
BELT AND ROAD PRACTICAL GUIDE

THE ADVANTAGES FOR INVESTORS OF A COMPETITIVE TENDER
PROCESS AND COMMON ISSUES WITH CONCESSION ARRANGEMENTS

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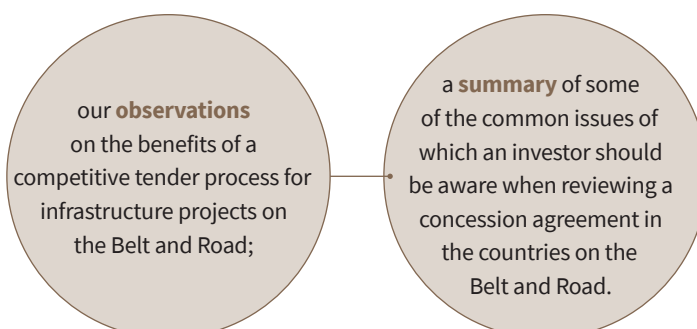
China's Belt and Road initiative has opened
up numerous investment opportunities in the
developing countries along the route.

CHINA MAINLAND'S BELT AND ROAD INITIATIVE- THE ADVANTAGES FOR INVESTORS OF A COMPETITIVE TENDER PROCESS AND COMMON ISSUES WITH CONCESSION ARRANGEMENTS

China Mainland's Belt and Road initiative opens up numerous potential investment opportunities in developing countries along the route. Governments the world over, and particularly in developing jurisdictions, are using concession arrangements in order to help plug their infrastructure gaps. In this publication, we will look at concession arrangements and the benefits of competitive tendering for investors in Belt and Road countries.

Under a concession, a government can licence a private company (**Concession Holder**) to finance, develop and operate infrastructure for a specified period of time. At the end of this period, often the infrastructure is transferred to the State at no cost. By licensing the private sector to build and operate public infrastructure, governments are able to get closer to meeting their public infrastructure objectives, without placing further pressure on already stretched budgets. This is particularly important in the post-COVID environment given the increased burden imposed on public budgets by the pandemic. Such licences, or concessions, are often granted to an investor following a competitive tender process.

While there is a range of publications about the Belt and Road Initiative(BRI), most of them focus on applicable laws; others are in country-by-country format providing statistics and other background. There seem to be few practical guides. Our series of publications aims to fill that gap. We will tell you about our own experience with our clients working on the BRI. Within each of our booklets, we will offer practical tips regarding the BRI subject in question.



TIP 1 | TENDERING ON THE BELT AND ROAD

Benefits of a tender process

Belt and Road investors often hear about projects through their strong relationships with governments in countries along the route. Because of these relationships, investors can often directly negotiate project development agreements, without first having to go through a competitive tender process. For investors that have spent the time to develop these relationships, the possibility to win projects by direct negotiations, rather than through a tender process, can be very tempting – it is quicker and provides certainty.

While strong government relationships are useful, investors should keep in mind that their project will last for many years or even decades. During the life of the project, government officials may come and go. It is therefore important for any project to be able to withstand these changes and ensure that subsequent governments honour the concession arrangements.

In order to help protect the long term legitimacy of a project, it is in the Concession Holder's interest to demonstrate that the project was awarded following a transparent and fair process. A common way to demonstrate this transparency is by winning a project through a competitive tender process. This is also a general trend in many Belt and Road jurisdictions to institutionalize government procurement processes through competitive tendering.

Such tender processes help remove any questions of undue favourable treatment that a previous government may have given to a Concession Holder by ensuring that:

- all bidders receive the same information;
- all bidders are subject to the same tendering rules; and
- evaluation of each tender and the ultimate award of the concession is conducted uniformly and in accordance with pre-determined and transparent criteria.

Although the tender process opens the project up to competition, an investor's relationships remain of significant value. Having strong relationships in a country can be translated, in a competitive bid context, into objectively measurable qualities such as demonstrated in-country capability and reliability, which will in turn put the investor in a better position to submit a competitive bid.

In light of the benefits of conducting a competitive tendering process and the push towards transparency, many

governments (including some countries on the Belt and Road route) have adopted competitive tender requirements for public projects into their domestic legislation. In addition, most multilateral agencies will also require a fair competitive tender process as a prerequisite to their involvement in any project.

Whether an investor would prefer direct negotiations or a competitive tender process largely depends on the political situation in the host country. Investors need to balance the convenience and certainty that is offered by direct negotiations against the potential need for long legitimacy and transparency offered by a competitive tender process. There is no one perfect approach for all situations, rather this will be a project-by-project consideration for each investor.

Alternative

Whether a competitive tender process is conducted or not is either prescribed in the domestic law of the host country or otherwise determined by the host government. If a project is awarded by direct negotiations, a Concession Holder may seek to further guarantee this award by having it approved by the host country's parliament.

Receiving parliamentary approval of an award of a directly negotiated concession is beneficial as it helps demonstrate to successive governments that the award had a level of bi-partisan support.

Of course, the effectiveness of a parliamentary approval largely depends on the parliamentary independence and integrity of the election process in the host country as well as the applicable constitutional legal principles in that country. However, where a competitive tender process is not an option, parliamentary approval of a directly awarded project may make it more difficult for any future government to question the legitimacy of the award of the concession. Parliamentary approval can also be useful to add an additional layer of legitimacy, even to projects which have been awarded through a competitive process.

TIP 2 | CONCESSIONS

In many Belt and Road countries the relevant ministry / governmental authority is given the exclusive authority to develop the infrastructure under their portfolio. This infrastructure often includes:

- transport infrastructure – rail, roads, ports, airports;
- utilities – power plants, water, waste;
- telecommunication infrastructure; and
- increasingly in recent years, other areas such as health and education (e.g. hospitals and schools).

Limited budgets and technical capabilities often prevent these ministries / governmental authorities from meeting their infrastructure targets. Therefore, they look to the private sector, through concession arrangements, to finance, build and operate this infrastructure.

Concession arrangements are often attractive to investors in many Belt and Road countries as many of the deficiencies in the domestic regulatory framework can be dealt with in the concession agreements. For example, if a particular country's laws do not adequately deal with foreign exchange rights, or guarantees on limited government interference, then it is possible to provide for the necessary protections contractually in the concession agreement with the government.

Concession contract structure

Following an award of a concession (via competitive tender or otherwise) the concession will be recorded in either: (i) one agreement between the awarding ministry / governmental authority and the Concession Holder; or (ii) in two agreements, one with the national government regarding some key terms of the concession, and the other with the awarding ministry / governmental authority regarding the terms relevant to the specific piece of infrastructure. From an investor's perspective, it is preferable to have two contracts since the national government has the power to grant rights and protections that the relevant ministry / governmental authority may not have. However, the contracting structure is largely determined by the laws and practices in each Belt and Road country.

A summary of each is set out below

Single contract

A single contract with the awarding governmental authority, rather than the national government, is normally only acceptable if:

- the domestic regulatory framework is sufficiently developed such that additional protections, which only the national government could grant, are not necessary; or
- the investor has little bargaining power to negotiate additional protections from the national government, and essentially has to determine whether or not to develop the project without such protections.

In this case the concession contract will be limited to matters that are within the powers of the awarding governmental authority to determine. These include specifications and operating requirements of the infrastructure.

Two contracts

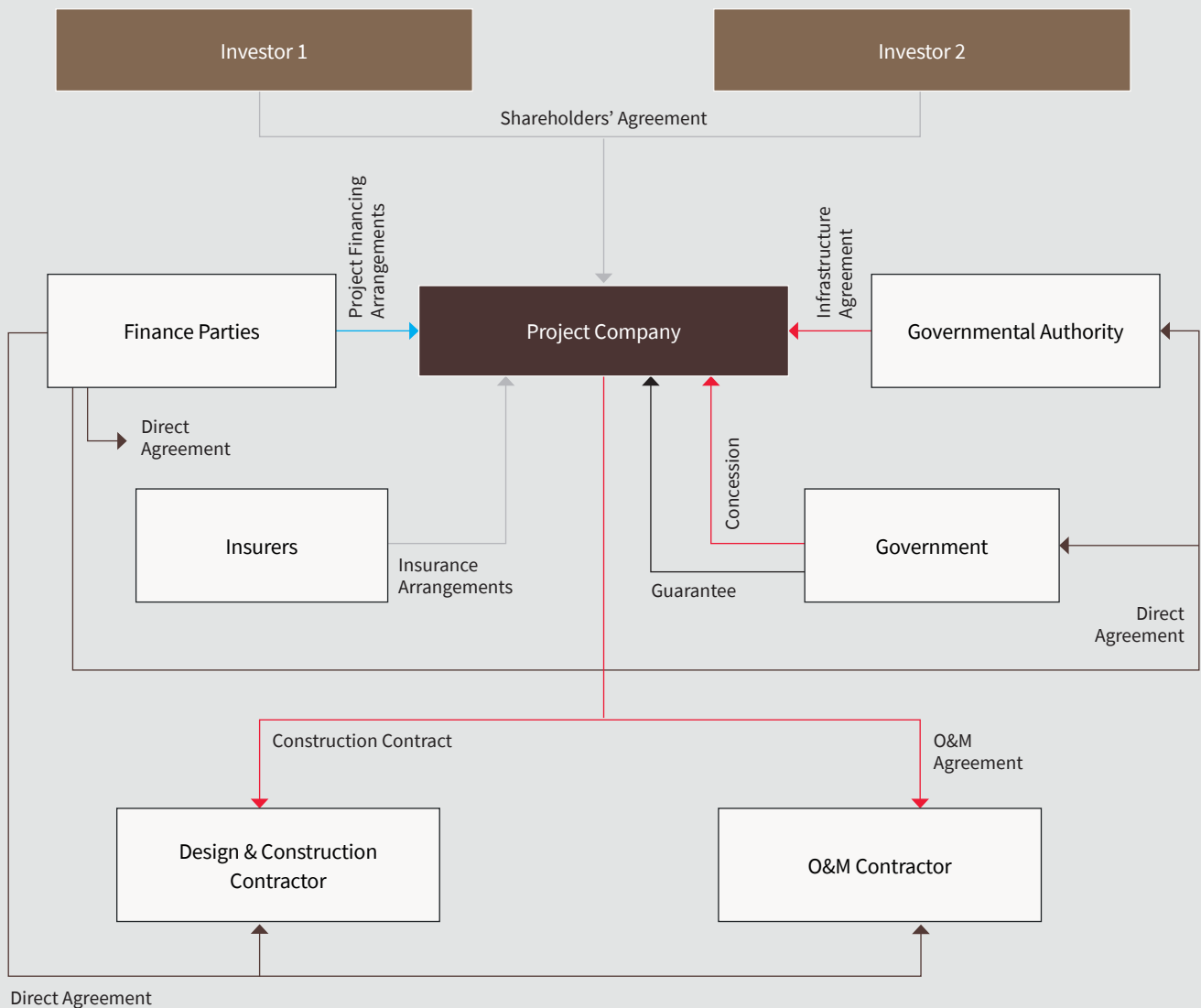
In many instances across the Belt and Road countries, regulatory frameworks are relatively under-developed and the need for private participation in infrastructure development is high. In this case, investors may be in a position to require the concession be formed under two contracts, where:

- the first agreement is with the State, which will grant the concession and provide rights that only the national government can grant; and
- the second will be an agreement with the relevant governmental authority dealing with the specifications and other terms specific to the infrastructure.

Under the two contract arrangement, the Concession Holder can seek a wider range of protections and guarantees, which may not be possible under a single agreement arrangement with the relevant governmental authority.

In addition to the concession arrangements, there will be a number of other contractual arrangements that the Concession Holder will have in place to implement the project. Diagram 1 below shows the two contract concession arrangement and some of the other main contracts commonly found in infrastructure projects. Note that Diagram 1 is a simplified illustration and may not include all of the contractual arrangements, as each project and type of infrastructure has unique requirements, including the number of investors and the number and type of sub-contractors.

SIMPLIFIED PROJECT FINANCED INFRASTRUCTURE CONTRACTUAL STRUCTURE





Common issues with concession arrangements

However a government structures its concession arrangements – one contract or two – there are a number of common issues that are relevant to most infrastructure developments. These issues mostly stem from the lenders' and the lenders' insurers' (Finance Parties) requirements, particularly since large projects are often financed on a limited recourse basis, as shown in [blue](#) in Diagram on page 6.

Some of the major concerns of the Finance Parties include:

- the importance of ensuring that revenue generated by the infrastructure is reliable and that there is very little opportunity for that revenue to be reduced, suspended or terminated;
- the fact that prior to termination of the concession for Concession Holder default, they have the opportunity to step in and cure such default, or to transfer the project to a third party; and
- that in the event of termination of the concession, there is an obligation, in some circumstances, on the government to purchase the infrastructure at a fair value.

In light of these concerns, set out below is a summary of some of the main factors in concession arrangements that should be carefully considered.

The information below is general in nature. Each country manages concession arrangements differently. The level of risk that a Concession Holder and their Finance Parties may accept will vary significantly depending on the risk profile of the host country, its history with concessions as well as the particular circumstances of the project. The points raised below are not exhaustive, and may not be relevant in every country and for every project.

Commencement of payments

In many cases, payments under a concession will not commence until the relevant piece of infrastructure has been constructed, satisfied performance tests and is available for operation. Payments may be from:

- a governmental authority for the Concession Holder providing a service (State Payments), for example supplying electricity to the national grid; or
- users of the infrastructure (User Payments), for example toll roads.

Note that there are occasions when payments could commence during the construction phase, although this is less common in project financed projects.

With respect to State Payments, after the infrastructure has passed, or is deemed to have passed, the performance tests and is ready for operation, then the concession agreement will often provide a minimum periodic payment. This payment often takes the form of an availability payment (Availability Payment). This means that the Concession Holder receives a minimum payment for having the infrastructure available for use, regardless of how much it is used. The obligation on the Concession Holder is ensure the infrastructure passes performance tests and is capable of delivering on the minimum availability.

It is in both the Concession Holder's and the Finance Parties' interests that these payments start in accordance with the schedule for the project. The question then arises: if there is delay in completing the infrastructure and/or passing performance tests, then who should take responsibility for that delay? The ideal situation for the Concession Holder, and what is normally required by the Finance Parties (which varies, depending on the cause of the delay) is discussed below.

- **Where the delay is not caused by fault of the Concession Holder:**
 - **State Payments:** the Availability Payment should commence. For example, if a power station is unable to conduct performance tests because the national electricity grid is unable to receive the electricity generated from such tests, then the power station should be deemed to have satisfied the performance tests and the Concession Holder should receive the Availability Payments under the power purchase agreement.
 - **User Payments:** if the Concession Holder is delayed in completing the infrastructure and cannot charge users of the infrastructure, then the concession agreement should include a compensation mechanism which may reflect pre-determined expected use.
- **Where the delay is caused by force majeure:**
 - **State Payments:** in many cases the obligation of the State to make payments will not commence, however the Concession Holder may have the right to extend the concession period by the duration of the force majeure event so that it enjoys benefit of the full operating period;
 - **User Payments:** in many cases the Concession Holder should at least have the right to extend the concession period by the duration of the force majeure event so that it enjoys benefit of the full operating period.
- **Where the delay is caused by fault of the Concession Holder:** this is normally considered a breach of contract and payments will not commence, nor will the term of the concession be extended.

Frequency of payments

With respect to State Payments, after the performance tests have been satisfied and the infrastructure is ready for operation, then both the Concession Holder and the Finance Parties will want to ensure that there are limited opportunities for payments under the concession to be interrupted. The following are some of the provisions in a concession contract that may impact the frequency of payments to the Concession Holder.

- **Ordinary force majeure events:** these are events, such as weather conditions, that are outside the reasonable control of either party. If the Concession Holder is unable to perform under the concession agreement, then this could cause payments to be suspended. However, in this case, a Concession Holder should try to negotiate in the concession agreement (and the Finance Parties may require this), that:
 - the Availability Payment is made so that debt repayment obligations are not affected; and/or
 - the term of the concession is extended by the period of the ordinary force majeure event in order for it to have the opportunity to recover lost additional payments, above the Availability Payment, that would have been earned had the ordinary force majeure not occurred.

A few years ago, the question arose whether COVID-19 related disruptions should be considered force majeure. Increasingly, as the pandemic comes under control and business become more experienced with dealing with COVID related disruptions, we are seeing the risk being pushed onto the Concession Holder to price in such risks in its tender (rather than giving the ability to claim relief).

- **Government force majeure events:** these are events that could be caused or influenced by the State, such as sanctions or blockades. In the case of a government force majeure event, the Finance Parties may require that at least the Availability Payment is paid. That said, Concession Holders should still attempt to negotiate in the concession agreement that full payments are paid – this is on the basis that the State is responsible for the government force majeure events. If that is not accepted then, similar to ordinary force majeure, the Concession Holder should at least seek an extension to the concession term.
- **Suspension rights:** Finance Parties will pay close attention to any clause in the concession that gives the State the ability to suspend, delay or reduce payments to the Concession Holder, below the minimum Availability Payments. The Concession Holder should resist any such



suspension rights in the concession agreement that are not linked to the fault of the Concession Holder.

With respect to User Payments the Concession Holder and the Finance Parties will need to be comfortable with the expected demand for the infrastructure and that the use of the infrastructure cannot be unduly interrupted by the State.

Change in law

Concession Holders enter into concession arrangements, and Finance Parties participate, on the basis of relevant local laws that exist at that time. It is probable that these laws may change over the long life of a concession. For Concession Holders to protect their investment and rate of return, and for the Finance Parties to ensure there are no impediments to the Concession Holder repaying the loan, it is important that a concession include change in law protection.

Change in law protection ensures that the Concession Holder's position under the contract does not materially change as a result of any change in law. Essentially the State agrees that no change in law will materially impact the Concession Holder's rights and obligations under the contract.

The change in law clause should be reviewed carefully to ensure that it captures all changes to not only laws, but also regulations and other subsidiary legislation, policies and judgments, and also how such laws, regulations, policies and judgments are interpreted or applied.

Termination rights

Termination is often seen as a very last resort for large infrastructure projects. The State has an interest in the continuance of the projects, as they often provide a public

service, and the Concession Holder requires the concession to run full term in order to recover its investment and make its desired rate of return. In addition, if a concession is cancelled, it is possible that the infrastructure becomes a stranded asset, unable to be sold. For example, there is not really a second-hand market for a remote power station that cannot sell electricity to the national grid.

For this reason, Concession Holders and Finance Parties pay close attention to the obligations of the State in the event the concession is terminated. To reduce the possibility of termination, the concession agreement should have long default cure periods, particularly if the infrastructure is remote and rectification measures could take time to mobilise.

Should termination occur, the best position for Concession Holders and the Finance Parties is for the State to have an obligation to purchase the infrastructure at a fair value. This is not always possible in all jurisdictions. Set out below is a summary of some standard practices, although note that these vary significantly and are not applicable to every jurisdiction.

- **Termination due to Concession Holder default:** ideally the Finance Parties want the State to purchase the infrastructure for at least the amount of any outstanding debt. In this case the Concession Holder would lose its entire equity in the project. In some more developed jurisdictions, or where there may be a second hand market for the infrastructure, the State may have a right, but not the obligation, to purchase the infrastructure following default by the Concession Holder.
- **Termination due to the State's default:** the ideal situation for both the Finance Parties and the Concession Holder is that the State has the obligation to purchase



the infrastructure. The Finance Parties will be satisfied for the purchase price to be the amount of outstanding debt. However, as the termination is caused by the State, the Concession Holder should seek, in addition to repayment of debt and equity, an amount reflecting an agreed rate of return. Again, whether this will be possible will depend on each jurisdiction and the nature of the infrastructure.

- **Termination for prolonged ordinary force majeure:** often a concession agreement will allow either party to terminate for prolonged ordinary force majeure. In this case it may be difficult to impose an obligation on the State to purchase the infrastructure therefore the Concession Holder should seek to prevent the State's right to terminate, or, at a minimum, extend the length of time the ordinary force majeure event must continue before the State can elect to terminate.
- **Termination for prolonged government force majeure:** in this case, the Concession Holder has a stronger argument to require the State to purchase the infrastructure for outstanding debt, plus equity and an agreed rate of return. This again depends on the circumstances in each country and the nature of the infrastructure. If including a purchase obligation is not possible then the Concession Holder should seek a longer period that the government force majeure must continue before the State's right to terminate arises.

Foreign currency exchange / convertibility

An important consideration for any investor into a foreign country (and its Finance Parties) is the ability to convert local currency into foreign currency and the ability to repatriate profits off-

shore. In this regard, a Concession Holder should carefully review local currency laws and any currency restrictions that may be in the concession agreement. This is particularly important where the Concession Holder is paid in local currency, but has expenses / debt service obligations in foreign currency. Any limits on converting and repatriating funds will impede these foreign currency payment obligations.

Currency convertibility and repatriation restrictions may include:

- limiting the extent to which local currency can be converted into foreign currency;
- controlling the exchange rate for such conversion;
- regulating the types of currencies with which payments may be made;
- restricting or limiting the transferability of a currency off-shore and repatriation of profits off-shore.

Government guarantees

Under a concession agreement, where payments will be made by a governmental authority to the Concession Holder, both the Concession Holder and the Finance Parties are assuming the credit risk of the governmental authority. If the governmental authority is unable to make payments then the Concession Holder and lenders may have limited practical recourse.

In jurisdictions where concession arrangements do not have a long history, or where the credit worthiness of a particular governmental authority may be questionable, then the State government may guarantee the payment obligations of the governmental authority. The guarantee arrangements are highlighted in black in Diagram 1. Governments are normally reluctant to provide these guarantees and, where a guarantee

is provided, the scope of that guarantee, and the conditions on which it can be called, vary significantly.

Concession Holders should consult with their Finance Parties in order to determine if such a guarantee will be a requirement for their specific infrastructure project and then determine if such a guarantee is possible and if so, the terms on which it is provided.

Other Issues

While this paper is not intended to be an exhaustive summary of all of the issues to consider when entering into a concession arrangement in a Belt and Road country, there are several other common issues that are often of particular interest to Concession Holders. They include:

- **Land:** land ownership / use rights are often a heavily regulated and politically sensitive issue. Where possible, a Concession Holder should seek to move the obligation to obtain land to the State, provided that the State undertakes to do so in a fair manner and in accordance with applicable laws. This is particularly the case for infrastructure that may cover significant distances, such as power lines, roads and rail.
- **Governing law:** it is preferable for a Concession Holder to have the concession agreements governed by the laws of a reliable jurisdiction, and dispute resolution by way of arbitration in a reliable venue (e.g. London, Paris, Singapore or Hong Kong). However, the procuring government's receptibility to such proposals can vary significantly. Some emerging economies are prepared to accept this in order to attract foreign capital, but most developed jurisdictions would require local governing law and local dispute resolution processes.
- **Local content:** often either the terms of the concession or local law will require the use of local materials and labour. The extent of this requirement varies considerably from strict quotas and limits on foreign materials and labour to merely best efforts obligations. The impact of these requirements on procurement, labour (and the availability of skilled labour) and costs should be considered during the tender process.
- **Government participation:** often the State or governmental authority will want (or be required by domestic law) to take an equity interest in the Concession Holder's project company. This can be a benefit – government participation can ensure the project progresses smoothly; however it can also cause added complexity, particularly if the government wants involvement in management decisions.
- **Local participation:** some jurisdictions may have minimum domestic ownership requirements, or an obligation to divest a certain percentage of equity to local shareholders after a period of time. The impact this may have on management and decision making and rates of return should be assessed during the tendering process.
- **Back-to-back sub-contracts:** in most cases the Concession Holder will sub-contract out at least the construction and operation and maintenance of the infrastructure. In this case, the construction contract and operation and maintenance agreement, and any other main sub-contract, should be back-to-back with the terms of the concession agreement. The Concession Holder should look to replicate risks, obligations and timing of payments in the sub-contracts so that they mirror those in the concession agreement. The contracts which should be back-to-back are highlighted in red in Diagram 1. To the extent there are any discrepancies between the sub-contracts and the concession agreement, the Concession Holder will bear that risk.
- **Direct agreements:** as a condition to lending, banks will require direct agreements with the counter parties to all major contracts, including the concession agreement, the construction contract and the operation and maintenance agreement, as highlighted in purple in Diagram 1. The banks will largely determine the terms of the direct agreements, however their main purpose is to give the banks certain rights to either remedy defaults of the Concession Holder or to step in place of the Concession Holder to avoid the agreements from being terminated.

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