

achieving security. Broadening the scope of negotiations also provides more opportunities for cooperation on economic, scientific, and educational issues. Linkage of such an array of issues, including human security and economic benefits, should be utilized to achieve progress. East Asian states should seize the opportunity to find common ground and create a permanent security structure for the region. Resolving the DPRK problem within this context would improve the prospects for a more sustainable security and prevention of another nuclear crisis from erupting in the near future.

## The Korean Market for Private Participation in Infrastructure - An Analysis of Risks and Opportunities for Private Investors

*Seung Ho Choi\**

### Abstract

*The driving factor behind Korea's push for development of infrastructure is its recognition in recent years that the acute lack of infrastructure in key sectors affects the country's overall productivity. Despite this pressing need, the government has had to turn to the private sector for its much-needed greenfield infrastructure projects due to budgetary and financial constraints. In this respect, the Korean government firmly recognizes the correlation between a nation's highly-developed infrastructure and its overall competitiveness in today's globalized economy, and it is this need for development which has led the Korean government to focus on its private participation in infrastructure ("PPI") scheme, encouraging both equity and debt participation by domestic and foreign participants.*

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*With the inauguration of president Roh Moo Hyun in 2003, Korea's recently announced policy initiative to become the Northeast Asian economic hub will be a further impetus for development of its much-needed infrastructure. The success of the Korean government in inducing private investment in infrastructure can be seen in the relative level of interest by both domestic and foreign participants. The Korean PPI sector is currently experiencing an increase in "bottom-up" efforts with increasingly heated competition amongst potential participants through submission of project proposals for not only projects that are "solicited" by the government, but also for projects that are "unsolicited." Indeed, by some industry estimates, \$70 billion to \$80 billion worth of infrastructure projects should come on stream in the next five years. Many of these projects when completed will alleviate the problems of a fast-growing economy such as Korea, particularly in areas such as roads and transport infrastructure. The objectives for this discussion are as follows: 1) to provide an overview of the current regulatory framework and market environment for Korean PPI projects, especially from the viewpoint of potential international debt and equity investors; 2) to highlight some of the more important regulatory features found in the PPI Act and its Enforcement Decree - noting current market practice by PPI participants as most often embodied in the concession agreement; 3) to address some of the major risk factors inherent in Korean PPI projects (which may or may not necessarily be unique to the Korean PPI context); and 4) to provide recommendations for improvement of the regulatory framework related to the assessment and allocation of risks by project participants.*

## I. Introduction

The Republic of Korea's infrastructure market has traditionally been an area reserved for investment by the central government, with direct investment by the private sector playing a secondary role. Upon the aftermath of the 1997 financial crisis, and with the subsequent drastic economic policy changes implemented by then president Kim, Dae-Jung,<sup>1)</sup> Korea has vigorously sought more innovative approaches to develop its much-needed infrastructure, one of the key initiatives related to the overall restructuring of the Korean economy. In this regard, the Planning and Budget Committee of the government announced its economic policy in July 1998, which included plans to: 1) privatize state-owned enterprises, 2) create a regulatory framework for private participation in infrastructure ("PPI"), 3) promote competition in the market, 4) address labor issues, and 5) find optimal privatization techniques.<sup>2)</sup>

With the announcement of the 1993-1997 Five-Year Economic Development Plan, the government committed itself to improving the living standards of Koreans through programs in development of housing, improvements in the environment and alleviation of urban congestion, while expanding what it refers to as "social overhead capital" (e.g., transportation and distribution networks).<sup>3)</sup> In this regard, as of 2001, Korea's infrastructure budget reached 14.6% of the national budget, up from 11.2% in 1993 and 14.2% in 1997.<sup>4)</sup>

1) See generally, Young-Hak Kim, "Economic Overview", *INT'L. FIN. L. REV.*, available at <[www.legalmedia.com/iflr/default.asp?Page=1&SID=3860&F=F](http://www.legalmedia.com/iflr/default.asp?Page=1&SID=3860&F=F)>. The areas of the economy restructured have included corporate, financial, public and labor sectors. For instance, in the financial sector, "As of the end of February 2002, a total of 618 insolvent financial institutions had been closed down, including 14 banks, 28 merchant banks and 15 insurance companies. Foreign interests are now becoming major players. One leading financial institution, Korea First Bank, has been sold to Newbridge Capital of the US. Further international financial institutions, such as Commerzbank and Allianz Life, have expanded their presence in Korea through joint ventures. Since the crisis, the Korean government has consistently targeted the financial industry in an effort not only to plug the gaps, but to ensure that it will secure world-class competitiveness." See *id.*

2) See Jaebong Ro, "Infrastructure Development in Korea", 19, available at <<http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan008650.pdf>>.

3) See Ro, *supra* note 2 at 7.

4) See *id.*

The driving factor behind Korea's push for development of infrastructure is its recognition in recent years that the acute lack of infrastructure in key sectors directly affects the country's overall productivity (e.g., due to the lack of adequate roads and highways).<sup>5)</sup> According to certain estimates, for example, Korea's total logistics costs attributable to an inadequate road network amounts to 17% of GDP.<sup>6)</sup> Despite this pressing need, the government has had to turn to the private sector for its much-needed greenfield infrastructure projects due to budgetary and financial constraints. In this respect, the Korean government appears to firmly recognize the correlation between a nation's highly-developed infrastructure and its overall competitiveness in today's globalized economy, and it is this need for development which has led the Korean government to focus on its PPI scheme, encouraging both equity and debt participation by domestic and foreign participants.

In addition, the pace of development of PPI projects in Korea may be attributable to the drive for privatization of state-owned enterprises, which has been one of the hallmarks of the economic liberalization policies in newly-industrialized countries ("NICs") such as Korea. For instance, because governments of NICs are often politically constrained in their ability to charge tariff rates for the use of infrastructure facilities in excess of certain levels - even at the expense of operating at below cost<sup>7)</sup>-such governments have focused on private ownership of infrastructure facilities under the banner of economic efficiency.<sup>8)</sup>

5) *See id.* at 6; See also Nick Lord, "Building bridges...(and roads and tunnels and ports)", FINANCEASIA, 40 (May 2002).

6) *See* Ro, *supra* note 2 at 21.

7) *See generally*, Yang Ho Oh, "Privatization", *INT'L. FIN. L. REV.*, available at [www.legalmediagroup.com/fflr/default.asp?Page=1&SID=3868&F=F](http://www.legalmediagroup.com/fflr/default.asp?Page=1&SID=3868&F=F). Privatization efforts in Korea have included such utilities industries as telecommunications, electricity, gas and steel. As of the time of writing, the government has not been successful in privatizing its state-owned enterprises in all of these industries (most notably the Korea Electric Power Co or "KEPCO") mainly due to opposition from different segments of Korean society - notably, organized labor - and the lack of a systematic approach and organized government leadership. *See id.* There have been, however, some notable successes in such industries as steel (POSCO) and heavy industries (Korea Heavy Industry Corp.). For a brief discussion of the social impact of privatization efforts in Korea, see generally Kim Jin Soo, "Privatization, conflict and discontent", SOCIAL WATCH, available at <http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan008668.pdf>.

With the inauguration of president Roh Moo Hyun in 2003, Korea's recently-announced policy initiative to become the Northeast Asian economic hub will be a further impetus for development of its much-needed infrastructure.<sup>9)</sup> Indeed, the most recent 2003 Annual Plan for Private Participation in Infrastructure (the "2003 Annual Plan") specifically identifies the Northeast Asian economic hub initiative as a key basis for promoting PPI.<sup>10)</sup> Another related policy basis put forth by the Roh administration is the promotion of PPI for the purpose of stimulating the currently lagging Korean economy.<sup>11)</sup> All eyes are on the president Roh to see whether he will continue the difficult task of economic restructuring begun by his predecessor.<sup>12)</sup>

8) For instance, in the subway infrastructure sector in Korea, which is handled by local city governments, tariffs do not cover construction costs, and attempts to adjust them have not been successful in the past. *See* Ro, *supra* note 2 at 21. Similarly, the road sector's ability to increase its tolls charged to users is restrained. Even with soaring traffic congestion throughout the country, the Korea Highway Corporation (the national operator of Korea's road system) raised toll rates by a meager 5.2% in 2002 - the first such increase in several years - 88% of which goes to repayment of interest and principal on outstanding loans. *See* PICKO/KRIHS, PPI PROGRAM AND INVESTMENT PROJECTS IN KOREA, 25 (2002), available at <[http://picko.krihs.re.kr/eng/content/eng\\_n007/d0/5.3.5.3.ppi\\_system.pdf](http://picko.krihs.re.kr/eng/content/eng_n007/d0/5.3.5.3.ppi_system.pdf)>. In contrast, private operation of infrastructure, in theory, would be based more on market principles, allowing for operators to charge market rates. Some observers believe, due monopolistic conditions, the opposite could be just as likely. *See generally* Nagla Nassar, "Essay: Project Finance, Public Utilities, and Public Concerns: A Practitioner's Perspective", 23 *FORDHAM INT'L L.J.* 60, 61 (2000) (discussing the possibility of less-than competitive arrangements in PPI projects due to lack of alternative service providers).

9) *See* BBC News/World Edition, "Roh Moo-hyun's inauguration speech," available at <<http://news.bbc.co.uk/2/low/asia-pacific/2797053.stm>>

10) *See* PICKO/KRIHS, 2003 ANNUAL PLAN FOR PRIVATE PARTICIPATION IN INFRASTRUCTURE, 97, available at <[http://www.picko.krihs.re.kr/eng/content/eng\\_sys3/d0/4.1.2003\\_PPI\\_Annual\\_Plan.PDF](http://www.picko.krihs.re.kr/eng/content/eng_sys3/d0/4.1.2003_PPI_Annual_Plan.PDF)>.

11) *See id.* The 2003 Annual Plan provides that promotion of private investment in infrastructure will help stimulate economic recovery by "Tak[ing] advantage of trends that stimulate project finance such as low interest rates, plentiful liquidity, and the increased interest of financial investors such as pension and endowment funds in PPI." *See id.*

12) *See generally*, Lauren Scott, "Korea-Resisting the Cold", ASIANLEGALONLINE, (May 2003), available at <[http://www.asianlegalonline.com/asia/detail\\_article.cfm?ArticleID=827](http://www.asianlegalonline.com/asia/detail_article.cfm?ArticleID=827)> (discussing the various reform issues facing the current administration). Many view the current Roh administration with skepticism, but there are those that equally believe that president Roh will continue the restructuring, especially as to Korea's conglomerates known as "chaebol".

### A. Current Market Trends in Korean PPI

The success of the Korean government in inducing private investment in infrastructure can be seen in the level of interest by both domestic and foreign participants. The Korean PPI sector is currently experiencing an increase in “bottom-up” efforts with increasingly heated competition<sup>13)</sup> among potential participants through submission of project proposals for not only projects that are “solicited” by the government, but also for projects that are “unsolicited.” Indeed, by some industry estimates, \$70 billion to \$80 billion worth of infrastructure projects should come on stream in the next five years.<sup>14)</sup> Many of these projects when completed will alleviate the problems of a fast-growing economy such as Korea, particularly in the roads and transport infrastructure areas.

In particular, the roads sector has received much attention of late especially since this is an area of strategic economic importance in facilitating rapid industrial growth around major metropolitan areas in Korea. As such, the government currently plans to promote approximately 60% of total investment for the construction of new roads.<sup>15)</sup> As of 2002, the government was promoting 21 road projects totaling

13) According to local lawyers, firms such as Shinhan Macquarie Financial Advisory, which is a joint venture between Shinhan Financial Group and Macquarie Bank, has been going “gangbusters” for mandates on Korean infrastructure projects. See Scott, *supra* note 12. Shinhan Macquarie Financial Advisory also established the Korean Road Infrastructure Fund in January 2003 to invest in road infrastructure projects in Korea; KRIF recently invested US\$27 million in the five-year project bonds issued by the Daegu-Busan Expressway Company, a toll road project connecting two urban centers, Daegu and Busan. See, Korea fund buys toll road stake, *CNN*, Oct. 9, 2003, available at <<http://edition.cnn.com/2003/BUSINESS/10/09/korea.macquarie.biz>>.

14) See Lord, *supra* note 5 at 40 (quoting John Walker, President and CEO of Shinhan Macquarie Financial Advisory).

15) See PICKO/KRIHS, PPI PROGRAM AND PRIVATE INVESTMENT PROJECTS IN KOREA, 23. Please refer to this source for a discussion of Korea’s infrastructure needs in the roads sector. As to some notable road projects, the Daegu-Busan Expressway project is an 82-kilometer toll road linking the southern metropolitan city of Daegu with the southern port city of Busan. The project cost is US\$2.14 billion, and is to be completed in early 2006. The project company holds a 31 year operation and management right. See *CNN.com*, Korea fund buys toll road stake. Another is the Seoul Beltway project, which was met with opposition by environmental and religious groups, preventing completion of the last section of the beltway. The government formed a committee to resolve the dispute, but delays in construction have lasted for many months since November 2001. See Kim Ki-tae, Major SOC Projects Up in the Air, available at <<http://168.126.177.8/project/Press.nsf/WebView1/88FE93F117FF2D7449256D40000072D9>>.

US\$10.7 billion,<sup>16)</sup> with total projected investment of US\$50.8 billion between the years 2000 and 2004.<sup>17)</sup>

The government’s analysis of the current competitive environment in the PPI market, and its desire to balance out overall investment by promoting underdeveloped PPI sectors, is summarized by this statement in the 2003 Annual Plan: “Management of excessive competition in unsolicited projects centered around road projects in the capital area through rational administration of annual project implementation scale and priorities.”<sup>18)</sup> It remains to be seen how the government will in practice even out the current competitive environment for PPI projects.

## II. Objectives

The objectives for this discussion are as follows: 1) to provide an overview of the current regulatory framework and market environment for Korean PPI projects, especially from the viewpoint of potential international debt and equity investors; 2) to highlight some of the more important regulatory features found in the PPI Act and its Enforcement Decree - noting current market practice by project participants as most often embodied in the concession agreement;<sup>19)</sup> 3) to address some of the major risk factors in Korean PPI projects (which may or may not necessarily be unique to the Korean PPI context); and 4) to provide recommendations for improvement of the regulatory framework related to the assessment and allocation of risks by project participants.

16) See PICKO/KRIHS, PPI PROGRAM AND PRIVATE INVESTMENT PROJECTS IN KOREA, 25.

17) See *id.* at 30. The US\$50.8 billion in total road sector investment would be divided up between the government (US\$42.1 billion) and private sector (US\$8.7 billion). See *id.*

18) See 2003 Annual Plan, 98. The government also recognizes the need to diversify the types of private investors in the PPI sector beyond construction companies. See *id.*

19) A concession agreement is an agreement entered into by the relevant government ministry and the project company detailing the terms and conditions of the PPI project.

### III. Private Participation in Infrastructure and Economic Restructuring

Before discussing in more detail the government policy, regulatory framework and commercial environment, the Korean PPI scheme should be placed in context, most notably the economic restructuring initiated by the Korean government related to its corporate and financial institutions and markets. The economic restructuring in Korea was prompted by the Asian financial crisis,<sup>20)</sup> and this event triggered a greater pace of liberalization of the Korean market, as a result of which foreign investors gained greater access to restricted areas of investment. Likewise, Korean corporations and financial institutions have also benefited from this liberalization through its greater ability to access the international capital markets.<sup>21)</sup> It is within this context in which the Korean government has implemented a policy of proactive and aggressive promotion of its PPI scheme.

Because of the interrelationship between the economic restructuring and the PPI scheme, government support for PPI may be intrinsically tied to such restructuring efforts (the argument goes), with the ever-present possibility that the government would be tempted to breach its commitments in project agreements entered into with private investors during difficult economic and political circumstances.<sup>22)</sup> Such actions would obviously not only jeopardize the credibility of Korea's PPI program, but also discredit the Korean government and its economic programs. For a developing country

20) See generally Hwa-Jin Kim, "Living With the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions", 17 *BERKELEY J. INTL. L.* 61 (1999) (outlining the various corporate governance and financial regulatory reform measures enacted by the Korean government since the Asian financial crisis). The bailout fund extended to the Korean government by the International Monetary Fund ("IMF") was through the Korea-IMF Memorandum ("IMF Memorandum"). Notable reform measures under the IMF Memorandum upon which the bailout fund was conditional included corporate transparency measures (e.g., introduction of the concept of "outside directors"), government non-intervention in commercial lending activities of banks and restructuring of corporate finances. See generally Kim, "Living With the IMF".

21) See Kim, "Living With the IMF" at 89-90.

22) Most notably, the Dabhol Power project in Maharashtra, India is the most recent example of the risk of governments choosing, for political reasons, to not honor its commitments to private investors. See generally Harvard Business School, *Enron Development Corporation: The Power Project in Maharashtra, India (A)* (1998) for a discussion of this now infamous project.

such as Korea, which has limited financial resources for undertaking massive development projects, such actions would be anathema, especially in the context of the harsh realities of today's international financial markets. It is this author's view that this interrelationship may, in the end, actually constrain the government's ability to breach its project commitments with private investors by significantly raising the political and economic costs incurred by breach. Any signs of dwindling support for PPI projects by the government could be viewed as the signs of a retreat from its commitment to push forward wider economic restructuring efforts.

Furthermore, the current regulatory framework encourages investment in a whole range of sectors, as opposed to some countries that have promoted just one or two government "pet" projects or sectors. In the latter case, the political and economic costs incurred by a government in expropriating one or two pet projects may be different than in the former case where government breach in one or two projects may be seen as jeopardizing the PPI program as a whole. It is this aspect of the Korean PPI program, which may constrain the Korean government's ability to take any drastic unilateral measures in breach of project commitments. Furthermore, countries that promote "pet" projects could be more vulnerable to political pressures upon changes in government leadership.<sup>23)</sup> In both of these cases, the motivations may appear identical, but the end results may be quite different.

### IV. Government Policy and Administrative Procedures

International project finance is characterized by a high degree of concentration of project risks in the "pre-completion" phase, with more ascertainable project risks upon the commencement of operation. Because of this unique risk profile, the value of early information about potential project risks is of significant value, particularly in relation to such areas as government policies, strategies, political stability and project parameters and benchmarks.<sup>24)</sup> To the extent such information is clearly set

23) In the Dabhol Power project, the government that had originally led the support for the project was ousted by a rival coalition that brought alleged corruption and other charges, appealing to nationalist sentiments. Indeed, the project became highly politicized during the election process. See generally *id.*

24) See Mansoor Dailami and Danny Leipziger, "International Project Finance and Capital Flow: A new

forth or readily ascertainable, project participants will be able to appropriately measure the level of risk of particular projects and factor in such determinations into their project assessments.

The Korean government's effort to project a transparent regulatory framework and investment environment is reflected in the various government pronouncements related to its PPI sector. The following pronouncements should aid potential private project participants in effective risk assessment of the PPI sector.

#### A. Basic Scheme for PPI

In this regard, the Korean government's policy for implementation of its "Basic Scheme" for the PPI program is summarized as follows:

1) Change from a government-centered or government-financed scheme to a private-sector-oriented or private-investment-initiated scheme<sup>25)</sup> - One of the clear policy reasons for the stated direction is to attract foreign capital (both debt and equity).

2) Promotion of creativity and efficiency from the private sector throughout the stages of planning, design, construction and operation of the infrastructure project<sup>26)</sup> - Clearly the government believes that giving the private sector the power to initiate infrastructure projects fosters a more efficient allocation of resources throughout the different stages of infrastructure development.

3) Restructuring domestic systems to meet international standards<sup>27)</sup> - The government has provided many favorable incentives to private investors in the form of a competitive rate of return on investment, minimum operation revenue guarantee, foreign exchange risk reduction, and a termination payment/buyout of the project, some of which will be discussed in more detail below.

perspective", *WORLD BANK DEV. INST.*, 5 (1997).

25) See PICKO/KRIHS, PPI PROGRAM AND PRIVATE INVESTMENT PROJECTS IN KOREA, 13. This is a good source for an overall view of Korea's PPI program, including a summary of specific projects earmarked by the government.

26) See *id.*

27) See *id.*

#### B. Mid to Long Term Plan for Private Investment Projects

Furthermore, the Mid to Long Term Plan for Private Investment Projects (the "Mid/Long Term Plan"),<sup>28)</sup> encompassing the period from 2002 to 2011, provides the basic government policy with respect to PPI and states that it is to "Relieve the burden on government expenditures by inducing private investment in infrastructure in response to the increased demand for government expenditure such as strengthening of welfare systems and expansion of future investments." Based on the government's estimated forecast, total infrastructure investment required during the 2002 to 2011 period is 198.9 trillion won, with government expenditure projected to be 10 to 13 trillion won annually (approximately 2.4% of GDP, assuming 4% to 6% GDP growth) and private investment of 46.7 trillion won.<sup>29)</sup>

#### C. Annual Plan for Private Participation in Infrastructure

Since 1999, the government has formulated its Annual Plan for Private Participation in Infrastructure (the "Annual Plan"), which includes more detailed information on the government's policy orientation for each infrastructure sector, matters concerning designation of solicited projects, investment scope and support for PPI projects in general.<sup>30)</sup>

As the government gains increased experience in the administration of PPI projects, such experience should be reflected in improved administrative procedures and the overall regulatory framework. It is clear that the most recent 2003 Annual Plan embodies initiatives for such improvement of the existing PPI scheme through various measures.

#### D. Private Infrastructure Investment Center of Korea ("PICKO")

The governmental agency responsible for coordinating the central government's

28) The Mid to Long Term Plan for Private Investment Projects is available at <[http://picko.krihs.re.kr/eng/bbs/list.asp?name=eng\\_sys4&group=sys4](http://picko.krihs.re.kr/eng/bbs/list.asp?name=eng_sys4&group=sys4)>.

29) See Mid/Long Term Plan.

30) See Article 7 of PPI Act.

promotion efforts is known as the Private Infrastructure Investment Center of Korea (“PICKO”),<sup>31)</sup> which is under the umbrella of the government-operated Korea Research Institute for Human Settlements (“KRIHS”). PICKO was established pursuant to the PPI Act.<sup>32)</sup> Much of the credit for the positive investor sentiment in regards to Korean PPI can be attributed to PICKO, which has greatly facilitated the entire private investment process.

As to its statutorily-delegated authority, PICKO is authorized to review individual solicited projects, conduct feasibility studies and evaluate project proposals.<sup>33)</sup> In contrast, it is the Private Investment Project Committee (“Project Committee”), organized under the jurisdiction of the Ministry of Planning and Budget,<sup>34)</sup> that is statutorily-authorized to conduct such activities as policy formulation, establishment of the Annual Plan and designation of the concessionaire.<sup>35)</sup> The government agency having jurisdiction over a particular project (referred to as the “competent authority” in the PPI Act), however, must request the director of PICKO to review a potential concessionaire’s project proposal for unsolicited projects,<sup>36)</sup> and the director of PICKO must submit his opinion on whether to accept such project proposal to the competent authority and the Minister of Planning and Budget.<sup>37)</sup> Accordingly, the competent authority is to make its determination, “taking into consideration the opinion of the director of PICKO, except in cases,”<sup>38)</sup> which gives the opinion of the director of PICKO some weight in the competent authority’s decision to designate a concessionaire. Accordingly, if the competent authority determines that it will accept the project proposal, it must submit the matter for deliberation to the Project Committee.<sup>39)</sup>

Furthermore, it is worth noting that under Article 7 (4) of PPI Act, the competent

31) PICKO’s website is at <<http://picko.krihs.re.kr/eng/>>.

32) See Article 23 of PPI Act.

33) See Article 23 (1) of PPI Act.

34) The Ministry of Planning and Budget’s website is available at <<http://www.mpb.go.kr>>.

35) See Article 5 of PPI Act.

36) See Article 7(2) of PPI Act.

37) See Article 7 (3) of PPI Act.

38) See Article 7 (4) of PPI Act.

39) See Article 7 (4) of PPI Act.

authority is procedurally required to notify a potential concessionaire of its decision after receipt of the opinion of the director of PICKO, implying the importance of the opinion of the director of PICKO in the determination of the competent authority. Also, the 2003 Annual Plan specifically provides that the competent authority having jurisdiction over a particular project that is valued at 200 billion won or more must consult with PICKO when concluding the concession agreement.<sup>40)</sup>

As a practical matter, because of the administrative function and authority given to PICKO, potential project sponsors should establish contact with key members of PICKO early in the process of determining whether to invest in the Korean PPI sector. PICKO is often involved during the actual process of negotiating the concession agreement and may be delegated authority to finalize or modify concession agreements by the competent authority over a specified PPI project.<sup>41)</sup>

## V. Regulatory Framework - PPI Act

Despite its short history, Korea’s PPI scheme has been hailed as a model for other fast-developing countries throughout Asia and other parts of the world. Much of the interest in Korea’s PPI program is attributable to the government’s promulgation of the Act on the Private Investment in Infrastructure (“PPI Act”),<sup>42)</sup> the Enforcement Decree of the Act on Private Participation in Infrastructure (“Enforcement Decree”)<sup>43)</sup> in 1999 and the aggressive promotion of the PPI scheme to various potential investor groups. It is worth noting that prior to its passage, only the public sector could initiate projects pursuant to certain industry sector specific laws (e.g., the Harbor Act authorizing development of Korea’s harbor sector).<sup>44)</sup> As a result of

40) See 2003 Annual Plan, 120.

41) See *id.*

42) The text of the PPI Act can be found at <<http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan011496.pdf>>

43) The text of the Enforcement Decree can be found at <[http://picko.krihs.re.kr/eng/content/eng\\_sys2/d0/2.1.2003\\_enforcement\\_.PDF](http://picko.krihs.re.kr/eng/content/eng_sys2/d0/2.1.2003_enforcement_.PDF)>

44) See generally, Jay K. Lee and Kwon Hoe Kim, “Project Finance”, *INT’L. FIN. L. REV.*, available at <[www.legalmediagroup.com/iflr/default.asp?Page=1&SID=3869&F=F](http://www.legalmediagroup.com/iflr/default.asp?Page=1&SID=3869&F=F)>

the PPI Act, however, both the public and private sectors may initiate and develop projects in the industry sectors designated pursuant to its provisions.

More importantly, the level of government financial and other support for infrastructure projects with private participation was previously unavailable for projects initiated by the government. The most notable government support under the PPI Act includes the minimum revenue guarantee, financial subsidy and buyout payment. Certain tax benefits are also given to project companies.<sup>45)</sup>

The following section looks at some of the more important provisions of the PPI Act and its Enforcement Decree, which embody the regulatory framework for Korean PPI. In examining some of these provisions, the discussion will also reflect some general legislative principles outlined in the United Nations Commission on International Trade Law's ("UNCITRAL") Legislative Guide on Privately Financed Infrastructure (the "UNCITRAL Guide") as applicable.<sup>46)</sup> UNCITRAL is a commission established under the auspices of the United Nations in order to facilitate the harmonization of private international law,<sup>47)</sup> and the UNCITRAL Guide contains a set of recommended legislative principles "intended to assist in the establishment of a legislative framework favourable to privately financed infrastructure projects."<sup>48)</sup> Besides the legislative framework itself, the UNCITRAL Guide recognizes the importance of "adequate administrative structures and practices, organizational capability, technical expertise, appropriate human and financial resources and economic stability."<sup>49)</sup>

Contrary to previous work of UNCITRAL, although the UNCITRAL Guide was not drafted as a model law-and despite the criticisms levied against the UNCITRAL Guide in this regard<sup>50)</sup>-it is a useful guide with which observers of national private

45) For example, 5% of the amount invested by a project company is recognized as investment reserves, permitting deduction as expense from the corporate income tax; 0% VAT for infrastructure facilities constructed under the BTO and BOT schemes. See sec. 4.1 of 2003 Annual Plan.

46) The UNCITRAL Guide can be found at <[http://www.uncitral.org/english/workinggroups/wg\\_1/wg1-pfip-index-e.htm](http://www.uncitral.org/english/workinggroups/wg_1/wg1-pfip-index-e.htm)>

47) UNCITRAL's website can be found at <<http://www.uncitral.org>>

48) See sec. A par. 5. of UNCITRAL Guide.

49) See sec. A par. 6 of UNCITRAL Guide.

50) See generally Don Wallace, Jr., "UNCITRAL Consolidated Legislative Recommendations for the Draft

infrastructure laws can: 1) analyze key provisions of relevant legislation and government policy with respect to private infrastructure projects to determine whether such provisions and policies are consistent with current international practice; 2) assess whether the overall administrative procedures and framework as well as the technical and economic resources provide for a competitive environment responsive to the concerns and incentives of private project participants.

#### A. Methods for Investment

The PPI Act authorizes projects under the 1) build-transfer-operate (BTO),<sup>51)</sup> 2) build-operate-transfer (BOT),<sup>52)</sup> 3) build-own-operate (BOO),<sup>53)</sup> and other methods proposed by the competent authority in the instructions for proposal.<sup>54)</sup>

#### B. Concession Granting Authority

Although the Government of the Republic of Korea is responsible for formulating the Annual Plan,<sup>55)</sup> the governmental authority having jurisdiction over a

Chapters of a Legislative Guide on Privately Financed Infrastructure Projects: UNCITRAL Draft Legislative Guide on Privately Financed Infrastructure: Achievement and Prospects", 8 *TUL. J. INT'L & COMP. L.* 283, 286-87 (2000) (discussing the criticism that the nature of the UNCITRAL's work, which is to provide model law provisions for countries to follow (i.e., harmonization of national laws to prevailing international standards), was not achieved in the case of the UNCITRAL Guide). Wallace argues that it was the unwillingness of the UNCITRAL commission to face up to the fact that civil law systems apply administrative law to "concessions" as opposed to civil, commercial law of private contracts - giving civil law governments the right to freely alter the scope of the project - as the main reason for the UNCITRAL Guide not being adopted in the form of a model law. See *id.* at 287.

51) In a BTO project, ownership of the project facilities is transferred to the government upon completion of construction and the concessionaire bears the right to operate the project facilities for the concession period. See Article 4 par. 1 of PPI Act.

52) In a BOT project, concessionaire assumes ownership of the project facilities for a specified period of time after completion of construction, and ownership of project facilities is transferred to the government upon termination of the concession period. See Article 4 par. 2 of PPI Act.

53) In a BOO project, concessionaire operates and controls the project facilities upon completion of construction. See Article 4 par. 3 of PPI Act.

54) See Article 4 of PPI Act.



particular project (“competent authority”) - e.g., Ministry of Maritime & Fisheries, Ministry of Construction & Transportation - is delegated the authority to formulate the instructions for proposal<sup>56)</sup> and to designate the concessionaire<sup>57)</sup> for a specific project.<sup>58)</sup>

The UNCITRAL Guide’s general principle for the concessionaire selection process is that of transparent competition among eligible project sponsors. This is believed best achieved by implementing a balance between providing some statutory structures while allowing for free negotiations between project participants.<sup>59)</sup>

Accordingly, the Korean government implements certain factors into its process for evaluation of project proposals by potential concessionaires under the PPI Act. The government is required to consider various factors in its evaluation of a submitted project proposal, including: 1) the make-up of the project sponsors, 2) feasibility of the project, including total investment cost, the period, location and details of construction, 3) financing plan, including equity and loan procurement capacity, 4) economic feasibility of the project, including the tariff rate, 5) plan for land acquisition, 6) applicable construction technology, 7) managerial capability, 8) degree of service in the public interest, and 9) other measures deemed necessary by the competent authority.<sup>60)</sup> Pursuant to statute, however, the government does have significant leeway in applying these standards to a given project, which is a risk that project sponsors cannot completely avoid.<sup>61)</sup>

55) See Article 7 of PPI Act. Please note that the function of formulating the Annual Plan is actually delegated to the Minister of Planning & Budget upon deliberation by its Private Investment Project Committee and in consultation with the relevant competent authority. See Article 5 (1) of PPI Act.

56) See Article 10 of PPI Act.

57) The concessionaire for a project is the project company granted the operation and management right (i.e., concession) by the competent authority to construct, operate and manage the project for a specified number of years.

58) See Article 13 (3) and (4) of PPI Act.

59) See *id.* at 292. Selection of concessionaire based on negotiations alone may be seen as arbitrary and lacking transparency. See *id.* at 291.

60) See Article 13 of Enforcement Decree. The competent authority may adjust the weight given to each criterion according to the special needs of a given project. See Article 13 (2) of Enforcement Decree.

61) For instance, the competent authority may adjust the weight given to each criterion according to the special

### C. Concession Agreement

The designated concessionaire for a given project enters into a concession agreement with the competent authority for “the conditions for project implementation such as total project cost and the concession period.”<sup>62)</sup>

### D. Operation and Management Right (In Rem)

Upon completion of construction of a project facility, the competent authority is authorized to grant the operation and management right to the concessionaire to operate the project,<sup>63)</sup> which the concessionaire must then register with the competent authority.<sup>64)</sup> The operation and management right is deemed a property right pursuant to the Civil Act,<sup>65)</sup> and the concessionaire must receive advance approval from the competent authority for actions such as “dispositions.”<sup>66)</sup>

### E. Determination of Tariff Rate

The issue of tariffs can be a politically sensitive topic for many NICs, including Korea, and the high profile nature of many greenfield infrastructure projects, especially in cases with significant foreign participation, may open up the government to varying degrees of political criticism, especially from political sectors dependent on popular support.

The PPI Act provides that the concessionaire may charge a tariff to users of project facilities,<sup>67)</sup> but the concessionaire must submit certain documents regarding the tariff rate to be charged to the competent authority sixty (60) days prior to actual

needs of a given project. See Article 13 (2) of Enforcement Decree.

62) See Article 13 (3) of PPI Act.

63) See Article 26 (1) of PPI Act.

64) See Article 26 (2) of PPI Act.

65) See Article 27 (1) of PPI Act.

66) See Article 27 (2) of PPI Act. Security can be taken over the operation and management right in the form of a kun mortgage under Korean law. Project lenders should obtain local counsel advice on this matter.

67) See Article 25 (4) of PPI Act.

collection.<sup>68)</sup> The specifics pertaining to the determination or adjustment of tariffs, however, are to be settled according to the concession agreement.<sup>69)</sup>

The PPI Act also alludes to the competent authority's right to request the concessionaire to charge a tariff lower than what the concessionaire has determined to charge users of the project facilities<sup>70)</sup> (generally the type of right reserved by the government in regulating PPI projects). The issue of tariff rate adjustments may reflect the government's concern for the general public - i.e., the concern for charging a "politically correct" price.<sup>71)</sup> The circumstances under which the government could make a request for lowering/adjustment of tariffs are spelled out in the concession agreement and might include such reasons as sector specific economic policy reasons (i.e., raising the competitiveness of a given project's sector) or even regulatory issues affecting the project. It is unclear whether the concessionaire could reject a government request for adjustment; mere prior "consultation" with the concessionaire may be the only requirement to be fulfilled by the government.

In the event of a government request for tariff adjustment, the concessionaire should, to the extent possible, be adequately compensated in the form of a financial subsidy or adjustment of the concession period, as any costs related to political considerations should in theory be borne by the government.

Instead of leaving the details to be worked out through negotiations by the parties, however, the government should amend the PPI Act to clarify: 1) the concessionaire's rights in the event of a lowering/adjustment of tariffs and 2) the concessionaire's right to reject any government request for tariff adjustments.<sup>72)</sup> Such an amendment could significantly aid project sponsors and lenders in their risk assessments.

68) See Article 23 (2) of Enforcement Decree. This provision seems to imply that the competent authority may have a right to veto the concessionaire's determination of the tariff pursuant to the concession agreement.

69) See Article 23 (1) and (3) of Enforcement Decree. Under the concession agreement, the concessionaire is typically given flexibility in determining the tariff to be charged users of the project facilities, but such determination is subject to an adjustment by the competent authority.

70) See Article 10 of PPI Act.

71) See Nassar *supra* note 8 at 77. In Korea, such controversy did arise at one point over the toll rate to be charged on the new expressway running from the city of Seoul to the Incheon International Airport.

72) The right to reject a government request for tariff adjustments may be in contravention of the administrative policy principle that government should retain the broad authority to regulate infrastructure projects.

### F. Minimum Revenue Guarantee

Private investors contemplating participation in Korean PPI projects will undoubtedly be concerned over the level of support (financial or otherwise) by the Korean government as well as the level of return on investment. To alleviate profitability risk, the Korean government has implemented a minimum revenue guarantee system during the operation period of the concession-based project.<sup>73)</sup> The statutory language states that the government may grant a subsidy or long-term loan where operational profits fall "considerably short" of estimated profits "to such an extent that the operation of the facility is difficult."<sup>74)</sup> In lieu of this language, the Korean government has typically guaranteed up to 90% of estimated project revenue for solicited projects, and up to 80% of estimated project revenue for unsolicited projects.<sup>75)</sup>

The flip side to this minimum revenue guarantee is that the project sponsors are often required to return to the Korean government project revenues, typically in excess of 110% (solicited projects) and 120% (unsolicited projects) of estimated project revenue.<sup>76)</sup> This minimum revenue guarantee system is implemented for a fixed period (e.g., 20 years).

It is important to note, however, that such statutory guarantee of minimum

73) See Article 35 of PPI Act and Article 37 of Enforcement Decree. One observer has argued that such minimum revenue guarantees (and the corresponding obligation to revert excess revenues to the government) may be in contravention of the fundamental rationale for privatization of infrastructure, which is to enhance efficiency of operation and quality of service to the public. See Nassar, *supra* note 8 at 67. One way it can do this is by encouraging the project's tariff to be fixed at higher prices so that the excess revenue reverts to the government; the fact that concessionaires have the exclusive right to develop a certain project exacerbates this problem (i.e., absence of competition in a given project's sector and loose "regulatory" authority of host country in its oversight of such project). See Nassar, *supra* note 8 at 67.

74) See Article 37 (1) item 4. of Enforcement Decree. For international lenders skeptical of whether the Korean government would honor such guarantees, according to Shinhan Macquarie Financial Advisory, the government has actually made payment on the revenue guarantee on the toll road between the Incheon International Airport and Seoul. See Lord, *supra* note 5 at 42.

75) See PICKO/KRIHS, PPI PROGRAM AND PRIVATE INVESTMENT PROJECTS IN KOREA, 17.

76) See *id.* Lenders will want to try and subordinate the government's right to the excess project revenues in relation to the lenders' senior debt repayment.

revenue does not necessarily translate into a financial subsidy from the government. In many cases, the government provides alternative support, such as an increase in the tariff rate to be charged by the concessionaire or an extension of the concession period for the project. These alternative measures should be spelled out as clearly as possible in the concession agreement.<sup>77)</sup> For example, the concession agreement should provide the mechanism for calculating the shortfall and for determining how the shortfall in profits will be compensated (i.e., through financial subsidy, increase in tariffs or concession period). Furthermore, the parties should clarify whether the minimum revenue guarantee will apply if the government requests lower tariffs pursuant to Article 10 of PPI Act. For example, the concessionaire should be entitled to the full difference between actual profits and estimated profits due to the lower tariff attributable to a request by the government.

The preferred approach from the concessionaire's perspective, however, would be to amend the PPI Act to provide details on the mechanism for compensation.

The government has recently announced a plan to "rationalize" its minimum revenue guarantee system by implementing such measures as: 1) a reduction of the fixed period for minimum revenue guarantee (i.e., 15 years), 2) a de-escalation of the percentage for minimum revenue guarantee during the life of the fixed period and 3) reimbursement of only a percentage of the difference between the guaranteed minimum revenue and the actual revenue.<sup>78)</sup> As such rationalization measures are specifically aimed at encouraging efficient operation of PPI projects,<sup>79)</sup> the measures may alleviate concerns that PPI projects are not operating in a competitive environment where companies utilize economic resources in an efficient manner.

Depending upon the financial projections of a given project, however, project sponsors may or may not necessarily favor the minimum revenue guarantee, as the projected revenues may be favorable enough that the cost of having to revert the excess revenues to the government may outweigh the added benefit of revenue

77) Lenders to PPI projects will want to maintain adequate control over this process, which can be addressed in the financing documents.

78) See 2003 Annual Plan, 100. For example, the de-escalating guarantee would operate so that 80% to 90% of the estimated revenue would be guaranteed during the first 5 years of the fixed period, 70% to 80% for the next 5 years, and 60% to 70% for the last 5 years.

79) See *id.*

protection.<sup>80)</sup> Accordingly, the parties may decide to forego including any reference to a minimum revenue guarantee in the concession agreement. In such a case, the concessionaire may be foregoing a later claim to a government subsidy under Article 37 of PPI Act in case of a deterioration of project economics. The government could argue, in the event of a dispute under such provision, that the concessionaire had waived its right to the government subsidy pursuant to Article 37 of PPI Act, since the concessionaire could have reasonably foreseen a possible deterioration of the project's revenue stream at the time of execution of the concession agreement. In this regard, sponsors in most concession-based projects - especially those with project revenues generated in local currency but that have foreign-denominated debt - may want to ensure the later availability of the government subsidy by expressly reserving this right under the concession agreement.

### *G. Change in Total Project Costs*

A substantial project risk for project sponsors in a concession-based project is the inability to obtain authorization for an increase in project costs (including construction costs) as a result of subsequent events beyond the project sponsor's its control. This risk is addressed in the PPI Act which provides that the total project cost under the concession agreement may not be amended except in the case of: 1) adjustments resulting from price fluctuations during the construction period, or 2) adjustments resulting from "inevitable causes" pursuant to the concession agreement.<sup>81)</sup> This provision is very important in that the economics of a project may drastically deteriorate if project sponsors are unable to obtain an automatic adjustment to the government subsidy in the event of an increase in project costs (especially construction costs). Although the PPI Act does not provide for an automatic adjustment, the concession agreement should provide project sponsors with an automatic increase in the government subsidy for any recognized increase in project

80) The recent financing for the Pusan Newport project was arranged without the minimum revenue guarantee. See Nick Lord, "A new era for Korean project finance", *FinanceAsia.com*, June 3, 2003. But this project also generated dollar revenues to match its dollar financing, a benefit that is not common in most Korean project financings.

81) See Article 22 (3) of Enforcement Decree.

costs.<sup>82)</sup> The preferred approach from the perspective of private investors would be for the government to amend the relevant provision of the PPI Act to provide for an automatic adjustment in the event of an increase in project costs.

#### *H. Unilateral Change in Project Scope*

A fundamental principle outlined in the UNCITRAL Guide is that governments should provide “assurances that private property [will be] respected by the host country and not interfered with other than for reasons of public interest and only if compensation is paid.”<sup>83)</sup> In this regard, a significant project risk for both sponsors and lenders is the ability of the Korean government to unilaterally alter the scope of the project.<sup>84)</sup> For instance, Article 29 (1) of PPI Act - starting out by stating that the competent authority shall not alter the rights of the concessionaire with respect to the use of the project facilities pursuant to Article 25 (1) and (2) - provides that the competent authority may, upon consulting with the concessionaire, alter such rights “where the State or local government requires it for any direct[ly] official or public

82) Other options available to the government in lieu of the subsidy in such case are an increase in the tariff rates or an extension of the concession period. In such cases, the lenders to the project will want to maintain control over any decision-making for the grant of relief other than the government subsidy.

83) *See* sec. A. par. 4. of UNCITRAL Guide.

84) *See* Wallace, *supra* note 50 at 293-294 (stating that this is common in many civil law countries where administrative law, rather than private, commercial law, is applicable to concession-based projects and related agreements.) The notion that the government has the right to unilaterally alter projects may also be attributable to the idea that infrastructure projects are a public service where private sector investment should be upon government authorization and regulated accordingly. *See* Nassar, *supra* note 8 at 60. Indeed, section 2.3 of the 2003 Annual Plan broadly reaffirms this notion in providing that the “competent authority may supervise the business operation of the concessionaire and issue orders necessary to prevent inferior construction and operation of the facilities.” It further goes on to state that the “competent authority may take necessary administrative measures such as change the concessionaire, suspend or alter the construction, reconstruct or return to their original state any of the facilities, in the event of violation of laws and regulations by the concessionaire, or when required by the public interest.” The competent authority also has the right to initiate an adjustment of the tariff level upon negotiation with the concessionaire, if deemed to “significantly impair the benefit to user(s).” *See* sec. 3.2 C. of 2003 Annual Plan. Such overarching administrative powers are quite significant.

use” and for such use as prescribed by the Enforcement Decree.<sup>85)</sup> The concessionaire is entitled to compensation from the administrative agency using the project facilities for any loss incurred as a result of such use.<sup>86)</sup>

Despite the language requiring “consultation” with the concessionaire, this provision nevertheless poses a significant risk to project sponsors and lenders who may not have any power to stop the government from altering the rights of the concessionaire with respect to the project facilities, regardless of the specific provisions in the concession agreement contrary to any such right of alteration. For instance, the strict reading of Article 29 (1) does not appear to give the concessionaire the right to object to any proposed use by the government-only a “consultation” right. It is also unclear under what circumstances the government could exercise its rights under this provision. What types of uses would qualify as “direct[ly] official” or “public”? Another issue is how the government will go about compensating the concessionaire for its losses incurred as a result of such alteration. How will the losses be calculated,<sup>87)</sup> and in what form will the compensation be made? These issues are left unspecified in the statute. Such unilateral right to alter the scope of the project undermines free bargaining, contravening the general principle outlined in the UNCITRAL Guide.<sup>88)</sup> It is clear that this statutory provision should be amended in order to provide more certainty to project participants.

#### *I. Foreign Financing/Foreign Exchange Risk*

The concessionaire is authorized to obtain foreign financing pursuant to the Foreign Exchange Transactions Act (“FETA”) and the Foreign Investment Promotion Act.<sup>89)</sup> Furthermore, concession agreements in Korean PPI projects will

85) Article 26 (1) of Enforcement Decree states that the project facilities may be used by the government where the “competent authority recognizes that public use of the facility concerned is absolutely necessary for the public interest, and the objective of the project cannot be achieved by any other way than to change the use of the facilities.”

86) *See* Article 29 (2) of PPI Act.

87) Article 26 (2) 1. of Enforcement Decree only states that: 1) losses from failure to recover total project cost and 2) other losses incurred shall be compensated through negotiation with the concessionaire.

88) *See id.* at 293.

89) *See* Article 54 of PPI Act.

typically include a provision whereby the government is required to provide its full assistance with respect to the concessionaire's execution of financing in general.

Furthermore, the government will protect project sponsors from foreign exchange fluctuations in excess of a certain threshold level.<sup>90)</sup> Typically, pursuant to the concession agreement, the government will guarantee a percentage of the total foreign exchange loss calculated for a given year.

Project sponsors and lenders should also be aware that any guarantee of debts that is: 1) between a Korean "resident"<sup>91)</sup> and a "non-resident"<sup>92)</sup> requires the prior approval of the Ministry of Finance and Economy ("MOFE")<sup>93)</sup> and 2) between "residents," in which payment may be made with "foreign currency,"<sup>94)</sup> reporting<sup>95)</sup> to the MOFE. Project sponsors and lenders should obtain the advice of local lawyers on the effect of such provisions, especially as to the level of scrutiny in the approval process for debt guarantees made by Korean residents for the benefit of non-resident lenders. As debt guarantees between Korean residents that involve the payment of foreign currency require reporting to MOFE - presumably a lower level of government scrutiny-these regulations may affect the structuring of debt guarantees.

Article 3 (1) 13 of FETA provides, however, that "branch offices, local offices or other offices of non-residents located in the Republic of Korea shall be deemed to be

90) See PICKO/KRIHS, PPI PROGRAM AND PRIVATE INVESTMENT PROJECTS IN KOREA, 18 for a summary of the foreign exchange protection.

91) See Article 3 (1) 12. of FETA. "Residents" is defined as any "private person who has a domicile or residence in the Republic of Korea, and any juristic person whose main office is located in the Republic of Korea." See *id.*

92) See Article 3 (1) 13. of FETA. "Non-residents" is defined as any private person and any juristic person other than residents: provided, that branch offices, local offices or other offices of non-residents, located in the Republic of Korea, shall be deemed to be residents *notwithstanding whether such offices have the legal authority as agents.*" See *id.*

93) See Article 18 (2) of FETA.

94) See Article 3 (1) 2. of FETA.

95) See Article 18 (1) of FETA. The reporting requirement does not apply to "negligible or standardized capital transactions designated by the Minister of Finance and Economy..." See *id.* Local lawyers should advise whether this reporting requirement must be satisfied prior to or after the debt guarantee is executed. If the reporting requirement is prior to the execution of debt guarantee, such requirement in practice may operate similar to an approval by MOFE.

residents notwithstanding whether such offices have the legal authority as agents." Notwithstanding any withholding tax issues with respect to tax treaties applicable to lenders' receipt of interest income, lenders booking the project debt through a Korean branch office could presumably qualify its branch office as a "resident" under Article 3 (1) 13 of FETA, requiring only prior approval by MOFE on any related debt guarantee.

### *J. Buyout Payment*

Under Article 59 of PPI Act, the concessionaire has the right to request a buyout of the project by the government in the event of: 1) certain force majeure events which cause a delay of six months or longer or increase in construction or operating costs of more than fifty percent, 2) failure of the government to perform its obligations under the concession agreement, causing delay of six months or longer, or 3) a cause pursuant to the concession agreement whereby the competent authority determines it reasonable to make the buyout payment.<sup>96)</sup> Project participants should note that the language of this provision does not require the government to automatically make the buyout payment if the concessionaire makes the request. Furthermore, the provision does not specify the method for calculating the buyout payment nor the manner in which the buyout payment is to be made, as these are matters usually specified in the terms of the concession agreement. In any event, the calculation of the buyout price should be determined in consideration of the market value of the project (e.g., net present value of future income streams), since this will ensure fairness to both parties, and should at a minimum include outstanding project debt (principal and interest).

## **VI. Market for PPI Financing**

Korean PPI projects are typically financed through a combination of equity, debt and government subsidy. Because the government subsidy - which can be as high as 30% of total project cost in some cases-is often counted as equity without conferring

96) See Article 39 of Enforcement Decree.

any corresponding ownership rights to the government, both the sponsors' return on equity (boosted by the percentage of subsidy) and the project's credit profile are enhanced.

Most lenders to Korean PPI projects typically require (in addition to upfront equity injections as opposed to pro rata injections) project completion guarantees<sup>97)</sup> and cash deficiency support from the project sponsors.<sup>98)</sup> While favorable for lenders seeking mitigation of project risks, project completion guarantees require project sponsors to maintain project debts on their own balance sheets, which detract from the benefits of using special purpose project companies in project financings (i.e., restricting the project debts to the special purpose project company).<sup>99)</sup> Furthermore, such practice is not in accordance with "limited recourse" financing prevalent in international project finance-referring to limited obligations and responsibilities of the project sponsor<sup>100)</sup> in contrast to the "classic non-recourse project financing [which] would result in no potential liability to the project sponsor for the debts or liabilities of an individual project".<sup>101)</sup> Accordingly, the level of recourse in a particular financing is determined by the specific risks in a project and the appetite of the credit markets to accept such risks.<sup>102)</sup>

Korea's PPI program has recently witnessed keen interest by both domestic and foreign lending institutions. Most notably on the domestic front most of the domestic funding to date has been led by the government-owned Korea Development Bank

97) Project completion guarantees require the project sponsors to be liable in the event the project company's financial situation prevents it from carrying on with the project.

98) See Lee and Kim, *supra* note 44. Another harsh practice of lenders to projects is the request for a blank promissory note from sponsors with a power of attorney allowing the lenders to later insert an amount, which they deem appropriate in the case of a certain triggering event. If the sponsors refuse to honor the promissory note, this causes tremendous difficulty for sponsors in later securing credit facilities from Korean banks. See *id.*

99) Project finance structures are used to assist in undertaking large debt commitments with a minimum of risk, which permit "off-balance sheet" treatment of the debt of the project company. See SCOTT L. HOFFMAN, *THE LAW AND BUSINESS OF INTERNATIONAL PROJECT FINANCE*, 12 (Kluwer Law International).

100) See *id.* at 8. "For example, if the lenders perceive that substantial risk exists during the construction phase of a project, they could require that the project sponsor agree to infuse additional equity if the risk actually materializes. The lender would have recourse to the project sponsor's assets until the risk subsides or construction is complete. Thereafter, the loan would be nonrecourse." See *id.*

101) See *id.*

102) See *id.*

("KDB"). This financial institution is truly a dominant player in the Korean financial market, and it has been involved in most of the notable PPI projects to date.<sup>103)</sup> In some of the more recent transactions, however, other Korean banks have been asserting themselves in a bid to compete with KDB, and even non-bank financial institutions-such as life insurance companies-have been actively pursuing arranging roles.<sup>104)</sup>

Government policy currently seeks to promote the active participation of non-bank financial institutions such as pension funds.<sup>105)</sup> In this regard, one notable development is the Korean Road Infrastructure Fund ("KRIF"), which was established in January of 2003 by Shinhan Macquarie Financial Advisory (a joint venture between Shinhan Financial Group and Macquarie Bank of Australia) as a 10-year closed fund with some US\$300 million raised from Korean institutional investors.<sup>106)</sup> Such developments should have a positive impact on Korea's PPI market, as project companies looking to borrow on the domestic front will undoubtedly be able to secure more competitive rates and terms and conditions than were previously available.

Furthermore, increased competition among domestic lenders, combined with the increasing availability of foreign financing, may facilitate the gradual move toward limited recourse project finance for Korean PPI projects. International lenders hungry for solid (and relatively safe) returns on their lending have recently been eager to participate in Korea's PPI market. With the downturn in the global economy, international banks in the Asian region have actively sought arranging roles for some of the largest and most high profile (by even international standards) Korean PPI projects. Some of these projects have had significant foreign debt components relative to domestic debt components,<sup>107)</sup> which undoubtedly increases

103) For the period from 1995 to June 2003, Korea Development Bank had successfully arranged 7,435 billion won in debt financing for 23 PPI projects. See Korea Development Bank, Project Finance, available at <<http://www.kdb.co.kr/screen/jsp/IHEng/IHEngUPrt02050001E.jsp>>.

104) Indeed, the Mid/Long Term Plan envisages private participation by insurance companies, mutual aid associations and pension fund management companies.

105) See 2003 Annual Plan, 99.

106) See CNN.com, *Korea fund buys toll road stake*.

107) For instance, on the Pusan Newport project, the offshore facility was US\$276 million as opposed to the onshore facility of KRW245 billion. See Lord, *supra* note 80.

the bargaining power of the international banks in negotiating the financing terms and conditions and in the intercreditor relationship with domestic banks. Further, the more recent Korean PPI projects have been concluded as true limited recourse financings, most notably the US\$1 billion Pusan Newport project.<sup>108)</sup>

An increase in foreign investor participation by creditworthy participants will also contribute towards the development of limited recourse finance, as foreign project sponsors with strong financial backing will decrease the overall project risk perceived by potential lenders, which should reduce the level of credit enhancement mechanisms required by lenders.

#### A. Common Terms Agreement

Not all projects under the Korean PPI program include foreign financing, and a number of factors may lead to foreign debt participation in a Korean PPI project. One notable issue is whether one group of lenders will have their rights and obligations adequately protected in relation to another lending group.

One approach used in international project financing for different lending groups to have each of their rights clearly defined is to effect a common terms agreement—often with a governing law provision of a neutral country—which enumerates the terms and conditions which are “common” to all lending groups while leaving other more basic terms unique to each of the different currency facilities to be dealt with in separate loan agreements for each lending group. International lenders will argue that the use of a well-defined common terms agreement is in accordance with international practice. As can be imagined, different lending groups will have arguments for or against the use of a common terms agreement (which typically contains the conditions of precedents, representations and warranties, undertakings—positive and negative, accounts structure and events of default). International lenders will often cite the need for the relative parity of rights and obligations of all lending groups to ensure that one lending group does not have any advantage over or is

108) The lead arrangers on the offshore facility were Banca Intessa, Bank of Tokyo Mitsubishi, Credit Lyonnais, DZ Bank and Bayerische Hypo-und Vereinsbank. The arrangers on the onshore facility were Kookmin Bank and Samsung Life Insurance. *See id.*

adversely affected in relation to the other lending group(s). Despite such fundamental differences of opinion, domestic and foreign lenders to Korean PPI projects have implemented common terms agreements, but often only in projects where one of the key project sponsors is a foreign investor.

## VII. Governing Law and Dispute Resolution

A significant point of contention between the different lending groups on whether to use a common terms agreement surrounds the issue of the governing law, as one lending group, depending on the particular governing law chosen, may believe it is at a relative disadvantage to the other lending group(s). International lenders, however, will argue that resort to the laws of a neutral jurisdiction (e.g., England or New York) - with a well-tested and in-depth body of financial and commercial laws - will ensure that the rights of all parties are adequately protected.

In the Korean PPI context, Korean lenders will often cite the need to have a separate loan facility agreement governed by Korean law, pointing to such issues as enforcement of security over assets and accounts of the project company and sponsors often located in Korea. Some Korean lenders will also argue that it would be impractical to require the Korean courts (if resorted to in the event of a dispute) to bring in outside legal experts to testify on foreign law, which would undoubtedly create unnecessary delays and costs. Such claims, however, may be overrated as, in practice, the only court proceedings that are often necessary are for obtaining judgments for payment defaults, which do not involve any complex legal issues.<sup>109)</sup>

But such arguments overlook one practical legal advantage from the standpoint of Korean lenders; an enforcement action would have to be brought before a Korean court before original action could be taken over the project company’s assets located in Korea, which means the ever present possibility that the Korean courts may ignore the governing law when it conflicts with overriding Korean law, regardless of whether the original action is brought in Korea or in another jurisdiction.<sup>110)</sup> This may

109) *See* PHILIP WOOD, *LAW AND PRACTICE OF INTERNATIONAL FINANCE*, 6 (Sweet & Maxwell, 1980).

110) *See id.* at 4.

involve the Korean court overriding the choice of foreign law with respect to: 1) a Korean party's capacity to enter into contracts and 2) the law pertaining to the creation and enforcement of security interests.

This is particularly true if the enforcement action in the Korean courts concerns an award by a foreign court upon the parties' resort to litigation as the method of dispute resolution.<sup>111)</sup> Korean courts may not necessarily be obliged to recognize and enforce foreign court judgments, and the Korean courts may exercise broad judicial review,<sup>112)</sup> particularly with respect to procedural safeguards, e.g., whether: 1) a final and conclusive judgment was rendered by the foreign court, 2) the foreign jurisdiction recognizes judgments rendered by the Korean courts, and 3) the foreign judgment is consistent with public policy in Korea.

Such fundamental differences of opinion on governing law between the different lending groups are, of course, not a novel issue restricted to Korean project finance. It can be encountered in many different commercial contexts. Indeed, the issue of governing law goes to the heart of the relative bargaining power of the parties concerned.

#### A. Arbitration

In contrast, parties seeking to have the Korean courts enforce an arbitral award by an international arbitration panel should note that Korea is a signatory to the UN Convention on the Recognition and Enforcement of Foreign Arbitral Award (1958) (commonly referred to as the "New York Convention"), which obligates signatories to enforce arbitral awards obtained in foreign jurisdictions. Due to the potential benefits of flexibility, efficiency and neutrality of arbitration over litigation as a means of dispute resolution, foreign investors in Korean PPI projects would be well-advised to incorporate a carefully drafted arbitration provision into its project documents. This will increase the possibility that Korean courts will enforce decisions reached by arbitration panels without any substantial review of the merits

111) See Dana H. Freyer, "Practical Considerations in Drafting Dispute Resolution Provisions in International Commercial Contracts-A US Perspective", *J. INT'L ARB.*, 24 (1998).

112) See *id.*

of the case. Private investors should note, however, that the arbitration law of a particular country is potentially significant to an arbitral award since such law may prescribe certain procedural safeguards prior to enforcement by the local courts.

Under the Arbitration Act adopted by Korea in 1999, Korean courts must enforce arbitral awards (whether foreign or domestic) with the same effect as court judgments.<sup>113)</sup> Arbitral awards, however, are not enforceable in Korea unless a court renders an enforcement judgment.<sup>114)</sup> Perhaps more significantly, the Arbitration Act distinguishes between domestic and foreign arbitral awards and applies different conditions to their enforcement. For example, arbitral awards obtained in the Republic of Korea are to be recognized or enforced, subject to the following grounds under which a court may set aside the arbitral award: 1) the subject matter of the dispute is not capable of settlement by arbitration under Korean law or 2) the recognition or enforcement of the award would be in conflict with the morals or other public policy of Korea.<sup>115)</sup>

In contrast, foreign arbitral awards are distinguished between those rendered in signatory countries of the New York Convention - which are to be governed under relevant provisions of the convention - and those rendered in non-signatory countries, which are to be governed pursuant to the Civil Procedure Act.<sup>116)</sup> In the latter case, the Arbitration Act requires the Korean courts to apply procedures related to enforcement of foreign court judgments as embodied in the Civil Procedure Act.<sup>117)</sup> In order to avoid a potentially broader judicial review by the Korean court on at least procedural matters, foreign investors should take care to draft arbitration

113) See Article 35 of Arbitration Act.

114) See Article 37 (1) of Arbitration Act.

115) See Article 36 (2) par. 2 of Arbitration Act.

116) See Article 39 of Arbitration Act. For foreign arbitral awards governed under the New York Convention, relevant provisions of such convention provide that a court may refuse to recognize or enforce a foreign arbitral award if: 1) the subject matter of the dispute is not capable of settlement by arbitration under the laws of the State of enforcement or 2) recognition or enforcement of the award would be contrary to public policy in the State of enforcement. See Article V 2. of New York Convention. Please note that these are the same conditions under which a Korean court may refuse enforcement of domestic arbitral awards pursuant to Article 39 of Arbitration Act. As in the case of a petition for setting aside of a domestic arbitral award, the Korean court may exercise a degree of discretion in determining whether a foreign arbitral award is in contravention of public policy.

117) See Article 39 (2) of Arbitration Act. This provision provides that Articles 203, 476 (1) and 477 of Civil



provisions into the project documents by choosing an arbitral seat in a country that is a signatory to the New York Convention. Otherwise, the Korean courts may exercise a wider discretion over a foreign arbitral award in rendering an enforcement judgment. Foreign investors should note, however, that Article 477 of Civil Procedure Act prohibits the Korean courts from reviewing the merits of a case decided in a foreign court.

## VIII. Issues of “Bankability”

### A. Project Documentation

Many of the notable risk factors inherent in Korean PPI projects are related to the lack of clarity in the project documentation (e.g., concession agreement, construction contract, operation & maintenance agreement, shareholding agreement, etc.), which are often not in accordance with international best practice.<sup>118)</sup> Especially for international lenders mandated as arrangers of US dollar facilities for the project company, clarity in the project documentation will be a fundamental concern as to the “bankability” of the project. Without sufficient evidence that the project is bankable, international lenders will be inclined to conclude that the project’s risk profile does not justify the investment.

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Procedure Act apply *mutatis mutandis* to the recognition and enforcement of foreign arbitral awards from non-signatory countries (of the New York Convention). Accordingly, Article 203 of Civil Procedure Act provides that a final foreign judgment shall be valid and enforceable only if it satisfies the following conditions: 1) the jurisdiction of the foreign court of judgment is not denied by any law or treaty, 2) if the losing defendant is Korean, he received service of summons or other orders necessary for the commencement of the action other than by public notice, or he made an appearance without receiving service thereof, 3) the foreign judgment is not contrary to the public policy or good morals of Korea, and 4) reciprocity is ensured between Korea and the foreign country. Furthermore, Article 477 of Civil Procedure Act provides that 1) an enforcement judgment shall be rendered without inquiring into the merits of the foreign judgment and 2) a suit demanding an enforcement judgment shall be dismissed in the following cases: (i) when it is not certified that the judgment of a foreign court has become irrevocable or (ii) when the foreign judgment does not fulfill the conditions prescribed in Article 209 of Civil Procedure Act.

118) For example, Korean construction contracts are often brief in comparison to construction contracts executed by parties to international project finance.

International lenders will often cite the failure of Korean project documentation to meet prevailing standards in international project financing. As a result international lenders will often seek to address its concerns through appropriate undertakings and covenants in the financing documents, through amendments to the project documents or by entering into direct agreements with the relevant project participants (e.g., the concession-granting competent authority, contractors, operators, etc.).

The relative success or failure of lenders to procure amendment of the project documentation—many times executed well in advance of entering the financing phase—based on due diligence efforts is a difficult task at best, but which nevertheless must be undertaken. It is at this stage where the lenders must sufficiently determine, through the advice of their technical, legal and other advisors reviewing the various project documentation, whether the project is indeed “bankable.”

In particular, Korean PPI project documentation generally lacks the clear interface expected between the various documents (e.g., concession agreement vis-a-vis the construction contract, concession agreement vis-a-vis the operation and maintenance agreement and the construction contract vis-a-vis the operation and maintenance agreement). Without this clear interface among the project documents, it is difficult for lenders to assess whether a certain potential liability of the project company resulting from a particular “triggering event” under one project document is adequately covered in another project.

A prime example of this problem can be seen in force majeure provisions, which are sometimes different under the concession agreement and the construction contract in a particular project. This will expose the project company to the risk that the construction contractor could be excused for performance under the construction contract for a particular force majeure event while the project company would continue to be liable for its timely construction obligations to the governmental authority under the concession agreement. This could result if the force majeure event occurring under the construction contract is not likewise deemed a force majeure event under the concession agreement.<sup>119)</sup>

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119) This problem is also typically present in other project documents such as the operation, maintenance and management agreement. This problem, however, “can be cured with a so-called “resurrection” clause, in which the contractor agrees with the project company that where force majeure inconsistencies exist between contracts, the contractor will not receive relief greater than the relief available to the project company under other relevant contracts.” See Hoffman, *supra* note 99 at 254.

Whether a contractor will take the risk of certain force majeure events will also be determined to an extent by the prevailing practices in a particular country's construction industry. For instance, in the United States, contractors generally assume the risk of strikes by the contractors' employees or subcontractors.<sup>120)</sup> Although this may not necessarily be the case in the Korean context, given the highly volatile nature of the Korean labor market, the project company (and the lenders) should argue that Korean contractors are in the best position to assume the risks associated with labor disputes.

Another related example is in liquidated damages provisions. Liquidated damages recoverable from the contractor by the project company under the construction contract may not be sufficient to cover the project company's liquidated damages obligations to the governmental authority pursuant to the concession agreement in the event of construction delays/losses resulting from a breach by the construction contractor. Lenders will want these issues adequately addressed through appropriate credit enhancement measures before considering the project "bankable."

### *B. Exercise of "Step-In" Rights*

A major area of concern for lenders is their ability to secure various rights over a project, notably "step-in" rights whereby the lenders are able to exercise the rights and carry out the duties of the project company in the event of a default under a particular project document. For example, the lenders may wish to cure a certain default of the project company prior to the governmental authority's exercising its right to terminate the concession agreement for default by the project company. This can most effectively be addressed by a document known as a "direct agreement," which secures the rights of the lenders to exercise certain rights in relation to a project. A direct agreement between the lenders and the other project participants (e.g., governmental authority, contractors, operators, etc.) will address the lenders' rights in relation to the project.<sup>121)</sup>

<sup>120)</sup> See Hoffman *supra* note 99 at 255.

<sup>121)</sup> Please note, however, that the Korean government does not typically enter into such direct agreements with private project participants.

### *C. Termination Payment*

Although termination payment provisions often included in concession agreements for Korean PPI projects presumably require the government to provide the concessionaire with a termination payment in the event that the concession agreement is terminated due to the government's breach, it is unclear in certain projects whether the government would be required to make a termination payment in cases where the concession agreement is terminated for breach by the concessionaire. Although this issue can be adequately addressed in a direct agreement, the Korean government, upon request from the concessionaire, has more often addressed this issue in a document of less-binding form (e.g., statement of clarification).<sup>122)</sup> Because the termination payment would be a critical factor for project lenders, however, the concession agreement should at least provide for all circumstances under which the government would pay the termination payment - ideally even in the case of termination of the concession for breach by the concessionaire - and the method for calculation of such payment.

### *D. Enforcement of Security Interests*

Lenders to project financings that are implemented on a non-recourse or limited recourse basis will be particularly concerned with the ability to enforce its various security rights over project assets most often located in the host country. The security interest of the project lenders will include: 1) ownership rights to the project company, 2) all rights, title and interest of the project company in the project agreements (e.g., concession agreement, construction contract, operation and maintenance) and 3) mortgages and charges over project company assets, including bank accounts. In this regard, it is crucial from the standpoint of international project lenders to determine whether Korea maintains a fair and adequate system of laws and procedures for the enforcement of security interests. This aspect of project financing becomes more crucial given the fact that the courts of many host countries

<sup>122)</sup> Other than agreements that they are statutorily authorized to execute (e.g., concession agreement), government officials in the Korean PPI context are often not willing to enter into any binding agreements such as a direct agreement with project participants.

may not recognize the choice of law of another jurisdiction (e.g., English or New York law) in governing the enforcement of security interests over assets located in the host countries.<sup>123)</sup> It is this risk that should be taken into consideration when working with local lawyers to make sure that the rights of project lenders with respect to security interests are adequately protected.

Another major concern for lenders is whether the governmental authority may hinder the lenders' ability to exercise their rights over the security pledged by the project company for securing the project financing. This concern has in some cases been addressed in the Korean PPI context through the concession agreement, whereby the competent authority is required to "cooperate" with the lenders in such cases.

Potential lenders will also want to note that pursuant to the Annual Plan, the competent authority requires a project performance guarantee from a third party to be jointly liable with the concessionaire or a performance guarantee deposit from the concessionaire.<sup>124)</sup> In the case of a non-cash performance guarantee (i.e., issued by a financial institution), lenders will want to ensure that the issuer will be subordinated to the lenders in the event of a call under the performance guarantee.

As to the PPI Act in particular, lenders should note that any mortgage on the operation and management right of the concessionaire must be registered with the relevant competent authority for validity and enforceability.<sup>125)</sup> As discussed above, the operation and management right is deemed a property right under the Civil Code,<sup>126)</sup> and security can be taken over the operation and management right in the form of a *kun* mortgage.

123) See Richard Walsh, "Pacific Rim Collateral Security Laws: What Happens When the Project Goes Wrong?", 4 *STAN. J.L. BUS. & FIN.* 115, 122 (1999).

124) See sec. 2.3 of 2003 Annual Plan. In practice, the performance guarantee deposit can be either cash or an insurance policy or guarantee issued by a financial institution.

125) See Article 28 (1) of PPI Act.

126) See Article 27 (1) of PPI Act.

## IX. Conclusion

Private investors are bound to see a more favorable environment for foreign investment development as Korea's private infrastructure market continues to develop towards prevailing international best practice. Positive foundations are currently being laid by a partnership between the public and private sectors, which is bolstered by the Korean government's firm overall commitment to a liberalized economy in step with developed countries.

Private investors, however, should be aware of some very real risks, especially in the broadly-structured regulatory framework embodied in the PPI Act. Under the broad provisions of the PPI Act and its Enforcement Decree, parties are left to hammer out the detailed terms and conditions through the concession agreement. Although project participants may view this feature as an advantage from the standpoint of added flexibility in the early phases of a project's development, it may at later stages become a serious flaw for all parties concerned, especially where more detailed provisions in the relevant laws would provide for greater certainty when disputes arise under the concession agreement. In such cases, the only recourse available to private investors would be the rights provided under the concession agreement. Although it is inconceivable that the Korean government would follow down the path of some other NICs by breaching its international obligations for domestic political gain, private investors should never underestimate this risk.

Relatedly clarity in the PPI Act could also insulate the government from political vulnerability to charges of corruption and a rigged bidding process. The current PPI framework provides for great flexibility, but such flexibility may turn into a liability for the government at later stages if certain political sectors or civic groups allege wrongdoings, pointing to the lack of detailed provisions in the PPI Act and the wide discretion exercised by public officials in the negotiating process for the concession agreement.

Despite such risks, private investors can find comfort in the Korean government's strong commitment to the PPI scheme. Because of this fact, Korea's PPI market should continue to generate much interest from international lenders and sponsors in the years to come.