Balancing Government & Investor Interests
Legal Issues in Port Concessions

Cairo, 12 April 2010

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ALLEN & OVERY

About A&O Global Projects Group

"The magic circle law firm led its closest rivals by a clear 22 deals, separating itself from the second-ranked firm by more than USD2.5 billion." *Infrastructure Journal, 2010*

- The market-leading projects firm with 70 partners and 200+ lawyers across 34 cities worldwide
- The group has advised on projects in 174 countries, including numerous market firsts and landmark projects
- Leading firm in the wider Middle East and Africa with MENA presence for over 30 years
- Extensive language capability including Arabic, French and Portuguese speakers and relationships with leading local counsel across Africa and Mid East

Ports specialists

League table of port projects finance legal advisers for 2004-2008 (Source: Dealogic)	Rank	Firm	Value (USDbn)	No. of deals	% share
	1	**Allen & Overy LLP**	**2,928.921**	**15**	**10**
	2	Shearman & Sterling	3,277.000	4	11
	3	Clifford Chance LLP	3,119.733	4	11
	4	Linklaters	2,149.136	9	7
	5	Freehills	1,859.069	8	6

Partner
Dubai

Ian Ingram-Johnson

- extensive experience of project financing, acquisition financing and ECA/multi-sourced financing in Africa, the Middle East, Europe and Asia
- advises various parties including sponsors, governments, lenders and project companies in sectors as diverse as transport, infrastructure, oil & gas, petchem, power and water.
- **Ports experience** includes Aqaba Port in Jordan, Qasim port in Pakistan, Bluewater Port in India and Sines port in Portugal
- "*bright and to the point*" and has "*a brilliant reputation*." (Chambers Global, 2008)

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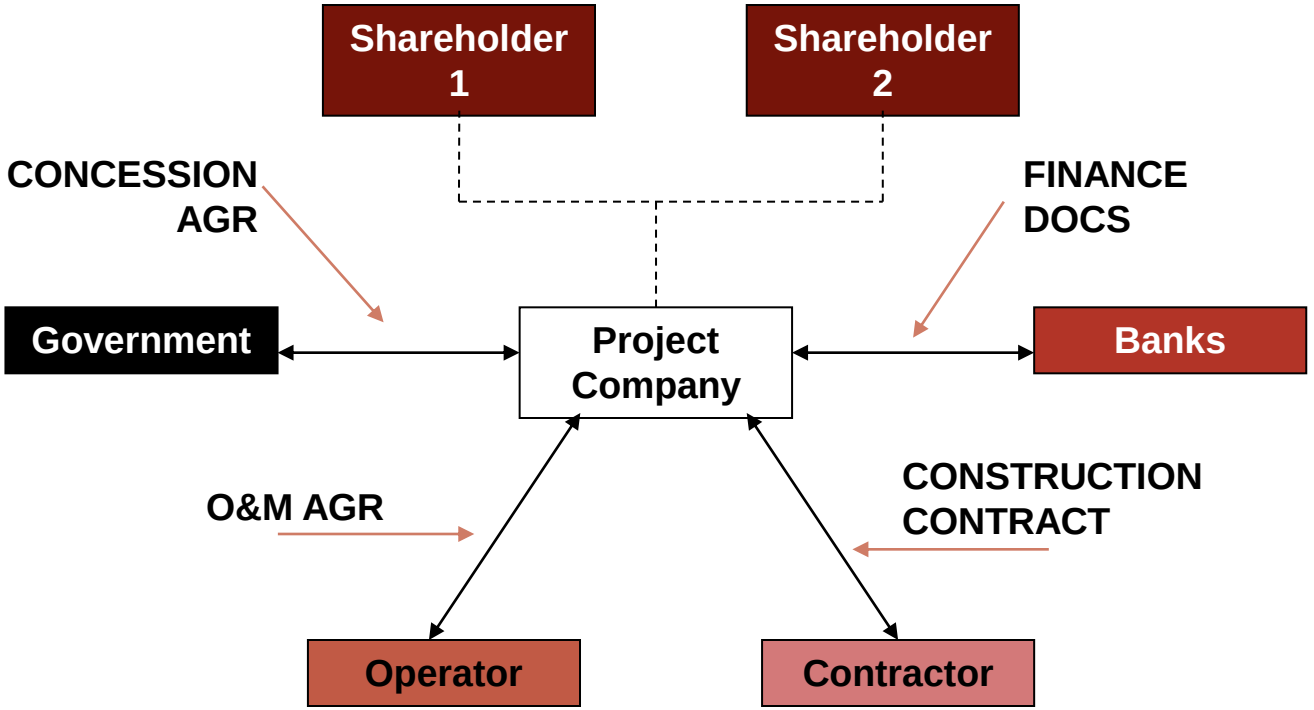
Background to Project Finance: The Parties' Motives in Port Projects

"I struggled for years to understand what motivates me to do the things I do. Only took the jury five minutes."

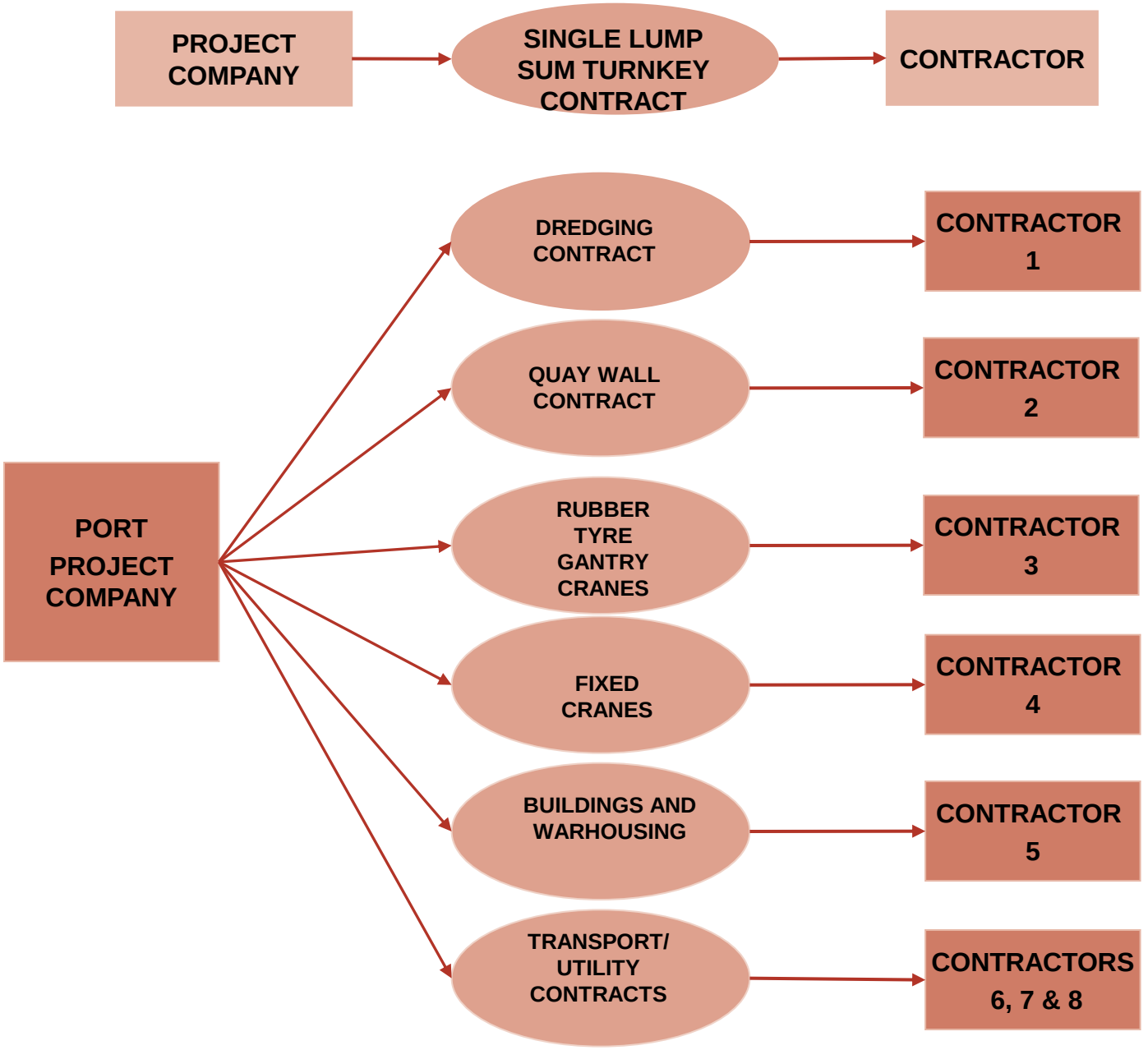
Key Issues in Financing a Port Project: Liquidity issues in the commercial bank market?

The "Typical" Projects Structure



N.B. Government equity participation and conflicts of interest (can these be managed and is it a double edged sword?)

Contrast between Typical Projects Construction and Port Project Construction = Interface Risks



All parties are motivated for success of a project…but in different ways…

Government	Sponsors	Lenders
➢ **Asset/operational by date certain** ➢ **Provision of long term public service**	➢ **Profit (sponsor IRR)** ➢ **Strategic investment**	➢ Get money back with return
➢ Harness technical & operational capabilities of private sector	➢ Construction &/ or operating fees	➢ **Credit risk profile vs. equity risk profile**
➢ **"Efficient" risk transfer to private sector**	➢ "Balanced" risk sharing	➢ Debt = risk averse ➢ Preserve the project
➢ Payment on performance = less risk of delay and cost overrun	➢ Off balance sheet	➢ Control over key decisions
➢ Harness funding streams	➢ Ability to participate in large deals	➢ Take full control when things go wrong

The Philosophy Behind and benefits of PPP

- Large capital projects let by the public sector have historically been poorly managed and over-budget
- Services should be procured on the basis of an "output" specification only
- Risks should be borne by those most able to manage them
- Life-cycle view of asset cost

- Involving the private sector in the provision of services to or for government should:
  - encourage the private sector to take a long-term view of the service-providing
  - enable a significant degree of risk in both the construction and the operating phases to be passed to the private sector
  - result in better value for money
  - encourage innovative solutions
  - free up money for front-line government services

Content of Typical Concession Agreement 1

- Term
  - Possible extension for certain events (e.g. Force Majeure)
  - Generally for the useful life of the asset
  - Handback criteria
- Construction obligations
  - Generally output-spec based but with some specific inputs
  - Independent certification of completion
  - Possible LDs for failure to complete
- Taking over of existing asset
- Operation and Maintenance obligations
  - Facilities Management
- Periodic price benchmarking
- Payment
  - Revenue sharing for ports
  - Deductions for performance shortfalls

Content of Typical Concession Agreement 2

- Land – generally lease
- Force Majeure
- Relief Events (time relief)
  - Unforeseen Ground Risk
- Compensation Events (time and money)
  - Expropriation
  - Withdrawal of Project Consent
  - Change in Law
- Compensation on Termination
  - Debt for Project Co default
  - Debt and equity or for FM
  - Debt, equity and return on equity for Government default
  - Alternatives based on Fair Market Value with adjustments depending on cause of termination

Key Differences in Ports Projects

1. Project company usually pays the Government rather than vice versa
   - Fixed Fee/Rent
   - Variable fee – 1% of (gross) revenue
   - Availability of set-off mechanism as a result of fee structure/compensation
   - Transhipment versus local/ domestic traffic?
   - Minimum through-put/ revenue assurance (bulk/ cargo vs transhipment)?
2. Key Performance Indicators (KPIs) to measure performance
   - No commodity supplied so need independent measuring standards
   - Efficiency driven as a in traffic = less revenue for Procurer (who shares in revenue)

Key Differences in Ports Projects

3. Management Services Agreement
   - Conflicts of interest competing port managers, also majority shareholder of Project company
   - Termination consequences
     - Penalties
     - Operability
4. Insurance
   - Sabotage & Terrorism Issues
   - Environmental (oil spills, collisions etc)
5. Greenfield versus brownfield
   - Significant “in water works” funded by governments
6. Intellectual property
   - Access to IT/ Computer programs for operation

Risk Allocation: Construction Risks

HEALTH WARNING:

THERE ARE NO DEFINITIVE TEMPLATES FOR RISK ALLOCATION

RISK ALLOICATION WILL DEPEND ON THE SECTOR, MARKET, GEOGRAPHHY ETC. ETC ETC.

Risk	Government	Project Co	Contractor
Land	X		
Planning		X	X
Environmental	X	X	X
Design		X	X
Ground risk		X	X
Antiquities		X	X
Insurable FM		X	X
Variations	X		
Force majeure	X	X	
Cost overruns		X	X
Change of law	X	X	X
Delay		X	X
Latent defects		X	X
Insurance		X	X

PPP Typical Risk Allocation: Operating Risks

HEALTH WARNING:

THERE ARE NO DEFINITIVE TEMPLATES FOR RISK ALLOCATION

RISK ALLOICATION WILL DEPEND ON THE SECTOR, MARKET, GEOGRAPHHY ETC. ETC ETC.

Risk	Government	Project Co	Operator
Variations	X		
Performance		X	X
Change in law	X	X	
Increased costs		X	X
Maintenance		X	X
Insurance		X	
Force majeure	X	X	
Expropriation	X		

Note: different markets, different sectors and different countries have differing allocations; emerging markets or first of kind projects likely to have more conservative risk allocation with government retaining more risks

PPP Typical Risk Allocation: Revenue and Transfer Risks

HEALTH WARNING:

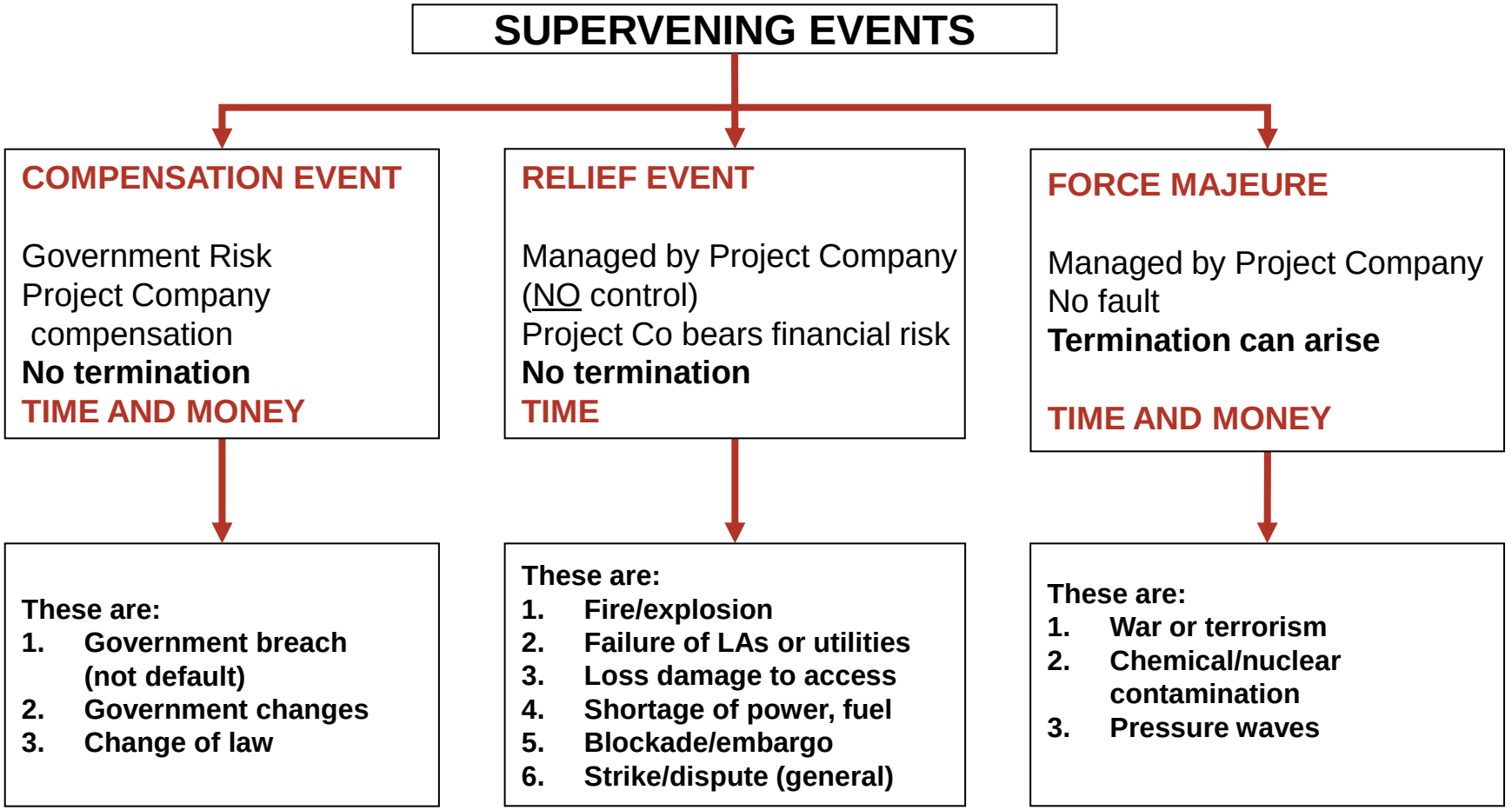
THERE ARE NO DEFINITIVE TEMPLATES FOR RISK ALLOCATION

RISK ALLOICATION WILL DEPEND ON THE SECTOR, MARKET, GEOGRAPHHY ETC. ETC ETC.

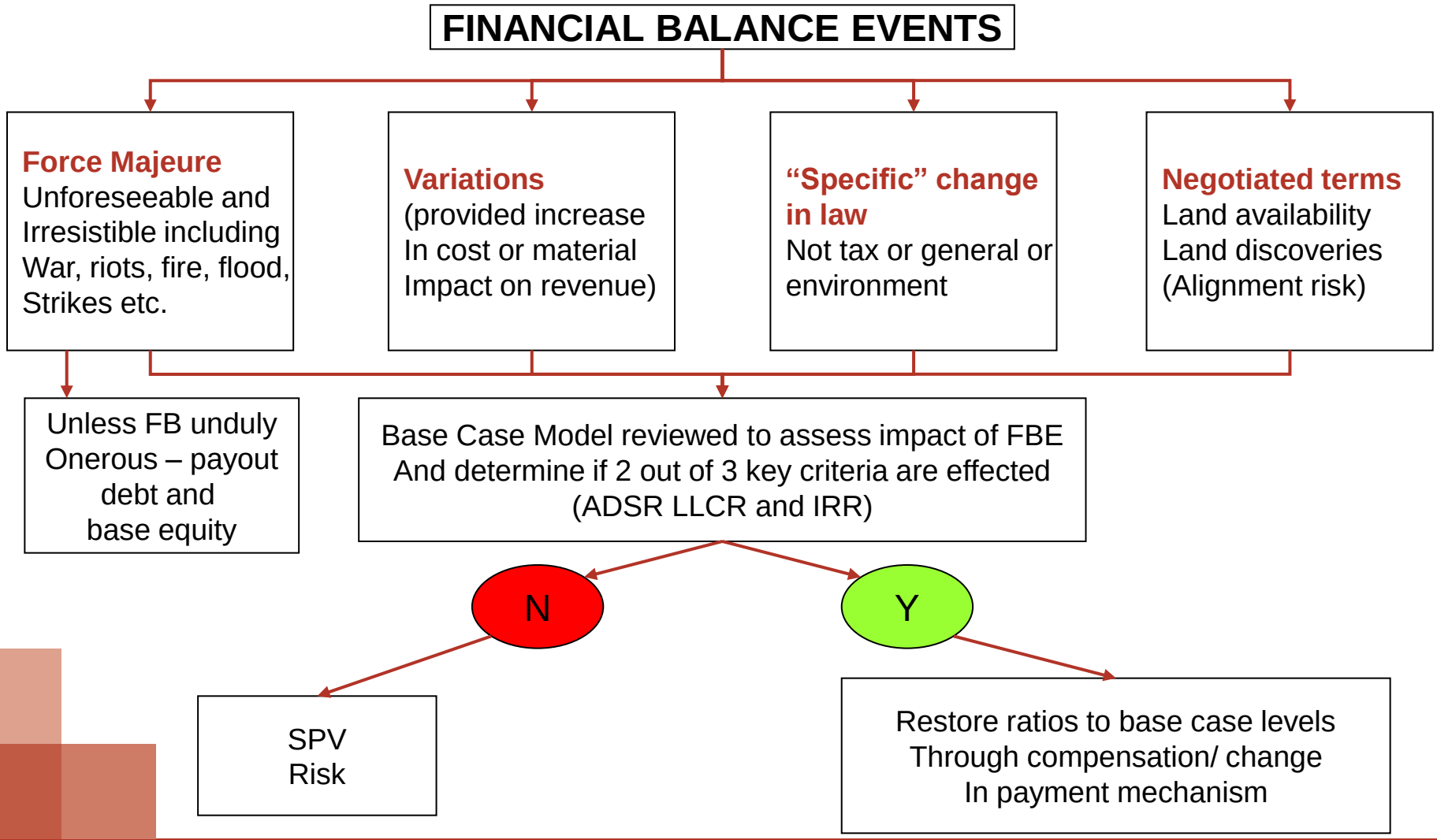
Risk	Government	Project Co	Operator
Traffic/usage	(X)	X	(X)
Fares/revenue		X	(X)
Taxes		X	(X)
Competing schemes	(X)	X	
Interest		X	
FX	(X)	X	

Risk	Government	Project Co	Operator
Land rights	X	X	
Repair		X	(X)
People		X	X
IP		X	X

“Supervening” Events



Financial Balance Procedure



The Termination Compensation Issue 1

- It is assumed only 3 causes of termination:
  1. Project Company Default
  2. Government Default
  3. Extended or Prolonged force majeure

The Termination Compensation Issue 2

Compensation	Government Default	Force Majeure
Debt	Yes	Yes
Break Costs	Yes	Yes
Return of Equity	Yes	Yes (net against previous dividends?)
Return on Equity	Yes, cap?	No

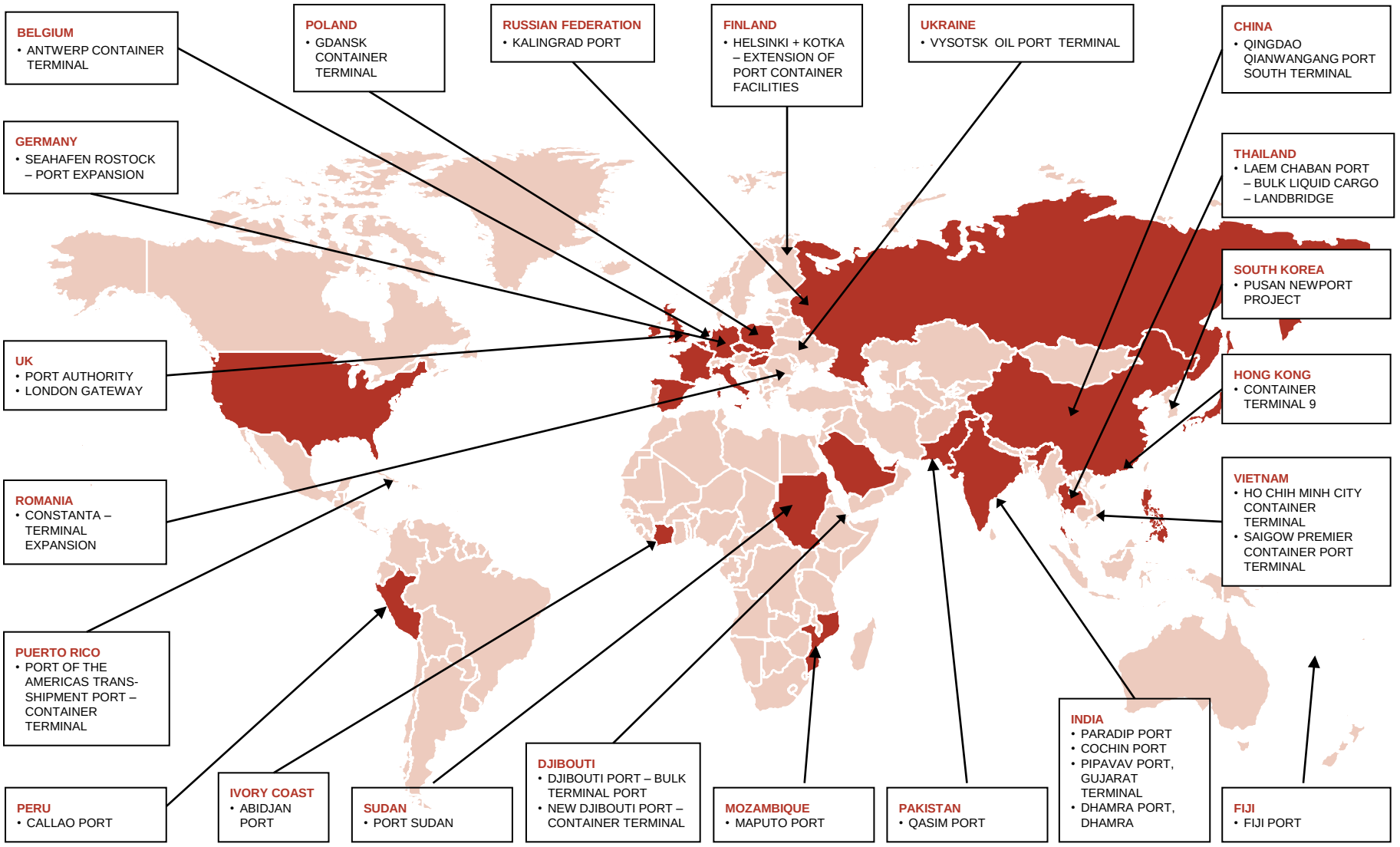
Key issues is level (if any) of “lenders’ haircut” on termination payments. Some jurisdictions driven by government’s ability to get Project “off balance sheet.”

The Termination Compensation Issue 3

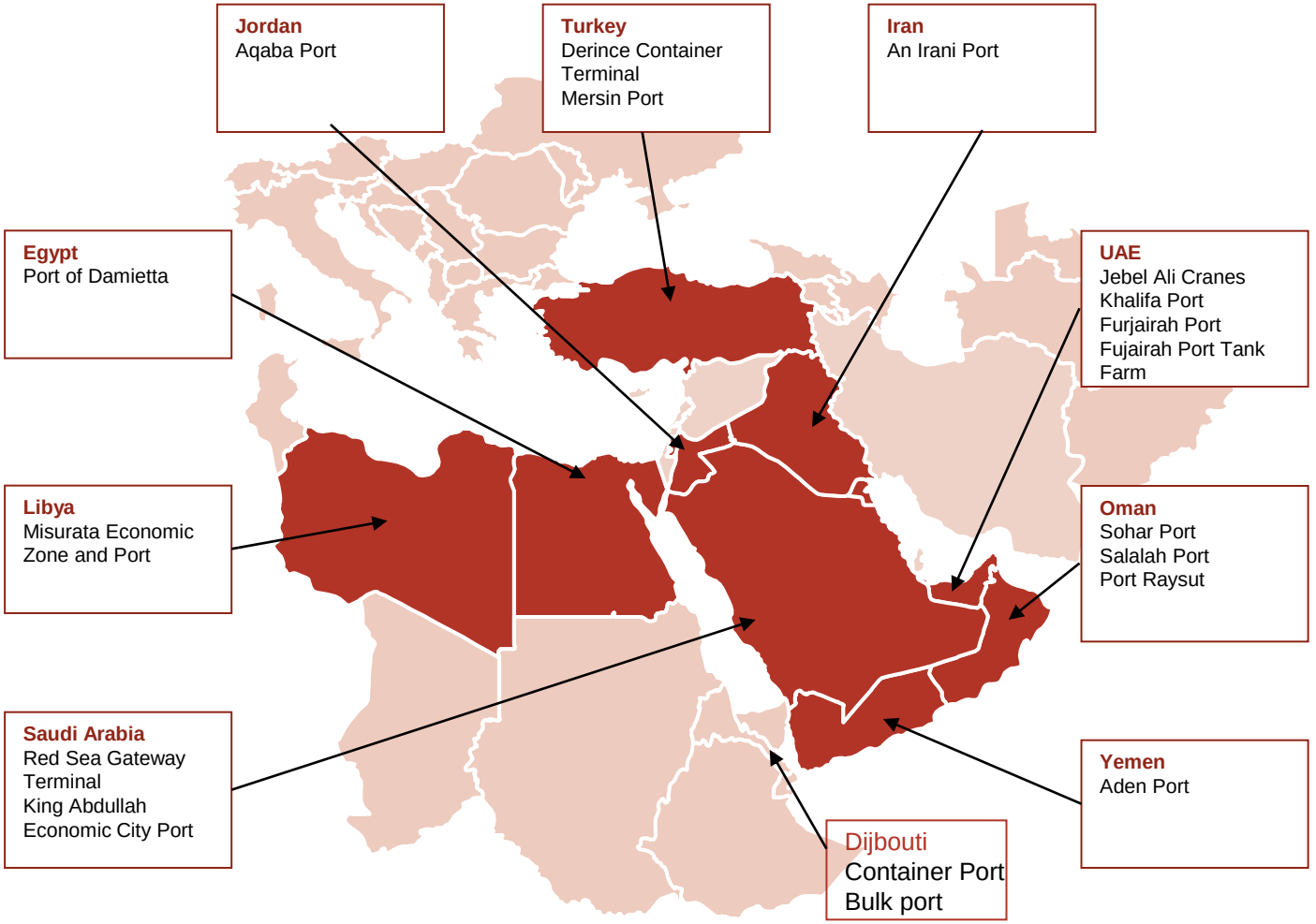
Project Company default (the difficult case)

Argument for termination payments	Arguments against termination payments
Government otherwise gets asset for free	Government innocent party
Unjust enrichment	Drain on public purse
Penalty	To easy to manipulate default
Prejudice bankability	

Sample global A&O port projects



Sample MENA A&O port projects



Sample market practice for Port Projects

	Port 1	Port 2	Port 3	Port 4	Port 5	Port 6	Port 7	Port 8
Country	South Korea	Morocco	Turkey	Poland	Taiwan	United States	Belgium	Spain
BOT/ Concession *	✓	✓	✓	✓	✓	✓	✓	✓
Deal Value (US$)	961m	202.6m	876.4m	239.8m	648m	544.9m	256.2m	49.2m
Debt: Equity	67:33	73:27	69:31	Market	70:30	60:40	Market	Market
Term of Concession	29 1/4 years	30 years	36 years	30+30 years	50 years	30 years	40 years	30 years

*** Balance of the Concession Agreement is a primary driver as to the viability of the relevant port project.**

More detailed port market survey

	Term Yrs	Govt concession	Govt change/ variation	Natural FM	Political FM	Change in law	Delay in Govt permits	Delay in Govt utilities
Port 1	50	✓	✓EOT ✓FC	✓EOT ✓FC	✓EOT ✓FC	✓EOT ✓FC	✓EOT ✓FC	✓ bankable utility agr
Port 2	<market	✓	✓EOT ✓FC	NA	NA	✓EOT ✓FC	✓EOT ✓FC	✓bankable utility agr
Port 3	30	✓	✓EOT ✓FC	✓EOT ✓FC	✓EOT ✓FC	✓EOT ✓FC	✓FC	✓EOT ✓FC
Port 4	40	✓	NA	✓EOT	✓EOT	NA	NA	✓ EOT ✓FC
Port 5	50	✓	✓ FC	✓EOT	✓EOT ✓FC	✓EOT ✓FC	✓FC	✓bankable utility agr

EOT = extension of time
FC = financial compensation
Bankable utility agr = supply from existing source with bankable contractual terms
See table distributed for further detailed analysis including levels of termination payments and FC

Core themes

- Many ways to procure successful ports
  - Privatisation, operation agreements, sale of land etc
  - PF structures used to harness capital markets/ funding
- Importance of development banks and multilateral agencies
- Majority (if not all) port projects are brownfield expansions and as such:
  - most if not all “in water works” are funded by state
  - most ports have proven business (trans-shipment figures for existing port facilities and all utilities and infrastructure in place)
- Majority (if not all) project financed ports have a sovereign/ state concession grantor (or at least quasi sovereign authority)
- Concession in bankable form for a Project Financing
  - Political risk assumed by state
  - Termination payments in line with “market”
  - Other key bankability provisions (force majeure, change of law etc)

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