Walid Labadi, Senior Counsel, and Anila Gramshi, Associate, EBRD

Anita Ramasastry, Professor of Law, University of Washington*

A favourable concessions regime: a lender's perspective and perceptions from transition countries

The first part of this article discusses the legal issues of primary concern to lenders generally, and in particular to the European Bank for Reconstruction and Development (EBRD), in assessing the risks associated with lending to a concessionaire in the context of an infrastructure development project. The second part describes the results of the EBRD's Legal Indicator Survey assessing the legal regime for concessions in the transition countries. Many of the questions in the survey focus on issues of concern to both developers and lenders in assessing the legal regime applicable to concessions in a particular jurisdiction.

You are a policy maker in an eastern European country with limited budget resources. Your goal is to encourage economic development and implement infrastructure projects in your country. You may face some or all of the following problems that need to be addressed: you lack adequate roads to facilitate trade and development within your country and the rest of Europe; waste-water in your country is dumped untreated or minimally treated into your rivers; your country possesses monopolies over the distribution of heating and electricity, each of which requires large public subsidies to operate, massive investment to meet public needs and accurate user charges to limit the draw on the public budget; and your country possesses some natural resources, but their development requires substantial investment.

The challenge you face is to develop a legal regime that will encourage private investment in these sectors. Privatisation of public monopolies is an objective, but the outright sale to third parties of "public" activities is not a viable alternative given the resulting lack of competition. Accordingly, the development of a legal regime which permits the grant of concessions[1] or specific contractual or licensing rights to private sector entities, while retaining other public rights and ownership over specific assets, is a primary policy objective.

In developing this legal regime, you will need to provide an environment which will attract foreign equity investment from international companies with experience in the relevant development sectors. However, private sector companies will generally not undertake large-scale private sector investments without significant debt financing from financial institutions. While the views of lenders and developers often overlap in respect of the importance of various aspects of a legal regime necessary to encourage private sector investment through concessions, lenders generally, and international financial institutions like the EBRD in particular, have specific concerns, which if accommodated can significantly enhance the bankability of infrastructure development through concessions.

Issues of concern to lenders in concession financing

Lenders are most comfortable when lending money against known or identifiable commercial risks. Lenders can establish formulas for assessing the country risk associated with loans to a project in a specific country. Similarly, lenders can assess and price the market risk of a project (i.e., whether there will be sufficient demand for the project's product to make the project profitable). However, lenders, and in particular international lenders, are less comfortable in assuming many legal and political risks associated with a project. Accordingly, in determining whether to invest in a company which is awarded a concession and intends to develop an infrastructure project, lenders will assess the extent to which they are being asked to assume non-commercial risks. In making this assessment, they will look at the allocation of risks as provided in the concession agreement and the general legal regime governing concessions in the country. To the extent that the general legal regime minimises

legal uncertainty in connection with the award and implementation of concessions, allows the concession granting authority, concessionaires and lenders to contractually allocate risks among themselves and takes into account the interests of lenders to ensure effective security over a project, such regimes can enhance the bankability, and thus the viability, of concession projects. More specifically, there are seven areas where policy makers can act to enhance the bankability of concession projects through the development of a concessions regime.

1. Award concessions fairly

In considering whether to finance a concession, lenders are particularly concerned with the process by which a concession was awarded. If a concession is awarded to a private investor in a manner which suggests that the concessionaire obtained such rights through influence, corruption or on the basis of having access to non-public information, lenders face a number of risks. First, the credit risk for the lenders is increased because it may be easier for the award of the concession to be challenged, either legally or politically. A new government may decide that an awarded concession is unfair and actively seek ways of either terminating the concession or inhibiting the ability of the concessionaire to exercise rights. Second, most lenders are wary of risks to their reputation associated with financing a project where there are, or may be, rumours of corruption or unfairness in the award of the concession. Third, international financial institutions like the EBRD have a policy objective to encourage public tendering for concessions as part of their objectives to facilitate the transition of the economies of their countries of operations to market economies. By encouraging public tendering for concessions, the EBRD strives to enhance investor confidence in the process for awarding tenders, and to allay investor concerns of corruption or unfairness in connection with the investment in a particular country.

2. Clarify power of granting authorities

Lenders are obviously concerned that any concession agreement to be financed has been properly entered into by the relevant governmental parties. In addition, it is important that the government's authority to enter into a concession agreement will not be subject to challenge. This issue is not always clear. For example, in a Sofia water and waste-water concession project in which the EBRD provided financing in December 2000 there was some uncertainty under applicable Bulgarian law regarding the respective scopes of authority of the mayor of Sofia and the municipal council. It was therefore necessary to exercise great care in negotiating the concession agreement and the financing agreements to ensure that the appropriate level of approval was obtained. Accordingly, it is essential that either the general concessions law or the sector-specific concessions laws, if any, identify the authority/authorities that are empowered to enter into concession agreements, and specify the scope of their authority to modify the terms of a tendered concession agreement.

3. Clarify tax and licensing regimes

An important component of lender due diligence in a concession project is to ensure that the concessionaire has (or will obtain) all licences necessary for the construction and operation of a project. In addition to licensing issues, the financial viability of a project often hinges on whether tax or customs duties exemptions granted contractually in a concession will be respected by the relevant authorities. Unfortunately, in many jurisdictions inconsistencies among various laws and the terms of a concession agreement raise uncertainty regarding the tax and licensing regime applicable to a project. In assessing the efficacy and clarity of the legal regime applicable to a concession, lenders would look at the existence of a general regime that regulates the tax and licensing issues relating to the grant of concessions in a number of different sectors. It is often preferable to have such overriding legislation that defines in broad terms the tax and licensing regime applicable to different sectors, thus giving lenders some assurance of the stability of the legal system. However, it is important to strike a balance between the issues regulated by the general regime, and matters left to the parties to negotiate and define in the concession agreement. In any event, lenders are generally unwilling to accept uncertainty in the tax and licensing regime applicable to a project.

4. Provide lenders effective security

A legal regime which seeks to establish a framework for concession financing should allow and encourage structures which provide for protection of the rights of lenders under their relevant security documents, and in the event of the termination of a concession. Of fundamental interest to any lender considering project finance of a concessionaire is whether the lender will have effective security over the assets of the concessionaire. Lenders require security from which they can realise value in the event of a borrower's non-compliance with a loan agreement. Such security includes real property, buildings, equipment, insurance proceeds, bank accounts and receivables. Lenders also require security which is readily realisable. For example, some jurisdictions have effective legal regimes, where enforcement of rights is relatively straightforward and in which lenders feel comfortable protecting their loans by taking security. On the other hand, in other jurisdictions, including some in central and eastern Europe, the enforcement of lenders' security rights is more problematic. One approach that

[1] The term concessions, as adopted in the Legal Indicator Survey, is "an agreement or license pursuant to which a governmental authority grants rights and agrees obligations to be undertaken in relation to the construction, refurbishment or provision of infrastructure or the exploration for and/or exploitation of natural resources (including any related treatment or transport facilities) to a private sector entity to utilise government assets in order to proved facilities or services to members of the public or otherwise".

lenders might use to reduce enforcement risk in such cases is to require that sponsors hold their interests in a concessionaire through a special purpose company located in a foreclosure-friendly jurisdiction, and provide that lenders would take liens on the shares of such special purpose company.

One of the challenges of concession-based financing, however, is that a concessionaire's primary asset is usually a contract right, the concession agreement, which may be subject to termination in the event of a concessionaire's non-compliance with its obligations. Under most concession agreements, the concessionaire is not the owner of the property associated with a concession and, accordingly, the lenders may not obtain a mortgage over the real property on which the project will be built. Under most concessions, even if a concessionaire is the owner of facilities constructed or equipment associated with a project (which is not always the case) upon termination of the concession such facilities typically pass to the grantor of the concession. Notwithstanding the limited nature of the assets owned by a concessionaire, it is important for lenders to take security over whatever those assets are, such as contract rights (including the concession contract), insurance proceeds, bank accounts and equipment. Lenders require such liens primarily to maintain a level of control over the concessionaire, ensure their priority over other creditors in bankruptcy and, in many jurisdictions, enhance their level of control over bankruptcy proceedings.

5. Permit government undertakings to lenders

Lenders invariably require some form of direct agreement or consent to assignment with the government authority granting the concession the granting authority. The legal regime should allow for the granting authority to make such undertakings. Lenders will look for direct agreements with the granting authority on a number of issues:

- formal recognition by the granting authority that lenders are financing this project, have an interest in the concession agreement, and are relying on representations from the granting authority regarding the validity of the concession agreement;
- acknowledgement by the granting authority that the lenders have a lien on the concession agreement and the other rights associated with the project;
- commitment to notify lenders in the event a concessionaire is breaching its obligations under a concession agreement;
- granting authority agreement not to terminate the concession agreement without permitting the lenders an opportunity to cure breaches which give rise to such termination rights;
- permission for lenders to introduce a substitute concessionaire in the event that the existing concessionaire is not performing its obligations under relevant financing agreements;
- agreement that any termination payments due to the concessionaire shall be payable to lenders; and
- clear waiver of sovereign immunity by the granting authority in the event disputes arise under a concession agreement or the relevant direct agreement.

Lenders also seek to minimise the risk of termination by requiring the granting authority to pay the fair market value of the facilities to be transferred to the granting authority in the event of termination.[2] In mining or oil and gas activities under a production licence, lenders try to minimise the risk of termination by agreeing that if the licensing authority terminates the licence it will require bidders for the re-tender of the licence to undertake to repay the lender's debt. Similarly, in a number of telecommunications transactions where the concession is in effect a licence, licensing authorities have agreed as an accommodation to lenders to restrict the circumstances in which termination of such a licence might be possible.

6. Permit concessions to be governed by investor-friendly choice of law rules and dispute resolution mechanisms

Choice of law

Lenders are more comfortable with the legal risks associated with financing concession contracts when such contracts are governed by a set of legal rules that are well known, generally acceptable internationally, and rooted in a system with effective enforcement. In many jurisdictions, however, where a concession agreement is entered into between a local authority and a company formed in the country in which the project is located, the concession agreement must be governed by local law. Obviously, the more developed local law is in enforcing concession agreements, the more flexible lenders are on this issue. However, lenders are often unwilling to proceed with financings where the concession agreement is governed by a local law which is uncertain as to the interpretation and enforceability of the terms of the concession agreement.

Dispute resolution

Lenders are not comfortable in relying on enforcing any rights they may have under a concession agreement exclusively in the courts of the granting authority. In most cases, they require that such disputes be resolved in accordance with an international arbitration regime outside of the relevant country, in order to avoid any perceived (or real) bias in the local courts which may not have a track record in adjudicating against the government.

In addition to these concerns, it is also worth noting the special requirements of international financial institutions like the EBRD. The EBRD's normal practice would be to require arbitration in accordance with UNCITRAL rules with a dispute resolution mechanism that is impartial, regulated according to established rules, confidential and provides a binding decision which forecloses the possibility of endless appeals.

While the EBRD will consider other arbitration regimes, certain regimes can be problematic. For example, in some jurisdictions, like Croatia, international arbitration between two local entities is not permitted, other than arbitration conducted under the rules of the International Centre for Settlement of Investment Disputes (ICSID). However, ICSID arbitration presents a number of problems for international financial institutions like the EBRD and the IFC. Under Article 25 of the ICSID Convention, the jurisdiction of the Centre extends only to legal disputes arising directly out of an investment between a contracting state and a national of another contracting state. If the EBRD as a lender were to exercise its rights against the grantor of a concession under a concession agreement subject to ICSID arbitration (which might be the case in the context of exercising its foreclosure rights), it is unclear whether ICSID would be able to exercise jurisdiction over such dispute since the EBRD is not a national of a contracting state. Similarly, if the EBRD were to assume control over the shares of a concessionaire, it is not clear whether ICSID would view a project company in effect controlled by an international financial institution as a national of a contracting state for the purposes of exercising jurisdiction.

In any event, the bankability of concession-based financing can be dramatically enhanced by the reassurance provided to lenders of a concession agreement that is governed by an internationally recognised and established commercial law and an independent and internationally recognised dispute resolution forum.

7. Provide for financial stabilisation

Lenders and concessionaires are particularly concerned about the effects of changes in the tax or licensing regime on the financial viability of the project. In a number of projects lenders and concessionaires are also concerned about the effects of currency devaluation and *force majeure* events on the ability of the concessionaire to meet its debt service obligations.

It is important that a concession-friendly legal regime permit the grantor of the concession to include provisions in the concession contract which would provide for additional compensation in case such events occur. These provisions are generally known as financial stabilisation provisions and are fundamental mechanisms for allocating risks. One such risk for which a concessionaire would expect to be compensated would be changes in the tax or licensing regime which have financial implications for a project, as these risks are often in the control of governmental authorities who may have granted the concession in the first place. While a government would not agree to restrict its ability to enact such tax laws, it would generally be expected to place the concessionaire in the same position as it would have been had the legal regime not changed. With respect to other risks, the decision as to which party will bear the cost of such events (and in particular the scope of *force majeure* events) would be the subject of negotiation and discussion in any project. The decision over how these risks are allocated will often determine whether a concession project is financeable.

EBRD Legal Indicator Survey: perceptions of concessions law and climate

In 2000 the EBRD's annual Legal Indicator Survey (LIS) included a new section on concessions.[3] This addition was a recognition that an increasing number of infrastructure and utilities projects in emerging markets are achieved using concessions and a key determinant of the success of these investments is the legal regime. The LIS concessions questions are based, in part, upon the work of UNCITRAL, which has developed a legislative guide to the financing of public-private infrastructure projects.[4]

As with other LIS segments, the concessions questions attempt to capture the perceptions held by local lawyers as to whether a country's concessions laws are comprehensive (referred to as extensiveness) and whether they work in practice (referred to as effectiveness). The Survey questions focused not only on elements of a legal regime that are perceived as necessary to encourage private sector investment but also on those which will enhance the bankability of infrastructure development.[5]

Many of the local lawyers surveyed represent lenders as well as concessionnaires. Their perceptions provide an interesting insight into whether a country appears legally prepared for concessions activity. To the extent that local lawyers perceive that a certain concessions climate is legally uncertain or unfavourable, this may translate into a lesser degree of confidence among investors or lenders.

[2] Fair market value is typically determined on the basis of a formula, but such formula would normally include an amount not less than the amount of the lender's debt. As the lender's debt is normally used solely for the construction of the relevant facility, such a formulation would normally be considered reasonable.

[3] The LIS results are not readily verifiable and reflect the subjective assessment of survey respondents. The information and views provided by respondents were not always consistent. Where there were large discrepancies, recourse to the EBRD's in-house knowledge of the conditions in that country was used to arbitrate among the differing views. Accordingly, while the purpose of the survey was to gauge the perception of lawyers concerning concessions law in the region, care must be taken in reading and interpreting the results.

[4] See infra at p.29.

[5] The LIS concessions survey was divided into several parts and included questions on the following:
- the legal framework for concessions (whether a unified or coherent body of legislation exists that identifies which government entities may grant concessions and in which sectors);
- procedures for the selection of a concessionaire (whether a process exists that is fair and transparent);
- terms and conditions of the concession agreement (whether the legal framework permits for clear terms that may include choice of foreign law and international arbitration);
- security interests and ownership of concession assets (whether a concessionaire may grant a security interest in concession property); and
- performance of the concession agreement (whether there could or have been any legal disputes arising from the performance of a concession contract and whether they are fairly resolved).

Perceptions of the adequacy of the legal framework for concessions in transition countries

Note: No country received a rating of "Comprehensive". No data available for Bosnia and Herzegovina, FR Yugoslavia or Turkmenistan
Source: EBRD Legal Indicator Survey 2000

Trends across the region

In general terms, the state of reform of concessions laws can be seen to fall into five broad categories (see accompanying map).

Comprehensive

The legal framework for concessions is perceived as comprehensive and highly effective. The selection process is seen as fair, well defined and transparent in practice. Effective mechanisms exist for dealing with challenges to the selection of concessionaires and to legal disputes generally. The rights of concessionaires under the law applicable to concessions are clear. The contracting authority is largely free to enter into concession agreements that include governing law and dispute resolution provisions as the parties agree. The legal regime provides lenders with effective means for taking security over or otherwise protecting their interest in concessions. Procedures may exist for certification of a bona fide concession agreement by a government authority protecting such agreement from subsequent legal challenge.

Adequate

The legal framework for concessions is perceived as adequate and reasonably effective. The selection process is seen as well defined although not always consistently or transparently applied. Mechanisms exist for dealing with challenges to the selection of concessionaires and to legal disputes generally. However, these are not always effective. The rights of concessionaires under the law applicable to concessions are reasonably clear. The contracting authority is largely free to enter into concession agreements as the parties agree, although there may be some restrictions regarding governing law and dispute resolution provisions. The legal regime provides lenders with effective means for taking security over or otherwise protecting their interest in concessions, although there may be significant restrictions on the effectiveness of this security.

Barely Adequate

The legal framework for concessions is perceived as barely adequate with minimal effectiveness. The selection process is defined, but not always in clear or consistent terms. Mechanisms exist for dealing with challenges to the selection of concessionaires and to legal disputes generally. However, the authority of the court is unclear particularly in relation to the invalidation of improperly awarded concession agreements. Rules governing the terms of the contract between the contracting authority and the concessionaire exist, but are frequently unclear and sometimes unenforceable. There are significant restrictions regarding governing law and dispute resolution provisions. The legal regime may provide lenders with effective means for taking security over or otherwise protecting their interest in concessions, although there are significant restrictions on the effectiveness of this security.

Inadequate

The legal framework for concessions is perceived as inadequate and ineffective. There may be no unified framework for concessions in the country and the law affecting concessions may be very unclear. The selection process is generally viewed as not transparent or unfair in respect of at least some key elements of that process. Mechanisms may exist for dealing with challenges to the selection of concessionaires and to legal disputes generally.

However, there is a perception that the courts would not be impartial and transparent in their decision making process. Rules governing the terms of the contract between the contracting authority and the concessionaire may not exist or, if they exist, may be highly uncertain or grant limited freedom to the parties to agree the terms of their contract. The legal regime may not provide lenders with effective means for taking security over or otherwise protecting their interest in concessions.

Detrimental

The legal framework for concessions is perceived as wholly ineffective and may discourage economic activity based on concessions. There is either no unified framework for concessions or, if there is, it is not utilised in practice. The granting of concessions as a means of promoting infrastructure development and attracting investor participation is not an established concept in practice. The legal regime does not provide lenders with effective means for taking security over or otherwise protecting their interest in concessions.

Concessions climates perceived as adequate at best

Concessions legislation in many transition countries was not enacted during the first part of the 1990s. For many governments, the decision to grant concessions is a recent one, necessitated as a means of financing needed infrastructure and of exploiting natural resources. Legislative activity in this area is a relatively recent phenomenon.

The concessions results indicate that many concession systems function, but the legal framework regulating them is rather weak. The overall scores in the concessions category are far lower than in other LIS categories (e.g., in secured transactions, company and insolvency law). The lower concession scores may reflect the newness of such laws. At most, half of the countries surveyed have enacted consolidated framework legislation. Many countries have laws solely on procurement or perhaps have licensing laws for specific sectors like energy or telecommunications. Consequently, respondents were often unclear as to how concessions agreements were negotiated or performed in practice.

For the majority of countries, concessions scores also showed a perceived gap between extensiveness and effectiveness (with a few notable exceptions discussed below). At present, none of the countries surveyed are perceived as having a "comprehensive" concessions framework. The majority of countries fell into the "inadequate" or "barely adequate" category for their concession laws, with a handful obtaining a rating in the "adequate" category. Effectiveness scores were also quite low. Nearly all of the surveyed countries received scores of lower than 50 per cent for legal effectiveness and more than one-third received an effectiveness score of lower than 30 per cent. The low effectiveness scores suggest a widely held perception that many jurisdictions are not selecting concessionaires in a consistent, open and transparent manner. Only three survey countries fell into the "detrimental" category. This indicates that in the majority of jurisdictions' lawyers perceived there to be some framework governing concessions or infrastructure projects.

Some countries with similar concessions laws and legal systems were rated differently. For example, the Czech and Slovak Republics have virtually identical concessions systems. None the less, the Czech respondents rated its concessions as "inadequate" rather than "detrimental". To some extent, greater economic activity in the Czech Republic may have created a more conducive environment for concessions, or at least the perception of one.

The lack of a coherent legislative framework very often led to confusion as to the scope and nature of concessions practice. Russia, for example, fell into the "inadequate" category, in part because of low effectiveness scores as well as seemingly uncertain or inconsistent responses about the extensiveness of its legal framework. However, in some cases even the existence of a relatively coherent legislative framework was outweighed by the ineffectiveness of the applicable legal regime. For example, Tajikistan has a law on foreign investment that recognises the right of foreign investors to use land, other natural resources and property rights, but does not have any specific measures for concessions. Tajikistan also has a general concessions law that provides parameters for concessions to be entered into by government authorities. Accordingly, respondents rated Tajikistan as generally "adequate" in respect of the extensiveness of the legal regime. However, respondents perceived the effectiveness of the concessions regime to be so ineffective so as to place it in the "detrimental" category.

The existence of a framework concessions law appeared to impact the legal community's awareness and understanding of concessions as a subject matter. The majority of countries that are grouped in the "adequate" and "barely adequate" categories have a unified framework law. The existence of a framework law appeared to be a key determinant of whether a legal system was perceived as reaching a baseline of adequacy. Respondents may have been more aware of a concessions framework when it was self-contained within a single act as contrasted with jurisdictions where multiple laws, regulations and administrative decrees cover the same ground.

With the exception of Estonia, countries grouped in the "barely adequate" category are jurisdictions that have a framework law. Ukraine, for example, enacted a new concessions law which became effective in July 1999. The Ukrainian law is comprehensive in its scope and provides detailed guidance on the terms to be included in the contract.[6] The law provides a clear process for tenders. It also allows parties to seek international arbitration for disputes when one of the parties is a non-resident of Ukraine. Survey respondents

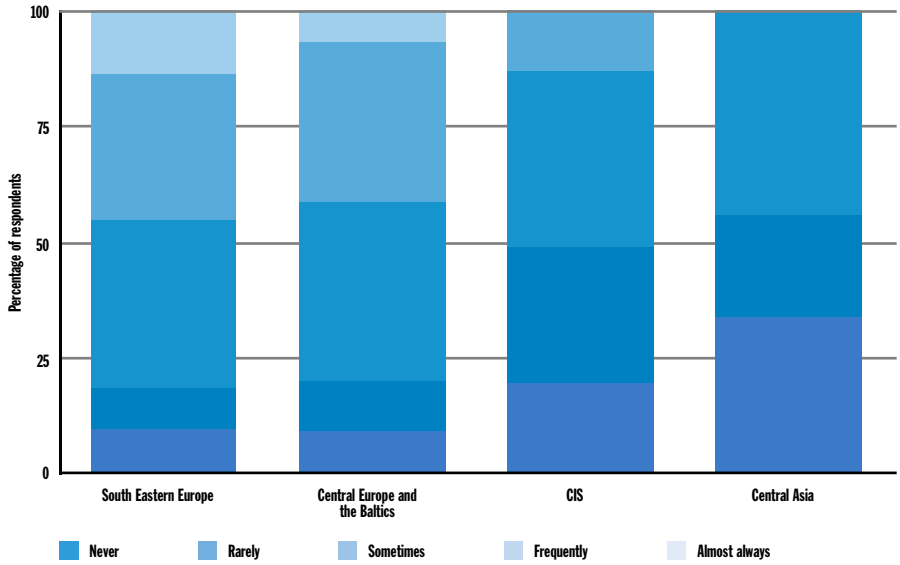
[6] S. Brown and V. Laconic, "Ukraine: Law on Concessions", Eastern European Forum Newsletter, pp. 45-49 (June 2000). ("The foreign investor will not be subject to vague and unfair rules of tenders past because the Law provides clear, concise and detailed terms and conditions for competing in the concession tender.")

appear to have taken the substance of the new law into account when responding to the Survey. Ukraine's extensiveness score was very strong; its effectiveness score, however, was significantly lower. This may be because there were few, if any, concessions granted in Ukraine during the first year of the new law's operation. The significant implementation gap caused Ukraine to fall into the "barely adequate" category.

Bulgaria also fell into the "barely adequate" category. This may initially seem unexpected, given the enactment of a concession law in October 1995, together with a Law on Municipal Obligations in May 1996. The Bulgarian laws did translate into a fairly strong extensiveness score, though some respondents perceive that the law does have some ambiguities or problems.[7] Some commentators have noted, for example, that the assignment by a concessionaire of its rights in a concession agreement (or alternatively arrangements that would provide lenders with the ability to substitute concessionaires in the event of foreclosure) are not permissible under Bulgarian law. In addition, it is unclear under Bulgarian law whether concession rights are in *rem* or contractual. If such rights are contractual, disputes can be resolved by arbitration. If they are in rem, only Bulgarian courts can resolve disputes over such rights. Concession agreements are also non-assignable in Bulgaria. As noted above, these restrictions in the Bulgarian legal regime make it difficult for lenders to extend credit to a concession project.

Most countries in the "adequate" category have a unified concessions framework and more importantly, had strong effectiveness scores. The existence of a legal framework was bolstered by a concessions system that appears largely to be effective in practice. The adequate countries include FYR Macedonia, Georgia, Hungary, Poland, Romania and Slovenia. Poland does not have a framework concessions act, but does have an act on procurement as well as a Geological and Mining Act and an Energy Law, which provide for private sector investment.

Transparency and fairness of concessionaire selection process



Note: Survey respondents were asked whether in their view the concession selection process in their particular country was fair and transparent.
Source: EBRD Legal Indicator Survey, 2000.

Nor does Slovenia have a framework concessions law. Some data exists, however, to suggest that Slovene concession practice is functioning quite efficiently and frequently in the absence of a single framework law.[8] It appears that other legislation, combined with administrative decrees and customary practice, has created in Slovenia what is perceived as a well-functioning and predictable concessions regime.[9] The process of granting a concession in Slovenia is based on provisions of the Slovenian Public Services Trading Act of 1993 (PSTA). The PSTA allows concessions to be granted only through competitive bidding, and provides that the deed of concession shall be a government regulation or a decree of local authorities. It provides for a tender process and an appeal procedure. The certainty of Slovenia's concessions climate has translated into external lending from institutions such as the EBRD. Perhaps one of the reasons Slovenia has done so well in the rating is that a large number of smaller concessions have been granted in Slovenia. Small municipalities have granted a number of concessions for wastewater and gas supply projects. The large number of concessions is driven by the lack of available municipal finance and the drive for water projects to facilitate EU accession. Frequency and awareness of concession activity is one factor that may contribute to a belief that an adequate concessions climate exists.

Nevertheless, it should be noted that while the legal regime in countries perceived as adequate would appear generally conducive to the fostering of concession projects, work remains to be done in order for the legal regimes of such countries to be categorised as comprehensive, including effective, consistent and transparent implementation.

Some concession climates function without framework laws

In a few cases a country received a higher effectiveness than extensiveness score. Respondents may have believed that, despite the lack of a comprehensive or unified concessions framework, it was none the less possible for government entities (at some level) to effectively grant concessions. Countries such as Armenia, Azerbaijan, FYR Macedonia and Kazakhstan all received higher effectiveness than extensiveness scores.[10] Of these countries only FYR Macedonia has a specific law concerning concessions. In practice, a system may work despite the paucity of the legal framework.

Perceived lack of fairness and transparency in the selection process

The LIS asked local lawyers whether, in practice, the concession selection process in their jurisdiction was fair and transparent.[11] The chart at left shows the responses received from lawyers in various regions. There appears to be a perception that concessions are not consistently awarded in an open and predictable manner. The majority of respondents in all four geographic regions believed that the selection process was, at best, fair and transparent some of the time (i.e., less than or equal to 50 per cent of the time).

Respondents in Central Asia showed the highest degree of scepticism, approximately 33 per cent indicating that the selection process is never fair and transparent. No respondents in Central Asia believed that the process was fair frequently or almost always. CIS lawyers also appear to lack confidence in the selection process. Only 13 per cent of CIS respondents believed the process worked frequently; none selected "almost always". Both central European and Baltic respondents and south-eastern European respondents gave more positive responses. Roughly 45 per cent of lawyers surveyed in each of these regions found that the selection process was fair and transparent more than 50 per cent of the time (i.e., responding "frequently" or "almost always").

Uncertainty over taking security

As noted above, it is critical for lenders to be able to take some form of security over concession assets, including the concession contract itself. The ability to obtain a security interest promotes certainty for the lender with respect to repayment of the loan.

The LIS asked respondents whether a contractor could grant a security interest in the concession itself. Only 23 per cent of respondents overall indicated that this was clearly possible in their jurisdiction. Thirty-five per cent responded that it was unclear whether such assignments were permissible and 42 per cent responded that it was not possible for such a security interest to be granted.

Seventy-seven percent of lawyers surveyed felt that it is either non-permissible or unclear as to whether third parties can take security interests in concessions, a key requirement for lenders interested in financing concession-based investments. As a result, the survey has identified an area where legal reform could improve the overall concession regime.

We note, however, that the specificity of this question may not have captured other methods employed by lenders for protecting their security interests in a concession. By way of illustration, while it is preferable for lenders to have a so-called "lien" on a concession contract, the primary interest of lenders is in creating a mechanism for transferring the concession to a reputable and financially capable third party in the event that the existing concessionaire fails to fulfil its requirements under the relevant financing agreements. Such a transfer can necessitate a lender obtaining further consent from relevant governmental authorities for a transfer, provided that such consent would be granted if certain criteria were satisfied. These "security" arrangements are typically more comprehensively addressed in direct agreements between grantors of concessions and lenders. It is not entirely clear whether respondents took a broad view of whether granting a security interest was possible or a narrow one, although as a practical matter a legal regime which recognised the enforceability of direct agreements between governmental authorities and lenders with respect to transferring rights under a concession would achieve a great deal in creating an environment conducive to financing concessions.

Uncertainty with respect to freedom to contract

There were several issues regarding concessions on which respondents did not have a clear understanding. For example, a high number of respondents were uncertain as to whether contracting parties could choose an applicable law other than the law of the contracting authority. Freedom of contract, or the latitude afforded to the contracting authority, was the area where respondents appeared the least knowledgeable. This may reflect either an under-utilisation of concessions law in some jurisdictions or, alternatively, a lack of clarity with respect to what can or should be included in a concession agreement.[12]

Additionally, respondents were often unclear whether an international arbitration clause could be included in a concession agreement. Because respondents were unsure about the substance of the law, often they

[7] For a discussion of the Bulgarian Concession Law see "Bulgarian law on concessions", infra at p.45.

[8] The EBRD has recently initiated a legal transition project to assist the Slovene Ministry of Finance develop a framework concession law.

[9] For a discussion of a concession project in Slovenia see "Slovenia case study: The Maribor waste-water project", infra at p.56.

[10] Aykhan Asadv, "Azerbaijan Oil & Gas New Laws Regulate Oil and Gas Exploration", Russia/Central Europe Executive Guide (15 May 1999) http://www/wtexec.com. The author notes that 16 major production sharing contracts have been concluded in the oil and gas sector despite the absence of a legal framework. It should be noted, however, that some of the concerns of investors regarding these inconsistencies have been allayed by the fact that production sharing agreements (which by their terms provide for clarity regarding the legal regime applicable to a development) have typically been signed by the President of Azerbaijan, and ratified by its parliament.

[11] Respondents could answer with the following responses: 1 – Never; 2 – Rarely, 3 – Sometimes, 4 – Frequently, 5 – Almost Always.

[12] See, for example, M. Lequien, "Romania's New Concession Law", *Law in transition* (Autumn 1999), p. 13 ("The [Romanian] Concession Law does not make a clear distinction between mandatory and 'contractual' provisions of a concession contract and these notions remain effectively untested under Romanian law.") See also Herzfeld & Rubin (Romania), "Getting a Piece of the Pie: What an Investor should Know about the Concession Law", *The Romanian Digest Newsletter of Herzfeld & Rubin*, Vol. IV(11) ("[T]he [Romanian] Concession Law is noticeably silent on several pitfalls associated mostly with the need to draft a complete and all-encompassing agreement.)

were unable to answer how various concepts worked in practice.

Conclusion

In considering whether to finance projects based on concession agreements, lenders look to minimise the impact of non-commercial risks associated with such financings. To the extent a legal regime provides a cohesive and clear structure for the grant of concessions, lenders will be encouraged to provide financing. Similarly, to the extent a legal regime recognises lenders' interests in establishing effective security over a project, and in ensuring effective enforcement remedies, lenders will be better able to evaluate such projects on their commercial merits.

As the EBRD's 2000 Legal Indicator Survey shows, the transition countries have not yet reached the level of providing such a comprehensive legal regime for concessions. A number of countries have in recent years focused attention on improving their concessions laws. However, according to the Survey the major areas where there is a perceived need for further reform include:

- greater clarity in the legislative framework (this could, of course, be achieved via new laws or amendment/supplementation of existing laws);
- increased transparency in the tender/selection process and more publication of information pertaining to the invitation for bids and the selection of the concessionaire; and
- more examples of what should be included in a concession agreement, either through the promulgation of sample contracts or through revisions to the law.

It will be interesting to see in the future whether perceptions of LIS respondents in the surveyed countries improve with the increased use of existing laws and the introduction of new or amended concessions legislation. Additionally, there is room for study of the relationship between a favourable concessions climate and the degree of investor and lender financing of concessions. To the extent that a jurisdiction's concessions laws remain unclear or seem to be applied inconsistently, there will be a continued reluctance for lenders to finance projects.

* Walid Labadi
Anila Gramshi
Office of the General Counsel
EBRD
One Exchange Square
London EC2A 2JN
Tel: +44 20 73386000
Fax: +44 20 73386150
Email: labadiw@ebrd.com
Email: gramshia@ebrd.com

Anita Ramasastry
Professor of Law
Faculty of Law
University of Washington
Condon Hall
1100 NE Campus Parkway
Seattle, Washington 98105-6617
United States of America
Tel: +1 206 6168441
Fax: +1 206 6163427
Email: arama@u.washington.edu