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ISET
International School of Economics at TSU Policy Institute

POLICY PAPER N2024/07

A RISK PROFILE OF CHINA'S INVESTMENT IN ANAKLIA DEEP SEA PORT PROJECT

JULY 2024

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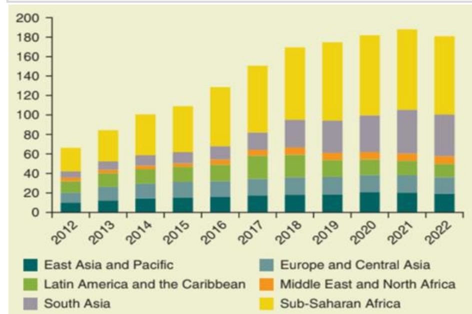
Prompted by the Georgian Government's recent decision to select a Chinese company for the implementation of the Anaklia Deep Sea Port project, ISET-PI's recent policy note (July 11, 2024) provides useful insights into China's ascent as the largest bilateral creditor for low- and middle-income countries (LMICs), its lending practices and case studies, with that background analyses the risks associated with the Anaklia project and provides recommendations. Here is a summary of the main findings. It is also important to note that selecting a Belgian company as the winner of the tender for the construction works (mainly water works) of the Anaklia port in August 2024 does not change or reduce the risks associated with the Chinese consortium as an investor for the port project.

1. WHAT ARE KEY FEATURES OF CHINA AS A CREDITOR?

China is presently the largest bilateral creditor to low- and middle-income countries (LMICs). China's lending mainly targets infrastructure, transport, energy, and mining sectors in developing countries driven by the strong push for a global infrastructure development strategy – the Belt and Road Initiative, adopted in 2013. Consequently, China has ascended to become the largest bilateral creditor to LMICs. As of the end of 2022, LMICs collectively owed China US$180 billion in public and publicly guaranteed external debt. Significantly, Sub-Saharan Africa (SSA), led by Angola, has seen marked increases in its borrowing from China since 2012 and SSA represented 44 % of the total debt obligations of LMICs to China. Meanwhile, in South Asia, the debt to China witnessed a nearly sevenfold increase over an 11-year span, jumping from US$6.4 billion in 2012 to US$42.9 billion in 2022, with Pakistan accounting for two-thirds of this debt (Figure 1).

Figure 1. Low- and Middle-Income Countries' Debt to China, by Region, 2012-22. US$



Source: Figure B1.7.1 from *International Debt Report 2023* (World Bank, 2023).

LMICs have access to different sources of funding from China which is primarily facilitated by state entities like government agencies, policy banks, and state-owned enterprises. Unlike traditional lenders (the World Bank, ADB, JICA), some special features of Chinese loan agreements include confidentiality of contracts, extensive default and cancellation clauses, and collateralized transactions which result in spectrum of contingent liabilities:

- **Confidentiality:** contracts contain clauses limiting the borrower from disclosing the terms of the contract, and in certain cases, even the existence of the contract, unlike contracts with traditional bilateral and multilateral lenders. This could limit the transparency for a country's citizens and their cognizance of the full extent of the debts and obligations undertaken by the government.

- **Default and cross-cancellations:** contracts contain cancellation and cross-cancellation clauses permitting the creditor to cancel the contract if substantial changes in laws or policies occur in either the debtor's or creditor's country, terminating diplomatic relations, and asking for prompt repayments of various contacts.

- **Collateralized debt instruments:** China uses collateralized debt instruments for its lending for high-risk high-reward projects in developing countries. Collateralized loans give creditors rights over a borrower's assets and/or revenue streams. It can involve pledges of physical assets, financial assets, and present and future, related and unrelated revenue flows such as receivables.

- **Off-take guarantees:** these are guarantees on ensuring sufficient cargo volumes in case of transport infrastructure projects (ports, railways) and sufficient supply of energy and natural resources (hydro, oil, metals) in case of energy and extractive industries infrastructure projects. If cargo volumes fall below defined parameters, guarantees could be triggered requiring accelerated repayments and/or invoking asset pledges.

- **Contingent liabilities:** referred to as hidden debt in the recent literature, are often excluded from public debt because these are obligations that only arise if a particular event occurs in the future. Contingent liabilities arise from the host government's ownerships in other borrowing entities (such as SOEs, PPPs, IPPs, and so on) and/or product/service off-take guarantees and collateral pledges. A potential financial obligation that may arise in the future as a result of past events or transactions, but its existence and/or amount is uncertain until one or more future events occur or fail to occur.

Despite being one of the world's largest bilateral creditors, China is not a member of the Paris Club, an informal group of official creditors focused on finding coordinated solutions to debtor countries' payment difficulties; instead, China opts for direct, often less transparent, bilateral negotiations for debt restructuring and relief, incorporating strategies such as extended loan maturities, interest rate adjustments, debt-for-resource and debt-for-equity swaps, while more recently also endorsing the G20's Common Framework for coordinated debt treatments.

Collateralized debt borrowing is associated with a higher risk of debt distress, and it has increased the complexity of some recent debt restructurings. Angola, Argentina, Chad, Ecuador, Ghana, Guinea, Malawi, Republic of Congo, Suriname, Zambia had a high risk of overall debt distress and received debt treatments which include debt restructurings since 2020 (Table 1). There are other debt contracts that are also deemed problematic and have been undergoing debt treatments since then.

Table 1. Collateralized Borrowing and Risk of Debt Distress

Country	Last Reported in Debt Limits Policy	Risk of Overall Distress*	Debt Treatment**
Angola	Jan-22	N.A.	Yes
Argentina	Apr-23	High	Yes
Chad	Jan-23	High	Yes
Congo, Dem R.	Jul-23	Moderate	
Ghana	Mar-23	High	Yes
Guinea	Jan-23	Moderate	
Malawi	Nov-23	In distress	Yes
Rep of Congo	Jun-23	In distress	Yes
South Sudan	Mar-23	High	
Suriname	Mar-23	High	Yes
Zambia	Jul-23	In distress	Yes

Source: Table 1 from *Collateralized transactions: Recent developments and policy considerations* (International Monetary Fund & World Bank, 2023).

* The results are either from the IMF's Sovereign Risk and Debt Sustainability Framework or the Debt Sustainability Framework for Low-Income Countries

**Debt treatment includes debt restructuring that took place since 2020.

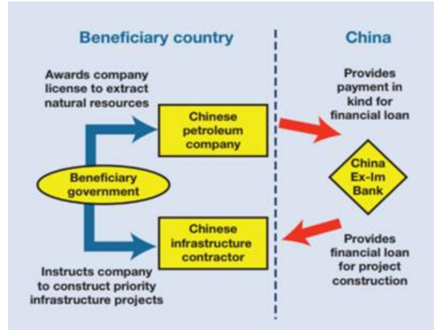
2. HOW CHINA'S COLLATERALIZED DEBT INSTRUMENTS WORK IN PRACTICE?

The modalities of China's collateralized instruments can be categorized based on their intended use into two categories: goods for infrastructure and services for infrastructure.

Goods for infrastructure is a two-stage transaction model in which the supply of goods and labor for infrastructure construction in the first period is paid by goods exports in the second period. Employed for decades and commonly referred to as the Angola mode, or the oil-for-infrastructure model, this financing approach was deemed to withstand the test of time until the emergence of debt restructurings since 2020. Financing disbursements are equivalent to goods and labor supplied by China for infrastructure construction and the debt service paid by the borrower is equivalent to goods exports supplied to China by the host country. These are usually collateralized transactions with off-take guarantees and other asset pledges. Example:

- **The "Angola mode"** of financing represents a solution for countries lacking sufficient financial guarantees to secure loans, by leveraging their natural resources for infrastructure development without direct fund transfers to the government. Under this model, a framework agreement is established for specific infrastructure investments, with the government contracting a Chinese construction firm and a Chinese petroleum company obtaining production rights. Infrastructure projects are financed through a credit from the China Exim Bank and repaid with oil produced by the Chinese petroleum company (Chart 1). This method offers a physical security to China over oil resources, with loan terms adjusting to oil price fluctuations. Originating with the Republic of Congo in 2001 and gaining prominence with Angola in 2004, this resource-backed financing has expanded to include various resources. The model has facilitated large-scale infrastructure development, albeit with complex financial nuances due to its reliance on commodity prices Since 2020, Angola has pursued debt restructuring with China, a response to the considerable repayment challenges triggered by the 2018-2019 drop in oil prices. The specifics of how Angola's debt to China has been restructured remain largely undisclosed, reflecting the typically non-transparent nature of China's loan agreements and debt restructuring practices.

Chart 1. How the "Angola Mode" Works



Source: Figure 2 from *China's emerging role in Africa. Part of the changing landscape of infrastructure finance.* Foster, V., Butterfield, W., Chen, Ch., & Pushak, N (2008).

Services for infrastructure modality is more complex – supply of goods and labor by China for transport services infrastructure (ports, railways) construction in a first period is paid by foreign exchange receipts from transport services operations in the second period. This requires transport services to generate sufficient foreign exchange cash flow to meet the debt service to a China. These are usually collateralized transactions with off-take guarantees on transport service volumes and other asset pledges. Examples:

- **The Laos-China Railway,** a pivotal project connecting Vientiane to the China border, is a cornerstone for Laos's development and a strategic asset for China within the Belt and Road Initiative, forming part of the Kunming-Singapore Trans Asian Railway corridor. Initiated in 2017 and completed in 2021 at a cost of US$6.7 billion, this 420-kilometer electrified rail, with 60% of its track in tunnels or on bridges, was a joint venture between Chinese state-owned enterprises (70% ownership) and the Lao National Railway State Enterprise (30% ownership). The project, financed through a mix of loans from the China Exim Bank and equity investments, with Laos pledging revenues from mineral mines as collateral, has significantly boosted passenger and freight transport, reporting a 274.4% increase in freight volumes in early 2023. Despite its economic benefits, the project has raised concerns over transparency, reliance on Chinese labor and firms, environmental and labor regulations, and has contributed to Laos's mounting debt, which has led to significant financial scrutiny and criticism over potential sovereignty concessions. These concerns are especially evident in the energy sector. Due to substantial levels of loans from China, the state-owned Electricite du Laos (EdL) established Electricite du Laos Transmission Company Ltd.

together with the China Southern Power Grid Co., where the Chinese company holds majority equity share.

- **The Addis Ababa–Djibouti Railway**, a 759 km cross-border project connecting Ethiopia's capital to the Port of Djibouti, represents a strategic development under China's Belt and Road Initiative, aimed at enhancing freight and passenger transport efficiency, bolstering Djibouti's maritime hub status, and fostering economic growth in landlocked Ethiopia. Owned by the Ethio-Djibouti Standard Gauge Railway Share Company (EDR), a joint venture between the Ethiopian Railway Corporation (ERC) and the Société Djiboutienne de Chemin de Fer (SDCF), with a share distribution of 75% to Ethiopia and 25% to Djibouti, the railway's construction was undertaken by Chinese firms CREC and CCECC, with China also financing 70% of about US$5 billion project cost through loans. The railway has encountered financial challenges due to lower-than-expected traffic volumes, exacerbated by the Ethiopian Birr's depreciation and leading to debt restructuring for Ethiopia. Similarly, Djibouti has faced debt sustainability concerns, with a significant rise in its debt-to-GDP ratio due to infrastructure investments, prompting debt restructuring discussions with China's Exim Bank.

- **The Hambantota Port project in Sri Lanka** became a well-known example of China's approach to financing infrastructure projects in foreign countries through significant loans, sparking debates on "debt-trap diplomacy" and political corruption. Initiated by President Mahinda Rajapaksa in 2007, despite skepticism from investors due to its proximity to the already dominant Colombo port, China emerged as the sole willing financier under Public Private Partnership (PPP), Build- Own-Operate modality (BOO) with Sri Lankan state-owned-enterprise (SOE) holding controlling share in the venture, which was in turn financed by Chinese loans. China Communications Construction Company (CCCC) was selected as a contractor. Allegations of corruption surfaced, including a reported US$7.6 million transfer from China Harbor Engineering Co. to Rajapaksa's campaign. Funded by a US$307 million loan from China Eximbank for its first phase and an additional US$809 million for the second phase, the project's financial sustainability came into question, due to lower-than-expected traffic volumes, leading to a debt-for-equity swap in 2017. This deal granted China Merchants Port Holdings Company a 99-year lease on the port, alleviating part of Sri Lanka's debt by converting it into equity, thereby raising concerns over Sri Lanka's sovereignty and financial independence. Sri Lanka is undergoing debt restructuring with all its creditors, including China, presently.

3. WHAT DO WE KNOW ABOUT CHINA'S ANTICIPATED CONTRACTUAL AGREEMENT FOR THE ANAKLIA PROJECT?

So far, the primary known features of China's investment approach in the Anaklia port project seem to resemble those of the Hambantota port project in Sri Lanka. In both instances, China was the sole financier, CCCC was chosen to operate under PPP/BOO terms, with a Sri Lanka SOE holding a majority stake in the venture, which received phased financing from China.

- **CCCC.** On April 29, the same day as adopting the foreign agents' controversial legislations, the government has announced the selection of China Communications Construction Company (CCCC) and its subsidiary China Harbour Engineering Company (CHEC), which is based in Singapore. In 2020, the US prohibited financial transactions by US citizens in CCCC due to its involvement in building artificial islands and contributing to the militarization of contested areas in the South China Sea and discouraged the People's Republic of China from leveraging CCCC and other state-owned enterprises as tools to enforce an expansionist military agenda.

- **PPP/BOO.** The Anaklia New Deep Sea Port project will be executed in the format of an institutional Public-Private Partnership (PPP). The proposed PPP contract is set to adopt a Build-Own-Operate (BOO) framework, which is not transparent, as opposed to the Build-Operate-Transfer (BOT) model. A significant point of difference here is the requirements for adherence to the International Public Sector Accounting Standards (IPSAS). Under IPSAS, all BOT contracts must be recorded as debt on the government's balance sheet. This requirement for debt recognition mandates a comprehensive level of transparency, thereby guaranteeing clear visibility into the financial commitments stemming from the BOT contract. BOO contracts do not have such requirements.

- **SOE/FIZ.** The government of Georgia will hold a controlling 51% ownership stake through the state-owned company (SOE) Anaklia Sea Port LLL, with the Chinese-Singaporean consortium acquiring the remaining 49% share. The government will allocate up to 340 hectares of land for the project, with consideration given to establishing a free industrial zone (FIZ). The contractor will be responsible for both equity and debt financing for its obligations on the project. The initial investment for the first phase of the project totals US$600 million, while the total cost of the project was initially estimated in the range of US$2 billion. The first phase encompasses constructing a wharf capable of handling 7 million tons of cargo annually and must be operational within 3 years since the construction initiation. The project is envisioned to span 49 years.

4. WHAT ARE KNOWN UNKNOWNS ABOUT CHINA'S ANTICIPATED CONTRACTUAL AGREEMENT FOR THE ANAKLIA PROJECT?

Analyzing China's financing approaches and case studies from various countries reveals several high-risk and high-impact uncertainties about China's anticipated contractual agreement for the Anaklia project:

- **Loans:** The terms of financing from China, as well as the specific financing agencies involved in providing loans for the project, remain to be defined. The employment of a PPP/BOO/SOE framework for the Anaklia project suggests that the associated debt transactions will not be subject to the same level of oversight as public debt transactions. Instead, these transactions will be recorded on the balance sheet of the SOE.
- **Equity financing:** Details regarding how the state plans to finance its ownership stake in the SOE for the Anaklia Port project are scarce. For the state to secure 51% ownership in the Anaklia Port SOE, it must make an equity investment to fulfill this obligation. It is uncertain whether these investments will come directly from the state budget or from other government funds - such as the pension fund, especially since recent legislative changes have made this a possibility. Alternatively, the state may choose to secure a loan directly from China and subsequently on-lend it to the SOE from the state budget.
- **Cargo volumes**: The financial viability of the project hinges on securing enough cargo volume to generate the foreign exchange cash flow necessary for covering the debt service obligations tied to the construction and operation of the project. The extent to which underlying studies on cargo volume flows, under various scenarios, have been stress-tested to guide negotiations remains unclear. Additionally, there is uncertainty regarding the wharf's ability to achieve the anticipated

cargo volumes within three years post-construction, especially given the highly unpredictable geopolitical environment.

- **Guarantees:** Considering the uncertainties surrounding the project's financial sustainability, creditors are likely to request asset pledges (liquidity, land, etc.) and off-take guarantees for cargo volumes, in line with their customary approach to financing high-risk projects in other countries. There is scant information on whether the Ministry of Finance, the National Bank of Georgia (NBG), the Ministry of Justice, and other pertinent state agencies are engaged in the negotiations concerning potential guarantees and the examination of the proposed contract terms, risk scenarios, and their potential impact on the public sector's balance sheets.
- **Distress:** China debt financing through the SOE and the contingent liabilities stemming from utilizing off-take guarantees and asset pledges could result in direct debt obligations for the state budget, potentially leading to Georgian taxpayers covering the debt service using the NBG foreign exchange reserves. These fiscal risks could intensify if the pension fund opts to invest in the Anaklia project.

5. WHAT GEORGIA COULD DO TO MITIGATE THE RISKS OF CHINA'S ANTICIPATED CONTRACTUAL AGREEMENT FOR THE ANAKLIA PROJECT?

Georgia can better manage the complexities of the Anaklia Deep Sea Port project, ensuring it serves as a catalyst for economic growth while safeguarding the interests of its citizens. The Anaklia Deep Sea Port project in Georgia is emerging as a cautionary tale, highlighting the risks associated with substantial Chinese investment. The project's uncertain profitability, potential fiscal liabilities, and geopolitical context call for a meticulous re-evaluation of its strategic viability and financial sustainability. Drawing from the experiences of other countries, Georgia should prioritize transparency and implement stringent risk management frameworks to navigate the complex dynamics of mega-scale Chinese investment in its critical infrastructure projects. Georgia can prioritize:

- **Risk Management:** For the Anaklia Deep Sea Port project in Georgia to achieve its full potential and ensure beneficial outcomes, a comprehensive approach to risk management, stress testing, and project governance is essential. The Georgian government and relevant stakeholders should prioritize sound institutional and legal frameworks. This includes conducting exhaustive reviews of contractual terms to ensure they align with domestic laws and international obligations and conducting risk scenario stress testing to inform financial agreements and to safeguard critical assets.
- **Transparency and accountability:** To mitigate the risk of corruption and self-dealing practices, it is paramount to promote transparency and accountability throughout the entire process. Ensuring that every aspect of the project aligns with Georgia's broader debt strategy and macroeconomic policies will be crucial for its success. Additionally, enabling supervisory and back-office teams from relevant state agencies to have immediate and comprehensive access to review and contribute to negotiations as they happen, will ensure a more inclusive and informed decision-making process.
- **Capacity Building:** To support these structural and procedural reforms, the Georgian government must also focus on capacity building within key areas. Strengthening the expertise and resources available in legal, debt management, fiscal risk management, and public investment management is critical. This effort should aim at developing in-house capabilities that can provide the technical know-how required for the execution and ongoing management of the Anaklia port project.

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