Navigating through the winding One Belt One Road

October 2018

Hogan Lovells

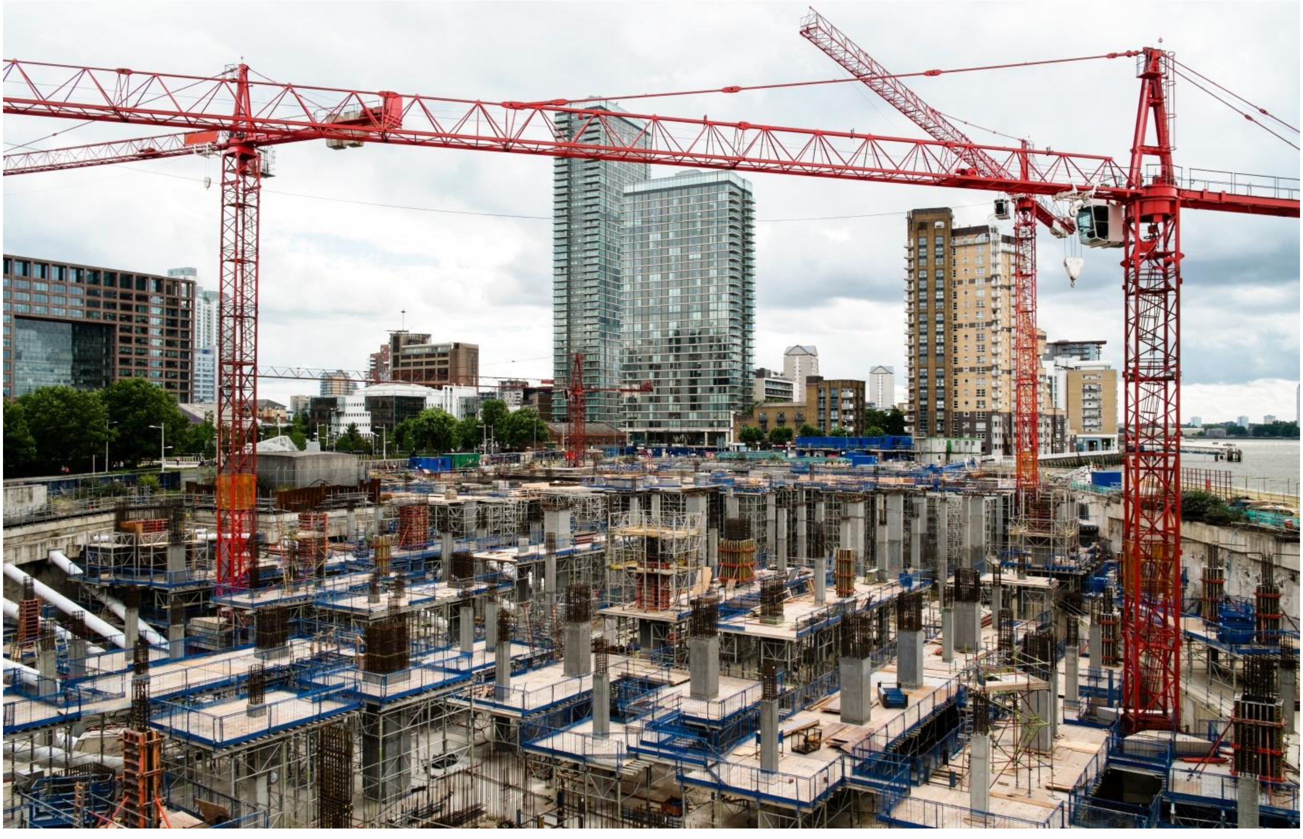
Contents

Hogan Lovells in Belt and Road

For many years, Hogan Lovells has been assisting Chinese and non-Chinese investors, sponsors, lenders, insurers and contractors undertaking projects in Belt and Road countries.

Hogan Lovells offers extensive experience and insights gained from working in some of the world's most complex legal environments and markets for corporations, financial institutions and governments. We help you identify and mitigate risk and make the most of opportunities. Our 2,500 lawyers in 50 offices in Asia Pacific, Africa, Europe, the Middle East, Latin America and the North America provide practical legal solutions wherever your work takes you.

Given our unrivalled global presence, coupled with our on-the-ground presence in China, which covers both PRC and international law, Hogan Lovells is uniquely placed in assisting Chinese and international companies in capturing opportunities arising from BRI.



Introduction

Announced in 2013 as the project of the century, Chinese President Xi Jinping unveiled the Belt and Road Initiative ("BRI") to revitalise trade and economic growth in the Eurasian region.

Arguably the most ambitious infrastructure investment initiative in modern history, the initiative is seen as a consolidation of the "Silk Road Economic Belt" – which is comprised of six regional corridors connecting China with Europe and encompassing countries within Central and Western Europe, the Middle East, and Asia – and the "21st Century Maritime Silk Road" – a sea route from China's east coast to Europe, India, Africa and the Pacific through the South China Sea and the Indian Ocean.

The initiative has since been under international spotlight due to its ambitious scale and the efforts to promote economic cooperation with the countries along the BRI roads in accordance with the Chinese foreign policy. Investments in the BRI continue to set new targets with increased global participation in various forms. However, as risks start to surface in some BRI projects, it remains to be seen how the BRI will move forward to navigate through these challenges.

Source: The Straits Times

What is happening now

The National Development and Reform Commission reported that at least 103 countries and international organisations have signed 118 cooperation agreements with China on the BRI. By June 2018, trade between China and the countries along the BRI road surpassed USD 5 trillion. In terms of the investment value of the BRI projects, it has been estimated that the range is somewhere between USD 1 trillion to USD 8 trillion and this large range reflects a lack of clarity on the scale of the BRI.

Though tightened controls over capital outflows to stabilise the yuan in 2017 caused Chinese outbound direct investment to fall by about 19%, Chinese investments in the BRI countries remained relatively unaffected and instead rose to a record USD 20.1 billion in 2017, an increase of about 30%.[1] Further data from the Chinese Ministry of Commerce shows that the record may be surpassed again in 2018. Chinese investment in the BRI countries (excluding the financial sector) has increased by 12% to USD 9.5 billion within the first eight months in 2018.[2]

The continued surge in Chinese BRI investments is largely attributable to the robust political will to move forward the BRI agenda amidst the restrictions on capital outflows. A joint clarification by the National Development and Reform Commission, Ministry of Commerce, People's Bank of China, and Ministry of Foreign Affairs was released in August 2017 explicitly encouraging enterprises to promote the BRI and "*primarily focus on investment in overseas infrastructure projects that facilitate the communications and connections that are beneficial to the "Belt and Road" initiative*".

However, the risks associated with the BRI have not gone unnoticed. Uncertainties in the legal and political systems in high risk jurisdictions continue to be bankability red flags, and this may often lead to suspension or cancellation of BRI projects. While these BRI projects assist with infrastructure upgrades in developing countries, critics have pointed out that some recent developments on a number of BRI agreements may have set a negative tone for projects in high risk jurisdictions where debt levels have not been well maintained

Notwithstanding, the risks associated with the BRI projects do not appear to have dampened the steady momentum of the BRI and BRI investments are expected to continue to increase exponentially going forward.

Source: Metal Supply SE

1 China's Belt and Road investment hits high as overall FDI falls.
2 Regular Press Conference of the Ministry of Commerce.

BRI projects – what, where and how

What is considered a BRI project

There appears to be no clear consensus or guidelines on what is qualified as a BRI project and a comprehensive list of BRI projects or deals has never been published by China.[3] Notwithstanding, the absence of published eligibility requirements for BRI projects is understood to be deliberate so as to allow flexibility to expand the ambit of the BRI. Indeed, the geographic scope of both the "Belt" and "Road" has been interpreted to be flexible and some interpretations have extended the paths to Australia[4] and the United Kingdom[5].

Accordingly, the sole pre-requisite appears to be Chinese participation in projects or deals in the countries situated along the "Belt" or the "Road" of the BRI. Apart from this requirement, further eligibility conditions are difficult to identify.

The flagship BRI projects

Although the scope of the BRI remains unclear to date, it generally envisages the following six major economic corridors:

(a) China–Pakistan Economic Corridor;

(b) China–IndoChina Peninsula Economic Corridor;

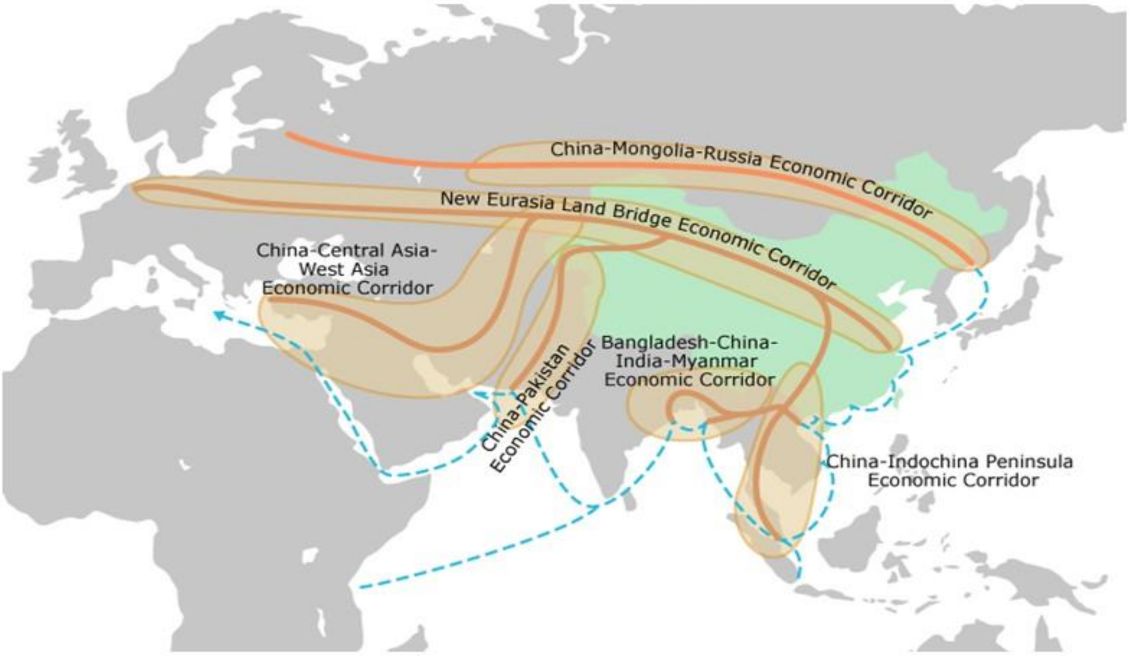
(c) New Eurasian Land Bridge;

(d) China–Mongolia–Russia Economic Corridor;

(e) China–Central Asia and West Asia Economic Corridor; and

(f) Bangladesh–China–India–Myanmar Economic Corridor.

The Belt and Road Initiative: Six Economic Corridors Spanning Asia, Europe and Africa



Source: Hong Kong Trade Development Council

3 The Belt and Road portal (https://eng.yidaiyilu.gov.cn/) does not contain a comprehensive list of BRI projects.
4 Geoff Wade, Foreign Affairs, Defence and Security, China's 'One Belt, One Road' initiative (August 2016).
5 Britain can be a key partner in China's new Silk Road .

Gwadar Port is situated along the China–Pakistan Economic Corridor in the Balochistan province, **Pakistan**. The total investments planned along the China–Pakistan Economic Corridor is estimated to be USD 54 billion with the Gwadar Port, being the crown jewel, sometimes referred to as the "gateway city" or the "gateway to Asia". Gwadar Port is estimated to cost around USD 1.02 billion, and is located near key oil shipping lanes along the Arabian Sea, where more than a third of the world's oil passes.

Source: Islamic Republic News Agency

The project is divided into two phases; the first phase was completed in 2006 with the port having the capacity to handle 50,000 dead weight tonnage bulk carriers and the second phase is undergoing construction works and envisages an expansion of the port, including a 300MW coal-fired power plant. Jointly developed by Pakistan and China, the USD 248 million port was initially operated by PSA International of Singapore, but was later handed over to China 20-year concession agreement.[6]

Gwadar Port can also be seen as a potential strategic move by China to reduce its reliance on the shipping route through the Malacca Strait.

The **Khorgos Gateway** is the world's biggest dry port, bordering the land-locked **Kazakhstan** and China. It is a transport hub right at the centre of China and Europe that manages up to 15 million tonnes of freight a year, and is expected to increase its capacity to 30 million tonnes a year when the second Europe–China rail link comes online.

Chinese state-owned COSCO Shipping Corporation Limited and Lianyungang Port Holdings Group Co., Ltd. bought a 49% stake in the facility in 2017, representing one of China's many efforts in acquiring ports and logistics hubs.[7] Kazakhstan Temir Zholy, a Kazakh state enterprise, continues to be the largest shareholder and KTZE-Khorgos Gateway LLP Company operates the port with the assistance of DP World.

Source: eurasianet

[6] [Gwadar: Emerging Port City or Chinese Colony?]

[7] [Cosco leading China's 'Belt and Road' drive.]

Yiwu–London Railway Line is the world's second longest railway freight route after the Yiwu-Madrid Railway Line, spanning 12,000km across 9 countries (China, Kazakhstan, Russia, Belarus, Poland, Germany, Belgium, France and the UK) to **London**.

Cheaper than air freight and faster than sea freight, the Yiwu–London Railway Line is expected to handle 100,000 containers a year by 2020. The forthcoming departure of the UK from the European Union ("**EU**") – the Brexit, is set to channel more of the UK's attention to the Chinese market and may increase trade between the two countries.

Source: The Straits Times

Source: The Straits Times

The **Kyauphyu-Kunming Oil & Natural Gas Pipeline** is estimated to cost USD 2.54 billion and runs from Kyaukpyu, **Mynanmar** to Kunming, China. Similar to the Gwadar Port, the oil pipeline presents an alternative route to the Malacca Strait and has the capacity for transporting 22 million tons of crude oil annually.

Source: South China Morning Post

The oil pipeline is built and operated by South-East Asia Crude Oil Pipeline Co. Ltd., a joint venture company owned by China National Petroleum Corp ("**CNPC**") holding a 50.9% stake and Myanmar Oil and Gas Enterprise ("**MOGE**") with the remainder. Running parallel to the oil pipeline, the gas pipeline is built and operated by South-East Asia Gas Pipeline Company Limited, a joint venture company owned by South-East Asia Pipeline Company Limited of CNPC, MOGE, POSCO DAEWOO Corporation, ONGC Caspian E&P B.V., Gail Limited and Korea Gas Corporation.[8]

[8] Overview of the Myanmar-China Oil & Gas Pipelines.

Kunming-Singapore High-Speed Railway Network sits in the China–Indochina Peninsula Economic Corridor and plans to connect the region by bringing together the fragmented high-speed railways across China, **Myanmar**, **Thailand**, **Malaysia, Cambodia, Laos, Vietnam** and **Singapore** into an integrated network.

Source: The Nation

The network will be divided into three main routes, each originating from Kunming and culminating in Singapore, namely, the eastern route (from Kunming, through Hanoi, Ho Chi Minh City, Phnom Penh, Bangkok and Kuala Lumpur to Singapore), central route (from Kunming through Vientiane, Bangkok and Kuala Lumpur to Singapore) and the western route (from Kunming through Mandalay, Rangoon, Bangkok and Kuala Lumpur to Singapore).

The central railway from Kunming to Vientiane is estimated to cost about USD 6.04 billion and is expected to complete in 2021. The railway is owned by a China-Laos joint venture and the China Railway Group has been awarded the construction contract.[9] The USD 5.2 billion Thailand piece with Bangkok connecting to Nakhon Ratchasima is being financed by the Thai government and is expected to commence full operations in 2023.[10] On the other hand, other railways have been hindered with political uncertainties, such as the Kuala Lumpur-Singapore high speed rail, which has been put on hold following the change in Malaysia's political leadership.

Source: Geopolitical Monitor

9 [Fact Sheet: Kunming-Singapore High Speed Rail Network.]
10 [China's high-speed train plans in Southeast Asia stumble.]

The players in the game

Even without a clear estimate of the scale of the BRI, what is clear is that the infrastructure opportunities and economic growth potential in this transcontinental endeavour are huge, with the BRI being the key talking point on the global stage.

Financiers

The financiers feature as the main players in the BRI, with the Chinese policy banks, namely, China Development Bank ("**CDB**") and the Export-Import Bank of China ("**CEXIM**"), leading the Chinese development finance in infrastructure projects with Chinese participation in the BRI. While CDB often extends its support to fields such as mining, equipment manufacturing and agricultural processing, CEXIM is associated with the provision of concessional loans for construction projects of highways and railways, and for areas related to electricity and communication.

Both policy banks provide the majority of Chinese development finance in the form of commercial loans, whereas concessional loans and preferential buyer's credit are mostly provided by CEXIM. Importantly, concessional loans are extended on more generous terms as compared to market loan terms, with longer tenors in the range of 12 to 20 years and lower interest rates that are around 3% or below. By contrast, interest rates under commercial loans are almost at market-level (around 7%). However, concessional loans are accompanied by a government-to-government agreement pursuant to an application by the borrowing country to CEXIM.[11] This requires a longer approval process with both CEXIM and Ministry of Commerce as the reviewing authorities. On the other hand, commercial loans for the BRI do not usually require government support and the approval process is shortened but credit insurance is often required to be taken out on top of the higher financing costs.

It is noteworthy that CDB imposes strict caps on sovereign borrowers' credit lines while CEXIM imposes debt ceilings for each country. In particular, CDB also requires credit requirements for loans to heavily indebted countries to be aligned with requirements set out by the International Monetary Fund.[12] These limitations on credit are used as risk-control mechanisms to evaluate loan feasibility of each country.

Source: CGTN.com

In addition, local content requirements appear to be a condition for lending from these policy banks. Before the inception of the BRI, a large number of loans are conditional upon construction contracts being awarded to Chinese state-owned enterprises.[13] Further, where projects are seeking funds from the policy banks, insurance coverage from China Export & Credit Insurance Corporation ("**Sinosure**"), a state-funded and policy-oriented insurance company, is often required. However, the Sinosure coverage is available only where funding by Chinese banks is at least 70% of the total financing and Chinese goods and services procured is no less than 60% of the project value.[14]

[11] PWC, Chinese Outbound Funding (UN Portion).

[12] Behind China's Silk Road vision: cheap funds, heavy debt, growing risk.

[13] EU criticises China's "Silk Road", and proposes its own alternative.

[14] Liu Dongmin, Gao Haihong, Matthew Oxenford, Xu Qiyuan, Song Shuang, Paola Subacchi and Li Yuanfang, The 'Belt and

Multilateral financial institutions such as Asian Infrastructure Investment Bank ("**AIIB**"), World Bank and the Asian Development Bank are also financing the BRI. The AIIB was launched in 2014 and has 86 member states now (but note that US and Japan are not members). China is the largest shareholder in the AIIB, followed by India, Russia, Germany and South Korea. The AIIB is able to extend or facilitate financing to any member so long as the project benefits Asia (i.e. fostering economic development, creating wealth or improve infrastructure connectivity in Asia)[15] and membership is open to members of the International Bank for Reconstruction and Development or the Asian Development Bank.

The AIIB is also considered to be an alternative route to funding as the assumption of political risk is within its mandate[16] and therefore, allows borrowers to circumvent the Sinosure local content requirements. The AIIB targeted to increase its lending and investment to USD 3.5 billion in 2018, representing a 40% increase from 2017. With the highest possible credit ratings and careful screening of loan applications, it has been reported that AIIB continues to maintain its record of being focussed on infrastructure development financing. Indeed, a significant amount of the loans have been used in co-financing packages with other multilateral banks and there is no clear instance of preferential treatment to BRI projects.[17]

Meanwhile the other state-owned Chinese banks, such as Industrial & Commercial Bank of China, Bank of China, China Construction Bank and the Agricultural Bank of China are also heavily involved in the BRI. In 2016, there were over 800 BRI projects in which Industrial & Commercial Bank of China took part in 212 of those projects with credit facilities exceeding USD 67 billion. Bank of China and China Construction Bank provided USD 67.4 billion and USD 90 billion respectively for BRI projects.

Funds are also beginning to play a bigger role. The Chinese funded Silk Road Fund has an initial capital of USD 40 billion, which was contributed by CDB (5%), CEXIM (5%), China Investment Corporation (15%) and China's State Administration of Foreign Exchange (65%). By August 2017, the Silk Road Fund had provided investment for 15 projects with its committed investment at USD 680 million. Part of its initial fund went to financing the Mombasa-Nairobi Railway construction and a further USD 1.65 billion investment was made in the Karot Hydropower Project and other hydropower projects in the Belt area of China–Pakistan Economic Corridor.[18] It also acquired a 10% share in PJSC SIBUR Holdings, a Russian energy company.[19]

Road' Initiative and the London Market – the Next Steps in Renminbi Internationalization (January 2017).

15 AIIB, Financing Operations in Non-Regional Members (Technical Note) (24 February 2018).

16 See AIIB, Annual Meeting of the Board of Governors – Summary of Proceedings (25-26 June 2018).

17 So far, so good for the AIIB.

18 Commentary: Silk Road Fund's 1st investment makes China's words into practice.

19 Silk Road Fund Signs Definitive Transaction Agreement regarding Sale and Purchase of Minority Equity Stake in PJSC SIBUR HOLDING.

Notable investors and contractors

Western investors have started their engines down the Belt and Road. General Electric made USD 2.3 billion in equipment sales for BRI projects in 2016 and forecasted growth for the next few years.[20] In 2017, the Silk Road Fund and GE Energy Financial Services signed a 'cooperation' deal to set up an energy infrastructure investment platform in Beijing. The two sides will jointly invest in power grids, renewables and oil and gas in the BRI countries.[21]

Source: City A.M.

Other players such as Honeywell, Caterpillar and Maersk are also competing in the energy and transportation space. Caterpillar, the largest equipment maker in the world, is extending its financing capabilities to the BRI so as to lend to Chinese companies to bridge funding gaps.[22] China is also a huge market to Honeywell as the sales in China represented 6% of its revenue (around USD 2.4 billion) in 2016 and the American multinational company has now over 30,000 local employees along the Belt and Road.[23]

In a bid to boost involvement in the BRI, Siemens established its Beijing Belt and Road office in March 2018. Siemens also cooperated with China National Machinery Import & Export Corporation to build the second phase of the Bangladesh Sirajganj combined-cycle power station. Siemen's partnership with Chinese construction companies can be seen to be growing steadily over the recent years, cooperating with Sinopec Group, Power Construction Corporation of China and China Energy Engineering Corporation Limited.[24]

Partnership with western investors or contractors is welcomed as it seems to give Chinese companies credibility to raise financing for the projects. In the same vein, it is hard for western companies with Asian strategy to overlook the opportunities BRI presents.

20 Western firms are coining it along China's One Belt, One Road.

21 General Electric, China's Silk Road Fund to launch energy investment platform.

22 FOCUS-Caterpillar drives sales on China's new Silk Road.

23 US multinationals angle for inside track in Belt and Road push; Western Firms Bet Big on China's Billion-Dollar Infrastructure Project.

24 Siemens can become best partner for construction of Belt & Road Initiative, Siemens China CEO.

Risks and challenges – going forward?

Since its inception, the BRI footprints have grown significantly abroad but the path to date has not been easy. The political risks that are often due to instability within the government structures and regulatory uncertainties associated with emerging markets are real and cannot be ignored. Suspension of works in BRI projects has become fairly common due to such political and regulatory risks (e.g. lack of proper permits for foreign investments) and Chinese financiers may lack the expertise to effectively manage large scale cross border transactions.

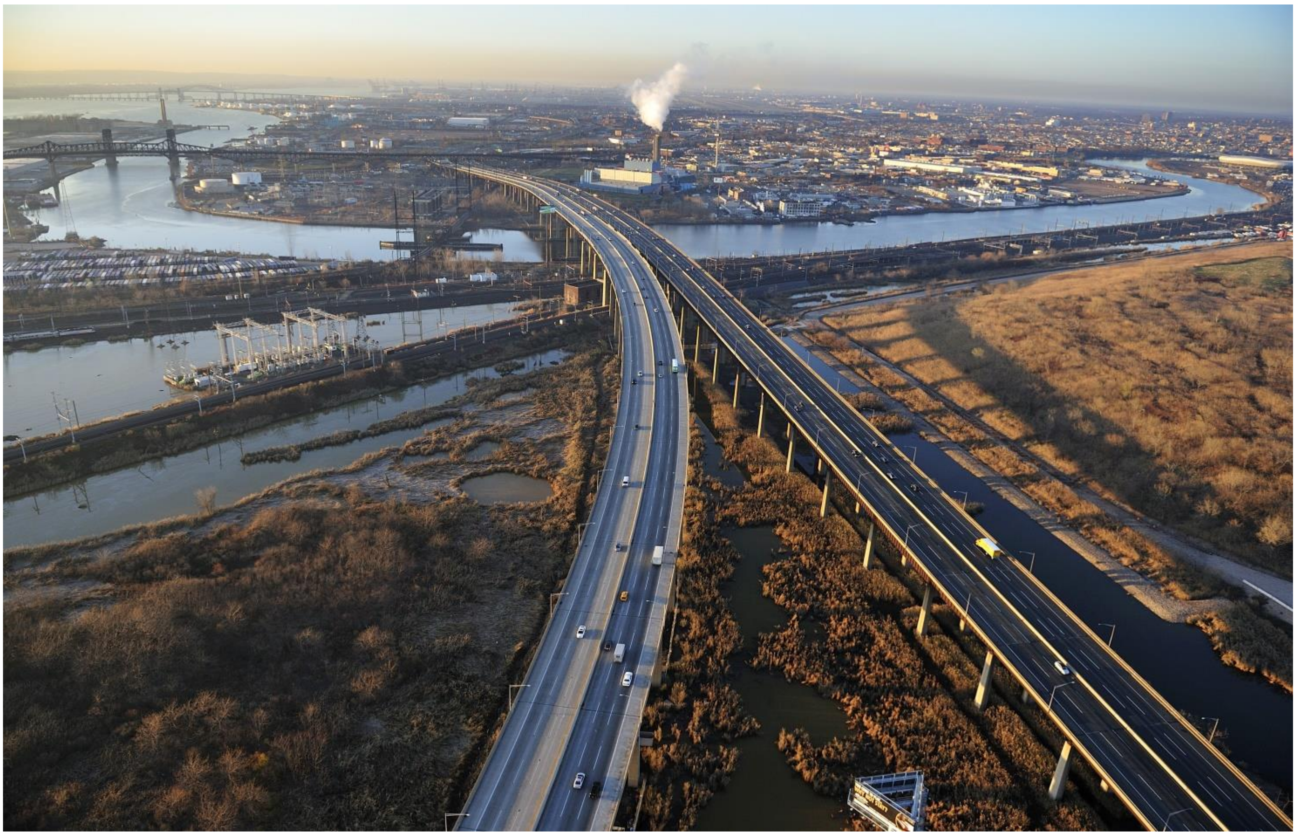
After a change of political leadership in Malaysia following a surprise election, USD 23 billion worth of Chinese projects (including two gas pipelines worth USD 2.3 billion and the USD 20 billion East Coast Rail Link) were cancelled. As a result of Prime Minister Mahathir's promise to review all infrastructure deals negotiated by his predecessor, the high profile Kuala Lumpur–Singapore High Speed Rail was also put on hold. Being the fourth largest recipient of Chinese investments of estimated financial commitments of around USD 34 billion, the cancellation of BRI projects by Malaysia sends a signal to the other developing countries to relook at the negotiated contracts. This may be especially concerning given that Mahathir was openly critical about unfair terms in the contracts and further claimed that some contracts were subject to unusually high interest rates.[25]

Indeed, Pakistan appears to be going through a similar phase. Prime Minister Imran Khan and his new government seek to renegotiate CPEC projects and review the country's over-reliance on Chinese debt.[26] Renegotiations in Myanmar over a USD 10 billion port project and in Nepal over two hydroelectric dams have also put the BRI in the spotlight. Heavy lending to these BRI countries (such as to Laos for a railway link representing half of its GDP) has highlighted the risks of these developing countries being unable to service these unsustainable debt levels. In particular, the control of Hambantota seaport in Sri Lanka was ceded to China on a 99-year lease together with 15,000 acres of surrounding land pursuant to a restructuring following failure to meet payment terms. Developing countries are expected to be more wary of project contract terms in the course of negotiation to avoid similar potholes.

Source: The Diplomat

The lack of a regional coordinating body to represent the interests of the host countries may hinder the progress of the BRI. Unlike the EU, ASEAN may not have been realised to its full potential to be an effective regional coordinating body. In respect of the BRI projects and initiatives, most ASEAN countries have acted independently. While the ASEAN connectivity plans share similar goals with the BRI network of projects, harmonisation and consistency should be taken into account to reap greater benefits.

[25] Malaysia's Mahathir says will raise 'unfair' contracts in visit to China.
[26] Gwadar: Emerging Port City or Chinese Colony?



Further from the west, competition is slowly creeping towards Asia. The EU has initiated the Euro–Asian connectivity strategy in September 2018 in a move to increase investments in Asia. Consolidating the existing EU projects in Asia, the EU plans to address sustainability issues and has expressed that it will adopt a comprehensive, rules-based and transparent approach.[27] Notably, a significant amount of its external budget of up to USD 140 billion will go towards investment in Asia. The US has also been expanding its reach in Asia, particularly the Asia-Pacific region, with plans to establish the US International Development Finance Corporation, armed with a spending cap of USD 60 billion.

Going forward

Notwithstanding concerns over the risks and challenges, opportunities in the BRI should not be discounted. Indeed, many firms believe that the benefits and opportunities far outweigh the risks. Competition from the West will only add to the prospects of increased bankable investments and will bring about promise of economic growth. Further, western participation may also be seen as improving performance and efficiency along the Belt and Road.

With increased cooperation and harmonised expectations across the regions, the journey on this winding road will be fruitful.

27 Explaining the European Union's approach to connecting Europe and Asia.

Key contacts

Jun Wei
Office Managing Partner, Beijing
T +86 10 6582 9501
jun.wei@hoganlovells.com

Alex Wong
Partner, Singapore
T +65 6302 2557
alex.wong@hoganlovells.com

Joseph Kim
Partner, Tokyo
T +81 3 5157 8260
joseph.kim@hoganlovells.com

Gaston P. Fernandez
Partner, Miami
T +1 305 459 6630
gaston.fernandez@hoganlovells.com

Miguel A. Zaldivar, Jr.
Regional Chief Executive – Asia Pacific
Middle East region, Hong Kong
T +852 2840 5674
miguel.zaldivar@hoganlovells.com

Sean Conaty
Partner, Tokyo
T +81 3 5157 8261
sean.conaty@hoganlovells.com

Samantha Campbell
Partner, Singapore
T +65 6302 7144
samantha.campbell@hoganlovells.com

Zack Lin
Associate, Singapore
T +65 6302 2595
zack.lin@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Rio de Janeiro
Riyadh
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar
Warsaw
Washington, D.C.
Zagreb

Our offices
Associated offices

www.hoganlovells.com