

## Rating Methodology – Hybrid Annuity Road Projects

[In supersession of “Rating Methodology –Hybrid Annuity Road Projects” issued in [August 2018](#)]

### Introduction:

The Government of India has approved the hybrid annuity model (HAM) to increase the pace of award and construction of national highways apart from de-risking the developers and lenders from inherent shortcomings associated with conventional toll and annuity based, design, build, finance, operate and transfer (DBFOT) model. National Highways Authority of India (NHAI) has started awarding hybrid annuity projects from January 2016.

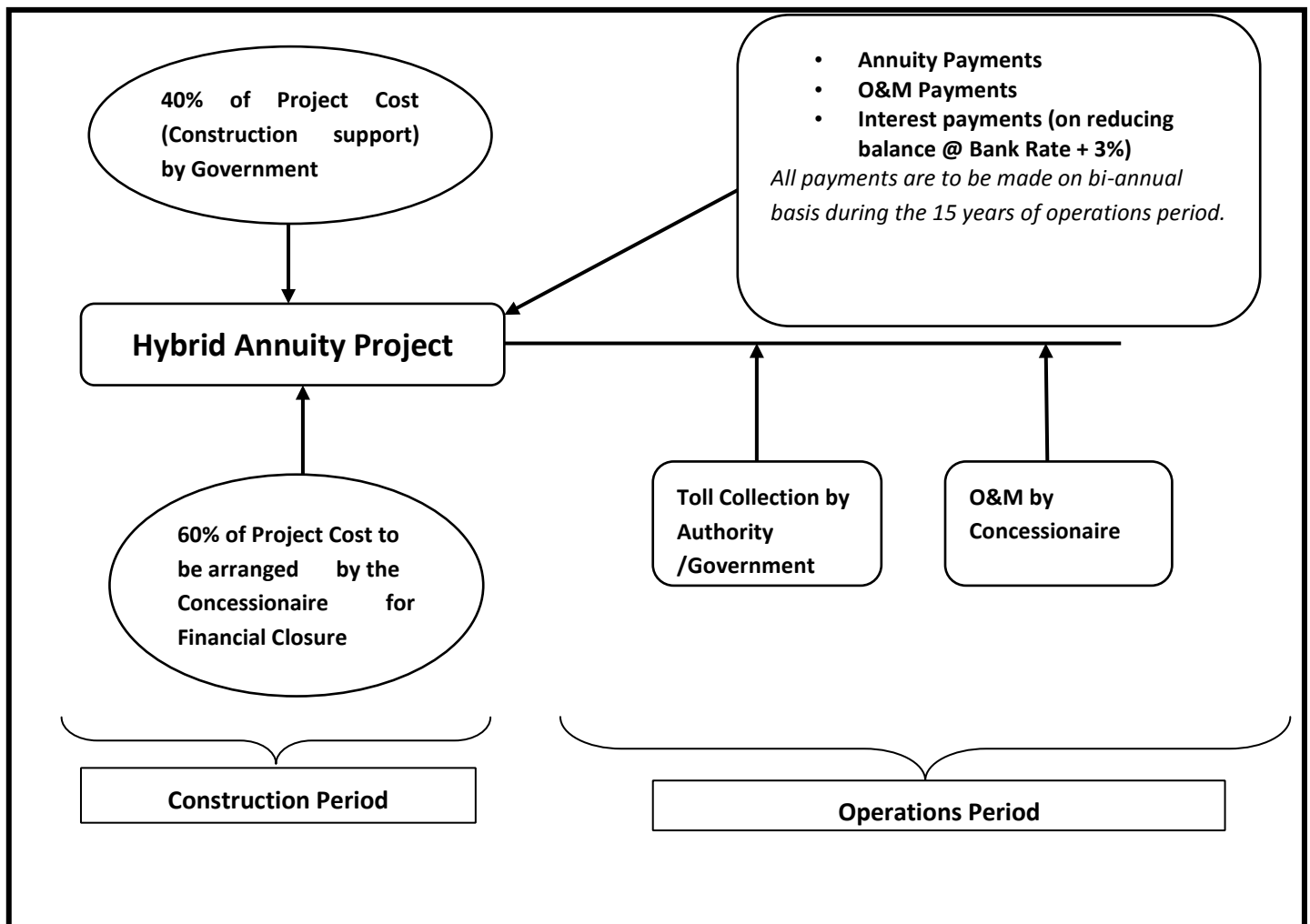
### The following sections cover salient features of hybrid annuity projects:

- 1. Bid parameter:** Project life cycle cost defined as Net Present Value (NPV) of the quoted bid project cost plus NPV of the operations and maintenance (O&M) cost for the entire operations period is the bid parameter. Bid is awarded to the developer quoting lowest NPV for project life cycle cost.
- 2. Cash Construction Support:** 40% of the bid project cost shall be payable to the concessionaire by the authority in five equal instalments linked to physical progress of the project. Concessionaire shall have to initially bear the balance 60% of the project cost through a combination of debt and equity.
- 3. Escalation clause in the project cost:** Project cost shall be inflation indexed (through a Price Index Multiple) (PIM), which is the weighted average of Wholesale Price Index (WPI) and Consumer Price Index (CPI) (IW) in the ratio of 70:30. The bid project cost adjusted for variation between the price index occurring between the reference index preceding the bid date and reference index date immediately preceding the appointed date shall be deemed to be the bid project cost at commencement of construction. Bid project cost shall be changed to variation in PIM on monthly basis till the achievement of commercial operations date (COD).
- 4. Stable cash flow of annuity payments:** Semi-annual annuity payments shall be made to the concessionaire by the Authority on completion of the project for the balance 60% of the final bid project cost. The annuity payments have been aligned with typical revenue profile for highway projects. Along with the annuity payments, interest shall be paid in the form of annuity on reducing balance of final construction cost. Interest rate for the same shall be Bank rate + 3 %.

## Rating Methodology – Hybrid Annuity Road Projects

5. **Assured O&M payouts by authority:** O&M payments shall be made to the concessionaire along with annuity by the Authority, in accordance with the amount quoted which will be inflation indexed. Concessionaire shall remain responsible for the maintenance of the project till the end of the concession period.
6. **Revenue for authority:** Toll collection shall be the responsibility and revenue of the authority.
7. **Concession Period:** It shall comprise construction period, which shall be project specific, with a fixed operations period of 15 years.

The following block-diagram provides an overview of the HAM Model.



## Rating Methodology – Hybrid Annuity Road Projects

### Comparison of features in concession agreement of hybrid annuity road projects vis-à-vis conventional DBFOT annuity road projects:

Particulars	Conventional DBFOT project	Hybrid annuity project	Impact Analysis
<b>Concession period</b>	Concession period is fixed from the appointed date and it comprises construction and operations period. This arrangement reduces the operations period if there is delay in achievement of provisional commercial operations date (PCOD). For example, concession period is 17 years from the appointed date which also includes construction period of 730 days. In this case, number of annuities to be received by concessionaire reduces from 30 to 29 if there is delay of six months in achievement of PCOD.	Concession period includes fixed operational period of 15 years from COD. Hence, numbers of annuities are fixed at 30 irrespective of delay in achievement of PCOD. However, Authority can levy damages or withhold performance securities for the delays attributed to concessionaire.	Positive for developers and lenders as it provides revenue visibility.
<b>Damages for delays attributed to the concessionaire</b>	If COD does not occur prior to 91 <sup>st</sup> day after scheduled project completion date (SPCD) unless the delay is on account of reasons solely attributed to the authority or force majeure, the concessionaire shall pay damages to the authority in a sum calculated at rate of 0.1% of the amount of performance security for delay of each day until COD is achieved.	In the scenario mentioned here, damages amount increases to 0.2% or 0.3% of the amount of performance security for delay of each day until COD is achieved. Upon concessionaire failure to pay damages, the same shall be paid with interest of bank rate plus 3% and shall be deducted from the annuity payments till the recovery of entire damages.	Positive for the authority and more binding on developers to complete the project within stipulated time frame.
<b>Bidding criteria</b>	Authority mentions project-specific Engineering procurement and construction (EPC) cost in the request for proposal. However, concessionaire can freeze the project cost based on technical viability on its own as it is not the bidding parameter. This results in wide deviations in the cost of project based on the assumption and margin estimated by the developers.	Bid project cost is finalized on the date of declaration of bidder offering lowest project life cycle cost (including construction cost and O&M cost) and hence the project cost cannot be changed except variations in PIM and change in scope. Bid project cost shall be inclusive of construction cost, interest during construction, working capital and physical contingencies except additional cost due to variations in PIM, change in scope, and change in law or force majeure. Furthermore, concessionaire is	Positive for authority and lenders. Nevertheless, this requires in-depth study of project cost by bidder based on the design and specification of scope of work.

## Rating Methodology – Hybrid Annuity Road Projects

Particulars	Conventional DBFOT project	Hybrid annuity project	Impact Analysis
		also required to extend additional performance security to the authority in the form of unconditional irrevocable guarantee from a bank if the bid project cost of the selected bidder is lower by more than 10% of estimated project cost of authority.	
<b>Deemed termination</b>	No such clauses.	In case, appointed date does not occur before the 1st anniversary of the signing of Concession agreement, the concession agreement shall be deemed to have been terminated by mutual agreement of the parties. Furthermore, if appointed date does not occur for the reasons attributed to concessionaire, authority shall en-cash performance security and additional performance security as damages thereof.	Protects the developer from inordinate delay in handover of land or regulatory clearances from the authority.
<b>Project milestone</b>	Project milestone linked to financial progress.	Project milestone linked to both physical and financial progress.	Positive for the authority and lenders as it protects them from any diversion of funds by developers.
<b>Release of construction grant</b>	Construction grant, if any, can be disbursed in the proportionate form of term loan disbursement after infusion of 100% contribution from sponsors.	Authority shall provide construction grant to the extent of 40% of the inflation indexed bid project cost. Construction grant is to be released in the form of five equal instalments subject to the achievement of physical progress of 10%, 30%, 50%, 75% and 90% respectively.	Positive for developers and lenders as funding of the 40% of the project cost from the authority is expected to reduce the funding need. Further, milestone for release of grant is relaxed from 20%, 40%, 60%, 75% and 90% respectively which is expected to reduce cost of borrowing in the initial phase.

## Rating Methodology – Hybrid Annuity Road Projects

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<b>Mobilization advances</b>	Concessionaire can grant mobilization advances to EPC contractor from the cost of project. No mobilization advance is granted from authority during construction period.	Mobilization advances can be availed from authority up to 10% of bid project cost @ bank rate of RBI compounded annually during construction period. Out of 10% mobilization advances 5% shall be available at any time after appointed date and balance 5% within sixty days from appointed date. Mobilization advances shall be released within one month from request by concessionaire. Such mobilization advances are to be deducted in four equal instalments from construction grant by authority. Interest on such advances shall be recovered as the fifth and final instalment upon expiry of 120 days commencing from the recovery date of fourth instalment.	Positive for developers as mobilization advances are available at bank rate. Low cost mobilization advances in the early stage of construction is expected to reduce interest during construction.
<b>Delay in handover of balance right of way (RoW) post appointed date(i.e. handover of 80% land)</b>	Concessionaire is required to complete the work on all lands for which RoW is granted within 90 days of appointed date and achieve PCOD after completing such work. However, final COD can't be issued even though work is delayed due to reasons attributed to the authority.	In the event the authority is unable to provide remaining site within 180 days from the appointed date, the remaining site shall be removed from the scope of work under the provision of change in scope. Hence, final COD can be achieved after completing the 100% work on the site available to concessionaire within 180 days from appointed date.	Positive for developers and lenders as it provides better clarity and mitigates the construction risk to an extent. <b>However, inordinate delay in the de-scoping despite lapse of 180 days from appointed date can hamper the project progress.</b>
<b>Bonus payment on early completion</b>	Bonus upto maximum one annuity (six months) shall be paid by authority along with first annuity subject to achievement of final COD(100% completion of work on the entire project length). Furthermore, annuity payment shall commence only after six months from scheduled project completion date (SPCD).	In the event concessionaire shall achieve COD on 30 or more days prior to scheduled completion date, authority shall pay bonus equal to 0.5% of 60% of bid project cost for 30 days by which COD preceded SPCD. Thereafter, the bonus shall be calculated on pro-rata basis. Bonus shall be due and payable along with the first annuity payment. Annuity payment shall commence within 15 days of 180th day from COD.	Positive for developers as bonus payment can be received even after completing 100% work on the land available within 180 days from appointed date.

## Rating Methodology – Hybrid Annuity Road Projects

Particulars	Conventional DBFOT project	Hybrid annuity project	Impact Analysis
<b>Release of performance security</b>	Performance security can be released after one year from appointed date or achievement of 20% of financial progress by concessionaire.	Performance security can be released after one year from appointed date or achievement of 30% of financial progress by concessionaire. Additional performance security can be released after achievement of milestone-III (i.e. 75% of physical progress).	More binding on developer and increases performance obligation of developer.
<b>Change in scope</b>	Authority shall pay the concessionaire any increase in scope of work approved by independent engineer. In the event of reduction in scope of work due to reasons attributed to authority or force majeure, annuity payment shall be reduced based on the cost assessed by independent engineer.	Same clause in case of increase in scope. While in case of reduction in scope due to reasons attributed to the authority, cost of such reduced cost is to be accessed by the independent engineer and bid project cost would be reduced by 107.54% of the civil cost for reduced scope. O&M payments shall also be increased or reduced in proportion of change in the length of project highway due to change in scope.	Neutral. Further, alignment of O&M payments with project length is favourable for the authority.
<b>Termination payment under concessionaire event of default prior to COD</b>	No termination payment.	Termination payment is allowed subject to achievement of second milestone for the payment of grant (i.e. 40% of the physical progress). Termination payment shall be paid in the range of 50-80% of the debt due or 9-32% of the bid project cost whichever is less minus insurance cover depending upon achievement of second to fifth milestone for release of construction grant.	Lenders are not entitled for termination payment till the achievement of 40% of physical progress which could require more than one year time. However, clauses of termination payment are less meaningful from credit perspective as rating methodology is based on probability of default and not loss given default.

### HAM- credit perspective

#### 1. Funding risk

Aggressive bidding, high debt levels and increasing working capital intensity as well as execution challenges had collectively affected the credit profile of prominent infrastructure developers / sponsors in the past. Deterioration in the credit profile of some of the large developers has increased the funding risk during construction phase and reduced participation of developers in DBFOT model.

## Rating Methodology – Hybrid Annuity Road Projects

At the same time, developers with strong execution capability and good financial flexibility are better placed to bag the sizeable opportunity in the road sector. HAM model entails lower sponsor contribution during construction period considering 40% construction support from authority and hence mitigates the funding risk to an extent. Furthermore, provision of mobilization advances at bank rate from authority is also expected to provide some support to concessionaire in the initial phase of construction. CARE expects equity commitment to be to the extent of 12-15% of project cost for HAM projects. However, delay in the tie up and release of term debt as well as bank guarantee for mobilization advances in current challenging fund raising environment can impact the project progress and needs to be monitored.

### 2. Sponsor evaluation

CARE Ratings considers credit strength of sponsor as important parameter for conventional DBFOT projects. In case of HAM projects, sponsor's project execution track record and commitment to support the project in exigencies are also important apart from sponsor's financial flexibility in light of following:

- Focus on cost based bidding requires in-depth assessment of project cost and O&M cost
- Cost competency remains crucial to generate envisaged Internal Rate of Return (IRR)
- Emphasis on physical progress for release of grant, increases reliance on sponsor
- Inflation indexed bid project cost protects the developers against price escalation to an extent. Nevertheless, extent of price escalation is difficult to factor at the time of financial closure. Hence, any variations in cost due to higher than envisaged price escalation is required to be funded through sponsors.

#### ***CARE Ratings considers the following points as a mitigation tool towards evaluation of sponsor risk:***

- Demonstrated execution track record of sponsor with lower reliance on subcontracting
- Sponsor's track record for completing the projects within envisaged time and cost parameter and signing of fixed price EPC contract with reputed EPC contractor or sponsor having good creditworthiness
- Sponsors' track record of supporting the projects in case of exigencies
- Ownership of the project Special Purpose Vehicle (SPV). SPVs with single sponsor owning majority stake is considered better as compared to joint ownership
- Corporate guarantee of strong sponsor till execution of project and receipt of first annuity
- Sponsor's financial flexibility and creditworthiness

Despite non-recourse nature of the debt of the SPV, financial flexibility and execution track record of sponsor are important in pre-COD phase. Furthermore, sponsor is required to fund cost overrun, if any

## Rating Methodology – Hybrid Annuity Road Projects

and shortfall, if any till receipt of first annuity as per sponsor support agreement entered with lenders.

### 3. Project implementation risk:

Project implementation risk is partially mitigated due to availability of 80% length of project before appointed date and NHAI's efforts for providing faster clearances. Nevertheless, declaration of appointed date on availability of 80% land on 3G basis (wherein payment of compensation of is pending to land owner unlike hand over of encumbrance free 80% land on 3H basis) can impact the project progress in case of hindrances or subsequent protest from land owner.

Provision of deemed termination and clauses to issue final COD in case of completion of 100% work on the lands available within 180 days from appointed date also protect the interests of developers and lenders to a considerable extent. Nevertheless, delay in de-scoping of un-available land even after lapse of considerable time post 180 days from appointed date can impact the project progress and increase the construction risk to an extent. NHAI and concessionaire sometimes opt for de-linking of the unavailable land considering practical difficulties in de-scoping. Under de-linking, provisional COD (PCOD) may be declared upon completion of 100% work on available land while concessionaire is required to execute the work on remaining land whenever it is handover by NHAI even post PCOD.

As compared with conventional BOT projects, challenges for developer cum EPC contractor to execute the project within envisaged cost, are greater as the project is awarded under competitive bidding based on the cost parameter as compared with conventional BOT project awarded based on the parameter of premium payment/grant offered to the authority. Further, construction risk increases in cases where sponsor has limited track record of execution of complex projects.

Construction grant is expected to be disbursed in instalment upon achievement of milestone based on the physical progress. Moreover, lender would disburse the project loan only upon achievement of desired project debt/equity by concessionaire. Consequently, working capital requirement for the EPC contractor or interim funding support from concessionaire till release of grant from the authority and release of term debt is expected to remain moderately high. However, relaxation in terms for release of grant and mobilization advances in recent model concession agreements is expected to provide relief to EPC contractors and provide cash flow cushion during construction period.

#### ***CARE Ratings considers the following points for analysis of project implementation risk:***

- Developer's track record in execution of large sized EPC projects



## Rating Methodology – Hybrid Annuity Road Projects

- Financial flexibility of sponsor and EPC contractor to fund increase in working capital due to delay in receipt of construction grant
- Availability of Right of Way (RoW) on 3G and 3H basis in terms of both length and area
- Gap between NHAI Project cost and bid project cost and reasons in case of large variations between NHAI project cost and bid project cost.
- Gap between completion cost for financial closure and bid project cost and analysis of reasons in case of large variations between NHAI project cost and completion cost.
- Gap between Lowest bidder (L1), L2 and L3 bidders
- Achievement of financial closure and status of funds deployment by sponsor and lender
- Status of clearances including forest clearance
- Complexity of the project road in terms of presence of structural work and terrain
- Stage of project progress and current project progress against stipulated progress
- Status of de-scoping or de-linking of unavailable land and its impact on project progress
- Status of approval of Extension of Timeframe (EOT) by NHAI, if any
- Details of damages levied in case of delay in achievement of project milestones or PCOD, if any.

### **CARE Ratings considers the following aspects as potential mitigants w.r.t project implementation risk:**

- Demonstrated track record of EPC contractor in executing large sized projects
- Good financial flexibility of sponsor and EPC contractor
- Availability of more than 80% land on 3H basis or in terms of length available for execution basis and timely de-scoping of unavailable land
- Presence of fixed price EPC contract
- Sponsor support undertaking to fund cost overrun and any cash deficit during under construction phase (including due to delay in release of grant)
- Corporate guarantee of sponsor till COD and receipt of first annuity
- Reasonable gap between NHAI project cost and bid project cost as well as L1 and L2
- Presence of minimal structural work

#### **4. Cash flow risk:**

During operational phase, cash flow is assured in the form of annuity payments from NHAI (rated CARE

## Rating Methodology – Hybrid Annuity Road Projects

AAA/Stable) on semi-annual basis covering 60% of the project cost along with interest at bank rate plus 3%. This assures cash flow during operational period.

### 5. O&M risk:

O&M risk is also partially offset due to fixed payment in the form of annuity which is also indexed to inflation movements with the base year considered as the year of bidding. However, developers would still face the risk of sharp increase in the O&M cost due to more than envisaged wear and tear of the project stretch. Increase in O&M cost other than inflation indexation during operational period and consequent breach of performance obligations by developers in light of their lower contribution can result in deduction of annuity payments. Hence, aggressive bidding in O&M cost due to front loading of EPC cost can result in moderate debt coverage indicators in operational period. This risk increases in case of sponsors with moderate to weak credit profile.

O&M cost of the stretch depends on the traffic, terrain and quality of road construction. O&M cost increases for the stretches dominated by heavy vehicles and highways falling under higher economic resilience area. O&M expenses generally remains lower for the state highways with relatively lower traffic. In case the road stretch is present in zones of high precipitation, possibilities of moisture percolating to bituminous layer is higher which in turn results in higher O&M and major maintenance expenses. Quality of road construction depends on design capacity of the road vis-à-vis actual traffic on the stretch and roughness index (ranges between 2000-2500 mm/km; lower the better). Furthermore, O&M cost is expected to be significantly lower in case of rigid pavement as compared to flexible pavement.

#### **CARE Ratings considers the following points for analysis of O&M risk:**

- Difference of O&M cost between L1, L2 and L3 and justification for wide variations; if any
- Adequacy of gap between bid project cost and completion cost in case projects are awarded with lower O&M annuity
- Comparison of O&M and MM cost with other projects
- CARE Ratings also considers fixed price O&M contract with experienced contractor post COD and experience of sponsor in managing operations of BOT projects as some of the effective strategies to mitigate O&M risk. Further, cash flow cushion during operational period improves despite lower bidding in O&M annuity in case total project cost considered for financial closure (i.e completion cost) is considerably lower than bid project cost. Further, cash flow cushion also varies based on actual completion cost post COD as against inflation indexation assumed, if any in base case business model.

## Rating Methodology – Hybrid Annuity Road Projects

### 6. Interest rate risk:

As per model concession agreement, Interest annuity shall be paid on reducing balance of bid project cost. Interest rate for the same shall be Bank rate + 3%. However, considerable lag between fall in bank rate and reduction in base rate by lender can reduce the margin of safety and increase interest rate risk to an extent.

For example, bank rate has reduced from 6.75% per annum to 6% per annum in last two years without corresponding reduction in interest rate for term loans raised at SPV level. Nevertheless, developer has margin of safety in the event of replacing the bank loans with long-term instruments at lower rates after establishment of some operational track record in light of strong credit quality of annuity provider (i.e. NHAI, rated 'CARE AAA; Stable').

### 7. Liquidity support mechanism:

Creation of Debt Service Reserve Account (DSRA) especially prior to commercial operations date (COD) and major maintenance reserve account (MMRA) from project cash flows would continue to provide comfort to the ratings.

## Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE Ratings analyses each of the above factors and their linkages to arrive at the overall assessment of credit quality of an issuer.

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