INFRASTRUCTURE FINANCE IN ASIA

Commentary

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May I first congratulate Barry Metzger on a perceptive and interesting paper which focuses attention on the thorniest problem in Asian infrastructure financing, sovereign risk. The analysis in the paper is stimulating, and it is interesting to see that the problems referred to are mirrored exactly by our own experience over a range of projects in different countries in the region.

Before proceeding any further, I would like to thank my partner Andrew Boxall, both for delivering this commentary on my behalf and for his observations on it, which like mine are born of at times bitter experience.

BACKGROUND

Our experience in BOT/BOO projects in the Asian region includes major roles in:

- Toll roads : Malaysia, Indonesia
- Water projects : Malaysia, Indonesia, China
- Power projects : Laos, China, Indonesia
- Railway : Malaysia, Indonesia, Thailand
- Privatisation of government services : Malaysia

I propose to draw on one transaction in particular by way of illustration. The project was one of the earlier privatisations in Malaysia, the Kuala Lumpur Toll Road project (also known as the Ceras Toll Road project). It shares with the Bangkok Expressway the distinction of being a

privatisation which foundered and collapsed, but in a somewhat more supercharged political environment.

AUSTRALIAN LAWYERS

While appreciative of Barry's comment that Australian lawyers developed many of the techniques now being used in project finance, it is necessary to strike a note of caution. The reality is that the international banking market does not accept that Australian law firms have the credibility to front major international loan transaction for Asian BOTs, or that Australian law represents an appropriate choice of governing law for such projects.

This should not come as a surprise to practitioners who were around in the 60s and 70s. The first major cross border loans into Australia wholly documented by Australian lawyers occurred only in 1979-80 (MIM, Tomago etc). These became common in the 80s as Australia become an attractive destination for lenders, but faded in the late 80s. Similarly, it was not until the mid 80s that international capital markets issues by Australian issuers started to be documented by Australian lawyers, or to adopt Australian law as their governing law.

As a battle hardened combatant, it is fair to say that despite an intellectual acceptance that Australian lawyers have the technical and commercial skills to front major loans in these deals, major international lenders will not use Australian firms. They want English (or, to a lesser degree, New York) law, and the market credibility of having their transactions documented by a well known London or New York firm. An Australian firm will not win a loan mandate for a major South East Asian project financing in a race against major UK/US firms, at least until Australian banks take a leading role in the market (and even then the Australian bank will need to fight strongly to overcome the commercial and market pressures which presently dictate the choice of lenders' lawyers).

On the other hand Australian firms have done very well in terms of persuading promoters of BOT/BOO deals of their value. The reason has been that the promoters have needed the skills Barry Metzger has referred to - being particularly the defensive skills developed by lawyers in capital importing countries in acting for borrowers on major projects - coupled with an ability to move comfortably in Asian jurisdictions. They have also appreciated the neutrality of Australians in jurisdictions where UK and US lawyers are treated with a degree of suspicion, as well as the streak of combativeness which Australian lawyers often show in dealing with European or American financiers and their lawyers.

It is a cause for concern that the Australian legal profession has, with the exception of my own firm, retreated from full engagement in Asia. There are now fewer Australian law firms operating in Asia than there were seven years ago.

SOVEREIGN RISK

It is a source of great pleasure to see expressed in clear, analytical language, the myriad of frustrations which we have experienced in dealing with governments in Asia on project financings. The comments on sovereign risk and the prescriptions for what governments ought to do should be compulsory reading for all politicians and bureaucrats involved in the privatisation process in Asia, as well as for the promoters of projects, if only so that they get a realistic feel for what awaits them in the course of negotiations.

It is in this area that the fundamental differences between Western and Asian infrastructure regulation become apparent. The paper lists as required elements the following:

(a) ***"Transparent rules, consistently applied, and effectively enforced"***

In the area of transparent rules, much progress can be made through the project documentation, until the day there is trouble. At that point, neat documentary dispensations disintegrate in the face of the aggressive exercise of political and bureaucratic power.

(b) ***"Independence of the regulator"***

This most laudable of objectives is generally the first to be refused in negotiations. Alternatively, an independent regulator is established, and the post filled by a low ranking employee of the supervising government department. Our experience has been that an independent regulator prepared to resist government pressure is a rare, if not mythical, creature in most Asian societies.

The creation of such a regulator can sometimes lead governments to endeavour to negotiate down protections in project documents, on the basis that the independent regulator exists. It is not easy to say boldly to a senior bureaucrat that you think his independent regulator will be a puppet of the politicians or bureaucrats! For an independent regulator to work, legal systems need to be totally reliable and the host country must pay more than lip service to principles of judicial independence. The number of Asian countries of which this can be said is limited.

This leads to a somewhat wider issue, which is the cultural transplantability of the project model. In essence, the classical project financing operates through a rigid contractual allocation of risks, and rests on two assumptions: first, that the parties will honour their contracts; secondly, that failure to honour them will ultimately be subject to sanction through the powers of the courts and the state. Experience suggests that neither assumption is necessarily valid in an Asian context:

- It is a cliché of business dealings in many Asian countries (but no less accurate for being a cliché) that a contract serves, not so much as the definitive statement of the parties' respective rights and obligations, as a temporary halt in the negotiating process, which is to be resumed as and when circumstances change. The concern is obvious: carefully crafted risk allocation provisions tend to be of peripheral relevance if they are to be renegotiated whenever they start to hurt. The universal validity of the first assumption is thus open to doubt.

- The hierarchical tendencies of many Asian societies mean that if the host country's government indicates that a particular course of action in relation to a project is desirable, local sponsors, lenders or investors will often be inclined to comply, whatever the project documents may say, and however illogical the particular course of action is in the context of the project. The motivations are numerous: convictions as to the role of authority, habits of compliance, and the perception that long term self interest is best served by complying, all play their part. Whatever the motivations, the result is the same: one cannot necessarily assume in relation to an Asian project the same preparedness on the part of local participants to assert and enforce contractual provisions as one can in, say, Australia or the US.

CONFLICTS

The paper identifies one of the critical factors in Asian BOT projects as problems caused by internal conflicts on the government side.

In our experience there is one fundamental precondition to a successful BOT project: that is, strong political will exercised by a Minister with the political power to force the project through. If this factor is not present projects almost inevitably collapse.

One common factor of Asian bureaucracies is their ability to set up endless obstacles to any project. Having gone through the process on a number of occasions I have come to the view that in an Asian society such a process has value. It achieves several things:

(a) All really hard issues run into bureaucratic roadblocks which can only be resolved by Ministers. This relieves the bureaucracy of the need to make decisions for which they can be blamed. When their face and careers are no longer on the line, the bureaucrats can often be more accommodating on other issues.

(b) It slowly educates the bureaucracy as to what the deal is about. This is an important part of the process. In our experience, if the bureaucrats do not fully understand the project and problems arise after completion, the reaction is savage. The project lawyer plays a crucial role in winning over the bureaucracy. If the lawyer does his job properly the bureaucracy fully understands the project documentation and, more importantly, understands the risks that the government is taking on and the reason why it is taking on such risks.

To the uninitiated layman the concepts underlying risk allocation in BOT projects are alien and difficult to grasp. The better the project lawyer explains them and the simpler the documents the more successful the project will be.

It is in this area that Australian lawyers have had a degree of success. English and American lawyers tend to write documents which are too subtle and sophisticated (and often too long and wordy) for the market. Put crudely, what is needed is a document which spells out in crystal clear English in short didactic sentences exactly what will happen:

eg "*If the Government does not hand over all the land for the railway on Day 1 it will pay $X, plus $Y for every day of further delay.*"

There is no scope for elegant and subtle drafting. What works best is a crude, simple style. After all, the people who need to understand the risk allocation are generally not lawyers, the lawyers advising them do not usually have a commercial or banking law background, and many of them - bureaucrats and lawyers alike - speak and read English only as a second language. Australian lawyers seem to have worked this out rather better than their competitors. Perhaps it comes naturally to those involved.

Having had a minor involvement with the Bangkok Expressway we would gently suggest that it was a lack of understanding of the real deal at the outset which caused some of the problems later on. The feedback we had was also that the promoters were inclined to believe what they were told and accepted assurances without reducing them to simple statements in the documents. Again experience suggests that the only provision which counts is one which is so clear that to break it allows no argument as to interpretation of the clause.

TARIFFS/TOLLS/FARES

Barry's paper canvasses the annoyance of the lenders faced with clearly drawn toll increase provisions which were totally ignored.

Our own experience with the KL Toll Road Project in the late 1980s is a similar salutary lesson. Our client, the concession company, had a concession to build, operate and toll certain roads in KL. The first stage of the road was completed on time, within budget and in accordance with all the financial and operational parameters - notably as to toll rates and the closure of alternative routes - established by the government several years previously, when it was awarded the concession. The road opened with great fanfare, which was followed shortly by a realisation by the residents of certain suburbs that they could not get from their homes to central Kuala Lumpur without either (1) paying a toll, or (2) undertaking massive detours. This led to riots at the toll booths, and to stoning of the collectors for several days running: ironically, the most vigorous rioting seemed to come from groups of motorcyclists, who did not even have to pay the toll!

The protesters then took direct action and broke down the earth walls surrounding the toll plaza, so as to create a toll free route around the toll booth. Not unnaturally, thousands of cars went around the toll booth, and only a handful paid the toll.

As a general election was imminent, a senior Minister "gently invited" the concession company not to charge tolls; the local constabulary suggested too that the operator avoid public disorder, by suspending collection of tolls. These events amounted to a default by government under the terms of the concession agreement. The concession company complied with the government's request by suspending tolling, having received public assurances from highly placed Ministers that the government would comply with its contractual obligations to compensate the concession

company for suspending tolling, and that a mutually satisfactory renegotiation of the concession would take place, which preserved the financial position of the concession company and the financiers while achieving the government's political objectives.

In the finest traditions of "*Yes Minister*" two committees were then set up to deal with the matter. These consisted of around thirty bureaucrats, on one hand, and a smaller number, on the other. The company was called before the larger committee on several occasions, to which the company and its advisers presented a series of proposals to restructure the transaction in the way foreshadowed by the government.

Also in the finest tradition of such committees, neither one reached either consensus or decision, other than to reject all the restructuring proposals put forward by the company. After several months and much intrigue the matter was resolved by a local group with good political connections buying out the shareholders in the concession company and repaying the debt with a large government subsidy; in yet another irony, this was a somewhat more costly variant to the government of one of the proposals which had been put to (and rejected by) the review committees several months previously. In other words a virtually identical solution to that used in Bangkok some years later.

FARES INCREASES/SCHEME OF CONTROL

The issue of tolls/fares is always the most vexed in any set of negotiations on concession documents. In particular the issue of regular increases is always heavily negotiated.

The power to control fare increases is the single most argued over issue in most projects. In some countries Ministers will not concede any automatic increases, which makes projects somewhat difficult. The compromise which seems to be finding general acceptance is one under which if a Minister does not want fares increased at a particular point then the fares are frozen, but the government makes up the difference. As a trade-off fares are artificially capped, usually by reference to CPI and there is put in place a scheme of control to clawback profits in excess of certain defined returns on investment. Any excess profits are held by government against obligations to fund future fare freezes.

This mechanism allows Ministers to control the timing of fare increases, especially at "*sensitive*" times. It also protects the operator, while at the same time eliminating the political irritation of operators reaping unfair profits.

EDUCATION

Barry refers briefly to a proposal to provide technical assistance to the Indian Government to train government lawyers and give them access to international lawyers.

In principle this is a fine suggestion, which should be extended to other jurisdictions. The difficulty is that where the government lawyers really need assistance is also in the area of document review of specific transactions.

There is much to be said for encouraging governments to use international lawyers more actively. The cost could relatively easily be recouped from the promoters, especially if some aid funding were used to bridge the gap between the rates usually paid by governments and the rates international firms need to charge. We normally advise promoters of BOT schemes in less sophisticated Asian countries to ensure - if need be, by paying for it - that the host government receives at least some sophisticated legal and financial advice on the project. This goes to the point made earlier, concerning the need to ensure that the host government understands fully the implications of the project.

CONCLUSION

It is easy to become discouraged by the potential risks outlined in the paper.

In our experience, Australian banks in particular (and commercial banks in general) tend to be overwhelmed by such theoretical risks and end up not participating in the BOT market in Asia.

The reality is that most deals which make it through the tortuous process of putting together an Asian BOT survive very well. Those that do not tend to be sorted out in what some describe as "the Asian way": ie quietly, out of public view, and in a process where a reasonably fair deal is struck to sort out the mess. Typically, such a deal entails a change in ownership and control of the project at a modest profit to the initial investors, a refinancing and the chance of future projects, once the dust has settled, for investors who exit quietly and quickly. To a local investor, this is often a not unattractive prospect; to foreign investors, however, it may be less appealing.

Perhaps too much focus is placed on the deals which come unstuck and too little on getting the political and bureaucratic settings right at the outset. After all, if it were too easy it would not be anywhere near as lucrative or as much fun.

It would like to thank Barry for providing us with a well thought out and stimulating paper which will no doubt become essential reading for any intending infrastructure lawyer in Asia.