

NAM THEUN 2 HYDROELECTRIC PROJECT

**MEMORANDUM OF LEGAL ISSUES IN RELATION TO THE
CONCESSION AGREEMENT**

An Analysis

For

Mekong Watch

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INTRODUCTION

This report presents an analysis of the Concession Agreement (“CA”) between the Government of the Lao People’s Democratic Republic (“GOL”) and Nam Theun 2 Power Company Limited (“NTPC”) and identifies the principal legal issues that may be of interest to outside observers. It particularly focuses on the undertakings of the GOL, the risk allocation between the GOL and NTPC and certain clauses that can affect the ability of the GOL to make changes to the Project for the benefit of its citizens.

The CA relates to the construction, operation and ownership of a hydroelectric power plant and its transfer back to the GOL on the expiry date of the CA (the “Project”). The constitution of the Lao People’s Democratic Republic (Lao PDR) explicitly permits private enterprise and foreign investment. However, in March 2001, a presidential decree on the implementation of the Foreign Investment Law required special presidential approval for any investments that relate to natural resources, environment, public health and national culture.¹ The use of this power of presidential decree indicates that the GOL wants both to retain an ability to filter out undesirable investors in areas that are of strategic importance, while also assuring investors that it will relinquish its normal regulatory powers over projects once the investment is approved, as indicated in the CA. The CA was signed between the GOL and NTPC in 2002², where the GOL granted NTPC the right to develop, own, finance, construct, operate the Project and transfer it to the GOL at the end of the 25 years of concession period.

The CA is a highly complex document, which appears to be generally in a form that will allow international financing of the Project through giving investors maximum protection from the project risks. It aims to strike a balance between the rights and obligations of the parties. However, a legal analysis of the structure raises questions in relation to the role assumed by the GOL as a Project participant and the sovereign power that should oversee the implementation of the Project. This is especially the case when we consider that the CA has the same ranking as a law of the Lao PDR for the next 25 years. As the sovereign power in Lao PDR, the GOL is obliged to oversee the implementation and operation of the Project. However its role as a Project participant, aiming to share in profits, align it with the rest of the investment community and can make it difficult for the GOL to take an impartial position when it comes to balancing commercial returns against environmental/social concerns and protecting the rights of affected communities. The GOL should separate its role as a government, with an overriding obligation to serve the interests of its citizens, from its role as a commercial body, with an interest in the commercial success of NTPC. The CA combines the two roles, and in the process allows the latter to dominate the former. The GOL is putting itself in a position whereby there will be no higher authority in the country to check and regulate the use of power by the NTPC, with the result that commercial objectives of the project are likely to be given systematic priority over social concerns.

¹ From the web site of the Department of Domestic and Foreign Investment of the Lao People’s Democratic Republic at <http://invest.laopdr.org/index.htm>

² A concession is essentially a licence granted by a governmental authority.

PART I: ANALYSIS OF LEGAL ISSUES

1. Stabilization, Political Risk and the Change Of Lao PDR Law

There are several concrete impacts of the GOL's confusion of its commercial and governmental roles. The first is that the GOL has created a substantial obstacle to its ability to regulate one of the most economically and environmentally significant projects in the country. The GOL has created this obstacle by signing a CA which contains the promise that the GOL will not increase the cost of doing business by applying fresh law or regulations to the project. Secondly, this restriction potentially stands in the way of the GOL meeting its future obligations under international environmental and human rights law. These obligations carry on applying to Laos, but the country may have to pay out compensation to the private investors if it chooses to implement them. The GOL is therefore caught in a vice: on the one hand it has to respect, protect and fulfill the rights of its citizens; and on the other it will have to pay a heavy price in compensation for doing so.

Long-term investment projects have a serious need for stability since key financial requirements of the investors include assured (and preferably rapid) investment recovery through a steady stream of income, which brings in cash flow over a long period of time.³ Therefore, the Project has a carefully negotiated risk allocation scheme. Financiers of the Project will commit funds on the basis of the commercial viability of the project, i.e. revenue projections and risk allocation. Should the project fail, the financiers will have limited recourse to the assets of the companies, which are the shareholders of NTPC.⁴

In 30 days after the Financial Close, which took place in May 2005, NTPC is obliged to reimburse the Sponsors⁵ for the development costs, which is the expenditure incurred by NTPC shareholders in moving the Project forward. The Shareholders Agreement specifies the development costs which will be reimbursed by NTPC (Article 3.1(f)). The GOL is also involved in the Project as a shareholder and is represented by Lao Holding State Enterprise (LHSE), which owns 25% of NTPC.⁶ When the financing for the Project occurs the LHSE will receive \$20,000,000 from the sponsors as consideration for the concession, as partial reimbursement of funds previously expended by the GOL and as a compensatory payment for the GOL's loss of future benefit from any residual land, timber, mineral, terrestrial or aquatic biodiversity or ecotourism assets or resources arising as a result of the GOL's grant of the concession (Article 19.1(e)).

³ M. Coale, "Stabilization Clauses in International Petroleum Transactions" (Denv. J. Int. L.&Policy, Vol 30:2), p. 219.

⁴ 30% of the Projects costs are met by the Sponsors and 70% of it by the financiers. For more information about the financing see <http://www.namtheun2.com/partners/partfinance.htm> and [http://www.namtheun2.com/mediango/pdffiles/0505%2003%20-%20NTPC%20signs%20US\\$%201%20billion%20loan%20agreements.pdf](http://www.namtheun2.com/mediango/pdffiles/0505%2003%20-%20NTPC%20signs%20US$%201%20billion%20loan%20agreements.pdf)

⁵ Sponsors are Electricité de France International (35%), Electricity Generating Public Company Limited, a company duly incorporated in Thailand (25%) and Italian-Thai Development Public Company Limited (15%) who are the Shareholders of NTPC.

⁶ A. Fozzard, *Technical Brief: Revenue and Expenditure Management, Nam Theun 2 Hydroelectric Project*, The World Bank, March 16, 2005.

The World Bank and the Asian Development Bank will be involved in the project to provide guarantees and other forms of financial assistance. These guarantees are usually known as political risk guarantees. Political risk is the risk that the laws of a country will unexpectedly change to the investor's detriment after they have invested capital in the host state, thereby reducing the value of the investment. Essentially, political risk is the risk of government intervention.⁷ Investors try to deal with these possibilities either by spreading the risk; insuring against the risk; defending against the risk or creating contractual mechanisms for risk management.

Stabilization by Contract

Reducing the risk by contract involves incorporating stabilization clauses in the concession agreement which require the host state to freeze the applicable law to the given project. In the event that the effect of any change in Lao PDR Law directly results in the project costs being increased or the project income being decreased by an amount in excess of certain thresholds, the GOL may a) elect to exempt the Company from the Change in Lao PDR Law concerned or b) make a Change in Lao PDR Law to reverse or c) negate the effect of the Change in Lao PDR Law concerned or d) pay compensation. Disputes arising from the Change in Law are referred to an Expert⁸ (Article 6.3(d)). If the GOL does not pay the compensation amount, NTPC can get a suspension of its obligations under the CA (Article 6.4). Other disputes under the contract are to be referred to international arbitration (Articles 40, 43).

These are mechanisms built into the CA to mitigate the changes in Lao PDR Law in order not to disturb the financial balance of the Project. Although the stabilization clause of the CA is a comprehensive and detailed one, the very presence of it raises the following questions: if the GOL decides to raise environmental and human rights standards in the future and wants to enact progressive laws for that, will it have to pay a price in compensation to investors for doing so? Or can it avoid paying that price by letting its commitments to protecting human rights and the environment slide? Most governments in poor countries are given an incentive by this agreement and others like it to opt for the latter course.

The argument usually made by investors for allocating this risk to the GOL is that traditionally this is a matter for which host governments have responsibility, such that the investment is given protection from host governments' changes of policy. However this view is contestable. By signing up to this stabilisation clause the GOL is allowing its changes of policy, across the full spectrum of governmental concerns, to be treated as risks from which business is entitled to protect itself. However, it is not clear that this approach can be reconciled with the obligations a state has arising under international human rights law. Within domestic law, contracts between private parties and governments are normally subject to the principle that the latter can unilaterally refuse to be bound by the contract if it can be shown that it is exercising its governmental prerogative to act in the public interest. The device used in this concession agreement, and others like it, in order to avoid the impact of this principle

⁷ P. Comeaux, S. Kinsella, "Reducing Political Risk in Developing Countries: Bilateral Investment Treaties, Stabilization Clauses, and MIGA & OPIC Investment Insurance" (New York Law School Journal of International and Comparative Law, 1994), p. 1.

⁸ An expert is appointed for the purposes of resolving disputes about the interpretation and application of technical terms, as provided in relevant clauses in the CA..

on these investors is a) to declare that the “the GOL agrees that its obligations under this Agreement are private and commercial in nature, rather than public or governmental...” thereby waiving its right to refuse to be bound by an arbitral award (Article 40.5); and b) to place control of disputes under international arbitration (Article 43), a jurisdiction which – since it is outside domestic law - is more resistant to claims by governments that they have a sovereign power to refuse to be bound by contracts. Whether these ‘internationalized’ contracts are legally effective to attain their objectives is a matter of dispute among experts, but they have an important de facto power because of their endorsement by the international lending community.

It is important, in agreements framing projects such as this, that it be made clear precisely how much the GOL is relinquishing of its traditional responsibility to its population. Although one of the parties to this investment agreement is a private entity, the other is a state acting in a sovereign capacity. It undertakes obligations with respect to its sovereign powers, that is to say, powers that are essential for the protection and welfare of its people. Although Lao PDR possesses certain rights and privileges which private persons lack, at the same time it has certain obligations to further the public interest, which no individual has. The object itself of the parties’ contractual “bargain”, therefore, is closely related to the fundamental interests and rights of the Lao PDR’s citizens. It is in their interest that the GOL is acting when encouraging foreign investment; and it is also in their interest that the GOL should place restrictions on certain functions of that investment.

The Impact on Human Rights

The International Covenant on Economic, Social and Cultural Rights (**ICESCR**) (signed by the Lao PDR but not ratified yet) requires parties to it to take steps to achieving progressively the full realization of the rights recognized in the covenant by all appropriate means, including particularly the adoption of legislative measures. The stabilization clauses could seriously affect the ability of the host state to satisfy this requirement of progressive realization, by preventing it from applying new laws and regulations to the project that have an impact on the expected costs or income of the project, as these would give rise to an obligation to pay compensation for losses sustained by NTPC.⁹ This freezing of the capacity to change law will mean that the GOL will not be able with its domestic law to hold the project to progressively increasing standards of health and safety; environmental controls; and other protective standards that its population are entitled to elsewhere in the country.

It is not likely that the international arbitrator would declare changes in GOL law to be invalid, even though the changes were in violation of the stabilization clause. The reason is that such a comprehensive challenge to local legislation coming from a contract between the state and a private party could trigger serious domestic constitutional issues, and in any event many such legal changes are intended to govern the whole country, and not simply one project. The crucial interest of the investors is to make sure that their particular project is free from further regulation, and the threat of compensation is in part intended to act as a deterrent. This highlights a question of fundamental importance, affecting many such projects throughout the world: is it

⁹ Amnesty International, “Human rights on the line-The Baku-Tbilisi-Ceyhan Pipeline Project”. For text see <http://www.amnestyusa.org/business/humanrightsontheline.pdf>

legitimate for an investor to require such compensation in the first place? If so, under what conditions, and what are the proper limits of this obligation for a sovereign country? It is a basic principle of the public law in most countries that while wholesale destruction of the value of an asset can trigger an obligation to compensate, there remains a margin of power to alter regulations of investment without paying compensation, even though an alteration hurts the value of an investment.¹⁰

These principles highlight the fact that the obligation placed on the GOL to compensate NTPC for changes in Lao law is far more restrictive than anything the US government (as well as EU and other states from which investment originates) could or would accept for itself under its domestic law. The Concession Agreement's stabilization clause is only preserved from invalidity by the device of placing the agreement under the jurisdiction of international arbitrators, as indicated above. The agreement stipulates several bands of change in value/increase in costs for the project, and compensation is tied to these (Article 6.3). The compensation requirement begins at changes that impose \$250,000 of increased costs or decreased income. This is an extremely small change, as a proportion of the total income of the project -- well below the threshold of 'substantial reduction of value' that states normally require before they will compensate for interference with an investment.

The need for host countries to remain flexible, and to avoid the restrictions imposed by investment agreements such as this one, has recently been highlighted by UN High Commissioner for Human Rights, in a report, *Human Rights, Trade and Investment*, para 31(c). The report highlights the importance of preserving:

"...[a] careful balancing of States' rights and investors' rights with a view to promoting respect for human rights and development. Getting the right balance could take time, and furthermore might change over time. ... at times, modification of commitments to liberalize investment might be necessary to protect against unforeseen consequences of liberalization which disproportionately affect the poor, disadvantaged or vulnerable."¹¹

The Commission goes on to point out that sufficient flexibility for the state might require that it be free of having to pay compensation for changes it introduces to the terms governing an investment. It says that:

"... [w]hile compensation might be appropriate in some cases, a human rights approach would raise the question as to the effect that a requirement to give compensation, or a threat of compensation, might have on the ability or willingness of a State to take the necessary action to promote and protect human rights. Importantly, a human rights approach would seek to avoid the situation where a requirement to pay

¹⁰ As the principle was articulated in a famous US case, "Government hardly could go on if to some extent values incident to property could not be diminished without paying for every such change in the general law. Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 43 S.Ct. 158, 67 L.Ed. 322 (1922) The US constitutional principle is summed up in more general terms as follows: "One of state's primary ways of preserving public wealth is by restricting uses which individuals can make of their property and these restrictions are properly treated as part of the burden of common citizenship; takings clause did not transform that principle into one requiring compensation whenever state asserts its power to enforce it. "U.S.C.A. Const. Amends. 5, 14.

¹¹ High Commissioner for Human Rights E/CN.4/Sub.2/2003/9, 2 July 2003: *Human Rights, Trade and Investment*

compensations might discourage States from taking action to protect human rights - such a situation could reinforce the status quo or exacerbate human rights problems.”¹²

The Effect of the Concession Agreement on the GOL’s other International Commitments

The GOL also warrants that the execution and performance of the CA by the GOL will not conflict with or contravene any international agreement to which the GOL is party (Article 4.2(h)). This warranty can contravene the obligation undertaken in the ICESCR and the GOL may therefore consider not ratifying the ICESCR until the end of the concession period. This again highlights the potential damage that these agreements, seeming to be confined to commercial matters, can have. They can shrink the willingness of a host state to stay abreast of human rights and environmental commitments. Not only will those standards not be fully embedded in its domestic law; the state will avoid fresh international commitments so as to avoid any pressure to change that domestic law in the first place.

Possible Reforms in the Stabilization Strategy

It is possible to alter the extreme terms of the stabilization clause as found in this agreement, without abandoning the valid commercial objectives of stabilization. A precedent is to be seen in the BTC pipeline Host Government Agreement, as qualified by the BTC Human Rights Undertaking.¹³ By the Undertaking, the Consortium building the pipeline has agreed not to seek compensation under the stabilization clause of the Host Government Agreement, when the host government has changed the law applying to the pipeline in virtue of its obligations to conform with international human rights, environmental, or health and safety requirements.

PART II: FURTHER ELEMENTS OF THE LEGAL FRAMEWORK

1. Lao PDR Law and the Project

It is important to notice that the NTPC undertakes to operate and maintain the Project in compliance with several important and detailed standards: the Environmental and Social Objectives; Good Operating Practices; the World Bank’s Dam Safety Policy; the Performance Standards; the then current Health and Safety Plan; Company’s Environmental Monitoring and Management Plan; Emergency Contingency Plan. However, none of this can be made the subject of fresh internal regulation by the Lao PDR when doing so adds to the cost of doing business for the investor. If the state does impose such new regulations, it must compensate; or if it wants to avoid this result, then it must rely on the willingness of the NTPC to do as it says it will, backed with an eventual appeal to an international expert to resolve a dispute about the interpretation of these standards. Were the GOL to want to take more control of the process by using its own regulators, this route might be barred by

¹² Ibid (para. 31 c)

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<http://www.caspiandevlopmentandexport.com/ASP/LatestNews.asp?ArticleID=8&Language=English>

the statement in the CA that where there is any inconsistency between any of the documents mentioned above and the express provisions of the CA, the latter will prevail (Article 17(a)). This, as has been seen, prevents the application of any fresh domestic rules that affect the economic equilibrium of the project.

2. Change of ownership

The GOL is obliged not to unreasonably refuse or delay the giving of its consent to any ownership change of NTPC contemplated by the Shareholders. Although this change is not supposed to affect the rights of the GOL under the CA, the GOL has very little say in the future of the Project once it has signed the CA (Article 3.3 (b)).

3. Taxes

For foreign investments involving the exploitation of natural resources and/or energy generation, sector-specific taxes and royalties are prescribed in the project agreements entered into between the investors and the GOL. In highly exceptional cases, and by specific decision of the GOL, foreign investors may be granted special privileges and benefits. These can include a reduction in or exemption from the 20% profit-tax rate and/or the 1% import-duty rate. Such reductions and exemptions are normally given because of the large size of an investment and the significant positive impact that it is expected to have upon the socio-economic development of the Lao PDR.¹⁴ NTPC is exempt from the profit tax for the first 5 years of the Project. Between year 5 and 12 it will pay 12% of its profits as tax, between 12th and 18th year it will pay 15%. For the rest of the concession period, 30% of its profits will be paid as tax.

Apart from that, NTPC is exempt from some of the customs duties, Business Turnover Tax, Minimum Tax, Dividend Withholding Tax, Withholding Tax on interest, fees and other payments to Financiers and Credit Insurers, any withholding tax in relation to any security fee or intellectual property fee, any natural resources tax or royalties on the cost of producing electricity for export, document registration fees, including notarisation fees, in excess of USD20, tax license fees, investment license fees, fees related to the issuance of Lao PDR Approvals, certificates or other official documents utilisation tax on Project supplies.

4. Arbitration

The CA is signed between the GOL and NTPC. In the event that the rights of third parties are affected by the Project, such as those of local communities, the injured parties will not be able to bring disputes before the dispute resolution mechanism of the CA, as they are not parties to the agreement. They will instead have to rely on the GOL to bring the issue before an expert or arbitration. Critics have questioned the ability of an arbitrator to decide what is and is not reasonable for a government to do – an issue that involves inspection of issues of public policy - when he or she is only qualified to solve disputes between commercial parties.

¹⁴ From the web site of the Department of Domestic and Foreign Investment of the Lao People's Democratic Republic at <http://invest.laopdr.org/index.htm>

5. Amendment of Health and Safety Plan

Under the CA, NTPC has the right to modify, vary or amend the Health and Safety Plan, the initial Head Construction Contractor's Environmental Monitoring and Management Plan and the Emergency Contingency Plan without obtaining the GOL's consent provided that it is acting in good faith. In any case the modification, variation or amendment cannot breach the requirements of the CA (Articles 15.8(b) and 17(c)).

6. Force Majeure and Unanticipated Project Impacts

Many risks are difficult or impossible to control, such as those caused by geological and technical conditions, and they are often dealt with under the force majeure clauses in the investment agreements. The force majeure clause of the CA deals with unanticipated project impact. NTPC has to use the insurance proceeds plus an aggregate amount of \$10,000,000 to remedy these impacts. Given that it may take time to get the insurance proceeds, the only immediate cash that will be available to remedy the impact will be that money.

The GOL agrees that NTPC shall be entitled to compensation for all of the losses and costs suffered directly as a result of a Lao Sovereign Event occurring. Some of the Lao Sovereign Events include but are not limited to the following: invasion or armed conflict against the Lao PDR by any Foreign Country other than the Kingdom of Thailand; a blockade or embargo under international law or closure of borders all or any of which are initiated by Foreign Countries and against the Lao PDR, strikes, work to rule actions, go-slows or industrial disputes, revolution, riot, insurrection, civil disturbance, civil disobedience, mutiny, rebellion, state of siege, a blockade, a national emergency. Such an extensive clause may cause the GOL to suppress political opposition in the country that might disturb the operation of the Project.

CONCLUSION

The problems arising from the Concession Agreement stem from the fact that the GOL is trying to fulfil two roles that are not easy to reconcile: that of commercial actor, and that of the government of the Lao People's Democratic Republic. The risk allocation between the GOL and NTPC appears to be negotiated carefully, but this has been an exercise carried out in narrow terms: between two parties to a commercial transaction. The allocation to the GOL of an obligation to compensate the Project for its losses is simultaneously an added burden on its ability to protect the environment and the rights of its citizens. The GOL has made it difficult for itself to be sensitive to these issues because of the way it has allowed the deal to be structured. As a shareholder in the Project owning 25% of its shares, the GOL is signing up to what it has determined to be a commercially attractive proposition. However, as the government of a sovereign state, which takes its powers from individuals who make up the community, the GOL has obligations arising from international human rights law. Amongst these obligations are to regulate and supervise the entry and the operation of business in the country in order to protect its citizens from the adverse effects of the economic activities of individuals.

In the CA, it appears that the GOL gives primary place to its role as a commercial entity, and in doing so it is waiving some of its powers as a sovereign state. One of these sovereign powers is accompanied by an obligation: the duty to regulate progressively, increasing the protection, safety and welfare of its citizens. The Lao Government should not have to treat the carrying out of its duties to its citizens as a risk to business, the cost of which must be borne by itself. The Concession Agreement should be amended to reflect this principle.