China's Belt & Road Sri Lankan Projects – White Elephants or *Strategic Dormant Assets*?

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Not all projects that China has sponsored along its Belt & Road Initiative have been economically successful for the host county. Sri Lanka being a key example of a country riddled with debt, and limited options to escape it.

"Critics have said Sri Lanka could sink deeper into debt with China because of infrastructure projects that China funded under its Belt and Road programme[i]"

Geopolitics vs Commercial Motives

Infrastructure project financings go wrong. It's a fact of life. Business and financial assumptions are often aggressive, capital structures inappropriate and motives underlying projects mixed.

Factors such as these unfortunately appear to have combined in the case of Sri Lanka, which from a geographic perspective is a key location for China's Belt & Road Initiative ("BRI"). Failures such as have happened in Sri Lanka have fanned the flames of skepticism in relation to the BRI, with media commentators questioning China's motives for large infrastructure projects in remote locations, such as those funded in Sri Lanka.

Fundamentally are such projects commercially or geopolitically motivated? Is this little more than what has been termed "*Debt Trap Diplomacy*"[ii]? Lending emerging nations large amounts of debt capital in the expectation that there is no way commercial loans can be repaid and eventually ownership of assets will result in some form of restructured deal[iii]?

This paper provides an overview of two key Sri Lankan projects, considers the potential for this sort of project failure history to repeat itself along the Belt & Road countries and comments on the overarching geopolitics which undoubtedly (*and understandably*) form part of the agenda for China in securing its access to vital Indian Ocean maritime trade routes.

Belt & Road Linked Sri Lankan Infrastructure

Two key Sri Lankan infrastructure projects developed under the BRI are the Hambantota Port (“*Port*”) and the Mattala Rajapaksa International Airport (“*Airport*”).

Both of these were developed with a heavy reliance on Chinese capital combined with construction work carried out predominantly by Chinese contractors.

Background on Hambantota

Both projects are located within the Hambantota region, positioned on the south eastern coast of Sri Lanka, facing the Indian Ocean.

Just 10 to 15 nautical miles south of this coastline are the major east west shipping lanes connecting Asia with Europe. It is reported that 200 to 300 ships sail through these proximate waters per day[iv]. Being near such a marine super highway hopes were high Hambantota could develop a complimentary maritime industry.

Prior to the construction of the Port, Hambantota was a simple fishing village that had been comprehensively devastated by the Tsunami in 2004[v]. Comment on how impacted the area was by the tragedy included:

> *The landscape was nearly flat after the tsunami, with buildings washed away*[vi]

In Sri Lanka’s 2012 census, the population of the Hambantota district was a total of just 57, 264[vii].

A strategy to develop infrastructure in the Hambantota region had been floated as early as 2002, as a hope to bring employment and opportunity to an economically challenged area. This was under an attempted policy initiative titled “Regaining Sri Lanka”[viii]. Unfortunately the government at the time was not that long in power and the initiative never gained traction[ix].

Earlier still are reports for the project being considered in 1977[x].

The Hambantota Port Development

The development of the Port was seen to be a compelling proposition to deliver opportunity to this remote region, open up trade for Sri Lanka and generate significant revenues which the island nation’s economy desperately needed. Stimulating the region was a key political driver of the then President Rajapaksa.

Size of Port, Intended Uses & Anticipated Revenues

The Port comprises 4 terminals, 12 ship berths[xi], crane loading and connection to road infrastructure. There is also the 14 unit tank farm, with 8 tanks for Bunkering, 3 for Aviation and 3 for LNG[xii].

The Port Authority was meant to receive the following revenue streams for the Port’s operation[xiii]:

- USD$25,000 per hectare per year for the 56 hectares
- USD$2.50 for every container loaded or unloaded
- USD$30 wharfage for each container coming into Sri Lanka
- Usual Port charges such as navigation, piloting, tonnage, etc.

Reading into this the expectation was, given the revenue metrics, that significant container traffic was going to pass through the Port. Additionally, hopes were high that with such proximity to the shipping lanes, Sri Lanka could benefit from numerous revenue streams at the Port. These included such activities as ship repair & maintenance, medical and water supply, bunkering, etc.

Unfortunately, the result has been quite different than planned. Shipping traffic has been exceptionally low and associated industry struggling to gain any traction. The Industrial area adjacent to the Port still has tender requests up on the Sri Lanka Ports Authority website for parties wanting to commence complimentary industrial initiatives[xiv].

Maersk Line's South Asia CEO noted that it was too early for the company to understand the value proposition, and whether indeed there was economic sense in using the Port facility[xv].

All this brings into question both the political motives to champion such a difficult project, and China's willingness to fund it.

Development Capital & Debt Burden

Sri Lanka has been an aggressive borrower of Chinese debt, which is estimated to be circa US$8 billion[xvi].

The Export Import Bank of China (*EXIM*) extended 3 separate loans to Sri Lanka for the Port alone, reported as follows [xvii]:

- USD$307 million for Phase One construction which was completed in 2010 and carried out by a JV between Sinohydro Corporation and China Harbour Engineering Company (CHEC)[xviii]
- USD$77 million for construction of a bunkering terminal / tank farm completed in 2011 and built by Han Quin Engineering Construction Company of China[xix]
- USD$809.35 million for Phase Two construction which was awarded to China Communications Constructions, the parent company of CHEC[xx]

The Phase One loan was reportedly made on commercial terms at an interest rate of 6.3% and for a period of 15 years[xxi]. The Phase Two at a 2% interest rate[xxii].

This is significant capital for a greenfield infrastructure project in any location. Here more so given the interdependence on Chinese Contractors to build the facilities, allowing China to export skills, and a "hope" that sustainable economic stimulation would result. Any Business Plan appears to have been poorly conceived, and little resistance given in the face of a "champion" in the then President.

Mattala Rajapaksa International Airport – The World's Emptiest International Airport[xxiii]

The development of the neighbouring airport to the Port was also financed predominantly by a loan from EXIM[xxiv]. Much of the original thinking was an airport would open up infrastructure for both trade and importantly tourism for this remote part of Sri Lanka.

Needless to say that vision has not been delivered, and a "stranded asset" has been constructed in a remote jungle location. Attempts to make the Airport a local "hub" for Sri Lankan Airlines also failed[xxv].

With heavy debt burdens (*reported at circa US$17 million a year repayments*) and a lack of use to the point troops were mobilized to remove wild animals[xxvi], the airport has become a political football and an embarrassment. Compounded by the depreciation of the Sri Lankan rupee, the debt burden resulting from such "vanity projects" has only increased[xxvii], fueling speculation of an additional debt for equity deal[xxviii] on an asset that could arguably be used at some point as a Chinese air base[xxix].

The alternative, which was rumoured to be the sale or venture of the asset on a favourable valuation to an Indian company, also attracted spirited protest, including from the ex-President's son[xxx].

Airport & Port Debt Repayments

The total repayments on the debt burden of the Port were in the order of USD$111 million per annum – for interest and capital[xxxi]. A hefty sum, and when combined with the debt associated with the Airport amounts to close to $130 million per annum.

This does not include the operational expenditure and maintenance costs associated with the upkeep of such large infrastructure projects. Both the Port and Airport run at considerable losses.

Did Sri Lanka Have Options For Capital for Hambantota?

Sri Lanka faced a number of hurdles to securing capital. These included a small localised population in a region that had been cruelly impacted by mother nature, political leadership wanting to develop further economic opportunities, a lack of interest by India to fund the port development[xxxii] , a 26 year civil war[xxxiii] and EU sanctions imposed on Sri Lanka over Human Rights issues[xxxiv]. Against this backdrop Sri Lanka turned to the Chinese.

And whilst the West and India might now raise concerns, voice protests and question if there is any competitive bidding[xxxv], did Sri Lanka in fact have any real alternative to pursue these ambitions?

It is interesting to observe that despite the apparent failure of the Port and Airport projects, in May 2018 there has been an additional approval of a US$500 million LNG plant to be built adjacent to the Port by China Machinery Engineering.

The Projects Unravel

Undoubtedly both assets have been caught in political turbulence within Sri Lanka. Successive governments have changed direction in relation to the use of both the Airport and Port. Crane infrastructure required for effective trans shipping is yet to be acquired, and highways and railways internally which were intended to be upgraded have not been completed.

There have also operationally been poor decisions made, including the purchase of large quantities of substandard product[xxxvi] for bunkering.

The situation with overall debt in Sri Lanka reached a point where there was little choice other than to consider the sale of state assets. In the instance of Hambantota there was a debt for equity swap for 70% of the asset[xxxvii], but on the basis that a 99-year lease being granted to operate the asset and the harbour precinct. The debt consideration underlying this Concession Agreement was circa US$1.2 billion[xxxviii].

This deal was not met with enthusiasm, including workers at the Port striking following announcement of the deal with China and for a four-day period holding hostage a major Japanese transport vessel the Hyperion Highway which was bound for Sohar, Oman[xxxix]. Eventually the Sri Lankan Navy had to intervene to escort the vessel to sea.

No deal on the Airport has been announced although rumours have arisen[xl].

A Chinese Flag Flying Over Sri Lanka?

Picture A below illustrates the importance of the position of Hambantota within the Bay of Bengal / Andaman Sea region.

International concern is that China is strategically positioning to both influence and control geopolitics across the Bay of Bengal, including Hambantota as a potential naval "hub"[xli]. Although commentators have noted it would never be logical as a major naval base given its exposure to the Indian airforce, it might have uses as a staging point, including for refueling and repairs of naval vessels.

In 2017 India has increased its influence over the Bay of Bengal, when it was asked to join the Malacca Straits Patrol ("MSP") framework[xlii] – a collaborative that by design protects the security of the Malacca Straits and that of Singapore. Prior to India's joining the nations included in the MSP were: Indonesia, Malaysia, Singapore and Thailand. India's increasing role in the maintenance of independence and access to the Straits of Malacca is an important strategic move on its part. With Pakistan, Sri Lanka, South East Asian and Eurasian nations embracing aspects of the BRI, it is easy to understand why India is feeling somewhat isolated.

In a short period of time, however, China will control Energy and Maritime Port assets (*and likely an Airport)* in a crucial part of the Bay of Bengal. Sri Lanka forms a crucial node in what the USA has described as a "String of Pearls" initiative[xliii], which has other large strategic port assets under development in Africa and the Middle East, and additionally including one with Malaysia in the Straits of Malacca[xliv].

The military concerns are not without foundation given recent history & the tensions in the South China Sea. Events including the 2014 docking of a Chinese nuclear submarine and warship in Colombo[xlv] do not help allay fears of military undertones.

Although Sri Lanka's top defence official stated that there was no way Hambantota would be used as a military base[xlvi], given its strategic position and the control that the Chinese have, concern remains.

For China 99 years is a long time to have a key strategic foothold in the Bay of Bengal.

Conclusions & Observations

The Belt & Road Initiative is multi-dimensional, the Chinese are extremely patient and President Xi Jinping a visionary and powerful leader. The Chinese are building out multiple strategic initiatives including via the Space Silk Road, Polar Silk Road and initiatives such as the maritime "String of Pearls".

Sri Lanka is not the only nation that has aggressively pursued infrastructure projects based on heavy borrowing of Chinese debt, and they appear committed to continuing the practice. In May 2018 a US$500 million LNG facility adjacent to the Port was approved for development[xlvii].

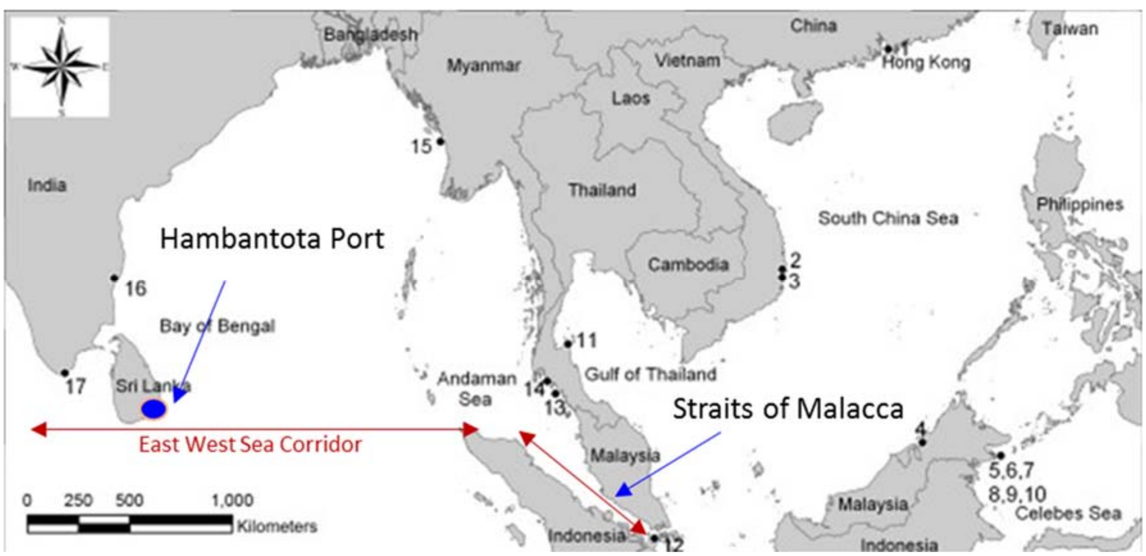
For nations that are considering partnering with Chinese capital and contractors numerous considerations need to be given. There is a strong case for independent & robust analysis being given to the fundamental commercial viability of projects, the terms of any external capital to be secured and the potential impact on sovereign rights in the event that debt burdens become overwhelming.

Using debt strategically can put in place what the author has termed as "dormant assets" for China which, without that debt, would likely have been difficulty to secure given often more stringent restrictions on direct foreign investment and asset ownership. Reflecting on the Hambantota Port, at some point in time over a 99 year lease, control of that asset may give rise to an alternate use - *even temporarily* – which would confirm the significance of the Belt & Road Initiative as a geopolitical tool, as well as a lubricant of commerce.

In conclusion, whilst it might appear positive news for politicians to announce large infrastructure projects in collaboration with the ambitious and transformational Belt & Road Initiative, the only measure of such projects success should be their clear ability to drive both local and international commerce, and generate acceptable financial returns.

Without a clear commercial business case on ambitious large scale infrastructure projects funded by China, questions on intent will continue to arise.

It is not illogical that China is patiently creating a portfolio of debt loaded *dormant assets* in highly strategic geographic locations which assist it maintain security of supply over international maritime trade routes.



Picture A – the strategic importance of Sri Lanka

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Nicholas provides strategic counsel in the areas of corporate growth, mergers & acquisitions and joint venture alliances, working with organisations to both design and implement cross border initiatives – including for those seeking to derive commercial benefit from the Belt & Road Initiative

Nicholas is a firm believer that the Belt & Road Initiative will not only be highly successful for China and participating countries, but has the potential to present tremendous commercial opportunities for other international organisations who can develop and implement complimentary strategies. But that being said, for many nations and companies engagement with the BRI it is not without its challenges – in particular where high levels of debt are part and parcel of infrastructure projects

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Other papers by Nicholas on the China Belt & Road, available via the *Social Science Research Network* at www.ssrn.com include :

- China's Polar Silk Road : Overview Challenges & Opportunities : https://ssrn.com/abstract=3179218
- China's Control Of The Heavens: An Overview of the Rapidly Developing Space Silk Road : https://ssrn.com/abstract=3176348

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