

LAD CASE STUDY

'Locked-In' to China: The Colombo Port City Project

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Nayana Mawilmada’s Decision

It is February 2016. Nayana Mawilmada is in his 13th floor office in Colombo contemplating his assignment from the Sri Lankan prime minister. As the secretary-general, the senior most operational authority of the Urban Development Authority, he has been asked to advise the Sri Lankan government in its upcoming negotiations over the controversial Colombo Port City project – an ambitious attempt to create high-end real estate through land reclamation. The reclamation was to be wholly realized through Foreign Direct Investment (FDI) of about \$1.4 billion by a Chinese company – the largest of its kind in Sri Lanka. In return, the Chinese company would get the rights to monetize a major portion of the marketable land with the remaining to be owned by the Sri Lankan government.

The agreement detailing this arrangement was hastily signed in September 2014 by the previous Sri Lankan government, under then-President Mahinda Rajapaksa. The project is highly controversial. It is opposed by environmentalists and fishermen because of its potentially negative effects on the coastline and marine life, and by international and Sri Lankan commentators who have raised concerns about sovereignty and corruption. Therefore, when the current government came to power in early 2015, they suspended the development, pending review, for failing to secure the necessary environmental permits.

However, government officials insisted that they had not fully understood the extent of their obligations as per the signed agreement, which included responsibility for securing environmental permits. Consequently, once negotiations began over restarting the project, the Chinese company filed claims seeking compensation for suspension, as permitted under the agreement. The Sri Lankan government also faced serious diplomatic pressure from China due to its indebtedness.

A new environmental impact assessment has cleared the project for approval and the required permits. Yet, aspects of the agreement still place onerous burdens on the Sri Lankan government both financially and geo-politically, and government officials have limited negotiating capital to address them. The government is also concerned about the public perception that compensating the Chinese government will make it seem weak and toothless. Mr. Mawilmada must take all of these factors into consideration and advise the Sri Lankan team on a negotiating strategy.

Karthik Sivaram conducted interviews and prepared this case under the supervision of Francis Fukuyama of Stanford University. This case was developed solely as a basis for class discussion. It is not intended to serve as a historical record, a source of primary data, or an illustration of effective or ineffective management.

A Country in Transition

Sri Lanka is a South Asian island nation located in the Indian Ocean (See Appendix A). It is officially a “democratic socialist republic” with a unitary state and a semi-presidential system. A British colony until gaining independence in 1948, Sri Lanka’s history has been marked by tensions between its two main ethno-linguistic groups – the majority Sinhalese and the minority Tamils. The 26-year civil war between the Sri Lankan government and the secessionist Liberation Tigers of Tamil Eelam (LTTE) came to a bloody end in 2009 under President Mahinda Rajapaksa. His regime faced considerable pressure from the West and India over civilian deaths and alleged war crimes committed during the final phase of the war.

Shunned by India and the West, Rajapaksa welcomed massive amounts of Chinese capital into Sri Lanka, especially for infrastructure projects. The ambition and scale of the Colombo Port city project is symbolic of this engagement; indeed, its construction was inaugurated by President Xi Jinping himself during a state visit to Sri Lanka in 2014. Rajapaksa also attempted to consolidate power through constitutional amendments removing term limits and increasing his presidential authority. Nonetheless, he ended up losing to Maithripala Sirisena in the December 2014 presidential elections. Previously a minister in Rajapaksa’s cabinet, Sirisena’s campaign railed against the systemic corruption of Rajapaksa’s regime and he promised to repair Sri Lanka’s relationship with India and the West. He focused on what he called “white elephant” infrastructure projects that Rajapaksa’s regime had approved, claiming that they had severely indebted the state while enriching the president and his family. Sirisena promised to review all the deals approved by the previous regimeⁱ. In March 2015, a week before a state visit by Indian Prime Minister Narendra Modi, the Sri Lankan government suspended the Colombo Port City project.

The Sri Lankan Economy

In 2015, Sri Lanka had a population of about 21 million and a gross domestic product (GDP) of about \$82 billion.ⁱⁱ Although the World Bank classifies Sri Lanka as a lower middle income country relative to other countries in the region, it has high human development indicators, including adult literacy (93%, HDI of 0.757) life expectancy (75 years), and gender equality (GDI 0.948).ⁱⁱⁱ Its economy has undergone significant restructuring (see Appendix B), moving from an agricultural base towards one dominated by services. In the first three years following the end of the war (in 2009), the Sri Lankan economy grew at a brisk 8.5% per year, driven largely by Chinese investments, especially in infrastructure (see Appendix C). This capital influx was particularly important since most of Sri Lanka’s infrastructure had deteriorated due to the war. Blessed with pristine beaches, lush rainforests, and snow-capped mountains, Sri Lanka has great tourism potential despite its small land area. However, poor infrastructure remains a major obstacle. Already in 2015, tourism attracted \$2 billion in valuable foreign exchange (the third largest source), directly contributed 4.5% to GDP, and employed 300,000 people, notwithstanding the spillover to other sectors.^{iv} Although most tourists entered Sri Lanka through Colombo, they spent more time at the country’s beach resorts (1.6 nights as compared with 5.5 nights)^v because of a perceived lack of shopping and recreational options in Colombo. Toward that end, developers conceived of the Colombo Port City as high-end real estate for tourists and a second home for foreign high net-worth individuals.

The China – Sri Lanka Relationship

Historically, Sri Lanka and China have always enjoyed good relations. Sri Lanka was among the first countries to officially recognize the People’s Republic of China under Mao; in return China signed the “Rubber-Rice Pact,” which provided Sri Lanka with much needed rice supplies at a third of market price.^{vi} This friendship helped spark years of trade and investment between the two countries. However, given Sri Lanka’s cultural and ethnic ties as well as its geographical proximity, India has always been the most influential regional power. Sri Lanka had also maintained a Western orientation thanks to its vast diaspora, and it received aid and traded enthusiastically with the US and the EU. In this manner, Sri Lanka had long maintained a “delicate balance.”^{vii} That balance began to shift when Rajapaksa came to power in 2005. While both India and the West initially supported his efforts to defeat the LTTE, they grew concerned over reports of the Sri Lankan Army’s ‘scorched earth’ tactics. In 2007, both the US and India stopped their respective military aid programs. In the same year, China greatly increased its military aid, providing arms and ammunition worth \$37 million. Further, once the war ended, Sri Lanka’s economy was in a poor state and its leaders desperately sought assistance to rebuild the country and deal with a looming balance of payments crisis. In 2009, it secured a \$2.9 billion IMF loan, although the US withheld its support for the deal and the package included a host of conditions on public-sector reform, fiscal austerity and an informal commitment to address human rights violations.^{viii} By contrast, China offered Sri Lanka a package worth \$6.1 billion to support various projects (more than the assistance received from all other donors combined) that included neither reform commitments nor pressure to right the wrongs of war.^{ix}

China’s beneficence is not without logic. Sri Lanka’s location in the Indian Ocean next to one of its busiest shipping lanes makes it strategically important; 85% of Chinese energy imports pass through this area. Moreover, the free port of Colombo is a major transshipment hub for Chinese goods and since 2010, a Chinese state owned enterprise (SOE) has developed and operated the biggest terminal in the Colombo Port. For this reason, Sri Lanka figures prominently in China’s plans for the One Belt One Road project -- a series of infrastructure investments to improve global connectivity (Appendix D). Therefore, consolidating its influence in Sri Lanka remains a strategic priority for China and consequently, Chinese SOEs have exuberantly pursued infrastructure projects in the country.

Chinese Infrastructure Investments in Sri Lanka

Chinese SOEs have been involved in all types of infrastructure projects in Sri Lanka, from ports to power plants, and since 2006 have initiated at least \$5.69 billion worth of developments (see Appendix E). Most of these projects resulted from unsolicited proposals (without the public issuance of a request for proposal) and were financed by Chinese bank loans.

The Rajapaksa regime enthusiastically sought and enabled these projects. In 2008 they eliminated the National Procurement Agency, the statutory body that handled competitive public procurement, including unsolicited proposals. Overwhelmed by a deluge of proposals, in 2010 a Standing Cabinet Appointed Review Committee (SCARC) was created to approve projects without public tendering or parliamentary approval. It was widely believed that proposals were approved without proper assessment of their commercial viability; parochial political interests and corruption were more determinative.^x The Hambantota Port and Mattala-Hambantota Airport are illustrative examples: both were built near a remote fishing village of just 20,000 residents by

a Chinese SOE financed through Chinese bank loans. Both proved to be commercial failures.^{xi} In 2014, the port was leased to a Chinese company and the Sri Lankan government is currently in talks with the Chinese to find a similar arrangement for the airport. Notably, both the port and the airport (named after Rajapaksa) are situated in what was then the constituency of Rajapaksa's son. Corruption within the Rajapaksa family, many of whom held powerful positions in the government, was no secret. In 2012, Wikileaks released a cable from the US ambassador to Sri Lanka indicating that 85% of the public viewed the Rajapaksa family as corrupt; the cable also referred to Basil Rajapaksa, the minister of economy and the president's brother, as "Mr. Ten-Percent" for his habit of taking 10% of all approved projects.^{xii}

To be sure, corruption was neither exclusive to Chinese projects nor the main driver of its prodigious growth. But compared with multilateral and private competitors, the Chinese have been far more willing to take on riskier, more ambitious projects. They also provided funding and, crucially, would approve projects much faster than any of the multilaterals. Moreover, the Chinese did not insist on meticulous evaluations of a project's commercial and environmental viability, unlike multilaterals such as the World Bank. However, the interest rates on most Chinese loans were high, close to commercial rates and certainly higher than those offered by the World Bank. But for politicians eager to open a new airport before their next election, this was not a concern; with the political capture of the approval process Chinese projects began to mushroom.

Sri Lanka's foreign debt ballooned as well, from 36% of GDP in 2010 to 94% by 2015. The country's debt to China alone was at least \$8 billion and debt servicing consumed a third of government revenue.^{xiii} In the past, the Chinese had been willing to ease that debt burden in return for additional investment opportunities. During a May 2014 state visit to China by then-President Rajapaksa, President Xi agreed to restructure Sri Lanka's debt and ease the payment schedule; a month later, a Chinese SOE acquired a controlling stake in the Hambantota Port.^{xiv} Four months after that, in September 2014, President Xi Jinping laid the foundation stone for China's largest single investment in Sri Lanka – the Colombo Port City.

History of Colombo Port City

The Colombo Port City is envisioned as an off-shore land reclamation project creating prime real estate to extend the Colombo Central Business District (CBD) adjacent to the busy Colombo Port (see Appendix F). The project resulted from a 2004 Sri Lankan government plan to expand the Colombo CBD by reclaiming 145 ha of land. It would rely solely on public funding. However, cost, along with other factors stalled the project.

In 2011, China Communications Construction Company (CCCC), a publicly traded company with links to the Chinese state through its fully owned subsidiary China Harbor Engineering Company (CHEC), submitted an unsolicited proposal to develop the Colombo Port City. This proposal envisaged the reclamation of 233 ha through foreign direct investment. Essentially, the deal called for CHEC to bear the financial costs of reclamation in return for rights to a share of some of the reclaimed land. This arrangement would be fundamentally different from previous Chinese projects in Sri Lanka since the Sri Lankan government would take loans to finance it. Negotiations began in 2012 after preliminary approval from the SCARC and continued for the next two years over various aspects of the deal. On September 16, 2014, the resulting Concession

Agreement (CA) was signed between the Ministry of Ports and Shipping (on behalf of Sri Lanka Port Authority (SLPA), representing the Government of Sri Lanka as the counterparty) and CHEC.

Vocal opposition emerged quickly. Environmental groups claimed that the required Environmental Impact Assessment (EIA) was compromised and that the project would severely damage the coast and marine life. Local fishermen's unions were also strongly opposed to the project, fearing that the sand mining for the land reclamation would affect their livelihood. Moreover, in late 2014, Ranil Wickremasinghe, the current prime minister but then the leader of the opposition party, publicly pledged to suspend the project on environmental grounds while campaigning for Maithripala Sirisena, the current president.

Once sworn in as prime minister in January 2015, after Sirisena's presidential victory, Wickremasinghe established a committee to review the project. On the basis of the committee's report, the government suspended the project in early March 2015 citing "environmental regulatory violations by the project developer;"^{xv} reclamation had commenced even though some of the necessary clearances were not in place. In the following months, a committee set up by the prime minister began negotiating with the project company (PC), a fully owned subsidiary of CHEC incorporated in Sri Lanka, over the future of the project. The PC claimed that the Sri Lankan government owed it compensation for the financial loss from the project's suspension on the basis of the compensation clause in the agreement. Those compensation claims grew as the project remained in limbo, totaling \$143 million by February 2016.

As negotiations continued through 2015, the Sri Lankan government faced pressure from China to restart the project. At the same time, debt service on the Chinese loans accumulated, severely constraining the Sri Lankan government's options. The Chinese tied any discussions over easing the debt burden through debt-equity swaps for projects such as the Mattala Airport with progress in the negotiations. Further, despite improving relations between the Sri Lankan government and India and the West, no additional financing offers emerged to supplant the Chinese. Thus, in September 2015, a new EIA was commissioned to address the committee's concerns, notably the lack of permits for sand mining. By early December 2015, the new supplementary environmental impact assessment (SEIA) was completed and released for public comment; it cleared the way for sand mining in specific areas and prescribed a compensation of 500 million Sri Lankan Rupees as livelihood support for fishermen who would be affected by the mining activities. Further, the SEIA also approved expanding the land area reclaimed to 269 ha, which the PC requested to make the project commercially viable.

However, protests continued despite the SEIA's findings, including by the fishermen's union.^{xvi} Critics questioned the integrity of the SEIA and criticized the government for renegeing on its campaign promises; newspapers bristled with op-eds that criticized various aspects of the CA as unduly favoring the PC.^{xvii} More broadly, opponents accused the government of being bought off by Chinese interests (much like the previous government^{xviii}) and given growing discontent with the lack of economic growth, there was immense pressure on the new government to respond. Moreover, legitimate concerns regarding many of the Sri Lankan government's obligations as per the concession agreement had significant geo-political and financial implications that the previous regime had not thoroughly scrutinized. Therefore, if the project were to continue, it was

crucial for the Sri Lankan government to renegotiate the deal to mitigate its exposure as well as not look spineless to the public. A technicality presented the opportunity: The original government counterparty to the deal, the Sri Lanka Port Authority (SLPA), was not legally authorized to conclude such an agreement and therefore incapable of discharging many of the stipulated obligations. As a result, on the advice of the attorney general, the PC agreed in principle to sign a new Tri-Partite Agreement (TPA) – with the Government of Sri Lanka (GOSL) and the Urban Development Authority (UDA) as counterparties. Although the PC made clear that it expected the counterparties to honor in-principle the commitments made under the original concession agreement, it was amenable to renegotiating certain terms to ensure the project's success.

The Evolving Deal

The Concession Agreement (CA) describes the roles, responsibilities, and the relationship between the PC and SLPA acting on behalf of the GOSL for the purposes of the Colombo Port City Project. The essence of the deal is that the PC will bear the commercial and financial risk while SLPA/GOSL shall bear the regulatory and environmental risks associated with completion of the project. The rationale behind the choice of the SLPA as the counterparty to the deal is not entirely clear, especially since the SLPA Act explicitly prohibits it from engaging in any activity that is unrelated to ports. It has been suggested that the deal reflects the desire of then-President Rajapaksa, who oversaw Sri Lanka's shipping and ports portfolio, to maintain personal control over the project. The salient features of the CA are listed below:

1. Land Reclamation and Allocation

The CA specifies that the area of reclaimed land will be at least 233 ha and that the PC shall bear the complete cost of reclamation, estimated at \$1.4 billion. In return the PC will have rights over at least 108 ha of so-called marketable land – 20 ha on a freehold basis and 88 ha on a leasehold basis. SLPA/GOSL shall be entitled to at least 62 ha of marketable land and the remaining 63 ha will be allocated to common areas such as beaches, parks, roads and so on. If the reclaimed land were to be in excess or deficit of the stated amount, it would be shared among the two parties on 60:40 split favoring the PC. Freehold land entitles the PC to outright ownership over the land; leasehold means that the project company will be awarded a 99-year master lease with a hold period of 35 years. The latter means that within 35 years after the granting of that lease, the PC may request GOSL to grant a fresh lease of 99 years to anybody, including itself, as it deems fit. After 35 years, it may only request a lease for 99 years minus the number of years elapsed since the 35th year of the master lease. In effect, the PC has complete ownership over 20 ha and a 134-year lease on 88 ha.

2. Mechanism for Selection of Marketable Land

The PC and SLPA/GOSL shall select marketable land as per the following arrangement. The marketable land will be delineated into plots of various size by the development master plan. Of these plots, all those permitted to be used for leisure will be first given to the PC and those all those permitted to be used for educational and cultural purposes will be allocated to SLPA/GOSL. The size of these plots will be subtracted from the total area of marketable land entitled to each party in the above section. Thereafter, the PC will make selections from the remaining plots not exceeding 10 ha in aggregate. Then

SLPA/GOSL shall be entitled to choose any one plot of land. Thereafter, the turn of selection shall be determined by comparing the ratio of total area selected by the PC to the total area selected by SLPA/GOSL with the ratio 108/62; if the former is equal to or greater than the latter, then it is turn of SLPA/GOSL to make selection(s) till the former becomes lesser than the latter. This shall continue until either party exhausts its total entitlement of marketable land.

3. Restrictions on Monetization of SLPA/GOSL Marketable Land

The CA details various restrictions placed on the monetization of SLPA/GOSL's marketable land. The rationale was that since it is the PC that is investing in the project, they must receive priority in obtaining a return on their investment. The restrictions placed are detailed below:

- a. For six years from the time of signing the CA, SLPA/GOSL may not monetize its share of marketable land other than for educational and cultural purposes.
- b. After the sixth year, in any given year the SLPA/GOSL may only monetize as much area as equals 1/7th (14.29%) of the area of land monetized by the PC in the previous year.
- c. The SLPA/GOSL shall ensure that the revenue per square meter generated through monetization of its land is not less than that of the last transaction completed by the PC. Essentially, SLPA/GOSL may not undercut the PC and sell its share for cheaper.

4. SLPA/GOSL Obligations

The CA details various obligations on the part of SLPA/GOSL to fulfill. They have been condensed and explained below:

- a. SLPA/GOSL will be responsible for securing all regulatory and environmental permits required for the project. The cost for obtaining these permits will be split as per their respective share of marketable land.
- b. SLPA/GOSL shall be responsible for providing road, electricity, water, and sewerage connections up to the periphery of the project. These should be of a standard that is satisfactory to the PC. The cost for these within the project site shall be borne by the PC.
- c. SLPA/GOSL shall ensure that the cabinet and the parliament grants the project "strategic development" status, entitling the PC to an income tax waiver for 25 years, tariff-free import of machinery, and easing of foreign exchange controls.
- d. SLPA/GOSL shall be responsible for setting up an Estate Management Company (EMC) for maintenance of the common areas of the project. Any equity infusion required will be the sole responsibility of SLPA/GOSL; however, the EMC may charge a reasonable fee from the tenants.

5. Compensation Events

The CA specifies the circumstances under which the PC may demand compensation from SLPA/GOSL. However, there are no provisions under which SLPA/GOSL may demand compensation from the PC. The stated rationale was that since the PC is undertaking the entire financial and commercial risk, these provisions are to ensure that SLPA/GOSL make good on their obligations or, in other words, these ensure that SLPA/GOSL have

some “skin in the game.” Further, the CA specifies that if such an event were to occur SLPA/GOSL must compensate the PC such that it is put in the “same economic position” as if the event had not occurred. The circumstances that can trigger a compensation event are listed below:

- a. If the SLPA/GOSL do not meet any of their agreed to obligations as specified in the previous section.
- b. If the PC is prevented or delayed carrying out construction or monetizing its share of land due to a challenge in court by a third party, given that the PC has not violated any applicable law.
- c. If a change in the law causes a financial loss of greater than \$2.5 million to the PC.
- d. If the SLPA/GOSL authorizes construction of “competing infrastructure” – any offshore reclamation project of greater than 20 ha and within a radius of 20 km from the project.
- e. If contaminants or pollutants were discovered in the water and resulted from the negligence of the respective government authority.
- f. If due to force majeure – an act of God – one of the parties is unable to meet its obligation, it may seek to terminate the agreement. However, if this were to be done by SLPA/GOSL, then the PC is entitled to claim compensation; the reverse does not apply – if the PC were to terminate the agreement then it would not be liable to pay compensation to SLPA/GOSL.
- g. If SLPA/GOSL were to default on the agreement and unilaterally terminate it, then the PC would be entitled to demand 200% of its net costs as compensation. However, if the PC were to default on the agreement and unilaterally terminate it, it is not liable to pay any compensation to SLPA/GOSL.

6. Dispute Resolution Mechanism

The CA requires that both parties shall first attempt to resolve any dispute through discussion and negotiation and only failing that shall consider either of following two options:

- a. Appointment of a mutually agreeable independent expert to adjudicate the dispute whose decision will be binding; neither party may appeal the decision in any forum.
- b. Take the matter to international commercial arbitration as per UNCITRAL Arbitration rules and to be administered by the International Bureau of the Permanent Court of Arbitration. The decision of such a body will be binding and neither party may appeal its decision in any forum.

Priority Issues for Renegotiation

The Sri Lankan negotiating team that Mr. Mawilmada is advising must prioritize issues of concern with the CA in terms of the trade-offs, since the PC will not accept changes without other concessions. The following sections describe and contextualize the three major issues and suggest options for consideration.

1. Compensation Claims

As noted above, the PC seeks compensation totaling \$143 million from the Sri Lankan government for the project's unilateral suspension and seems to have a strong case for its claims. The agreement the previous government signed clearly states that SLPA/GOSL is liable to pay compensation to the PC for any suspension of work, even if suspension was because the necessary environmental permits were not in place. However, the attorney general (AG) has opined that a case could be made to exempt the SLPA/GOSL from paying compensation. Irrespective of the fact that as per the CA SLPA/GOSL is responsible for obtaining the necessary permits, the decision by the PC to continue with reclamation work despite knowing that all permits were not in place constitutes illegal action.^{xix} To establish this, it would require submitting the matter to arbitration with no assurance that the government will prevail. While the financial burden of compensation would be significant, there are other considerations here. For instance, because the government is sensitive to how the public will view resolution of this matter, it could consider the following options:

- a. **Threaten Arbitration:** Given the AG's opinion, the government could threaten to take the matter to arbitration if the PC insists on claiming compensation, but offer to allow reclamation work to continue if it withdraws that claim. There is some reason to believe that the PC has a limited appetite for arbitration; it would much prefer the project continue, even if that means retracting the compensation claims (see section below). The public would likely support this position, making the PC more amenable to restarting the project. However, if the matter does end up going to arbitration, it could worsen the situation. Arbitration is lengthy and resource heavy. Moreover, arbitral panels tend to favor companies in such disputes and could end up awarding an even bigger amount as compensation. Further, arbitration would erode the relationship with the PC and make continued negotiations on other matters such as debt servicing more acrimonious.
- b. **Pay Compensation:** The government could agree to pay the stated amount and direct its limited negotiating capital towards more pressing issues. However, doing so will cause a loss of face for the government and make its decision to restart the project a harder sell to the public, and increase the financial strain on the embattled exchequer.
- c. **In-kind Compensation:** The government could accept the compensation claims but agree to pay in kind by allocating more of the marketable land to the PC. With the expansion of the project to 269 ha from 233 ha, an extra 5 ha of marketable land would be created, of which 3 ha would go to the PC and 2 ha to the government. The government could use this land to compensate the PC. Doing so would be easier to sell to the public than paying monetary compensation.

2. Freehold Land

The CA entitles the PC to 20 ha of marketable land on a freehold basis, a controversial provision geo-politically as well as among the Sri Lankan public. India has expressed concerns about the long-term strategic implications of China owning land in Sri Lanka, worried that the Chinese may use this land for future military purposes. Media reports have also raised questions about whether China could claim sovereignty over the airspace above the project since an entity of the state has legal title over the land.^{xx} While this may seem alarmist, China's aggressive claims and its militarization of islands in the South China Sea add credibility to such concerns. India remains an important ally of the current government and wields considerable political and economic influence in Sri Lanka as its largest trading partner and a major source of capital investments. India has made clear its opposition to the project; indeed, it was not a coincidence that the project was suspended a week before a state visit by the Indian prime minister. Moreover, Sri Lanka is in the process of closing an important trade and investment agreement with India, which could be affected by its decision on the project.^{xxi} Furthermore, in August 2015 (before officially signing the CA), Sri Lanka introduced new legal restrictions, allowing foreigners to lease but not own land.^{xxii} Although exceptions to this law could apply to the project because of its size, the public would certainly view such a move unfavorably. Therefore, the government could consider the following options:

- a. **Award Freehold Land:** This would produce a backlash from India as well as the public, but may provide negotiating capital for other priorities.
- b. **Convert Freehold to Leasehold:** The PC may not be immediately amenable to this change and may demand compensation, however, the PC ultimately desires freehold land to pursue investments with a long pay-back period. With that goal in mind, the hold period on the 20 ha of land could be increased from 35 to as long as 99 years. While India would prefer the project be cancelled, conversion to leasehold should address its concerns. Further, the public might see this move as a victory for the government, making the decision to restart the project more politically viable.

3. Financial Burden of the Sri Lankan Government's Obligations

Although the CA does not mention any direct financial commitment from the Sri Lankan government, its obligation has financial implications. As per the CA, the government is responsible for providing roads, power, water, and sewage connections to the periphery of the project as well as for developing and maintaining the common areas through an EMC. This significant infrastructure obligation will require investment of around \$1 billion.^{xxiii} While the Sri Lankan government could recoup its investments from monetizing its share of marketable land, estimated to be worth around \$2.2 billion, the cash-flow from that land will only be realized much later and depends on the project's success. Moreover, the restrictions placed on monetization of the Sri Lankan government's share of land adds further uncertainty. Given its limited fiscal room and high levels of indebtedness, the capital costs for such upfront investments will be significant. Furthermore, in case the project fails or if the estimated demand for utilities is

not met, the Sri Lankan government may end up creating excess capacity that goes unused. Since the CA does not provide for any compensation to be paid by the PC in that event, the risk profile of its investments is quite high. Moreover, failure to meet these obligations to the satisfaction of the PC could trigger a compensation event. With this in mind, the Sri Lankan government may seek to renegotiate the contract to include some of the following arrangements (which are not mutually exclusive):

- a. **Joint Ownership of Marketable Land:** The CA could be amended so that both parties could jointly own the entirety of the marketable land through a joint venture with equity that reflects their respective entitlement as per the CA. This would eliminate competition between the two parties in monetization, ensure more equitable sharing of risks, and do away with the restrictions placed on the Sri Lankan government's share. The project will benefit from economies of scale in marketing and better coordination. However, such an arrangement will mean that the PC will have majority stake and limit the Sri Lankan government's say in matters such as auditing lessors. Further, the PC may worry about expropriation risk and seek to legally limit the government's decision-making authority.
- b. **Joint Infrastructure Development:** The CA could be amended to place joint responsibility on the PC and the Sri Lankan government to develop the support infrastructure through a PPP structure. This arrangement would ensure more equitable risk sharing between the parties and make it easier to source financing. Similarly, a joint venture with equity infusion from both parties may be used to set up an EMC. However, the PC may not be amenable to such a proposal since it would be required to assume more risk. More realistically, the PC may be willing to help source financing from Chinese banks, an arrangement that would saddle the Sri Lankan government with additional loans.
- c. **Off-Take Agreements for Utilities:** The CA could be amended to include off-take agreements to guarantee demand by the PC. Such agreements would ensure that the PC purchases a fixed quantity of utilities at a certain price irrespective of actual demand, thereby lowering both the government's risk-profile and the cost of capital for the project. Guaranteeing demand and reducing uncertainty should also pave the way for private investors to take up these projects, yet also increases its financial exposure, even as it improves the project's chances of success and ensuring better service delivery.

Leverage in Negotiations

Beyond the issues outlined in the preceding sections, contextual factors will affect the negotiating strategies of both parties. Consider the following:

1. The Xi Factor

The PC's top priority is the project's quick restart. Because President Xi Jinping had

personally launched the project, a move that generated much media attention in China, its suspension was seen as a personal slight to the president. Therefore, the PC may have limited appetite to take the dispute to arbitration and may be amenable to changes in the CA that ensure a faster restart. While this gives the Sri Lankan government some leverage, President Xi's personal involvement also means that the project is a priority for the Chinese government and explains the considerable Chinese diplomatic pressure on Sri Lanka. Given Sri Lanka's indebtedness to China and its desire for continued financial support, Chinese diplomatic pressure should figure strongly in the Sri Lankan government's decision making. Therefore, it's neither realistic to cancel the project nor to threaten to do so.

2. Investor Sentiment

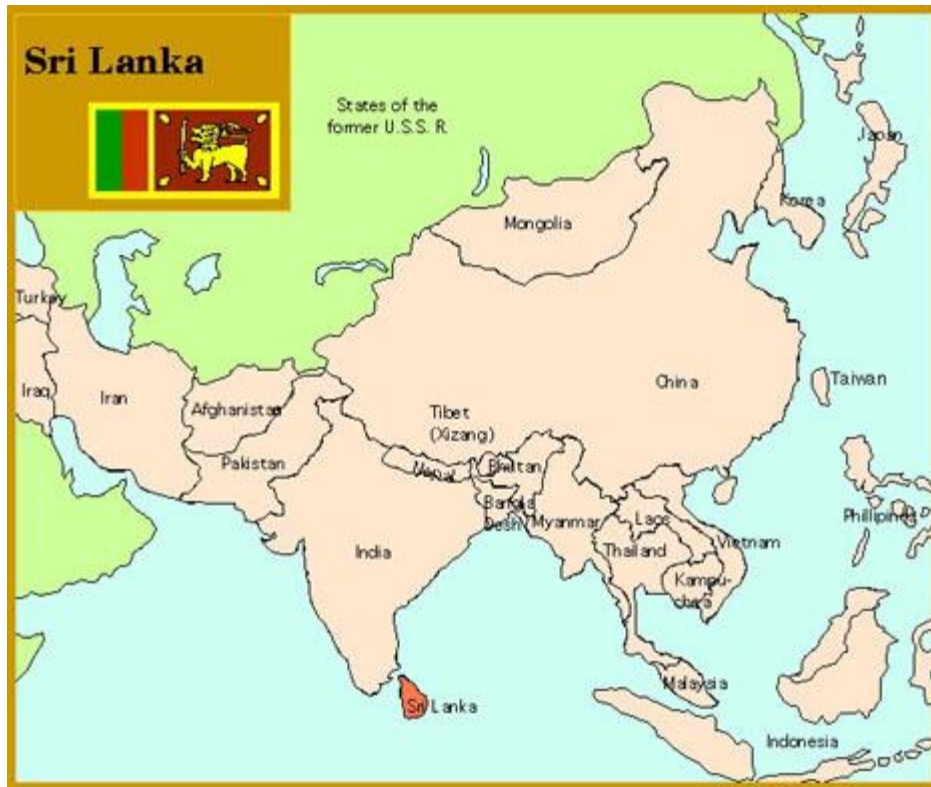
The Sri Lankan government should be concerned about the signal its negotiating strategy sends to international investors; it already has a reputation for inconsistent and abrupt policy changes and a history of state expropriation. Reneging or seeming to renege on the agreement signed with the PC will only underscore this reputation. Given the small size of its economy, Sri Lanka is dependent on external capital to drive growth. This is especially true with respect to infrastructure investments, an acute necessity. Moreover, China seems to be the most likely source for such investments in the future. Few other entities can match the Chinese in terms of capital outlay, appetite for risk, and long term ambition. Indeed, China's planned One Belt One Road could prove to be an economic bonanza for Sri Lanka. However, if negotiations antagonize the Chinese, they could very well look for more amenable partners.

Conclusion

Nayana Mawilmada has many factors to consider in deciding on a negotiating strategy and needs to find clever ways to capitalize on his limited negotiating strengths. As secretary-general of the UDA, he is well aware of the acute need for foreign investment to improve Sri Lanka's poor infrastructure, but he needs to foster the right kinds of investment. In this pursuit, he knows that the Colombo Port City deal will set a precedent for future agreements. He understands that he will have to make some trade-offs, but must act carefully to ensure the success of this and future projects. What negotiating strategy should he adopt?

Appendices

Appendix A: Locating Sri Lanka



Source: Wikimedia Foundation

Appendix B: Change in the Structure of the Sri Lankan Economy

Percentage Employed by Each Sector

Sector	1980	1990	2008	2010	2011	2012	2013	2014
Agriculture	46	37	33	33	33	31	30	29
Industrial	14	22	27	24	24	26	26	26
Services	40	41	40	43	43	43	44	45
Total	100	100	100	100	100	100	100	100

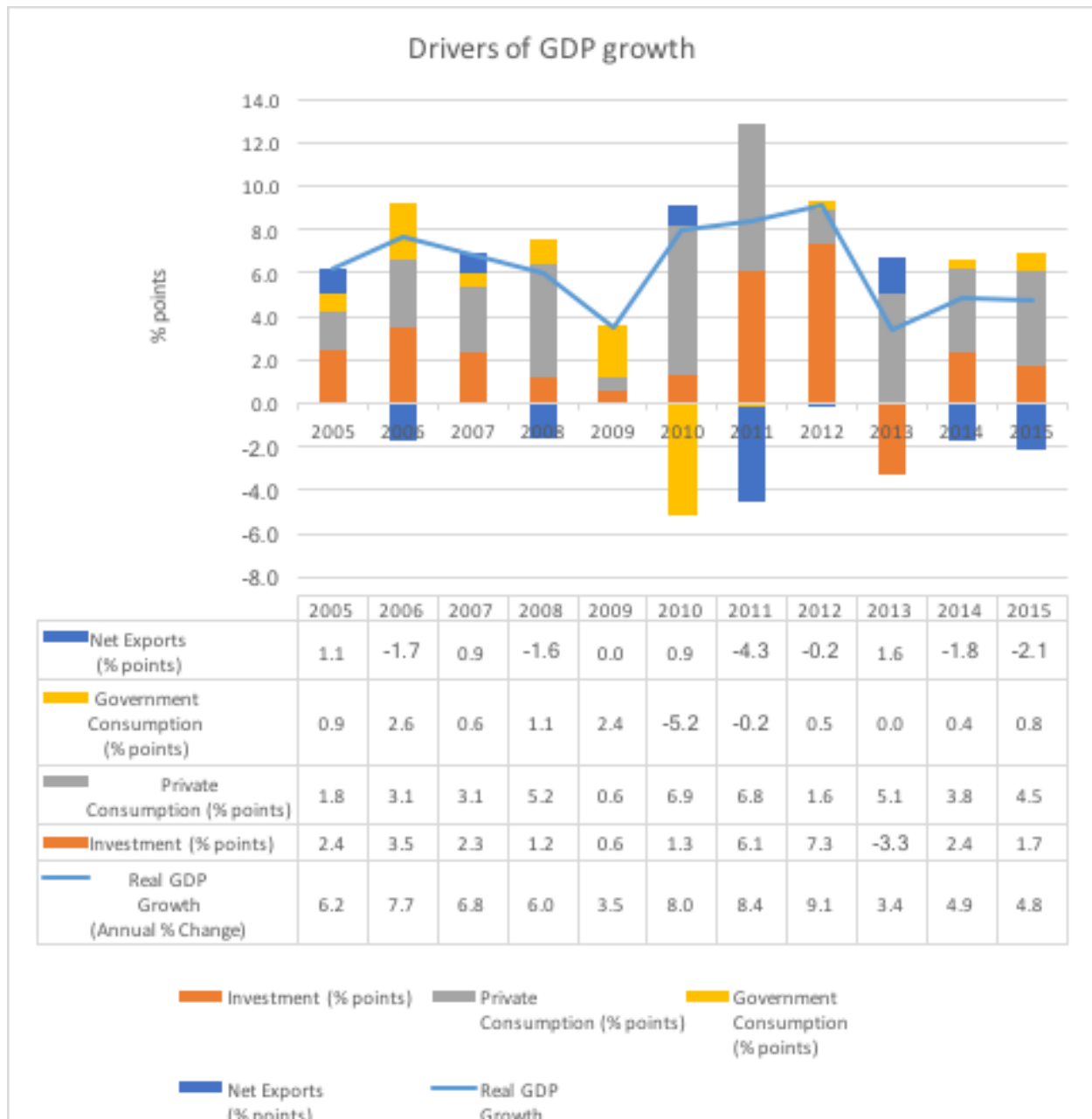
Source: Central Bank of Sri Lanka

Percentage Contribution to GDP by Each Sector

Sector	1970	1990	2000	2009	2011	2012	2013	2014
Agriculture	28.3	26.3	19.9	12.6	11.2	11.1	10.8	10.1
Industrial	23.8	26	27.3	29.7	29.3	30.4	31.1	32.3
Service	47.9	47.7	52.8	57.7	59.5	58.5	58.1	57.6
Total	100	100	100	100	100	100	100	100

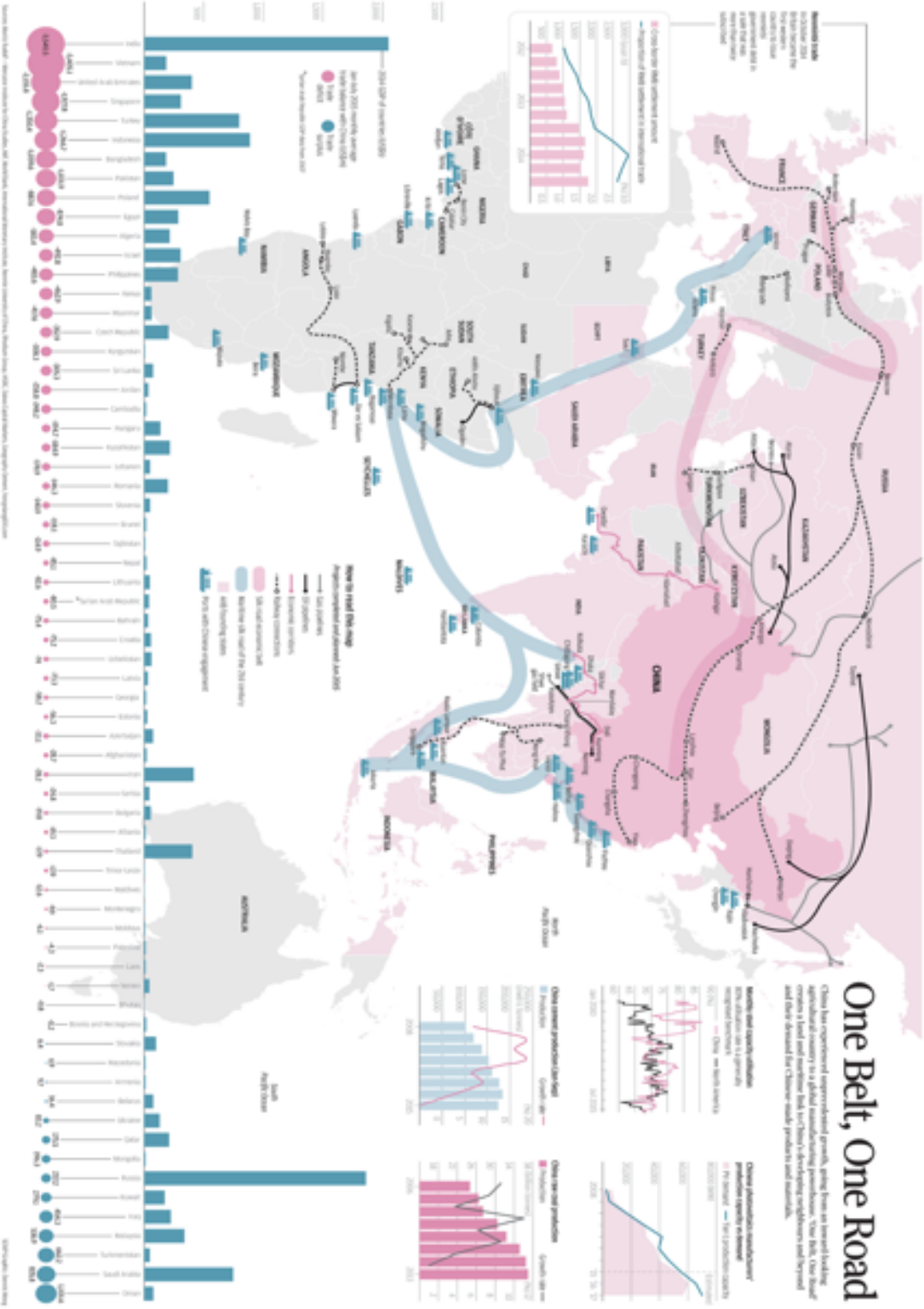
Source: Central Bank of Sri Lanka

Appendix C: Drivers of GDP Growth



Source: EIU Database; author's calculations

Appendix D: China's planned One Belt One Road Project



Source: South China Morning Post

Appendix E: Chinese Projects in Sri Lanka Since 2006 (Non-Exhaustive List)

#	Project	Type of Financing	Amount
1	Puttalam Coal Power Project Phase II	Preferential Buyer's Credit	\$891million
2	Road Projects in the North	Concessional Loan	\$570.3 million
3	Puttalam Coal Power Project Phase I	Buyer's Credit Loan	\$455 million
4	Hambantota Port Development Project	Buyer's Credit Loan	\$306.73 million
5	Colombo-Katunayake Expressway Project	Buyer's Credit Loan	\$248.2 million
6	Mattala-Hambantota International Airport	Concessional Loan	\$190 million
7	Lotus Tower	Buyer's Credit	\$104.3 million
8	Railway Locomotives	Concessional Loan	\$100 million
9	Bunkering facilities at Hambantota Port	Buyer's Credit Loan	\$65.1 million
10	15 Diesel Multiple Units	Concessional Loan	\$38.68 million
11	Railway passenger compartments	Concessional Loan	\$27.08 million
12	National Performing Arts Theater	Interest free loan	\$10.8 million
13	Select road projects	Grant	\$10 million
14	Maintenance and Upgradation of BMICH	Grant	\$8.4 million
	Total		\$5.69 billion

Source: Answer to question raised in Parliament; compiled by [transCurrents](#) and the author

Appendix F: Locating the Colombo Port City



Source: Supplementary Environmental Impact Assessment Report 2015

Endnotes

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