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Client Alert

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Turkish Concessions—Not for the Faint-Hearted

Lending and investing in concession-based projects in Turkey is not for the faint-hearted. Protections often found in emerging market concession agreements are absent and the drafting of the agreements and the official English translations of the original Turkish versions are often difficult to decipher. The tendering governmental authorities to date have not been particularly open to accepting proposed amendments to the draft concession agreements (whether the agreement is in the form of a transfer of operating rights agreement, an implementation contract, a lease or any other form), nor have they shown any inclination to enter into any negotiations with winning bidders. This "take it or leave it" approach stems partly from the fact that any improvement in the terms of a concession agreement after the tender has been released could result in losing bidders challenging the award on the basis that the concession agreement was not signed in the form it was tendered.

At the recent Third Turkey Infrastructure Conference hosted by Bayerische Hypo- und Vereinsbank in Istanbul, there was much discussion on the bankability issues arising from Turkish concession agreements. In a departure from the position that the Privatisation Administration of Turkey (the PA) has historically maintained, Ms. Yildiz Koc, the head of the Tollroads Project Team at the PA, indicated that the PA was prepared to take on board certain suggestions being made by foreign investors and international banks to make Turkish concession agreements more bankable.

In this article we examine the types of problems that are found in many of the concession agreements that have been signed in Turkey over the past four years, and outline the improvements that the banking community is likely to seek in a post-credit crunch world.

"The Privatisation Administration of Turkey could greatly enhance the attractiveness of its concession-based privatisations if it improved the contractual protections offered to concessionaires and their lenders."

Uncertainty as to the Terms of the Concession Agreement

In Turkish privatisations (other than those falling under the BOT regime), the draft concession agreement that forms part of the tender materials is subject to the review and approval of Turkey's Council of State which must issue an "opinion" before the concession agreement can be executed. However, the draft agreement is only submitted to the Council of State for this review following the award of the tender. The Council of State is then given up to two months to review the agreement (although there have been recent examples where legal challenges brought against the award by losing bidders or trade unions have resulted in this period being extended for several months and in some cases over a year). In issuing its opinion, the Council of State has the power to require the draft to be amended, even though the winning bidder (and the banks who are preparing to lend to such bidder) will have based its due diligence on the original draft. In certain recent privatisations the Council of State has required substantial (and substantive) amendments to be made to the draft concession agreement. As a result, the Council of State review process can give rise to uncertainty as to timing and the terms of the final agreement, and indeed can add several months to the project timetable.

Termination Rights and Termination Payments

The possibility of early termination of a concession agreement is a risk that lenders will examine carefully when assessing the bankability of a project. Where large sunk investment costs are involved or high up-front concession fees are payable (see *Payment Mechanics* below), the lenders will want to ensure that the circumstances in which the concession agreement can be terminated earlier than its scheduled expiry date are limited and clearly spelt out in the concession agreement. Furthermore, it is not uncommon in other jurisdictions for the concessionaire to be entitled to receive termination payments that take into account the investments made prior to the termination date. Lenders lending to a concessionaire generally will expect that if the concession agreement is terminated for a reason other than default of the concessionaire, the concessionaire will receive a termination payment that is at least sufficient to repay its outstanding debt.

Turkish concession agreements have traditionally given the granting authorities a unilateral contractual right to terminate the concession for default or insolvency of the concessionaire. However, the concessionaire has been given no corresponding contractual right to terminate the agreement, whether by reason of a default of the granting authority or a prolonged *force majeure* event. The legal philosophy behind this stance has been that because it is only the state that can grant the concession, it is also only the state that can take it away. In the event the granting authorities did breach the terms of the concession agreement (and it must be emphasised here that these concession agreements have generally included very few obligations on the part of the grantor entity) or an extended *force majeure* event prevented the concessionaire from being able to benefit from the concession, the concessionaire would have no choice but to pursue legal proceedings in Turkish courts based on Turkish principles of unjust enrichment, bad faith or other similar legal doctrines.

Furthermore, there have been few concession agreements in Turkey providing for any termination payment or refund of concession fees in the event of early termination of the concession agreement. The right to receive any type of compensation has only been seen in the recent port privatisations where the concession agreement contemplates a partial refund of the concession fee to the concessionaire in the event of an early termination of the concession agreement for reasons other than the fault of the concessionaire. The concessionaire has no right to a refund if the concession agreement is terminated due to the concessionaire's default or due to its insolvency. Arguably, it is not unreasonable to want to restrict the making of termination payments to circumstances where the concessionaire is not at fault, however, when this is viewed in light of the payment mechanics often found in these agreements (see *Payment Mechanics* below) and the fact that few concession agreements have included step-in rights for lenders to be able to step in and cure defaults by the concessionaire (see *Step-in Rights* below), the situation becomes very unpalatable for lenders who have funded heavy investment costs or the payment of the concession fee.

Step-In Rights

Because of the non-recourse or limited recourse nature of most project financings, banks lending to an SPV project company generally require that they be given "step-in rights" under the various project documents, particularly under any concession agreement, so that in the event the project company defaults on its obligations, the banks have the opportunity to take over the project and cure the default, thereby protecting their "asset". The implementation contracts and lease agreements entered into in respect of the airport privatisations and the privatisation of the vehicle inspection services that have taken place in Turkey contained no step-in rights for lenders. More recently, however, the concession agreements in respect of the port privatisations that came to the market in 2007 and 2008 have provided for certain limited step-in arrangements for lenders providing credit to the concessionaire (subject to certain conditions having been met). Nevertheless, in no case have the lenders been a party to the concession agreement, nor has there ever been any direct agreement between lenders and the granting authorities. As such, lenders do not have any standing to bring a contractual claim against the granting authorities if those step-in arrangements are breached.

In our view, the PA and other government entities involved in the privatisation process need to rethink the official approach to step-in rights. Lenders view such rights as an important component of the security package and will expect to be given the opportunity to step into the project effectively and cure concessionaire defaults so as to be able to prevent termination of the concession agreements. Given that there is no established precedent in Turkey for step-in rights, lenders need to be given (i) an express contractual right to be notified prior to the concession grantor taking any steps to terminate a concession by reason of a default by the concessionaire and (ii) a cure period during which the lenders or their nominee are permitted to intervene to cure the default giving rise to the termination event so as to save the project and prevent the granting authority from terminating the concession. Such rights need to be expressly spelt out in the concession agreements (as is the case in concession agreements found in other emerging markets such as Pakistan) and in direct agreements between the concession grantor and the lenders.

Payment Mechanics

In the past, a number of concession agreements have incentivised the winning bidders to pay the entire amount of the concession fee upfront as an advance payment by offering a substantial discount for doing so or by charging a high interest rate for staggered payments. To benefit from the lower fee, the concessionaire has had to ensure that the payment of the fee is in the PA's account (and that this can be verified by the PA) prior to the signing of the concession agreement and the transfer of any rights or assets to the concessionaire. This means that lenders financing the concession payment have had to allow the concessionaire to draw down on the loan facilities prior to there being a valid concession agreement in place.

In a country where legal challenges to privatisations are rampant and court injunctions preventing concession agreements from being executed are not uncommon, such an arrangement requires a huge leap of faith from the lenders. To date, lenders have relied on verbal assurances from the granting authorities and the protections available under the Turkish administrative laws and commercial code, such as the doctrine prohibiting unjust enrichment of the state, which would prevent the government from keeping the concession fee in the event the concession agreement was not executed. However, in practice, relying on these legal protections would involve potentially long, drawn-out disputes in Turkish courts.

Restriction on Share Pledge or Other Security

A robust security package is usually an essential ingredient of non-recourse or limited recourse financings, and a pledge over the shareholders' equity participation in the concessionaire is a standard part of the security package. Turkish concession agreements, however, generally restrict the ability of the lenders lending to the project to obtain a security interest in the share capital of the concessionaire. In certain airport BOT projects there have been explicit restrictions on the creation of pledges over the shares of the concessionaire. Even in cases where there has not been an explicit prohibition on creation of a share pledge, there has been a restriction on share transfers so that it would be impossible for lenders to enforce the share pledge without the prior written consent of the granting authority.

A strict interpretation of the relevant clauses have resulted in some Turkish lawyers holding the view that a share pledge of the shares in the concessionaire is also prohibited without the granting authorities' consent (since the pledge, if enforced, would result in a transfer). It has also been impossible for lenders to obtain security over any assets that form the concession or any rights under the concession agreement (although Turkish counsel have opined that an assignment of the receivables under the concession agreement is permissible). The absence of a share pledge, of course, severely weakens the security package available to the lenders particularly in projects where the concessionaire is an SPV and has few assets. In the airport transactions, for example, the granting authority retains ownership of almost all of the assets required for the project and there is an absolute prohibition on transferring the operating rights to any third party. In the absence of effective lender step-in rights, a share pledge becomes an even more important part of the lenders' security package.

No Change of Law Protection

Turkish concession agreements do not contain any protection for the concessionaire against changes in law that may adversely impact the project or the concessionaire (for example by taking away any tax exemptions that existed at the time the concession was awarded). Lenders and investors have drawn some comfort from the Turkish law doctrine of *imprevision* (commercial impracticability) which would authorise judicial termination or modification of contractual terms in the event that unpredictable changes in circumstances (provided that they have arisen through no fault of the party relying on the doctrine) would make the existing contractual terms unfair.

Additionally, where the concession agreements have been subject to Turkish administrative laws, the Turkish law principle of *fait du prince* would allow a concessionaire to claim compensation in case the financial balance between the parties is distorted due to acts of the party that is an administrative body. However, reliance on these doctrines remains untested and it is uncertain how the courts would apply such legal principles and whether any compensation or protection would, indeed, be provided by Turkish courts. In the absence of certainty in respect of this issue, the PA should include clear protections in the concession agreements themselves so that the concessionaire has contractual remedies available to it.

Currency Mismatch Risk

Turkish concession agreements have not always contained currency protections for the concessionaire. In many cases, the concession fees (and hence the financing obtained to pay these fees) have been payable in US Dollars or Euros, where as revenues from the projects have been in Turkish lira (this is particularly true of projects with market risk, such as the vehicle inspection services, ports and airports). This means that the concessionaire bears the risk of devaluation of the Turkish lira or restrictions on foreign exchange conversion. In some sectors there is an in-built currency hedge, for example in the airport sector duty-free sales (which are often paid for by foreign currency) provide a natural currency hedge. However, in other sectors the project revenues are exclusively in Turkish lira whereas the concession fees are payable in foreign currency. Although there are no currency exchange or repatriation restrictions in Turkey, such projects do give rise to a devaluation risk and currency hedging instruments can be expensive. Where possible, the granting authorities should try to peg project revenues to the same currency in which the concession fees are payable.

Summary

To date, although banks have obtained some comfort from general principles of Turkish law, they have looked mainly at the strength and experience of the project participants, particularly the sponsors, and the growth potential of the Turkish economy. In the post credit crunch world, those criteria are unlikely to be sufficient and lenders will need to apply greater scrutiny to the structure of the security package and the contractual provisions of the concession agreements. The PA could greatly enhance the attractiveness of its concession-based privatisations if it improved the contractual protections offered to concessionaires and their lenders, namely:

- obtaining the Council of State approvals (or equivalent, where relevant) for the draft concession agreement in advance;
- giving lenders effective step-in rights (backed by a direct agreement);
- giving concessionaires the right to terminate the concession agreement in certain circumstances and to be paid a termination payment in order to recover the investments already made (including any "unutilised" portion of any concession fee paid in advance);
- permitting the granting of share pledges and other security to the lenders;
- restructuring the payment mechanism for concession fees so that these are not front-ended and are staggered over several phases or the life of the concession;
- including provisions protecting the concessionaire against change in law risk; and
- providing currency protection by including, where possible, indexation of the revenue stream under the concession.

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