

# Land bridge for trade between East and West

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## Summary and conclusion

Whether you define Eurasia as a geographic expanse from the Isthmus of Suez to Sakhalin, the Caucasus to the Tien Shan or virtually as a polyglot exchange of trade, ideas and culture along the ancient Silk Road, the notion of Eurasia is increasingly at the forefront of the world's attention.

Across this vast expanse of nations and peoples, half a dozen countries and as many international financial institutions are building transportation networks, whether digital or of concrete and steel. These networks now form essential land bridges linking Russia, China, Europe, India and the Middle East. This bridge building, occurring without central direction, began modestly and now has an unstoppable momentum of its own. Anyone anxious to anticipate the future Eurasian routes of trade and transport may marvel at how they parallel the Silk Road of lasting through the eleventh century.

But the recent turmoil in financial and commodity markets has forced government and leading enterprises to

reassess their building plans, resulting in the indefinite postponement of many projects. An increasingly attractive alternative for governments and project sponsors are Public Private Partnership (PPP) funding schemes with a long history of success in Europe, Australia, South Asia and increasingly, in America.

## Overview

The recent dramatic contraction of the world economy has been a sharp reminder of how interrelated are the economies, nations and peoples of the world.

The nations of the Eurasian region are once again affected by this global contraction of capital. The result is limited availability of commercial term financing and the increased reliance on multi-lateral agencies such as the World Bank for funding important projects such as Kazakhstan's Moinak HPP Electricity Transmission Project. Other infrastructure is affected as well including road projects expected to benefit Kazakhstan, Kirghistan, Tajikistan and Uzbekistan.

Before the current funding crisis, Kazakhstan had widened 650 km of roads to handle heavy trucks traversing its roads, the shortest land route between China and Europe. The World Bank announced on 13 June 2009 an agreement to lend Kazakhstan US\$2.125 billion for its 1,062km South-West Roads Project. This is part of the US\$6.7 billion International Transit Corridor development, itself part of the broader Central Asia Regional Economic Cooperation Programme (CAREC) corridors linking China (at Khorgos) through Kazakhstan to Russia (at Zhaisan) and on to Europe.

Reliance on sophisticated project finance models such as PPP, and the stability of the regulatory and judicial regime upon which they rest, will need to be tested before any large projects can receive funding outside the government budgets.

Until then, the government and the state controlled banks holding liquidity will pick the winners.

For all such projects, the management of a transparent procurement process will remain an essential to attract private sector capital. With few exceptions, the minimum requirement of 1/3 equity may be a useful starting point for projects which seek funding on commercial terms.

Though there is an abundance of global liquidity sitting in money market accounts awaiting the bottom of the credit cycle, we expect the pricing and terms of commercial finance will continue to be scarce and costly through much of 2010. Terms will moderate as the balance of power between investors and issuers is restored to its long-term equilibrium level.

In this environment, only well conceived projects will receive funding on commercial terms. Competition between project sponsors for limited funds will also enhance the negotiating leverage of investor participants who will have great choice of projects.

## EPC risks and project cost management

The nature of risks confronting planners of large projects has changed dramatically in the past two years, nowhere more so than in the transportation and energy sectors.

In the transportation sector, the robust, long-term traffic and tariff projections of many projects raise the issue of liquidity. Such reassessment resulted in the cancellation of a toll road in the American state of Pennsylvania, where planners have witnessed a dramatic decrease in traffic volume.

Liability matching conventions make local currency denominated debt preferable, whether Kazakh Tenge or Russian Roubles. But for long-lived projects, this can be problematic for

tenors exceeding the 10 years interest swaps currently available.

Not to be underestimated is the risk of inflation. With declining hard currency flows from the export of oil and minerals, the continued demand from leading Russian and Kazakh banks for liquidity will force the depreciation of their currencies against the Euro and the US Dollar, further exacerbating inflation.

It is difficult to generalize how inflation affects turnkey EPC contracts, other than to say it is of particular concern for projects with long construction periods. The ability of EPC contractors to guarantee prices depends on their ability to enforce those obligations through their supply chain. That ability is problematic, exposing project sponsors to cost escalation as they will ultimately bear such risk.

Calculating political risk remains at the heart of doing business. The involvement of funding agencies such as the World Bank, IFC, EIB, EBRD and Vnesheconombank may provide some comfort, but can be time consuming as the details of their involvement in project finance schemes may only be finalized once all other terms are agreed.

As pathfinders establish the procurement parameters for big projects, the next few years will prove critical for the development of the PPP model and the realization of long-deferred infrastructure projects in Russia, Kazakhstan and elsewhere.

## Risk management and project finance

Project finance and its related PPP are risk-management techniques used to finance long-lived, capital-intensive projects. A well-conceived project can attract substantial funding by balancing risks and rewards among various participants.

When undertaking critical infrastructure development, project sponsors must identify and manage risks as effectively as they can, using the tools at their disposal.

Because every project is unique, there are many "Project Finance" structures, but they all have one common element: *the financing is based on the economics of the project and is not dependent on the credit support of the sponsor or the value of the physical assets involved.*

As a practical matter, this means the tolls or economic production of the project

yield a predictable amount of cash or pre-sold product on a periodic basis.

This last point is important where projects are developed under government license or concession to develop or utilize a resource such as those governed by Russia's PSA regime.

Such rights or concessions may not readily be assigned as collateral to third-party lenders. The value of the assets and rights granted by license are regarded as having limited value to lenders outside the country granting the concession.

The selective inclusion of strategic project participants is a traditional way to mitigate risk. This is why some projects such as the Shtokman gas field development operate as joint ventures.

## When does project finance succeed?

Every successful project financing provides a satisfactory and economic allocation of project risk among the various participants.

The participants in a project financing generally include the project sponsor, lenders, suppliers of equipment and raw materials and a purchaser of the project output. The purchaser is often an affiliate of the project sponsor seeking direct access to a resource or product at a long-term fixed price.

In general, project sponsors seek to allocate risks among:

- *A long-term production purchaser who agrees to buy product at a fixed price;*
- *A materials supplier who agrees to provide inputs (feedstock) at a fixed price;*
- *An EPC contractor who will build the project on a fixed-cost, turnkey basis;*
- *An export credit agency, multilateral, mono-line or other insurer;*
- *Other counter-parties (derivatives for hedging currency and interest rate); and*
- *A plant operator who will operate and maintain the project under an O&M contract.*

In order to limit financial liability, most projects are undertaken through a special purpose entity such as a limited liability company established by the sponsor. The sponsor maintains control through ownership or management contracts or a combination of the two.

Regardless of how well conceived a project is, *the foundation of a successful project financing is ultimately a stable regulatory, tax and judicial regime.*

## Conclusion

In a world of risk, public private partnerships and related project finance techniques enable governments and commercial enterprise to fund large projects without risking their balance sheet or annual budget. Properly managed as a technique for balancing risks and rewards, such programs can enable a large project which might not otherwise be affordable.

Such an exchange of risk and reward is not new. The rebirth of the nations of Eurasia reflects the return to their earlier role as a land bridge for trade between East and West and the associated free exchange of ideas. New, innovative financing schemes have been embraced and implemented, at least partially, in many Eurasian countries.

The opening of the countries of Central Asia since 1991 has transformed the region intellectually as thousands of the regions young people have gone to study as the best universities around the world. In an act of enlightenment worthy of Timur, the governments of Kazakhstan and Uzbekistan have paid for their gifted young people to acquire the most modern knowledge and bring it home, reconnecting their region and people with the global free trade of ideas and innovation.

Many of these young people are entering government and leading enterprises. Within the next decade, these young men and women will assume leadership roles in their societies and throughout the region.

They share a remarkable heritage that honors individual leadership, distinguishes such persons as beacons of reason and wisdom and places every individual in the mainstream of global development. They will lead the way to developing distinct and innovative financing programs for the development of their nations. It's in their DNA.

*Griffin Capital have advised on financings for KazakhstanEnergo, MTV Ukraine, NTVPlus, Mobile Telecom of Russia, Dal Telecom International (Khabarovsk), Cable & Wireless Sakhalin, Moscow CableCom, the Tbilisi Marriott Hotel and the Renaissance Grand Hotel in Tianjin TEDA, China. We are currently acquiring solar power generators in Germany and aerospace technology in the USA. [www.griffincap.com](http://www.griffincap.com) [partners@griffincap.ch](mailto:partners@griffincap.ch)*