser for losses arising from

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secondary. In June 1996, it issued *FAS 125*, which superseded *FAS 77* as the authoritative standard on accounting for securitisation.

[68] Debruin, above n 42, 381.

[69] *In re Kassuba,* 562 F.2d 511, 514 (7th Cir. 1977); *In re OMNE Partners II*, 67 B.R. 793, 795 (Bankr. D.N.H. 1989); *Stratford Fin. Corp. v. Finex Corp.*, 367 F.2d 569, 571 (2d Cir. 1966).

[70] Debruin, above n 42, 381-382.

[71] *Major's Furniture Mart, Inc. v. Castle Credit Corp.*, 602 F.2d 538 (3d Cir. 1979).

[72] Debruin, above n 42, 382.

[73] 602 F.2d 538 (3rd Cir. 1979).

failure to pay and breaches of warranties. The court found that the transferor retained too many of the risks of ownership for the transaction to be treated as a true sale.[74]

The servicing provision can be another key factor in the analysis of securitisation transactions. When the transferor maintains a role in the servicing of the assets, the transaction documents should clearly indicate that the SPE retains ownership of the books, records, and computer files relating to the assets along with some control over the collection activities of the transferor. The transferor's role in servicing the assets and subsequent compensation should also be well defined and established on an arm's length basis.[75]

Another key factor in determining whether a true sale has occurred is the structure of the SPE itself. In order for the transaction to constitute a true sale, the SPE should be created specifically for the securitisation transaction and should not have any pre-existing creditors. Additionally, the SPE's powers should be restricted as closely as possible to allow it to enter only into the securitisation transaction and other necessary transactions. Furthermore, the securitised assets should be free of all liens in favour of parties outside of the securitisation transaction. Independent directors appointed to the board of the SPE can make the commencement of a bankruptcy less likely, particularly when their votes are necessary for a bankruptcy filing. Finally, the founding documents of the SPE should prohibit merger and reorganisation of the SPE, and should include separateness covenants which ensure that the SPE 'holds itself out to the world as an independent entity.'

E *Criticisms*

The number of critics of securitisation transactions has not been insignificant however. They often point out that securitisation pools tend to include more secure, lower-risk loans, leaving higher-risk loans in the possession of the transferor. While this practice reduces the transferor's due diligence expenses and increases the credit rating of the pool, investors in the transferor argue that they are left with an inferior

[74] Ibid 545.
[75] Debruin, above n 42, 383.

asset base, increasing their risk of non-payment in the event of bankruptcy.[76] For example, critics have argued that unsecured creditors are harmed by securitisation because it reduces the amount of the originators unencumbered assets available for debt repayment but this has been countered with the argument that securitisation merely replaces one type of asset, receivables, with another type, cash and the unsecured creditor has the same amount of unencumbered assets to levy against after the securitisation as it did before the securitisation.[77]

A second major criticism of securitisation transactions is that they are merely 'window dressing,' that is, transactions enabling a financially distressed company to create off-balance-sheet financing and, in the process, to present a false picture of the company to the market.[78] The false picture occurs after the transaction, the balance sheet appears stronger because cash flow has increases without a corresponding liability. Alternatively, if the securities issued by the SPE received a high rating, it might signal improvement in the transferor's business when, in fact, the improvement has nothing to do with the stability of the transferor, and merely relates to its financial statement preparation.[79]

A third criticism is based on the proposition that securitisation could hurt creditors because the cash received is unlikely to stay within the originator who may speculate or fraudulently transfer the cash. Given that the originator will have already sold its receivables, the originator will have to wait until new receivables are created and mature for its cash flow to regenerate. This dissipation of cash may eventually result in a liquidity crisis unless the securitisation can be repeated or refinanced. This criticism has been countered with the proposition that wasteful behaviour cannot always be assumed because an originator sells its receivables for cash. Given the scrutiny imposed by rating agencies and other independent parties such as credit enhancers, securitisation may present fewer opportunities for self-dealing than other financing methods.[80]

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[76] Debruin, above n 42, 371-372. See note no. 6 as this is a reiteration of Frost's argument using the Modigliani and Miller hypothesis.
[77] Schwarcz, above n 1, 146.
[78] Michael J. Cohn, 'Asset Securitisation: How Remote is Bankruptcy Remote?' (1998) 26 *Hofstra L. Rev.* 929, 934.
[79] Debruin, above n 42, 372.
[80] Schwarcz, above n 1, 146-147.

One author has raised that the many legal and business problems arising in the securitisation process arise from the inherent conflict between contract law governing personal relations among creditors and debtors, and property law governing the same relations converted into 'commodities' issued or traded in the market among investors.[81] The fundamental differences between contract and property laws are: First, contract law historically prohibits a party to unilaterally transfer its rights and obligations without the consent of the other party. While this rule has been relaxed and the unilateral transfer of loan contract obligations and rights is no longer prohibited, the cost of such transfers is higher than the cost of transferring property in the form of securities. While the default rule in contract law is based on the assumption that in a personal contract the parties put a high value on maintaining the relationship, the default rule in property law on the other hand, prohibits a party from limiting the transferability of its rights and obligations on the assumption that parties whose obligations are commodified as financial assets put a high value on the ability to exchange 'partners' in the markets rather than on the identity of the initial parties to the relations.[82]

Second, while contract parties may choose any lawful terms to govern their relations, market law does not recognise the parties' agreements that change the fundamental models of property relations. While contract relationships can be unique and custom-made, property relations are standardised because too many forms of property may be confusing, leading to misunderstandings among trading parties, and imposing on them high information costs.[83]

Third, while both contract and market laws prohibit fraud, contract law protects the parties from fraud to a lesser degree than market law does because personal face-to-face relationships are presumed to enable parties to protect themselves better and cheaper than impersonal relationships that are usually established and conducted through market intermediaries.[84]

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[81] Tamar Frankel, 'Securitisation: The Conflict Between Personal and Market Law (Contract and Property)' (1999) 18 *Ann. Rev. Banking L.* 197, 197.
[82] Ibid 197-198.
[83] Ibid 198.
[84] Ibid.

Fourth, while contract law legislation protects small borrowers against large lenders, property law legislation protects small lenders (investors) against large borrowers (issuers). Legislation, therefore, does not offer protection according to the parties' position in the transaction – whether they are borrowers or lenders – but according to their relative bargaining powers.[85]

F *Role of Rating Agencies*

Market transactions in emerging markets in Asia and Latin America are almost always rated and the agencies involved are the principal rating agencies: Standard & Poor's Corporation (S&P), Moody's Investor Services, and Duff and Phelps Credit Rating Co. Rating agencies reduce the quality inquiry to a simple one, two or three letter code: AAA for the highest quality, AA for the next highest quality, A, for the next highest quality, BBB, for the next highest, etc, until D. Securities rated BBB or higher are investment grade; securities rated below BBB are speculative, or in some circles, 'junk.'[86] A rating reflects the agency's assessment of the likelihood that the security will be paid in accordance with its terms. All else equal, the higher a security's rating, the lower a return it needs to offer. Investors still investigate investments, especially new and complex types with which they may lack familiarity, such as securitisation securities. However, the imprimatur of the rating agency truncates this process considerably; investors know that the rating agencies have considerable reputational capital at stake in performing well.[87]

Countries and firms are both rated. Both have both local and foreign currency ratings. The ratings reflect the agencies' assessments of differential ability and willingness to repay debts in domestic and foreign currency. In the U.S., Western Europe and Japan, the two ratings will be the same. In emerging markets, the foreign currency ratings are often lower than the local currency ratings, reflecting the rating agency's assessment that foreign currency repayments may be more difficult. A

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[85] Ibid 199.
[86] John Downes and Jordan E. Goodman, Dictionary of Finance and Investment Terms 212, 218 (4th ed. 1997).
[87] Claire A. Hill, 'Latin American Securitisation: The Case of the Disappearing Political Risk' (1998) 38 *Va. J.Intl. L.* 293, 312-313.

firm's foreign currency rating reflects the likelihood, in the rating agency's estimation, that the firm's home country would restrict its ability to exchange funds into foreign currency or send foreign currency out of the country, or require the firm, together with other firms, to reschedule its debts. Rating agencies generally do not rate a firm's debt higher than the debt of the country in which it is located. This is referred to as the sovereign 'ceiling.' By using securitisation, a firm may be able to exceed the sovereign ceiling and issue higher rated securities. However, exceeding the sovereign ceiling typically requires a firm to retain a significant ongoing connection with the transaction. The firm's own local currency rating – which measures its creditworthiness generally – thereby becomes the applicable ceiling. An apt description of emerging markets firms using securitisation is, perhaps, 'good companies in bad zip codes.'[88]

Rating agencies use various methodologies to appraise emerging markets securitisation transactions. One representative methodology is Standard & Poor's 'weak link' methodology: the transaction cannot be rated higher than the weakest link in the payment chain. The payment chain in securitisation transactions is very long. It includes the firm conveying the receivables, the pool (and the manager of the pool, typically a trustee) the insurer (and/or any other provider of credit enhancement, such as a bank providing a letter of credit), and various other parties. It also includes the various parties counted on to generate any future receivables. The chain in a future flow oil receivables transaction would include the oil buyers. Any break can interrupt the payment flow to investors. Thus each link must be evaluated, as must the country in which the firm is located, with its attendant political, legal, and economic risks.[89]

III SECURITISATION OF FUTURE RECEIVABLES

Despite the criticisms, the financial advantages of asset-backed securitisation have also led companies to the securitisation of executory future flows, which consist of the future revenue stream of an asset.[90] Executory future flows are not assets *per se* but are cash flows dependent on some event occurring in the future that creates an

[88] Ibid 313-314.
[89] Ibid 314.
[90] Richard Gugliada, 'New Developments in Securitisation: Structured Finance Ratings Asset-Backed Securities' (1998) 781 *PLI/Comm* 511, 611-614.

asset. Whether the event creating the asset will ever occur is uncertain, it is also uncertain whether the executory future flows will ever be realised. While it is true that assets such as receivables also represent future cash flows, the difference is that the event upon which the cash flows depend has already occurred.[91] Executory future flows have yet to accrue on a company's balance sheet and they can be characterised as 'future receivables' or 'future future cash flows.'[92]

Future flows securitisation has been most common in Latin America and have helped firms attract foreign capital market investors scared off by the wave of defaults in the early and mid 1980s. The firms' alternative financing sources were either inefficient domestic banks or yield-chasing foreign investors, both of whom demanded high rates. The foreign capital markets investors offered significantly lower rates, since capital markets are deeper and more liquid – but only if their fears about political risk could be assuaged.[93]

For many firms generating export receivables payable in hard currency, future flows securitisation sufficiently assuages the fears of foreign capital markets investors. The investors buy securities backed by these receivables. Thus, the investors are repaid from the funds, which are never in the politically risky country or its currency. The political risk shadow has been dissipated, as to one portion of the firm. That portion can be financed at the foreign capital markets investors' lower rates, rather than the higher rates charged by the firms' alternative financing sources. For every portion it can finance at lower rates, the firm benefits.[94]

An example would be an energy company in search of lower-cost funding which are now accessing the benefits of securitisising hydrocarbon production using innovative financings and structures. The company may be seeking capital to finance the extraction of a newly discovered oil field but seeks a less expensive financing option than traditional debt financing and at the same time does not want to issue equity in the oil field since it prefers to keep all of the profits for itself.

[91] Gordon, above n 22, 1319.
[92] Ibid.
[93] Hill, above n 86, 295-297.
[94] Ibid 297.

A *Minimising Political Risks*

Future flows securitisation has been commonly transacted in Latin American countries whose economies are to a greater extent dependent on the export of commodities and often perceived to be politically risky. How these transactions were structured to minimise investors' exposure to political risk presented a daunting challenge. Political risk contains 'sovereign risks,' which in this context means that the sovereign will interfere with a firm's ability to pay its investors as promised.[95] Securitisation minimises investors' exposure to political risks in several ways. First, payments on the securitisation securities come from cash flows, which never enter the emerging market country's borders. The risk of sovereign interference thus should be smaller and easier to quantify. Indeed, a sovereign has fewer ways to interfere with payments on future flows securitisation securities than payments on most other types of securities. Once the goods or services have been exported, sovereign interference becomes more limited and difficult; the sovereign's only choice may be to restrict export of the product or service, which is to generate the future receivable.[96]

While investors' exposure to political risk may be minimised, it is not eliminated. A sovereign could still interfere with the transaction, even though interference was costly. And circumstances could arise under which recourse to the sovereign's courts might be necessary. And circumstances could arise which recourse to the sovereign's courts might be necessary. Some emerging market countries have enacted or are considering enactment of laws that will foster securitisation. But recently enacted laws offer less certainty than a more expansively developed regime

[95] It also contains various political, economic, and country-specific risks. Perhaps the best one can do is to articulate the underlying concept: risks associated with business or investment in a country which would not be present in another country with a more stable and developed business and economic climate and regulatory regime. Classic 'political risks' include outright and 'creeping' expropriation as well as political violence (violent acts undertaken with the primary intent of achieving a political objective.) Other political risks include imposition of currency and exchange rate restrictions, and failure to enforce or respect agreed-upon property and contract rights. Some of these risks would be present in more developed economies; however, the risks would likely be smaller, and amenable to lower-cost appraisal.

[96] Among the factors Standard & Poor considers in assessing the country's willingness to permit continued exports are: (1) How important is the product to the country; (2) Is the product a net export?; (3) Does the industry or the country specifically represent an important source of employment to the country?; (4) What raw materials are used to make the product; (5) How large a proportion of export receivables must be used to meet external debt service; (6) Are the export sales contracts arms length? and (7) Could interference with exports affect future foreign investment in the country?

which has been interpreted and affirmed many times by the courts, as is the case in the United States.[97]

Finally, selling interests in assets not yet in existence, as future flows securitisation does, is a challenge even in regimes with more developed bodies of commercial law. The challenge is exacerbated exponentially in emerging market countries. Even apart from the legal hurdles, carving out interests in cash flows to be generated in the future still presents daunting challenges. The most critical challenge involves generation of the receivables. In future flows transactions the receivables might never come into existence in a variety of circumstances. Usually, future flows transactions in emerging market countries are structured to give the home country as small a role as possible; for the country to do less, the firm must do more.

Some transactions include contracts in which the firm agrees to sell, and one or more buyers agree to buy, some quantity of the product at a specified price. There may also be a hedge against price drops. Other transactions involve commodities for which a liquid spot market exists. The firm commits to selling a certain amount of the commodity on the spot market at prevailing prices. Investors rightly are concerned that the firm's ability to perform is not sufficient to ensure that it will perform. After all, the firm has already received payment for the goods from the securitisation investors. If the firm were in an end-game, it could simply pocket the proceeds from selling the securitisation securities and renege on its obligations to create the receivables. While the investors would have a cause of action against such a firm, the transaction would scarcely be worthwhile for them, or the firm, if they had to discount sufficiently to allow for this possibility. Firms additionally bond their performance by taking residual interests in the pool of receivables; such interests are payable only once the securitisation investors have been paid and, often, guaranteeing the securitisation securities.

The additional jurisdictions involved also could present problems, especially as regards payments to investors from the pool. For instance, one of the jurisdictions involved could lay claim on the payments, or assess taxes or other charges on the pool

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[97] Hill, above n 86, 317-318.

or investor. For transactions involving multiple jurisdictions, any of these jurisdictions might be able to complicate the investors' claims to the pool.

B *The Mexican Experience*

Among the most interesting aspects of securitisation of oil and gas receivables is that the securitised assets are frequently comprised of future receivables, the creation of which is dependent upon future production. The securitisation of future receivables raises a host of issues unknown to more traditional securitisation involving existing receivables previously created upon, for example, the wholesale or retail sale of some product, or the provision of services.

An example of a recent 'energy securitisation' which involved future receivables is the securitisation in mid-1993 by a majority-owned Mexican subsidiary of Petroleos Mexicanos (Pemex), which securitised a share of future receivables to be generated from the sale of Mexican crude oil.[98] The subsidiary transferred a portion of its future receivables from ten designated U.S.-based oil companies that have supply contracts with the subsidiary to a trust established by Pemex under the laws of the Cayman Islands. The trust paid US$366 million to Pemex as a consideration for the transfer of the future receivables, which it raised pursuant to the private placement of the trust certificates with institutional investors in the United States. The securitisation resulted in an offering of US$366 million of 7.53% trust certificates maturing in 2000.

Legal opinions were issued for the benefit of the holders of the trust certificates by counsel to Pemex and the subsidiary under the laws of Mexico, the Cayman Islands, and the United States with respect to the 'true sale' of the receivables and, absent a true sale, the trustee's perfected first-priority security interest in the receivables.[99] Outside counsel in Mexico opined that the transfer of the receivables from the subsidiary to the trustee was effective to transfer the subsidiary's full right, title, and interest in the receivables to the trustee and that, in the event of the

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[98] P.M.I. Comercio Internacionale, S.A. de C.V. (PMI), a majority owned subsidiary of Pemex, is the exclusive exporter or Mexican crude and routinely generates accounts receivable from the sale of crude oil to foreign customers.

[99] 'Pemex Receivables U.S. Master Trust,' Standard & Poor's Structure Finance, Aug. 1993, at 89-90. (discussing the role of oil revenues in the Mexican economy and its effect on the rating of securities issued in connection with the Pemex securitisation).

bankruptcy of the subsidiary, payments on the receivables would be made directly to the trustee. With respect to the perfection of the trustee's security interest in the receivables, outside counsel in Mexico and the Cayman Islands opined that notifying the account debtors of the trustee's interest and instructing them to remit payments to a designated account in the United States would perfect the trustee's security interest. In addition, U.S. counsel in New York and each state where the account debtors were located opined that the trustee had a perfected first-priority security interest in the receivables and their proceeds.[100]

The trustee in the amount of the shortfall could draw letters of credit issued by Citibank, N.A., in the event that the structural mechanics were not adequate to generate sufficient cash flow to pay principal and interest in a particular payment period. Citibank would be reimbursed on a first-priority basis from collections on the next receivables allocated to the trust in the event that the trustee drew on a letter of credit. The letter of credit would then be reinstated in the amount of the reimbursement and available for draws in subsequent periods.[101]

In determining the rating to assign to the trust certificates issued in this transaction, in addition to considering the issues addressed by the legal opinions and the structural mechanics, Standard & Poor analysed the following risks: (1) sovereign risks associated with Pemex's status as an agency of the Mexican government; (2) generation risks associated with Mexico's proved oil reserves and Pemex's operational and export procedures; (3) collection risks associated with the ratings of the ten designated customers, and the historical delinquency and default rates of Pemex's customers; and (4) payment risks related to the mechanics by which payments would be made to the investors. Based on all of these factors and despite Mexico's foreign currency senior debt rating of 'BB+,' the trust certificates were assigned an 'A' rating by Standard & Poor.[102]

Standard & Poor gave the securities an 'A' rating, marking 'the first time that foreign currency debt securities indirectly issued by an agency of the Mexican

[100] Ibid 90.
[101] Charles E. Harrell, James L. Rice III & W. Robert Shearer, ' Securitisation of Oil, Gas, and other Natural Resources Assets: Emerging Financing Techniques' (1997) 52 *Bus. Law.* 885, 905.
[102] Ibid 906.

government have been rated higher than Mexico's foreign currency senior debt rating of BB+.'[103]

IV SECURITISATION IN CIVIL CODE SYSTEMS

The civil code system poses problems for many Asian countries, often in dire need to generate capital, in nurturing a viable asset securitisation market. Consequently some Asian governments have spurred the development of implementing legislation for asset securitisation. Asian countries have already adopted implementing legislation. Indonesia introduced the Mortgage on Land and Land-Related Objects Law to facilitate secured lending based on land assets. Thailand introduced implementing legislation to create insolvency and trustee laws that parallel the U.S. legal structure. Japan is successfully developing a strong asset securitisation market within its civil code system by integrating implementing legislation with the guidance of a competent regulatory agency.[104] The Philippines' bicameral literature is also deliberating a securitisation bill, which will cover the legal framework for the process of converting assets into marketable securities.[105]

The most common legal issue in a securitisation in civil law systems involve the transfer of assets. Transfers can be structured through the concept of sale or assignment, which involves a true sale and transfer not only of credits but also of the risks involved. The originator then can take the receivables off its balance sheets. Another structure that can also be considered is novation where the debt and debtor remain but a new creditor is substituted, which in this case would be the SPE. Its practicality is questionable because of the fact that it requires the consent of the debtor and may be daunting particularly if you are dealing with portfolios of receivables that are owned by a pool of debtors. In addition the originator may not want the debtor to know that the receivables have been transferred to an SPE where a problem of perception may arise, which may impair the originator's ability to engage in financing activities in the future. Subrogation, which involves an entity paying a credit

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[103] 'Pemex Receivables U.S. Master Trust', Standard & Poor's Structure Finance, Aug. 1993, at 88-89.
[104] Kevin T. S. Kong, 'Prospects for Asset Securitisation Within China's Legal Framework: The Two-Tiered Model' (1998) 32 *Cornell Int'l L. J.* 237, 244.
[105] 'Senate, House Against Consolidating SPAV, Securitisation Bills', *BusinessWorld (Philippines)* (Manila, Philippines), 28 January 2002.

obligation of another person resulting in an assignment of the credit, does not require the consent of the obligor. It has the interesting feature of allowing the new creditor to obtain all the security and collateral covering the credit initially without the necessity of additional documentation.[106]

Another issue for securitisation in civil law systems is the relative difficulty in the applicability of trust law, or at least, trust law similar to that in the United States. While the law of trust has been much more frequently applied in England and in the U.S. than it has been in Spain,[107] Philippine courts, however, may draw freely upon American precedents in determining the effects of trusts.[108] The trust structure as an SPE may prove beneficial because it avoids taxation at the entity level. As international asset securitisation is amenable to tax forum shopping and investors prefer a structure that obviates taxation, this may present a problem because the originator may need to sell assets to the bankruptcy remote trust. It is also not clear whether trusts in the Philippines can issue debt. The Philippines recognises security interests and the most common method is to take a mortgage that creates a lien in favour of the creditor. Foreclosures on land mortgages can be carried out extrajudicially but the lender must first obtain a power of attorney authorisation to enforce it.

One can distinguish between civil and common law systems by the degree of specificity required to secure collateral. In common law jurisdictions, a debtor can grant to a lender the right to all future project company receivables regardless of the fact that some of these receivables are not in existence at the time of the grant. Civil law countries, on the other hand, typically recognise the existence of collateral security rights only to presently existing pre-defined assets. The different degree of specificity required by civil and common law countries can be attributed in part to how their respective laws deal with the issue of 'false wealth.' False wealth refers to

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[106] 'Successfully Financing Operations and Projects' in Proceedings of the Ninth Annual Conference on Legal Aspects of Doing Business in Latin America: New Approaches – Looking to the Twenty-First Century (1996) 11 *Fla. J. Int'l L.* 1, 31.

[107] This blend can be attributed to the Philippines' colonial past. Spain occupied the Philippines and instituted throughout the period a civil code system. At the turn of the twentieth century, however, the U.S. defeated Spain in the Spanish-American War, and introducing some aspects of common law.

[108] *Philippine Civil Code,* Art 1442. 'The principles of the general law of trusts, insofar as they are not in conflict with this Code, the Code of Commerce, the Rules of Court and special laws are hereby adopted.'

the situation in which a debtor has a large number of possessions but few actual assets. Common law countries have addressed the issue through the implementation of a comprehensive public registration system. Also, under an English based common law security system, security rights are obtained for the most part, against debtors as opposed to against specific assets. As a result, lenders will register their security rights to assets through a *Companies Act* administered registry. The registry will provide for a security interest called a charge, which provides lenders with a means to secure interests in tangible as well as intangible assets.

There are two general types of charges: the fixed charge which signifies a right in property that affects not only the relations between the chargor and the beneficiary of the charge but also affects the rights of third parties by putting an immediate lien on a specific set of assets, and the floating charge which do not create a fixed security right but only convey a general security interest in the relevant property and leaves the assets covered by the charge at the project company's disposal until such time as an event of default 'crystallises' the charge.[109]

While the Philippines reject the 'false wealth' approach to non-possessory security interests, it does not entirely embrace the more flexible and comprehensive common law floating charge either. Rather, Philippine law provides for registrable non-possessory pledges of all movable tangible and intangible project company collateral through its chattel mortgage law. Philippine law requires separate registration of security interests in land but does not have in place a comprehensive collateral security vehicle such as the fiduciary transfer or floating charge. Two principal substantive limitations exist with regard to non-possessory mortgages over movable assets. First, the Office of Register of Deed permits mortgage interests only in pre-existing property. Lenders would therefore not be able to secure future SPE receivables through this mechanism. Second, such mortgage interests cannot be used to secure future obligations. In other words, the lender cannot register a mortgage, which secures later loan disbursements.[110] However, recent Philippine Supreme Court decisions have upheld security taken over future stock-in-trade and inventory of

[109] Richard Walsh, 'Pacific Rim Collateral Security Laws: What Happens When the Project Goes Wrong' (1999) 4 *Stan J. L. Bus. & Fin.* 115, 126.
[110] Rolando F. del Castillo, 'Philippines' in Creating and Enforcing Security in Asian Emerging Markets (Stuart Allen and Sarah Parker eds. 1997), 154-155

businesses. The Court's decisions were based on its interpretation of the overriding purpose behind registrability of such interests, which is to promote business and trade in the country.

V SECURITISATION OF THE MALAMPAYA PROCEEDS

For a practical analysis of the structure of this securitisation, this paper concentrates on the nature of the financial assets being securitised and the applicable legal regime under which the transaction will be regulated.

A *The Philippine Petroleum Upstream Industry Regime*

The principal legal concept that the Philippine government relies upon to control the utilisation and management of natural resources is the Regalian doctrine which declares that all natural resources in the territory belong to the State and therefore private ownership or title must emanate from it. This view has found expression in Article XII, Sec. 2 of the 1987 Constitution, which provides that:

> All lands of the public domain, waters, minerals, coal, petroleum, and other mineral oils, all forces of potential energy, fisheries, forest or timber, wildlife, flora and fauna, and other natural resources are owned by the State.

The same provision also establishes the modes of utilising natural resources:

> The exploration, development, and utilisation of natural resources shall be under the full control and supervision of the State. The state may directly undertake such activities, or it may enter into co-production, joint venture or production-sharing agreements with Filipino citizens, or corporations or associations at least sixty per centum of whose capital is owned by such citizens.
>
> The President may enter into agreements with foreign-owned corporations involving either technical or financial assistance for large-scale exploration, development, and utilisation of minerals, petroleum, and other mineral oils according to the general terms and conditions provided by law, based on real contributions to the economic growth and general welfare of the country.

While the State is accorded the primary responsibility for development and utilisation of petroleum resources, participation by the private sector is not prohibited under the constitution. Both the second and third mode allows such participation.

Under the second mode, three types of agreements are allowed: co-production, joint venture, and production sharing. The common element among these agreements is the intent to give the State greater participation in decision-making and in the sharing of profits.

The third mode gives the President the option to enter into agreements with foreign wholly owned corporations. This is an exception to the general rule laid out in the constitution that the utilisation and exploitation of natural resources be left solely to Filipino corporations that is, a corporation whose capital stock is 60% owned and controlled by Filipinos. The agreement must involve either technical or financial assistance according to the general terms and conditions provided by law.

The interpretation of the latter mode of private sector participation was the subject of a constitutional challenge filed before the Philippine Supreme Court on 07 February 1997.[111] While the petition was directed against Financial and Technical Assistance Agreements (FTAAs) under minerals legislation and not of production sharing agreements (service contracts) under petroleum upstream legislation, the petitioners assert that the law allowing FTAAs is unconstitutional because it allows fully foreign owned corporations to explore, develop, utilise and exploit mineral resources in a manner contrary to Section 2, Article XII of the Constitution. According to the petitioners, the said constitutional provision while an exception to the nationality requirement, however, restricts the participation of fully owned corporations for large scale operations by giving either technical assistance or, in the alternative, financial assistance. Respondents on the other hand argues that the said provision in fact allows the participation of foreign-owned corporations in large scale exploration, development, and utilisation of not only minerals but also petroleum and other mineral oils. The Supreme Court has yet to issue a decision on the petition but

[111] *La Bugal-B'laan Tribal Association, Inc. et al v. Victor O. Ramos, Department of Environment and Natural Resources et al*, G.R. No. 127882. Petitioners are mostly anti-mining non-governmental and public interest groups while respondents include government agencies mandated to implement mining legislations and WMC (Philippines), Inc., a wholly-owned subsidiary of WMC Ltd. of Australia and an FTAA holder.

it is interesting to see how the Court will rule in light of the implications it will have on the resources industry, particularly the Malampaya natural gas project.[112]

One matter of paramount concern is the mechanics for the conveyance of the receivables from the government to the government-created SPE in light of the State-ownership and control over natural resources as mandated in the constitution. The legal counsel who will participate in the structuring of the transaction must provide clarification that there is no relinquishment by the government of this mandate. The transaction is rather a transfer of title and interests to the SPE by the government of receivables arising from its right to a share of production or to a payment calculated by reference to the quantity of production though the resource has yet to be extracted. As a general rule, all resources *in situ* belongs to the State until separated from the ground and brought to the surface. Securitisation of future receivables, however, may imply that title already passes even before resources are extracted since consideration has been given out of a stipulated percentage or fixed share of production.

The Philippines has a production sharing style of petroleum development regime as contained in *Presidential Decree (PD) No. 87 of 1972, as amended by PD 1857 of 1983*, and service contracts[113] executed between the government and petroleum exploration companies, the principal provisions of which are briefly described as follows:

- The petroleum company shoulders the costs of exploration, development and production and assumes the risk that these costs will not be recovered if the exploration is not successful.

[112] The author who was then corporate counsel for private respondent WMC when the petition was lodged, tried to solicit the support of Shell Phils. Exploration B.V. (SPEX) in the litigation. However, SPEX wrote back to WMC and advised that it believed that the existing petroleum upstream legislations were not threatened by the constitutional challenge to Sec. 2, Art XII of the Constitution.
[113] The production sharing agreements are called service contracts but are not 'service contracts' *per se* where the State retains ownership of petroleum and minerals, plant, equipment and other assets acquired for operations while the foreign enterprise works as a contractor under the government's supervision and gets paid for its services, irrespective of the profits or losses. See A.F.M. Maniruzzaman, 'The New Generation of Energy and Natural Resource Development Agreements: Some Reflections' (1993) 11 *J. of Energy and Natural Resources L.* 207.

- The costs of exploration and production can be recovered from the gross proceed once production commences. These include tangible (capital) costs, although the extent to which these can be recovered depends on the conditions of development:

    - For deepwater developments (in which 85% of the development area is in waters deeper than 200 meters), intangible exploration costs can be recovered in full. Tangible exploration costs can be recovered over a period of 5 years. Intangible and tangible costs of development and production are treated on the same basis.

    - For other developments, exploration intangible costs are not included in the recoverable costs and the capital costs of development and production are recovered over a 10-year period.

- The gross proceeds are based on market values or spot rates of the petroleum produced or rates contained in contracts approved by the government.

- The maximum level of costs, which can be recovered in any year, is equivalent to 70% of the gross proceeds from production. Any shortfall in the amount claimed can be claimed in subsequent years.

- The net proceeds (being the difference between gross proceeds and the recoverable costs) are split 40/60 between the contractor and the government.

- The contractor is exempt from all taxes and duties including income tax on the proceeds of production. Capital items for exploration and development are depreciated over a period of ten years, and deductions are allowable to the extent of two-thirds of interest paid to finance operations, except interest to finance exploration.

- Filipino companies participating in the service contract will receive the Filipino Participation Incentive Allowance (FPIA). This applies to interests between 15% and 30% with a maximum level of 7.5% of the gross proceeds.

- Cross recovery of exploration costs only in deepwater areas is allowable against revenue from other production locations.

Under the *Local Government Code of 1991*, local government units shall have a share of forty percent (40%) of the gross collection derived by the national government from the preceding fiscal year from its share in any co-production, joint venture or production sharing agreement in the utilisation and development of the national wealth within their territorial jurisdiction.[114] This has been an issue with the provincial government of Palawan as the national government initially said that as the Malampaya gas field is located outside of provincial territorial waters, that province wasn't entitled to any of the revenues. The Department of Justice is currently drafting a final opinion that will in effect state whether or not the Palawan provincial government is entitled to receive revenues generated from the Malampaya project. If a compromise cannot be reached between the representatives of the Department of Energy, Department of Finance, and the Palawan provincial government, the latter will consider taking the issue to court and such a move may result in the courts putting a hold on the distribution of all or part of the revenues from Malampaya until the issue is resolved.[115] A favourable judgment for the Palawan provincial government while diminishing the production share of the national government may, nevertheless, entice the former to embark on a securitisation of its share as originator.[116]

In the Philippines, decommissioning must be addressed within the framework of the production sharing contract system. The problems related to decommissioning in a production sharing contract system relate to the operation of the cost oil recovery mechanism. In any field, the production will reach a plateau, after which the volume produced will decline. The removal of installations and structures generally occurs when no more petroleum remains to be produced, at which point, there is no income from which the contractor can finance the cost of removal. However, this problem is indirectly addressed in the current production sharing contract regime in the Service

[114] *Republic Act No.* 7279, ss 289 & 290.
[115] 'Philippines Rushes to End Malampaya Gas Revenue Dispute', *Dow Jones International News*, 9 January 2002.
[116] In Argentina, the province of Salta securitised 80% of all royalty payments from a group of 18 private companies operating oil and gas concessions in the province and created the Salta Hydrocarbon Royalty Trust.

Contract and PD87 where the only provision for decommissioning mandated by the Philippine government at the close of the petroleum operations was a requirement to plug wells and take other unusually undefined measures appropriate to 'good oilfield practice.' If the decommissioning obligation instead falls on the Philippine government as the owner of the natural resources, the government is left with the problem of making provisions to finance the cost of removal.

A second problem relates to the accounting period for cost oil recovery. Every calculation period, a portion of oil produced is recovered as cost oil. Expenditures not recovered are carried forward to the next calculation period. Ideally, all of the contractor's expenditures are recovered by the end of the period of the production-sharing contract. However, a situation may arise in which the contractor has unabsorbed cost oil at the end of the production-sharing contract. If the contractor must then finance the cost of the removal of petroleum installations, there is no mechanism to permit the contractor to recover its expenditures or to pay for the cost of the removal. A further problem arises in those cost oil recovery mechanisms that restrict recovery of cost oil based upon contract areas when each production sharing contract has its own contract area and the contractor may not be allowed to recover expenditures incurred in one production sharing contract area from income produced in a different area ('ring fence' provisions).[117]

Under the present upstream regulatory framework, there is no separation of the fiscal authority from the developing or operating authority. In order to recover removal costs by fiscal means, the government must be willing to forego revenue. One area, which might be examined, is the tendency to classify removal as a capital expenditure, rather than as a capital expenditure incurred in producing the income, on grounds that the structure is no longer utilized for producing income at the time when it is abandoned.[118]

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[117] Peter Cameron 'Tackling the Decommissioning Problem' (1999) 14 *Nat. Resources & Env't L. J.* 121, 123.
[118] Ibid.

B *The Malampaya Natural Gas Development*

The Philippine gas industry was ushered in with the development of the Camago- Malampaya field, located in deep-water northwest of the island of Palawan.[119] Occidental Philippines, Inc. (Oxy) discovered the Camago field in 1989 under Service Contract 38 (SC38). In 1990, Shell Philippines Exploration B.V. (SPEX) acquired a 50% participating interest and operatorship in SC38. SPEX subsequently explored and discovered the Malampaya gas field in 1992. Malampaya, which geological data indicated is linked to the Camago culmination, lies under 850 meters of water, making it one of the most challenging deepwater developments in the world. Three subsequent exploration wells drilled by SPEX in the Malampaya field confirmed natural gas reserves of at least 2.5 Tcf and 85 million barrels of condensate.[120] In 1998, following a global swap of assets, Shell acquired Oxy's remaining 50% interest in SC38 through Shell Philippines LLC (SPL). Texaco, Inc. agreed in 1999 to acquire a 45% interest in the project from SPEX and the Philippine National Oil Company-Exploration Corporation (PNOC-EC)[121] bought a 10% interest in 2000.

According to the Joint Declaration of Commerciality signed by Occidental, Shell and the Philippine Government in April 1998, the Camago-Malampaya field and the much smaller San Martin field, also located in the SC38 area, have 'gas reserves which could sustain an average daily production of 400 mmscfd of natural gas (3,000 MW of power generation capacity) for a period of 20 years'. This is equivalent to about 2.9 Tcf produced over the life of the field. But a market had to be found for the power generation capacity and the Philippine government assigned 1,500 MW each to the National Power Corporation (NPC) and Meralco for development.[122]

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[119] Section 2 of *DOE Department Circular No. 95-06-006 'Policy Guidelines on the Overall Development and Utilisation of Natural Gas in the Philippines* dated 15 June 1995 provides: 'The Malampaya/Camago gas field shall serve as the foundation for the Philippine Gas industry by panning and developing it to primarily supply efficient gas-fired power plants starting year 2001.'

[120] Malampaya Natural Gas Project, 'Malampaya Natural Gas Powers the Future.' This brochure was published by SPEX.

[121] PNOC-EC is the state-owned energy exploration company. It is treated like any other exploration company when applying for an exploration contract with the Philippine government.

[122] NPC is a government-owned and controlled corporation responsible for the generation, transmission and bulk supply of electricity throughout the Philippines. Meralco owns a government franchise to distribute electricity in Manila and Southern Luzon.

Three Gas Sales and Purchase Agreements (GSPAs) were concluded by the Philippine Government in December 1997 and April 1998: with NPC for Ilijan 1,200 MW plant near Batangas; with First Gas Power Corporation for Santa Rita 1,000 MW plant near Batangas; and with First Gas Power Corporation for Calabarzon 500 MW plant in South Luzon. These GSPAs are equivalent to 2,700 MW of generating capacity, short of the capacity of 3,000 MW or 400 mmscfd stated in the Declaration of Commerciality.

SPEX's further studies indicated more than 200 million barrels of oil in place, of which 30 million barrels are currently estimated to be recoverable. Oil reserves of this magnitude could translate to initial production potential of 20,000-25,000 barrels per day, and a potential for peak output of as much as 50,000 barrels per day by 2003, when SPEX completes construction of additional production facilities.[123] Condensate production will decline over the field life, reducing from a liquid to gas ratio of about 45 bopd/mmscfd at the commencement of the project to about 25 bopd/mmscfd at the end of the field life.

The Malampaya gas field started production at an initial annual rate of 145 billion cubic feet, which will be used mainly to fuel 2,700 megawatts of base load power plants. These are the three combined-cycle gas turbine power plants in Southern Luzon: the 1,200 MW Ilijan; 1,000 MW Sta. Rita; and 500 MW San Lorenzo power plants.

The total development cost of the project, including the cost of the production platforms, offshore pipeline and the power plants was estimated to be US$4.5 billion over a five-year period. During the period cover by the Philippine Energy Plan 1999-2008, the expected production of 0.8 Tcf that will be consumed by the committed plants will displace roughly 144.3 million barrels of fuel oil equivalent (MMBFOE) of imported oil, generating foreign exchange savings of US$2.2 billion.

[123] Philippines Reserves May Top Forecast, *Platt's Oilgram News*, 9 May 2000.

C *Contractual Agreements*

A series of agreements and undertakings have been executed to support the project.[124]

1. Gas Sales and Purchase Agreements

For purposes of developing a regulatory framework, the terms and conditions in the GSPAs of greatest interests are: Sales Price, Marketing Rights, and Facility Access. The Philippine government has given the Sellers an undertaking not to reduce the price paid for the gas under the GSPA signed with NPC. Future gas sales to third parties could be made in the following manner: the sellers to other buyers, the buyers through an assignment under the GSPA, the buyers through a separate on-sale, and the Philippine government under subrogation of rights from NPC.

Under the first option, the GSPAs contain a provision in Article 12, which gives the Sellers the right to sell natural gas produced from either within or outside of the Service Contract Area to other buyers. Under the Gas Sale Implementation Agreement, an irrevocable agency was created which gives the Service Contractor the right to market the Government's share to other buyers as well. This marketing right in the GSPA is expressed as a reservation in favour of the sellers.

None of the GSPAs contain a 'most favoured nation' clause that would obligate the sellers to reduce the price of gas sold to the buyers if a lower price were agreed with a third party. Furthermore, the pricing formulas do not reduce the price due to a greater efficiency in utilization of the capacity of the gas processing plant and submarine pipeline in the event that additional quantities are sold to third parties.

Gas deliveries to Ilijan began in October 2001 with deliveries for commissioning to be made for a period of three months. Although full contract

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[124] Access to the GSPAs and other agreements is restricted by way of policy by the Philippine Department of Energy. However, a summary of the commercial terms of these agreements are summarised in a report prepared by the Asian Development Bank by the Fuels and Energy Management Group Ltd entitled 'Gas Sector Policy and Regulatory Framework Project' (1999).

quantities are to be available for delivery in 2002, the demand for power will limit Ilijan's output. As a result Ilijan will operate to reduced capacity factors in the first seven years of operation. The Annual Contract Quantity (ACQ) of the NPC GSPA is equivalent to a capacity factor of 80%. The excess generation capacity will have a significant impact on NPC's take-or-pay obligations under the GSPA as the annual take-or-pay requirement is 100% of the ACQ. Based upon the 'Plangas' estimates, the take-or-pay liability for NPC will exceed US$ 558 million within the first seven years. This exposure could be higher due to a general reduction in economic activity or other contingency like an early termination or non-renewal by Meralco of a 3,600 MW bulk power purchase contract with NPC, which expires in 2005.

2. Gas Sales Implementation Agreement

The Gas Sales Implementation Agreement (GSIA) was signed by the Secretary of Energy on 30 April 1998 to satisfy the condition precedent in the GSPA to give the Service Contractor the authority to market the Government's share of the natural gas. Prior to signing, the Service Contractor requested that the GSIA include conditions that would allow cost-recovery for damages due to NPC under the GSPA for alternative fuel that must be supplied if upstream facilities cannot be completed within the time to commission the Ilijan power plant. The GSIA adopts the approach that claims regarding recovery of sales costs will be subject to DOE validation. Under the GSI funds received as take-or-pay payments are treated as in the same manner as income from the delivery and sale of natural gas. This means that the government is in the position of guaranteeing that it will receive its own share of the take-or-pay moneys.

3. Parent Company Guarantees

The parent company for the foreign petroleum companies has given a guarantee to NPC. These guarantees cover the full, prompt and complete payment of the Seller's obligations under the GSPA. However, the aggregate liability under the Guarantee is limited to US$ 100 Million.

4. *Administrative Order No. 381*

Signed on 17 April 1998, *Administrative Order No. 381* is an important document in the GSPA closing process for NPC, the main purpose of which is to establish the authority for the transfer into an earmarked account of the Net Government Share of proceeds from 'all petroleum, natural gas and geothermal contracts, and coal operating contracts'. This account is to be used for the purpose of repaying funds drawn from the Service Contractor's Malampaya take or pay Deferred Payment Facility (DFP). The DFP was created in order to loan NPC the funds to meet its take-or-pay obligations under clause 9.2 of the GSPA. The funds are not capable of being applied to NPC's take-or-pay liability unless the Ilijan power plant is meeting the generation capacity targets contained in the November 1997 Plangas profile. If the output from the power plant is below Plangas levels, the Service Contractor's only recourse will be to call on the credit guarantee provided in the DOF Performance Undertaking.

5. Support Assignments and Payment Agreement

The Support Assignment and Payment Agreement is a tripartite agreement between DOE, NPC and the Service Contractor, which allows NPC's take-or-pay obligations to be paid from the government's share of net proceeds under petroleum, geothermal and mineral contracts. Support for NPC's obligations is only effective if the Ilijan power plant is being dispatched at the rate set in the Plangas schedule, which is annexed to the SAPA.

6. Deferred Payment Facility

Even though the Government has provided a Performance Undertaking to guarantee payment of NPC's obligations for take-or-pay along with actual deliveries, a source of stand-by support was further needed as an alternative to foreign debt. In this respect, DOE and Depart of Finance (DOF) have pledged the government's share of net proceeds from petroleum, geothermal and mineral contracts under the SAPA. As this amount is exclusive of funds directed to Local Government Units and Contractor's income tax, the flow of funds under the SAPA may not be sufficient to match the level of NPC's take-or-pay obligations in the period 2002-2010. The residual shortfall is forecast to reach US$242.32 million by 2003. As a result, the Service Contractors to whom the payments are due have agreed to create a US$ 350 million deferred Payment Facility as a line of credit for NPC to draw upon. Drawings are limited to the so-called 'positive difference' i.e. the amount of take-or-pay due once NPC has met the target set for the generation of electricity from Ilijan. If NPC does not meet this performance standard the commitments under the SAPA and DPF are not applicable and a call is made on DOF under the Performance Undertaking.

7. Performance Undertaking

A guarantee for NPC's payment obligations under the GSPA signed on 29 April 1998 was a condition precedent wherein the Philippine government has pledged its 'full faith and credit' to the payment of NPC obligations for gas delivered to it as well as the take-or-pay obligations. Using the Plangas forecast of Ilijan's annual capacity factors, NPC's take-or-pay liability is approximately US$ 558 million. This amount includes take-or-pay payments for both the Service Contractor's as well as government's share of net proceeds. After the tenth anniversary of the Malampaya start-up the level of the guarantee will be reduced to 80% of the take-or-pay obligation. This means that subsequent financing by the Service Contractor, such as bonds, will have the benefit of a government guarantee. The Performance Undertaking was intended to be a backstop for the deferred Credit Facility. However, a downturn in the general economy of the Philippines may easily result in depressed power demand. If the Ilijan power plant does not meet the output targets contained in the Plangas projection, there is no obligation for the DOE to provide the Service Contractor with revenues from indigenous resource contracts. This will force the Service Contractor to make a call on the Government under the Performance Undertaking. Such a call would force the government to borrow funds from the international capital markets to meet NPC obligations. The Government has a right of subrogation for any of the gas paid for under this guarantee. However, the ability to have the gas delivered would still be subject to NPC's make-up rights, which require that in any year the full amount of the contract must have been delivered and payment made before the seller is obligated to deliver from the take-or-pay balance. The Performance Undertaking appears to restrict the Government from regulatory intervention that would reduce the gas price negotiated under the GSPA with NPC. This limitation is not worded to include the contracts signed with FGPC.

With respect to the Performance Undertaking, SAPA and DPF, the DOE and the DOF are addressing the issues of NPC's reimbursement of DOF for advances, debt service and borrowing and the authority for DOE to determine how gas will be delivered under the right of subrogation the government obtains by making NPC's take-or-pay payments. However, NPC advised DOF that the negative pledge conditions of the corporation's loans from multilateral development banks prevent the creation of any reserve accounts, which would earmark revenue from the sale of electrical power as a means of reimbursing for the take-or-pay payments under the Performance Guarantee.

D *Government-created Special Purpose Entity: Quasi-commercial Risks and Suability*

The Philippine government has already undertaken direct commercial activities in Malampaya through the participation of the state-owned resource exploration company, PNOC-EC in the SC38 joint venture, and NPC as an off-taker of the Malampaya natural gas. In a fully privatised economy such purchase risk would usually be regarded as 'commercial.' However, state-ownership of both PNOC-EC and NPC introduces performance risks that are often regarded as political.

It is sometimes suggested that undertaking infrastructure developments as public-private joint ventures may reduce an investor's exposure to political and regulatory risks. This is based partly on the hypothesis that a government may be less likely to prejudice the profitability of an enterprise in which it has direct commercial stake and partly on the notion that popular resistance to private sector involvement may be reduced.[125] However, there are many weaknesses in this strategy since the government's roles not only as resource owner, but also as joint venture participant, off-taker, and regulator (in the case of PNOC-EC, NPC and DOE respectively) are easily blurred, undermining the credibility of the regulatory framework.

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[125] Warrick Smith, 'Covering Political and Regulatory Risks: Issues and Options for Private Infrastructure Arrangements' in Timothy Irwin, Michael Klein, Guillermo E. Perry, and Mateen Thobani (eds), *Dealing with Public Risk in Private Infrastructure* (1997) 58.

Quasi-commercial risk can be defined as uncertainty over the willingness or capacity of government-owned enterprises to meet their contractual obligations in private infrastructure projects. Those defaults might arise deliberately, through direct political interference in what would otherwise be commercial dealings, or from the poor creditworthiness of government-owned enterprises that are not operating in a fully commercial manner.[126]

In the proposed securitisation, the special purpose entity under the auspices of a legislative charter or franchise has to be factored in. The nature and extent of the risk will depend in large part on the nature of the government entity. When the entity has been 'corporatised'- and hence has a commercial charter, autonomous management, and the ability to recover cost-covering prices and borrow in its own right - the supply or purchase risks may approximate those of a private firm. Government entities that lack these attributes will be more susceptible to political interference and are less likely to be creditworthy in their own right. As quasi-commercial risks often involve entities that lack taxation powers and may be uncreditworthy in their own right, their ability to meet compensation obligations in the event of default is often a key source of risk for security holders - a risk which is then passed on ultimately to the government.[127]

The weaker the separation between the government and the entity, the greater the potential for political interference and hence the stronger the case for treating performance risks as a responsibility of government rather than as a normal commercial risk.[128] Specific commitments can also be anchored in contracts that are subject to international arbitration.[129] The ultimate issue then is one of enforcing the entity's obligations.

Where the government wishes to retain some control over and interest in the SPE, this transaction falls into the middle of the spectrum between a true sale and a secured loan. This of course depends on the extent the government is willing to

[126] Ibid 54.
[127] Ibid.
[128] Ibid.
[129] Ibid 76.

relinquish control. At this point, we can only refer to the draft legislation to determine the structure of the SPE and the extent the assets are isolated and place presumptively beyond the reach of other creditors of the government.

When the government enters into a contract, it is deemed to have descended to the level of the other contracting party and divested itself of its sovereign immunity from suit with its implied consent. Such rule on implied waiver of state immunity, however, does not apply where the contract entered into by the Government involves its sovereign or governmental capacity. It is only when the Government enters into a contract in its proprietary or private capacity that it will be deemed to have impliedly waived its non-suability. Such proposition accords with the so-called restrictive theory, which recognises sovereign immunity from suit only with regard to public acts or acts *jure imperii* of a State, but not with regard to private acts or acts *jure gestionis*. The absence in the Philippines of legislation defining or characterising what activities shall be considered 'commercial' and as constituting acts *jure gestionis*,[130] the Philippine Supreme Court opted for coming out with its own guidelines:

> Certainly, the mere entering into a contract by a foreign state with a private party cannot be the ultimate test. Such an act can only be the start of the inquiry. The logical question is whether the foreign state is engaged in the activity in the regular course of business. If the foreign state is not engaged regularly in a business or trade, the particular act or transaction must be tested by its nature. If the act is in pursuit of a sovereign activity, or an incident thereof, then it is an act *jure imperii*, especially when it is not undertaken for gain or profit.[131]

Many legal jurists have tried to attempt to analyse the legal nature of petroleum agreements by analysing the elements of private law and the elements of public law which are involved and determine whether public law dominate their contractual or commercial character. The conclusion reached by jurists – particularly from capital exporting countries – is that the elements of public law, which undoubtedly exist in a petroleum agreement, do not efface the basically contractual and commercial

[130] In the U.S., the *Foreign Sovereign Immunities Act of 1976*, defines a commercial activity as 'either a regular course of commercial conduct or a particular commercial transaction or act' and declares that the 'commercial character of the activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather by reference to its purpose.' The 1982 enactment of the Canadian Parliament entitled *"An Act to Provide for State Immunity in Canadian Courts'* defines a 'commercial activity' as any particular transaction, act or conduct or any regular course of conduct that by reason of its nature, is of a 'commercial character.'
[131] *Holy See v. Rosario*, 238 SCRA 524.

character of the transaction. The petroleum agreement is classified as a species of private contract – an arms length transaction rooted in the free will of the parties of equal bargaining power and therefore subject to all the traditional rules and concepts applicable to contracts entered into between private parties. The opposite view advocated mainly by jurists from developing countries and representatives of host governments, asserts that petroleum agreements, being of a long-term nature and often spelling out comprehensively the relations between government and company in respect of the exploitation, marketing and sale of a vital and strategic public resource and specifying all relevant fiscal, ownership and control arrangements is anything but a private contract. Constituting a prominent feature of the development strategies of the host country, they regards such agreements as major instruments of public policy, lying more in the domain of public law than in the province of a private contract.[132] It is within the context of the latter school of thought that it can be argued that in a securitisation transaction, as a mere accessory of petroleum production-sharing agreements and a convenient resources development strategy, the SPE as an agent of the government will not be precluded from invoking immunity using public law, which is of a legal order superior to private contracts.

E *Risks, Risks and More Risks*

The proposed securitisation of the government's share in the proceeds of its first commercial natural gas resource is unique for a variety of reasons. Normally certain risks inherent in securitisation of oil and gas receivables are mitigated through diversification particularly if the assets are pooled. The fact that the asset base of this transaction is sourced from one field development under a single production-sharing license and the major component of the product thereof sold to pre-contracted off-takers through GSPAs, make the transaction prone to generation risks associated with Malampaya's proven petroleum reserves and operator/management risks because of the fact that the government is a 'passive' participant in the Malampaya joint venture. Nevertheless, the government through the exercise of its control and supervision mandate needs to ensure that the operator of the joint venture diligently undertakes 'good oilfield practices.' Also, natural gas, unlike oil and associated condensate that

[132] Noel Fabri, 'The Legal Nature of Petroleum Agreements: A Comparative Analysis' (1986) *1986 AMPLA Yearbook* 1, 14-16.

are both exportable commodities, is highly dependent on the efficiency of the power plants built by the off-takers and the appetite for energy by the domestic economy.

The Philippine government should also bear in mind that it may be restrained to divulge certain information by reason of confidentiality undertakings with the Service Contractors or if not, the Service Contractors' competitors may obtain access to information as a result of disclosures which may be required pursuant to the transaction implementation documentation, such as security disclosures, disclosures made in connection with concession and permit applications and filings, and disclosures made in connection with private placement memoranda.

Securitisation of the government share in Malampaya also presents a special case since the originator is not a state-owned company which is a party to the production sharing agreement but the Philippine government itself, though PNOC-EC owns 10% of the project and NPC is an off-taker of the gas with take-or-pay obligations under the GSPA. The presence of credit enhancements, which may be provided by third parties such as banks or insurance companies in the form of letters of credit, to minimize the risk that a non-payment by an obligor like NPC on a securitised asset will cause the SPE to suffer a loss or to be unable to satisfy its obligations with respect to the issued securities, will further complicate inter-creditor issues. The Philippine government will then have a three-tiered exposure in Malampaya since PNOC-EC's equity is highly leveraged, NPC's take-or-pay obligations in the GSPA unlike First Gas', are backed by a sovereign guarantee under the SAPA, Deferred Payment Facility and Performance Undertaking, and the Malampaya asset securitisation will certainly require credit enhancements. Then again, a sovereign guarantee as a credit enhancer is not discounted though this may not sit well with investors in light of the government's already heavy exposure in the take-or-pay provisions of the GSPA undertaken by NPC with the Malampaya Service Contractors.

The following risks must also have to be analysed in determining the rating to be assigned to the securitised debt instruments of Malampaya: collection risks associated with the ratings of NPC and FGHC as the designated customers for the natural gas and the historical delinquency and default rates of these customers.

VI CONCLUSIONS

Securitisation of the Malampaya proceeds adds another dimension to the Philippine government's involvement in this infrastructure project in addition to joint venturer, off-taker and regulator - as originator and presumably owner of the SPE. The amount of comfort that the potential purchasers of these securities will get from non-government credit enhancers or over-collateralisation will to a great extent be tempered-off by the exposures of the assets to the sovereign guarantees already undertaken by the government for the financial closing of the project. The government's multifarious role in the transaction will, during time of political expediency and economic distress, be a justification for intervention though such an act may have diplomatic and trade ramifications. As a result, securitisation has not really diminished the risk of sovereign interference as the payments of future receivables are mostly generated domestically. While recourse to the sovereign's courts is an option for security holders in instances of interference, the elements of public law may be used as an excuse to efface the contractual and commercial character of the transaction.

The positive advantage of increase liquidity with increased cash infusion from the securitisation proceeds can also be negated if the economic managers exercise fiscal imprudence through investments in infrastructure projects that are unprofitable. While projects pursued under traditional forms of financing will follow compliance procedures set by creditors, projects undertaken with cash infusion from future payment streams will not fall under the scrutiny of lenders. The result could be that future receivables from Malampaya will be committed to security holders while the cash may have already dissipated in some unfortunate 'white elephant' investment. Needless to say once the field has dried up, who is going to pay the clean up after? Decommissioning responsibilities at the most are as clear as the last drop of crude oil from Malampaya.

The analyses of legal risks presented by asset securitisation are currently the domain of the rating services and the attorneys involved in structuring the transactions. Asset securitisation specialists work through these risks in opinion letters issued to the rating services. The results have been that existing analyses of asset securitisation make use of doctrinal categories that do not directly address the risk allocation issues. More often the 'experts' exercise a significant influence on potential originators and their willingness to utilise securitisation as a funding and financing strategy in lieu of more traditional but certainly less profitable forms of financing for legal counsels and financial advisors. Furthermore originators may securitise their assets because of the persuasive influence of professional advisors who stand to benefit financially from an increasing number of securitisation transactions. Now before the Philippine government gets carried away, shouldn't policy makers and economic managers sit down and ponder if securitisation is the most advantageous way to tap financial markets.