Overview of the framework

Need for a framework

Economic growth and trade expansion in recent years have enhanced the relevance of port sector as a critical element in globalisation of the Indian economy. In particular, this sector has been witnessing significant interest from both domestic as well as foreign investors following the policy initiatives taken by the Government of India to promote Public Private Partnerships (PPP) on Design, Build, Finance, Operate and Transfer (DBFOT) basis. Several State Governments have also initiated similar policies for attracting private investment in ports. However, the actual inflow of investment has been less than expected, and future prospects will depend significantly on adoption of a comprehensive policy and regulatory framework necessary for addressing the complexities of PPP, especially for balancing the interests of users and investors. In particular, transformation of rules will have to be accompanied by a change in the institutional mindset.

This volume responds to the need for evolving a model document that reflects best practices, particularly from the perspective of public policy on the one hand and bankability of projects on the other hand. Besides all the advantages associated with such a document, this would also enhance the possibilities of securing upto 20 per cent of the capital costs by way of viability gap grants from the Central Government coupled with long-term debt from the India Infrastructure Finance Company (IIFC) for funding upto 20 per cent of the project costs.

A comprehensive framework is a pre-requisite for PPP

For building and operating a port on DBFOT basis, a precise policy and regulatory framework is being spelt out in this Model Concession Agreement (MCA). This framework addresses the issues which are typically important for limited recourse financing of infrastructure projects, such as mitigation and unbundling of risks; allocation of risks and rewards; symmetry of obligations between the principal parties; precision and predictability of costs and obligations; reduction of transaction costs; force majeure; and termination. It also addresses other important concerns such as user protection, independent monitoring, dispute resolution and financial support from the Government.

The MCA also provides the framework for commercialising ports in a planned and phased manner through optimal utilisation of resources on the one hand and adoption of international best practices on the other. The objective is to secure value for public money and provide efficient and cost-effective services to the users.

Elements of financial viability

The four critical elements that determine the financial viability of a port are the traffic volumes, port tariffs, concession period and capital costs. The concession period typically granted by the State Government for construction and development of ports is 40 years or more. Such a timeframe should normally enable a robust project structure and any further extension would improve financial viability only marginally as the present value of projected revenues thereafter would be comparatively low from the Concessionaire's perspective.

The capacity constraints currently faced by major ports mean that there is ample scope for State Governments to award concessions for new ports that would not only provide additional capacity but also enhance competition and efficiencies. Over time, efficiencies at the port level would contribute to improvement in efficiencies across competing ports, but that may reach its full potential only after creation of sufficient capacity at the respective ports.

In view of the limited competition between ports today, the Government would continue to determine the tariff but it should be capped in line with the tariffs prevailing in the region. A pre-determined tariff structure would also lead to greater predictability of the revenue streams of Concessionaires, besides incentivising efficiency and cost reduction. In the medium term, tariffs should find their own levels through competition, but that can happen only after adequate capacity has been created.

As three of the four above-stated parameters would thus be virtually pre-determined, capital cost is the variable that will determine the financial viability of a port DBFOT project. Bidders may, therefore, seek an appropriate capital grant/subsidy from the Government (the "Authority") in order to reduce their capital investment for arriving at an acceptable rate of return. Though PPPs undertaken so far in the sector have been financially viable and self-sustaining, the Government's initiative to build large capacities could give rise to the need for Government support in some cases.

Technical parameters

Technical parameters will focus on the level of service for the users

Unlike the normal practice of focussing on construction specifications, the technical parameters proposed in the MCA are based mainly on output specifications, as these have a direct bearing on the level of service for users. Only the core requirements of design, construction, operation and maintenance of the port are to be specified, and enough room would be left for the Concessionaire to innovate and add value.

In sum, the framework focuses on the 'what' rather than the 'how' in relation to the delivery of services by the Concessionaire. This would provide the requisite flexibility to the Concessionaire in evolving and adopting cost-effective designs and processes without compromising on the quality of service for users. Cost efficiencies would occur because the shift to output-based specifications would provide the private sector with a greater opportunity to innovate and optimise designs and processes in a way normally denied to it under conventional input-based procurement specifications.

Performance standards

At the port, the Concessionaire would not only procure the civil works and equipment, it would also provide services in the form of cargo handling. The efficiency of its services would normally reflect in the dwell time of cargo at the port. The framework identifies benchmarks for key performance indicators such as dwell time, vessel turnaround time, berth productivity, ship handling productivity and quay crane productivity, and specifies penalties for continued failure in achieving the requisite levels of performance.

Concession period

Concession period to be normally forty years

The guiding principle for determining project-specific concession period should normally be the capacity of the respective port to handle the expected cargo at the end of the proposed concession period. However, capacity constraints would normally be addressed by construction of additional terminals. As such, it would be advantageous to allow a longer concession period both from the perspective of the Concessionaire as well as the Government.

The time required for construction of a port (about three years) has been included in the concession period so as to incentivise early completion, leading to maximisation of revenues.

Selection of Concessionaire

Competitive bidding on single parameter will be the norm

Selection of the Concessionaire will be based on open competitive bidding. All project parameters such as the concession period, tariff, price indexation and technical parameters are to be clearly stated upfront, and short-listed bidders will be required to specify the proportion of revenues from user fees that they are willing to share with the Port. The bidder who offers the highest revenue share should win the contract. In exceptional cases where instead of offering a revenue share, the bidders seek a capital grant/ subsidy from the Government, the bidder who seeks the lowest grant would win the contract, subject to a maximum subsidy of 30 per cent of project cost and an additional 10 per cent for O&M after commissioning the port.

Concession fee

Concession fee should be levied only if revenue streams can sustain it

Concession fee will be a fixed sum of Re. 1 per annum for the concession period. Where bidders do not seek any grant and are willing to make a financial offer to the Government, they will be invited to quote a premium on concession fee in the form of a share in revenues from tariffs. The revenue share quoted for the initial year could be increased for each subsequent year by an additional 1 per cent.

The rationale for the above fee structure is that in the initial years, debt service obligations would entail substantial outflows. Over the years, however, the Concessionaire will have an increasing surplus in its hands owing to the declining debt service and rising revenues. Recognising this cash flow pattern, the concession fee to be offered by the Concessionaire will be based on an ascending revenue-share structure.

Risk allocation

As an underlying principle, risks have been allocated to the parties that are best suited to manage them. Project risks have, therefore, been assigned to the private sector to the extent it is capable of managing them. The transfer of such risks and responsibilities to the private sector would increase the scope of innovation leading to efficiencies in costs and services.

Risk allocation and mitigation is critical to private investment

The commercial and technical risks relating to construction, operation and maintenance are being allocated to the Concessionaire, as it is best suited to manage them. Other commercial risks, such as the rate of growth of cargo traffic, are also being allocated to the Concessionaire. On the other hand, all direct and indirect political risks are being assigned to the Government.

It is generally recognised that economic growth and port connectivity will have a direct influence on the growth of traffic and that the Concessionaire cannot in any manner manage or control this element. By way of risk mitigation, the MCA provides for extension of the concession period in the event of a lower than expected growth in traffic. Conversely, the concession period is proposed to be reduced if the traffic growth exceeds the expected level.

The MCA provides for a target traffic growth and stipulates an increase of upto 10 years in the concession period if the growth rate is lower than projected. For example, a shortfall of 10 per cent in the target traffic after 20 years will lead to extension of the concession period by 5 years. On the other hand, a reduction of up to 3 years is stipulated in the event of a higher than expected growth. For example, an increase of 6 per cent in the target traffic will reduce the concession period by 18 months.

Financial close

Project implementation must commence as per agreed timeframe

Unlike other agreements for infrastructure projects which neither define a time-frame for achieving financial close, nor specify the penal consequences for failure to do so, the MCA stipulates a time limit of 270 days for achieving financial close (extendable for another 90 days on payment of a penalty), failing which the bid security shall be forfeited. By prevalent standards, this is a tight schedule, which is achievable only if all the parameters are well defined and the requisite preparatory work has been undertaken.

The MCA represents a comprehensive framework necessary for enabling financial close within the stipulated period. Adherence to such time schedules will usher in a significant reduction in costs besides ensuring timely provision of needed infrastructure. This approach would also address the present problem of infrastructure projects not achieving financial close for long periods.

Port tariffs

A balanced mechanism for determination of tariffs has been specified for the entire concession period since this would be of fundamental importance in estimating the revenue streams of the project and, therefore, its viability. The tariffs shall be capped by the rates to be specified by the Government prior to invitation of bids. While this will ensure that users are not exploited in a situation of congestion in port capacity, there will be sufficient freedom for the Concessionaire to levy and collect competitive and economic charges at all times.

Tariffs should be determined with great care and precision

The MCA provides for indexation of the tariffs linked to Price Index in order to account for inflation during the concession period.

Construction

Handing over possession of the required land and obtaining of environmental clearances are being proposed as conditions precedent to be satisfied by the Government before financial close.

The MCA defines the scope of the project with precision in order to enable the Concessionaire to determine its costs and obligations. Additional works not included in the scope of the concession may be undertaken, only if the entire cost thereof is borne by the Government.

Before commencing the collection of tariffs, the Concessionaire will be required to subject the Port to specified tests for ensuring compliance with the specifications relating to safety and quality of service for the users.

Service quality and safety must be ensured

Operation and maintenance

Operation and maintenance of the port is proposed to be governed by strict standards with a view to ensuring a high level of service for the users, and any violations thereof would attract stiff penalties. In sum, operational performance would be the most important test of service delivery.

Maintenance standards will be enforced strictly

The MCA provides for an elaborate and dynamic mechanism to evaluate and upgrade safety requirements on a continuing basis. The MCA also provides for traffic regulation, security and rescue operations.

Right of substitution

Lenders will have the right of substitution

In the port sector, the project assets may not constitute adequate security for lenders. It is the project revenue streams that constitute the mainstay of their security. Lenders would, therefore, require assignment and substitution rights so that the concession can be transferred to another company in the event of failure of the Concessionaire to operate the project successfully. The MCA accordingly provides for such substitution rights.

Force majeure

Concessionaire will be protected against political actions

The MCA contains the requisite provisions for dealing with force majeure events. In particular, it affords protection to the Concessionaire against political actions that may have a material adverse effect on the project.

Termination

In the event of termination, the MCA provides for a compulsory buy-out by the Government, as neither the Concessionaire nor the lenders can use the port in any other manner for recovering their investments. Prior to termination, lenders will have the opportunity to identity and nominate a substitute entity to operate the concession. As a result, compulsory buy-out will occur only if the lenders fail to ensure continuation of port operations through a substitute entity

Pre-determined termination payments should provide predictability

Termination payments have been quantified precisely as compared to the complex formulations in most agreements relating to infrastructure projects. Political force majeure and defaults by the Government are proposed to qualify for adequate compensatory payments to the Concessionaire and will thus guard against any discriminatory or arbitrary action by the Government. Such termination payment shall not be less than the product of thirty and the Realisable Fee due and payable for and in respect of the last month of the Concession Period. Further, the project debt would be fully protected by the Government in the event of termination, except for three situations, namely, (a) when termination occurs as a result of default by the Concessionaire, only 90 per cent of the debt will be protected, and (b) in the event of non-political force majeure such as Act of God (normally covered by insurance), only 90 per cent of the debt not covered by insurance will be protected and (c) when termination occurs on account of Concessionaire Default during Construction Period, the Concessionaire shall bear the initial expenditure equal to 40 per cent of the Total Project Cost, and for the expenditure in excess of such 40 per cent, an amount equal to 90 per cent of the debt attributable to such excess expenditure will be protected.

Monitoring and supervision

Day-to-day interaction between the Government and the Concessionaire has been kept to the bare minimum by following a 'hands-off' approach, and the Government shall be entitled to intervene only in the event of a material default. Checks and balances have, however, been provided for ensuring full accountability of the Concessionaire.

Independent supervision is essential

Monitoring and supervision of construction, operation and maintenance is proposed to be undertaken through an Independent Engineer (a qualified firm) that will be selected by the Government through a transparent process. Its independence would provide added comfort to all stakeholders, besides improving the efficiency of project operations. If required, a public sector consulting firm may discharge the functions of the Independent Engineer.

The MCA provides for a transparent procedure to ensure selection of well-reputed statutory auditors, as they would play a critical role in ensuring financial discipline. As a safeguard, the MCA also provides for appointment of additional or concurrent auditors.

To provide enhanced security to the lenders and greater stability to the project operations, all financial inflows and outflows of the project are proposed to be routed through an escrow account.

Support and guarantees by the Government

Support and guarantees by the Government are essential

By way of comfort to the lenders, loan assistance from the Government has been stipulated for supporting debt service obligations in the event of a revenue shortfall resulting from political force majeure or default by the Government. Guarantees and/ or compensation have also been provided to protect the Concessionaire, though for a limited period, from construction of competing ports which can upset the revenue streams of the project.

Port estate development

Port estate can cross-subsidise tariff

Capital subsidies alone may not suffice in ensuring the financial viability of the Project. It may, therefore, be necessary to provide development rights over port estate for generating additional revenue streams with a view to making the Project self-sustaining. It is expected that revenues from port estate will also cross-subsidise the Project operations and help reduce the burden on the users as well as the exchequer. This would also help in an integrated development of the Project as well as the neighbourhood areas.

While allowing sufficient flexibility to the Concessionaire for exploitation of the earmarked land and spaces, the MCA stipulates some limits and restrictions to prevent excessive commercialisation of the port estate. The MCA also enables the Concessionaire to grant licences to third parties for the use of the port estate which would have to revert to the Government at the end of the concession period.

Funded Works

The MCA provides an option that enables the Authority to finance selected works, thus relieving the Concessionaire from the obligation to raise the requisite financial resources for such works. This provision can be used for capital-intensive works which cannot be sustained by user fee. This arrangement can also be adopted for other project-specific reasons.

Certain works may be financed by the Authority

The MCA provides for fixing a lump sum amount for construction of Funded Works, which would be paid to the Concessionaire in four equal instalments. The MCA also provides for a mobilisation advance of upto 20 per cent of the aforesaid lump sum amount in order to facilitate the Concessionaire in meeting the construction costs of Funded Works.

Miscellaneous

The MCA also addresses issues relating to dispute resolution, suspension of rights, change in law, insurance, defects liability, indemnity, redressal of public grievances and disclosure of project documents.

An effective dispute resolution mechanism is critical

Framework for new ports

The framework contained in the MCA is applicable to PPPs in building new ports on DBFOT basis. With some modifications, it can be applied to transfer of existing ports from the Government to private entities.

Conclusion

Together with the Schedules, the proposed contractual framework addresses the issues that are likely to arise in financing of port projects on DBFOT basis. The proposed regulatory and policy framework contained in the MCA is critical for attracting private participation with the concomitant efficiencies and lower costs, necessary for accelerating growth.

Private participation should improve efficiencies and reduce costs