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Indian Government steps it up a gear with roads programme

Business impact:

- India is continuing to push forward with its road development programme – the target is to build 7,000 km of highways annually for the next five years at a rate of 20 km per day.
- The Government has shown a renewed impetus to encourage foreign private investment in its road development projects.
- Ten planned "mega projects" – at around US\$1bn each – will be of particular interest to the foreign private investor.

India is continuing to push forward with its road development programme and, since our last client briefing in December 2008 the Government has shown a renewed impetus to encourage foreign private investment in its road development projects and, in particular, its planned "mega projects".

This briefing considers the recent initiatives undertaken by the Government to attract investors, including recent amendments to the model concession agreement for highways, and provides an overview of potential opportunities for private investors.

Background: a reminder of the framework for road development

National Highways Authority of India

As construction and maintenance of the road network is on the "concurrent" list under India's federal structure, road projects may be sponsored either by central government or at the state level.

Responsibility for the development, maintenance and management of India's highways, including the National Highway Development Programme (NHDP), lies with the National Highways Authority of India (NHAI). The NHDP involves the widening, upgrading and rehabilitation of approximately 55,000 km of

India's highways at an estimated investment of US\$60bn. A number of states are also active in the roads sector, including Gujarat, Madhya Pradesh, Rajasthan, Andhra Pradesh, Karnataka and Maharashtra. As the value of the state-sponsored projects will generally be less than that of the NHAI-sponsored projects, and therefore generally less attractive to foreign private investors, this briefing focuses for the most part on NHAI-sponsored projects.

Form of project implementation

While road construction projects may be developed through traditional EPC contracts funded by the Government (at central or state level) and/or by multilateral development agencies, the preferred model for development is the public private partnership (PPP) model, with more than 60 per cent of the projected investment requirement for the NHDP expected to be privately financed¹.

To date, PPP projects awarded under the NHDP have generally taken the form of a BOT (Toll) project or, to a lesser extent, a BOT (Annuity) project. In the BOT (Toll) model, the concessionaire receives its income from toll revenues (toll fees are prescribed by the NHAI) and, save for any grant it receives from the awarding authority, takes the risk that these revenues



India Gate... the Government is focused on attracting more foreign investment.

will be sufficient to repay any debt financing it has taken out to fund project costs and provide a return to shareholders.

By contrast, in the BOT (Annuity) model, the concessionaire's revenue is via sums payable by the awarding authority semi-annually. The level of annuity payment bid by the concessionaire is intended to be sufficient to cover project and finance costs and provide a return to shareholders. As the concessionaire does not bear the traffic or tolling risk in this model, it is generally considered to be less risky for investors. Lower perceived risk levels will be attractive to many private sectors players. This will, therefore, tend to promote competition and, in turn, lower likely equity IRRs. This may cause the projects to be less attractive to some potential investors – especially those with more demanding hurdle rates.

The NHAI has also recently begun tendering certain highway projects to the private sector under an operate, maintain and transfer concession, whereby private operators are eligible to collect tolls on the applicable stretch of highway in return for maintaining the highway and providing essential services.

Calls for change

The NHAI has sometimes struggled to garner sufficient private sector interest in its road projects, as evidenced by those recently tendered projects where there have been no, or only sole, bidders competing for a project. This lack of interest has in the past been blamed not only on the global economic slowdown, but also on concerns over the economic viability of projects (especially toll-based projects), land acquisition issues and the inefficient allocation of risks. Certain bidding rules, which restricted the number of projects that private sector players could bid for, further exacerbated the problem.

In light of these issues, in August 2009 the Prime Minister constituted a committee chaired by Shri B. K. Chaturvedi of the Planning Commission (known as the "Chaturvedi Committee") to review and consider any

procedural and financial impediments to the NHDP with a view to accelerating the pace of the programme.

Following an extensive consultation with various stakeholders, including private investors, lenders, consultants and representatives from the Ministry of Shipping, Road Transport and Highways (MoRTH), the NHAI and the Ministry of Finance, the Chaturvedi Committee published a report setting out its recommendations for revisions to the NHAI strategy for the selection of projects and a suite of amendments to both the bidding process and model concession agreement for national highways. The recommendations of the Chaturvedi Committee were formally adopted by a MoRTH memorandum in November 2009 (November Memorandum) and subsequent requests for qualification (RFQ) and requests for proposal (RFP) have adopted the recommended amendments to the bidding process and model concession agreement.

Form of implementation

Under the previous government policy, all NHAI projects were to be bid out firstly as a BOT (Toll)

project. If this bidding process failed, the project would then be bid out as a BOT (Annuity) project and if this process also failed, the project would be bid out under a traditional EPC procurement model.

In order to accelerate the implementation of the NHDP and to prevent projects being held up in multiple tendering processes, the Chaturvedi Committee recommended that this waterfall approach be replaced with a more streamlined approach to the selection of the appropriate model for

implementation. The new policy is therefore that roads below a certain financial threshold will not be considered for the BOT (Toll) model but instead may be implemented directly on a BOT (Annuity) basis. If no acceptable bids are then received, the project may be bid and awarded on an EPC basis. MoRTH has indicated that a bid for an annuity model project which includes an equity IRR of up to 18 per cent would be acceptable, but that bids exceeding this threshold would not be accepted (except in relation to certain

Key facts and figures

- Road transport is the dominant mode of transport in India, accounting for 70 per cent of freight movement and 85 per cent of passenger traffic.²
- 40 per cent of total road traffic is carried on the national highways network.³
- For the period from 1 January 2009 to 30 November 2009, bids were invited for 65 NHAI projects, 21 were awarded (including 19 under the BOT (Toll) model and two under the BOT (Annuity) model) and 23 were under process of award.⁴
- The Government is targeting the building of 7,000 km of highways annually for the next five years at a rate of 20 km per day.⁵
- The greatest uptake for the PPP model has been in the roads sector, with road projects accounting for 60 per cent of the Department of Economic Affairs' PPP database of 450 sample projects.⁶

"difficult" projects) and would instead be bid out on an EPC basis.

Bidding process

Government guidelines for centrally-sponsored PPP projects, including those sponsored by the NHAI, require a two-stage bidding process involving firstly the pre-qualification of the bidders through the evaluation of responses to an RFQ and secondly the evaluation of financial bids received from a shortlist of bidders in response to an RFP.

Among other matters, the Chaturvedi Committee has wrought the following amendments to the bidding process and such recommendations were accepted by MoRTH in its November Memorandum:

- **Bid Security.** Previously under the model RFP, a bidder was required to forfeit its entire bid security in the event that it was found to have a "conflict of interest" or if the bidder submitted an "unresponsive bid", with a fairly extensive list of sometimes immaterial events being included in the definition of "unresponsive bid". Future RFPs will now only require that the bidder forfeit 5 per cent of its bid security in the event of a conflict of interest being found or if a bid is deemed an "unresponsive bid", thereby significantly reducing the financial risk to bidders in submitting a bid.
- **Definition of conflict of interest.** The threshold above which a bidder is deemed to have a conflict of interest under the terms of the RFQs (e.g. due to having a common shareholder with another bidder) will now be 25 per cent instead of the previous 5 per cent. The Government hopes that this amendment will increase the potential pool of bidders for each project.
- **Single bids.** Instead of a tender failing where only a single bid is received, the board of the NHAI will now be empowered to accept single bids where it is satisfied as to the reasonableness of such bids.
- **Annual/Periodic pre-qualification.** Previously a bidder's request for pre-qualification in the RFQ process was specifically for an identified project or set of projects (up to three). In order to accelerate the pre-qualification process, pre-qualification may now be an annual exercise with each applicant being assessed to, and permitted to, quote its accepted technical score/threshold capacity. It is hoped that this will reduce the administrative burden of the pre-qualification process and help to accelerate the tender process overall.

It is also worth noting a change recently announced by the NHAI which restricts a bidder from being able to bid for more projects while it currently has three or more letters of award outstanding (i.e. where it is, or

is part of, a consortium that is the successful financial bidder but financial close has not yet been reached on the relevant project). This change has been introduced to prevent bidders overstressing themselves as there have been concerns that "non-serious" bidders will adopt aggressive bidding strategies in order to win projects and fill up their order books (which may in turn have a favourable impact on share price) when in fact they will struggle to finance the projects. However, if projects are not efficiently processed from preferred bidder to financial close, there is a danger that this change could clog up the system once again, reducing the pool of available bidders for future projects.

Model concession agreement

While recognising that further amendments may need to be considered (and recommending the setting up of an Inter-Ministerial Group to consider such future amendments), the Chaturvedi Committee recommended the following initial amendments to the model concession agreement, each of which were incorporated into a draft concession agreement enclosed with a recent RFP released by the NHAI:

- **Early termination.** Previously, under the model concession agreement for highways, the awarding authority was permitted to terminate the agreement if the average daily traffic in any accounting year exceeded the road's design capacity and continued to do so for three subsequent accounting years. Lenders have in the past strongly objected to this early termination right. The clause has therefore now been amended to provide that if the average daily traffic in any accounting year exceeds the design capacity, the authority may instead request the preparation of a detailed project report to assess: (a) the cost of augmenting the capacity of the highway; and (b) any extension required to the concession period to yield the concessionaire a post-tax return on equity of 16 per cent per annum. Following this report, the authority may issue a notice to the concessionaire requiring it to undertake the augmentation works. If the concessionaire refuses to do so, the authority may then terminate the concession agreement for an indirect political event with the level of termination compensation reflecting this (which crudely speaking is due debt

"The NHDP involves the widening, upgrading and rehabilitation of approximately 55,000 km of India's highways at an estimated investment of US\$60bn."

(less insurance cover) plus 110 per cent of adjusted equity).

- **Divestment of equity.** The position previously was that: (a) the winning bidders were required to hold at least 51 per cent of the shares in the concessionaire during the construction period; (b)

"the sector continues to offer significant opportunities to private investors, particularly in relation to the larger mega road projects that are now planned"

on the completion date and for three years into the operations period, the winning bidders would be permitted to reduce such shareholding to 33 per cent; and (c) thereafter, the winning bidders would be permitted to reduce such shareholding to 26 per cent. In order to encourage a faster recycling of capital and therefore a higher level of capital availability for potential bidders,

this minimum equity requirement has now been amended so that the winning bidders are only required to hold at least 51 per cent of the shares in the concessionaire during the construction period and two years thereafter. After this time, the original shareholders are generally free to divest their equity as they wish, except that the previous restriction remains whereby any acquisition of at least 15 per cent of the shares in the concessionaire, or of indirect or direct control of the board of directors of the concessionaire, is subject to the prior approval of the authority on national security and/or public interest grounds. Potential investors should also be aware that, in addition to the aggregate threshold requirement, the new model concession agreement for highways also includes a representation that each member of the winning consortium whose technical and financial capacity was evaluated for the purposes of the relevant RFQ must continue to hold at least 26 per cent of the shares in the concessionaire during the construction period and for two years thereafter.

- **Security.** Typically in BOT (Toll) projects in India, toll receipts are placed in an escrow account, with the lenders having priority over such cash flows through the waterfall mechanism prescribed in the relevant escrow agreement. As highways are public assets, the lenders have been unable to take a charge over the highway itself. Without any tangible security, lenders have had to classify loans as "unsecured" under the Reserve Bank of India's rules. Such a classification has led to the lenders

being subjected to higher provisioning and capital adequacy norms, thereby increasing the interest cost to the concessionaire and limiting the availability of funds. In order to overcome this issue, and to enable the lenders to classify the relevant project loan as "secured" under the Reserve Bank of India's rules, the concession agreement will now include a charge on the relevant escrow account as a permitted assignment and charge.

Land acquisition

Kamil Nath, the Minister for Road Transport and Highways, has openly recognised in the press the need to overcome the land acquisition issues that have faced highway projects in the past. In a bid to start to tackle some of these issues, the NHAI proposed at the end of 2009 the setting up of "Special Land Acquisition Units" to expedite the land acquisition process within certain key states (including Kerala, Tamil Nadu, Orissa, Karnataka, Andhra Pradesh and Jharkland). The streamlining of the land acquisition process is continuing and it is not yet possible to determine the extent to which the Government's efforts will be successful.

Note that the model concession agreement requires that the NHAI has acquired 80 per cent of the land required prior to financial close.

Opportunity outlook

The various projects under the NHDP are at different stages of planning for implementation. The NHDP is split into seven phases, with the first two phases almost complete and phase three projects under implementation or currently being tendered. While certain projects in the remaining phases have been awarded, many are still at the feasibility study or proposal stage and so opportunities remain for private sector investment.

- NHDP Phase IV envisages upgrading of 20,000 km into two-lane highways.
- NHDP Phase V involves the six-laning of 6,500 km of the four-lane highways comprising the "golden quadrilateral" and certain other high-density stretches.
- NHDP Phase VI involves construction of 1,000 km of expressways, including Vadodara to Mumbai (400 km), Kolkata to Dhanbad, Bangalore to Chennai and Delhi to Meerut.
- NHDP Phase VII involves the construction of 700 km of ring roads, bypasses, grade separators and service roads.

While foreign direct investment of up to 100 per cent is permitted in the roads sector, and foreign investors – particularly from the Asian region – have been participating in India's road projects for some time now, the market continues to be dominated for the most part by local players such as Larsen & Toubro and GMR Infrastructure.

In order to attract more overseas investors to enter the Indian roads market, the NHAI has recently announced that it intends to offer ten "mega road" projects involving an investment of at least US\$1bn each. The detailed project reports for certain of these mega projects are expected to be ready in the first half of 2010. There have been indications in the press that the Government may tighten the eligibility rules for these mega road projects so that only the very largest enterprises would be permitted to bid.

Tender notices are issued regularly by either the NHAI or individual state governments. In order to seek out tender opportunities, interested investors are advised to take a multi-pronged approach, including reviewing the NHAI website (www.nhai.org) where tenders for projects under the NHDP and others sponsored by the NHAI are posted, as well as state government websites and by keeping abreast of the latest news via MoRTH press releases (www.morth.nic.in) and local newspapers and trade press.

Conclusion

The Government of India is keen to push forward with its ambitious programme of national highway development. In light of past problems in attracting sufficient numbers of bidders to its highway projects, the Government has begun a process of review and revision of its road development policies, bidding documents and model concession agreements in order

to address some past concerns. The changes recommended by the Chaturvedi Committee and

already implemented in recent projects are a welcome start to this period of review. As recognised by the Chaturvedi Committee, further amendments may be required and MoRTH and NHAI are to continue their review and consultation with the various stakeholders.

Given India's long-term need for the continued development of its road network, the sector continues to offer significant opportunities to private investors, particularly in relation to the larger mega road projects that are now planned. It is hoped that the pro-active approach to resolving issues that have impeded the award of projects in the past will continue.

Notes:

1 "Guidelines for Investment in the Road Sector", Ministry of Shipping, Road Transport and Highways.

2 Ministry of Shipping, Road Transport and Highways, "Draft Final Report, July 2009: Consultancy Services for Formulation of Master Plan for the Indian National Expressway Network".

3 Ministry of Shipping, Road Transport and Highways, "Draft Final Report, July 2009: Consultancy Services for Formulation of Master Plan for the Indian National Expressway Network".

4 "Revised Strategy for Implementation of NHDP Initiated; Removal of Procedural Impediments to give Fillip to Highways Sector, Year-End Review 2009", Road Transport and Highways Ministry.

5 "Mega road projects may be open only to big boys", The Economic Times, 1 January 2010.

6 "Note on Public Private Partnership (As on November 15, 2009)", Department of Economic Affairs, Ministry of Finance.

7 As reported in the Ministry of Shipping, Road Transport and Highways press release "Mega Highway Projects", 1 December 2009.

The ten mega projects⁷

- Six-laning of Kishangarh-Udaipur-Ahmedabad section of NH-79A, NH-79, NH-76 and NH-8 (557 km) in the states of Rajasthan and Gujarat.
- Six-laning of Ichapuram-Srikakulam-Vishakhapatnam-Ankapalli-Rajahmundry section of NH-5 (436 km) in Andhra Pradesh.
- Four-laning of Gujarat-Maharashtra border-Dhule-Jalgaon-Akola-Amravati section of NH-6 (485 km).
- Four-laning of Gwalior-Shivpur-Biaora-Dewas section of NH-3 (450 km) in Madhya Pradesh.
- Two-laning with paved shoulder of Amristsar-Ganganagar-Bikaner-Nagaur-Jodhpur-Pali section of NH-15, 89 & 65 (700 km) in the states of Punjab & Rajasthan.
- Two-laning with paved shoulder of Kolhapur-Sangli-Sholapur-Latur-Nanded-Wardha-Nagpur section of NH-7 & SH (475 km) in the state of Maharashtra.
- Four-laning of Panvel-Goa/Maharashtra border section of NH-17 (475 km).
- Four-laning of Ahmedabad-Bamanbore-Samakhiali and Bamanbore-Rajkot-Gondal section of NH-8A & B (425 km).
- Six/four/two lane with paved shoulders of Bhavnagar-Pipavav-Porbandar-Dwarka section of NH-8E (445 km) in Gujarat.
- Six-laning of Aurangabad-Barwa adda-Panagarh-Dhankuni section of NH-2 (475 km) in the states of Bihar and West Bengal.

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- The ability to advise on strategy and policy in India, based on the extensive knowledge and experience of members of the group.
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For more detail on Ashurst's experience in India or on our India group, please speak to any of the contacts listed below or click [here](#). For more detail on our road sector experience worldwide, please click [here](#).

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