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# RISK ALLOCATION

## — Greenfield airports in India

By Sumeet Kachwaha

**W**hen one looks at the current buzz around privatisation of infrastructure in India, it is difficult to believe that six years ago, privatisation was virtually an unknown concept. The story started with the road sector in the late nineties. Initially, even that did not come under the Build-Operate-Transfer (BOT) model. The project was then funded by the Indian Government through a one per cent cess on diesel. It also floated infrastructure bonds, which were taken up by public sector corporations. It was only in this millennium that privatisation was adopted as a government policy.

### Why privatise?

Just look at the airport sector. This sector has witnessed a growth of 35% on an average year upon year for the last six years (global growth is only about nine per cent per annum). The growth is fuelled by the robust economy and indeed, infrastructure leads to economic growth, thus completing the cycle. It is estimated that without the infrastructural gap, India's GDP would have been two per cent higher per annum and at about par, with the phenomenal growth achieved by China.

Currently, the India airport infrastructure is totally inadequate. Due to congestion, it is fairly common for flights to hover around airports waiting to get landing permission or poised on the runway





in a queue for takeoff. To give an idea of infrastructure gaps, one has to only look at the Delhi Airport, which has a capacity to handle 12 million passengers per annum but is actually handling 16.5 million passengers per annum. This figure is expected to cross 20 million passengers by early next year. Airport modernisation is therefore something which we could have done with, as of yesterday. The time is right for privatisation.

As of now, India has two greenfield

are the only greenfield concession agreements signed so far. There is no "Model Concession Agreement" from the government for future projects (though it proposes to come out with one).

### Structuring

Though the concessionaire for the Bangalore airport is a private limited company, the Indian Government through its agencies and instrumentalities holds a 26% stake (13% by the Central Government

airport design is expected to be on par with a world class international airport and allows a second runway to come up in the near future. At a two kilometre distance from the existing one, the second runway will be approximately 4000 metres in length with a width of 60 metres.

A significant part of the project permits "non-airport" activities. The concessionaire can develop up to 300 acres land commercially for any activity not connected with the airport. This could cover for



airport projects at Bangalore and Hyderabad, where the concession agreements have been signed and completion is scheduled for next year. Additionally, we have two brownfield airport projects for Delhi and Mumbai to be completed by 2010. The country is in the process of inviting bids for six more greenfield airports in metro cities and 35 brownfield airports in other cities. Aviation is a sunrise sector in India.

### Bangalore international airport

Let us examine the Bangalore greenfield airport, which was signed off by India in July 2004. It is interesting to note that the next concession agreement for Hyderabad, which was signed six months later, was virtually on the same lines. These two projects

and 13% by the State Government). This 26% shareholding ensures that the government is able to veto certain "fundamental resolutions," which as per the Indian Companies Act require a minimum of 75% shareholders vote. This is applicable in cases such as issuance of new shares, change of directors and change of auditors. Hence the Government does retain a certain element of control in the venture. Amongst the private players in Bangalore airport, the German-based Siemens has a 40% majority, while Zurich airport holds a 17% stake.

### Salient features

The site is situated about 29 kilometres from Bangalore and covers about 4300 acres. The total investment involved is about 500 million US\$ in the first phase. The

Instance, hotels, malls, Special Economic Zones, manufacturing factories, country clubs, golf courses or a power plant. Considering that this huge chunk of prime land comes to the concessionaire on a long-term lease and virtually free of cost, it is easy to imagine that this would be the commercial backbone of the project.

### Nature of the concession

Basically, the concession is for Development, Construction, Operation and Maintenance of the Bangalore international airport for a period of 30 years (extendable by a sole option of the concessionaire for another 30 years). The land for the same is leased by the State Government. The concessionaire has the burden to independently evaluate the scope of the project and is responsible for all risks which



may exist in relation thereto. It is obliged to follow good industry practices and all applicable laws.

The Government on the other hand, undertakes to support the project. Article 5.4 of the concession agreement states that in so many words: ("Government of India (GOI) acknowledges and supports the implementation of the project"). It further states that the Government of India will not take any steps or action in contradiction with the Concession Agreement, which results in or would results in its shareholders or the lenders being deprived or substantially deprived of their investment or economic interest in the project. Further all statutory and non-statutory bodies under the control of the Central Government will act in compliance with the concession agreement as if they are a party thereto and the Government of India shall ensure that all statutory compliances as may be required in relation to the project are granted promptly. This is a unique feature of the Airport Concession Agreements.

In fact, the concession agreements in the port sector or road sector do not have similar obligations on the government. The Concession Agreement also insulates the concessionaire against competition by stating that no new airport would be allowed to be set up within 150 kilometre radius for a period of 25 years from the date of airport opening. Further, the GOI will ensure that no other airport in India gets any unfair competitive advantage as compared to the Bangalore airport. Again, a unique feature for the airport concession agreement.

## Monitoring of the project

It is provided that the Government shall not intervene or interfere with the design, construction, completion, commissioning, maintenance, monitoring or developing of the airport, unless it is on account of national emergency or as per any existing law or for

public safety. If intervention is on account of public safety, it shall be limited in time and for a period to be mutually agreed between the parties. The parties agree to set up a joint co-ordination committee comprising of representatives of the State and private parties to monitor the implementation of the project at all stages including post-completion.

The airport performance shall be monitored through passenger survey and as per the IATA Global Airport Monitoring survey standards.

## Airport charges

As mentioned earlier, the concessionaire is free to develop approximately 300 acres for non-airport activities (which will fund and finance the project). These charges are not subject to Government control and will be free market driven. However, airport charges, which ultimately fall on the passenger, will be fixed with the approval of the Ministry of Civil Aviation. This would include passenger fees, landing charges and user development fees. These charges will be fixed on the basis of the current charges in place for other airports in India and shall be consistent with the International Civil Aviation Organisation's policies on charges for airports.

## Risk categories

Before we get into an evaluation and allocation of risks, let us examine the nature of the contract. We are not looking at an ordinary construction contract. Airports are not mere places for flight to land or takeoff. They involve public interest, convenience and safety. Besides construction of airport buildings, ATC tower and administrative buildings, they can encompass mini-townships, commercial areas, Special Economic Zones manufacturing factories, golf course and country clubs. Therefore the project is both mammoth and diverse. Then, one is looking at it over a period of 60 years.

How huge is a period of 60





years in the life of a nation? Just consider the fact that India became an independent nation just about 60 years ago. And the history of civil aviation is probably not much more than a similar period. Unimaginable changes can and will take place in 60 years. The public element, complexity and diversity of the project and the length of the concession agreement are all so vast, that it would be somewhat naïve to try and enumerate all risks associated with the project – or try and address them through a contractual process of allocation of risks.

With this cautionary note, let us examine five categories in the allocation of risks in greenfield airport privatisation. They are:

- (i) Delays and consequences of delay in the airport opening;
- (ii) Change in law and the risks involved therein;
- (iii) Termination of agreement due to default of either party;
- (iv) The role of the regulatory authority; and
- (v) Dispute resolution

Let us examine these in greater detail.

#### (i) Delays

The target date for airport opening is stipulated as 33 months from the date of financial closure. The concession period starts running from this date (airport opening). In other infrastructure sectors like roads or ports, the concession period starts from the date of signing of the concession agreement. This is the greatest incentive, and, at the same time, a coercive measure to ensure timely completion of the project. For example, if the concessionaire is able to complete the project even before the target date of opening, it gets its reward automatically in the form of the extra concession period it "earns" for itself. If the concessionaire delays the project, it eats into the concession period and therefore, the profits. One would have thought this to be a fairly sensible approach of reward and punishment. However, in the airport sector, the provision for delays is

rather soft on the concessionaire.

Firstly, the 33 months period for completion can be extended by as much as six months if it can be shown that the delay was on account of failure by Government of its obligations under the agreement (surely, a very vague ground for extension, which if invoked, would probably end up in dispute). After the six months extension, liquidated damages would kick in at around \$ 2250 per day (once again, a fairly nominal amount considering the public interest involved in expediting the opening and costs incurred due to congestions). Further, if the airport does not open for another six months, then it becoming an "event of default", which has its own cure period. Finally, it will lead to termination of the contract. This gives easily up to two years or so to a defaulting concessionaire to extend the deadline without having the project cancelled on account of delay. With a total completion time frame of 33 months, one should think that it is not prudent

or justified to allow such a large period prior to termination.

#### (ii) Changes in law

It is obvious that a concession agreement over a long period of time cannot guarantee against change of law. The concession agreement divides and treats the subject of change of law into two categories. The first, in which, a change in law entitles the concessionaire to some compensation and the second, which does not entitle the concessionaire to any compensation.

The "no compensation" cases or case where the concessionaire is not entitled to any benefit on account of change in law are those which relate to any of the following four types of statutes.

- (a) any non – Federal (or State) law
- (b) any environmental law
- (c) any labour law, or
- (d) any tax law

Hence, change of law under any of these statutes would not entail any compensation to the concessionaire for any loss, which may be occasioned to it. However, in tax laws, there is a further refinement. If there is any tax benefit, which is currently allowed to the concessionaire, it cannot be taken away by change of law without corresponding compensation. For instance, the infrastructure sector (including private airports) enjoys the benefit of 10 year income tax holiday, which can be availed of at any time during a 15 year period. Save for such current tax benefits, the legislature is free to amend its tax laws to the detriment of the concessionaire and the concessionaire has no relief against the same.

As regards the second category laws, other than the above four, it is envisaged that if there is any change of law, which results in a financial loss or burden in connection with the development or operation of the airport and the effect to, which exceeds over \$200000 in any given year, then the concessionaire may notify the Government and propose amendments to the contract. This will





put it in the same financial position it would have been, had there been no such change in law. If the parties do not agree to the amendments necessary, the matter would be settled through the Dispute Resolution Mechanism.

It will be noticed that this somewhat limited insulation, against changes in law, is only in relation to "airport activities" and does not cover the "non-airport activities". More significantly, it leaves it to the parties to hammer out an agreement as would suffice restitution. This is not very satisfactory, as typically Government bureaucrats are ill-suited and may be naturally reluctant to take upon themselves the delicate balancing act. There will be delays and controversies in the decision making process. Or it may be ad hoc and lack transparency and invariably, it would be short of expectations. All this would lead to disputes. Perhaps, a more efficient mechanism to deal with this situation might be to set up Dispute Review Boards (DRBs) till such time as the Independent Regulator is in place.

(iii) Termination of the agreement due to default:

The Agreement enumerates the "events" which would tantamount to "events of default" for either party. Once an event of default (as defined) takes place, a 120 days cure period is stipulated in the first instance. If there is no cure, a notice of termination may follow. Once notice of termination is issued, two consequences would follow: (i) GOI will acquire the airport and all rights, interest and titles of the concessionaire relating thereto, and (ii) have the option to acquire and takeover the non-airport activities. It is to be noted that the airport will be taken over even though the termination may be due to the Government's own default.

After the takeover of the airport comes the issue of compensation. If the concessionaire is the defaulter, the compensation allowed is 100% of the outstanding debt and the value of investment of the concessionaire in

the non-airport activities (consequently taken over by the government).

If on the other hand, the GOI defaults and yet the airport is taken over, then the compensation is more liberal. It includes:

- (i) the outstanding debt or "Settlement Amount" (as defined), whichever is higher. Settlement Amount will include the net current asset, gross fixed asset and intangible assets.
- (ii) The value of investment in the non-airport activities, which the government decides to takeover and
- (iii) damages.

#### iv. Role of regulatory authorities

In infrastructure projects involving the public an independent regulatory authority has become necessary. Accordingly the Concession Agreement envisages that an Independent Regulatory Authority would be set up to regulate any aspect of the airport activity. Very vast powers are envisaged to be cast upon the regulator. The regulator will not only lay down and regulate standards, approve charges and impose penalties. It will also settle disputes between the public and the government and/or concessionaire in relation to the airport as well as between the concessionaire and the government.

Two points are noteworthy here. The first is that extremely vast powers have been cast upon the Regulator, to the extent, which will ultimately lead to fading away of the parties' contract. Ultimately, the Regulator will be the bedrock on which depends the fate of the project. The second point is that the Regulator is not yet in place. The draft for enacting the law in this regard is still at the discussion level with the Government. Once the Cabinet approves it, a Bill will be drafted and placed before Parliament, which will then be debated. It will go through several sub-committees of Parliament. So we are at perhaps three years or so away from the stage when an Independent Regulator is constituted.

Further, the history of an



Independent Regulator in India is not very encouraging. Roads were the first to go for privatisation. It was envisaged that they would have a Regulator – but one has yet to see a draft Act in place. It is the same story with ports, oil and gas. It is 15 years since the radio broadcasting sector has been privatised and it does not yet have a regulator. In the power sector, there are regulators at the state and central level but the track record is not very encouraging. The nuances of airport governance through regulators are yet to be worked out. The regulatory philosophy has yet to be developed. In short, we are years away from setting up an Independent Regulator (ensuring foremost his independence), then providing for transparency and accountability in its working. The government is still debating preliminary issues as to the constitution and composition of the regulators. One set of thinking is that instead of multiple regulators for multiple sectors, we should have only two or three regulators. For instance, one would deal with all types of carriage - roads, airports, ports and even transmission lines. The other





would deal with electricity and voice data. Another theory is that energy, communication and transportation should be under one regulator. It would seem that we are years away from having an independent regulator who can fulfil the enormous and all compassing role visualised for it under the Concession Agreement. Till that happens, there will be ad hoc decision making lacking transparency and leading to disputes, which may hamper the growth and privatisation in the sector.

#### V. Dispute resolution

Normally one would not expect to hear about dispute resolution on the subject of risk allocation. But here we have a somewhat unusual situation. The Concession Agreement envisages that Dispute Resolution shall be through ad hoc arbitration, under the UNCITRAL Rules and under the Indian Arbitration Act, at New Delhi. This is not unusual by itself – as ad hoc arbitration is more common in India, compared to institution arbitration. The peculiar feature in dispute resolution is that once an independent regulator is put in place, the arbitration agreement

shall stand overridden and disputes shall be referred to the regulator. In other words, parties would no longer be able to go for arbitration.

The only exception envisaged (to resort to the regulator) is where sums are payable under an indemnity guarantee by the Government of India, to the concessionaire relating to Airport Charges (as defined). Here resort to arbitration is permissible (but not otherwise).

I envisage two types of problems. First, international parties committing huge funds in a foreign jurisdiction will have far greater confidence in arbitration in a neutral country under the rules of a neutral Arbitral Institute. This basic expectation is taken away under the airport Concession Agreement. The second issue is that once the regulator is put in place (even if it is assumed that it will be independent and efficiently deal with the disputes), it will naturally be subject to the hierarchy of the Indian legal system. This will mean that it will be subordinate to and amenable to the Writ jurisdiction of the High Court. Besides, writs by High Court, any decision can be appealed to the

appellate authority.

In short, one is therefore looking at three or four stages in dispute resolution. First, the decision by the regulatory authority, followed by decision of the appellate authority, followed by a writ to the High Court followed by a discretionary appeal to the Supreme Court. Given the delays under the legal system, dispute resolution will become inefficient and expensive. Perhaps the Government should have segregated pure contractual disputes between the concessionaire and the Government and reserved these for international arbitration (which would be as per the expectations of the international investing community also). The Regulator should step in only where public interest is involved. Further, Dispute Review Boards should have also been envisaged in the Concession Agreement in a project of this type.

#### A second look

To briefly conclude, India is firmly on the path of privatisation in the airport sector. However, the Concession Agreements do need a further in-depth look. Hopefully, there will be a Model Concession agreement in the near future, which will bring uniformity and address some of the issues, which need a second look. **B**



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