# Where investors fear to tread: Risks and the Nam Theun 2 dam

**The proposed Nam Theun 2 dam in Lao PDR could be the first test for the World Bank's newly approved guarantee mechanism to protect private sector investment in infrastructure projects considered a risk due to uncertain financial returns. Charlie Pahlman examines the guarantee mechanism and its future impacts on the government and society of Lao PDR.**

As the global trend of privatization continues, international financial institutions are trying to attract more foreign private capital for infrastructure projects in developing countries. The World Bank is currently working on new mechanisms aimed at protecting commercial lenders from risks in investments with governments in some of the world's poorest countries.

In late-May the World Bank's Board of Executive Directors approved a proposal to allow funds from the Bank group's International Bank for Reconstruction and Development, to be used to insure financial risks of foreign companies and international banks investing in infrastructure projects in low-income countries normally only eligible for the Bank's concessionary (low interest rate) International Development Association (IDA) loans.

The World Bank group already uses various agencies to promote private sector investment in developing countries, including the International Finance Corporation, and the Multilateral Investment Guarantee Agency. However, both have constraints limiting their application to certain large-scale infrastructure projects in which there is substantial government involvement, especially in countries such as Laos which receive funding from IDA only.

In April 1997, the Bank's Executive Directors received a Memorandum from Bank Staff explaining that the rationale for the new guarantee mechanism is to mobilize private capital for "commercially viable projects in IDA-only countries that could generate large economic benefits and provide governments with a major source of foreign exchange revenue to be channeled toward general development and poverty alleviation." According to the Memorandum, "given the severe constraints on public financing in these countries, the only way to implement these projects is by mobilizing foreign private capital. But private lenders and investors will not invest in these projects unless the sovereign risk, inherent in undertaking a project in the country, is mitigated."

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The Bank Memorandum identified the controversial Nam Theun 2 hydroelectric project in Laos as a test case for the Bank's new guarantee mechanism.

The private developers of the Nam Theun 2 project, led by the giant Australian construction company Transfield, are unable to secure financing from commercial banks for the US$1.5 billion project unless there are World Bank guarantees to protect the banks from the so-called "sovereign risks" of doing business in Laos. The developers have threatened to pull out of the project if the Bank does not approve the guarantee.

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In the very limited information publicly available about the new guarantee mechanism, the Bank has failed to clearly define what it means by "sovereign risk" (sometimes also referred to as political risk or country risk), and under what specific conditions the guarantee may be called.[1]

It is clear, however, that the central aim of these guarantees is to ensure that the host government complies with all contractual obligations with respect to the project. Simply put, the guarantees are there to prevent the government from changing its mind in any way about the project for the full time period of private sector involvement in the project — at least 25 years in the case of Nam Theun 2.

The long-term impact of such arrangements on national sovereignty and the right to economic and political self-determination are issues that clearly deserve closer scrutiny and wider public debate.

### The Nam Theun 2 dam and sovereign risks

On the drawing board since the 1970s, the Nam Theun 2 dam was recommended as one of the best projects for Laos by a World Bank-appointed panel of experts in 1989. The project has raised very high expectations in Laos due to promises by developers that it will be a profitable investment generating vast amounts of foreign revenue. But after four years of studies, negotiations, and public workshops, the proposed dam is beset by delays, increasing cost estimates, uncertain financial returns, and steadily more conditions to be met by the Lao government.

In effect, the commercial developers have failed to deliver on their promises — and now the project cannot proceed without the World Bank stepping in with political and financial support for the transnational construction and finance corporations of NTEC.

The central issue is risks. Risks include all eventualities or factors relating to a project or activity which cannot be predicted or anticipated with certainty. The bigger and more complex the project, the greater the risks. Experience from all around the world clearly shows that large dams are extremely risky investments — with a history of underestimated costs and overestimated benefits. The private sector has traditionally been very reluctant to directly invest in large infrastructure projects like Nam Theun 2 precisely because of the magnitude and complexity of risks in these projects — and will not invest unless they are confident that their exposure to risk is minimal.

The Nam Theun 2 dam is a particularly risky project. It comes with the complex combination of social and ecological risks associated with any attempt to dam and divert a major river, flood a large area of forest and agricultural land, and resettle thousands of local people. Throughout the Mekong Region there are many examples of the long term consequences of ignoring these risks. But the Nam Theun 2 dam is also about the risks for Laos as it will be a testing ground for new and unproven models of private sector financing and risk management proposed by the developers and the World Bank. The size of the project — very large by any standards, and an enormous investment relative to the size of the Lao economy — means that these risks for Laos may translate into severe impacts for the entire country.

## Whose risks?

Responding to questions from an Australian aid organization about the Bank's involvement in the Nam Theun 2 project, Peter Nicholls, Australia's World Bank Executive Director wrote, "there is no doubt that it is a risky project with huge significance for Laos' future economic and social development."

He continued, "It is precisely these risks which justify Bank involvement as one of the Bank's central tasks is to catalyze resource flows which are expected to contribute to development and poverty alleviation in member countries, but which would not occur otherwise. The risky nature of the project *per se* is therefore a significant justification for possible Bank involvement."

The risks associated with the project and who or what is exposed to the risks include:

- **Risks to local environment/ecosystem:** loss of wildlife habitats, changes in riverine ecology and seasonal flow cycles, reduction in fisheries, extinction of species, added pressure on forest resources.
- **Risks to local people and communities:** loss of traditional livelihoods, loss of access to forest and forest products, reduction in fish and protein intake, new health problems, inadequate agricultural land, increased aid dependency, loss of cultural and social cohesion, weakening of community institutions.

### The proposed Nam Theun 2 hydropower project

- The Nam Theun 2 is a build-own-operate-transfer (BOOT) project of the Nam Theun 2 Electricity Consortium (NTEC) and the Government of Lao PDR.
- Proposed hydropower dam on the Theun River, a tributary of the Mekong, in Khammouane Province in central Laos.
- Installed capacity would be between 681 and 908 MW.
- 450 square kilometre reservoir on the Nakai Plateau and relocation of an estimated 5,000 people.
- Water from the Nam Theun reservoir will drop more than 350 metres through a diversion tunnel to a powerhouse, before being released into another river system, the Xe Bang Fai (which also flows into the Mekong, but about 150 kilometres south of the Theun River's confluence with the Mekong).
- NTEC comprises Transfield, one of Australia's largest private companies; Electricit de France, the world's largest state-owned electric utility; and three Thai companies: Ital-Thai Development; Jasmine International; and Phatra Thanakit.
- The project aims to generate revenue by exporting electricity to neighbouring Thailand. However, in February this year, the Electricity Generating Authority of Thailand announced that the project would not be among the final list of power facilities in Laos from which Thailand has promised to buy 1,500 MW of power by the year 2000.

- **Risks to Lao government:** project revenue flows below projected levels, increased debt, opportunity costs (cost of spending money on one project and not another project), all environmental and social costs, reduced generating capacity of other hydropower projects on the Theun River, local discontent, aid dependency, enormous external influence on government policy, loss of the right to economic and political self-determination.
- **Risks to NTEC:** loss of funds invested so far if project does not go ahead (approximately US$30 million), technical failures, cost overruns, electricity price uncertainties.
- **Risks to foreign banks and commercial investors:** hydrological risk, market risk and sovereign risk.

But whose risk will the World Bank guarantee? Its new guarantee mechanism is not designed to protect the people and government of Laos, nor to ensure that Nam Theun 2 delivers the benefits promised by the private investors. On the contrary, the guarantee protects the international commercial banks against possible losses resulting from their provision of loans for the project. That these banks are not prepared to invest in the project without such guarantees clearly indicates that Nam Theun 2 is a project involving extremely high risks.

## Financing risks

From the Lao government's point of view, the only justification for the Nam Theun 2 project is generation of financial revenue. Nam Theun 2 is not a rural development or poverty alleviation project — and the dam itself has no social value beyond the extent it can contribute to overall national economic development. The economic and financial factors and risks are therefore of the most importance. A close look at the proposed financing structure for the project reveals the liabilities and risks for Laos:

- **Current estimated total project cost:** US$1.5 billion
- **Estimated construction cost:** US$1.2 billion
- **Limited liability loans from international banks:** US$800 million
- **Equity:** US$400 million
- **Equity distribution:**
  Lao government 25% – US$100 million;
  Transfield 10% – US$40 million;
  Electricit© de France 30% – US$120 million;
  Ital-Thai 15% – US$60 million;
  Jasmine International 10% – US$40 million;
  Phatra Thanakit 10% – US$40 million.

Project proponents point out that the Lao government only has to invest what appears to be a relatively small amount of funds into the project — US$100 million equity compared to a total cost of US$1.5 billion does not sound like much — the implication being that the Lao government gets a valuable asset at a low cost.

However, the Lao government equity contribution is greater than any of the other equity holders, except Electricit© de France. Having very little available capital, the Lao government will need to borrow their equity amount from external sources. Furthermore, as an equity holder, the government will also have limited liability for 25 per cent of the total commercial debt on the project. So the Lao government equity, far from being low cost, will significantly worsen Laos' already heavy debt burden.

Moreover, the bulk of the Lao government equity contribution will be spent outside the country and will directly increase the profits of the private sector equity-holders who will provide engineering services, equipment, and supplies during construction. The Lao government will have very little capacity to assess whether they are in fact getting value for their money, or indeed if the price is reasonable as there is no tendering process that would indicate actual market prices for services, etc.

It is noteworthy that the value of the river and natural resources, without which there could be no project, are not considered to be equity. But any such arrangement would make the project less attractive (more expensive) for the private developers.

According to the World Bank proposal, once the project is completed and operating, all income will be kept in an "offshore" account, probably in a bank in Thailand, for security of foreign exchange. Revenue from electricity sales would be deposited into the account (administered by the World Bank), and the commercial lenders would have the first priority on this revenue for debt servicing. Remaining profits, if any, would then be divided up between project shareholders on an equity basis, with the government of Laos receiving 25 per cent of the total. This arrangement would apply for 25 years, the length of the BOOT concession agreement. Although the World Bank has been careful not to give specific examples of circumstances under which the risk guarantee could be called, there are a number of possible scenarios: if services provided by the government related to the dam were to become more expensive, or if failure to meet the deadline for completion of the project were somehow connected to government inefficiency.

Business deals can fall apart for many reasons, and should the Lao government not get what they wanted from the project in terms of revenues or otherwise, or if the government wants to change any aspect of the project, this is considered a political risk that could force calling of the guarantee.

Furthermore, downstream from the site of the proposed Nam Theun 2, another major hydropower project, the Theun-Hinboun dam, is under construction, partly funded by a concessional loan from the Asian Development Bank. [See Map, page 56, see also *Watershed* 2 (2).] The Nam Theun 2 dam, by diverting water from the Theun River to another river, the Xe Bang Fai, will reduce the generating capacity of the Theun-Hinboun dam, especially in the dry season. Any move by the Lao government to increase downstream water releases from the Nam Theun 2 dam in order to keep the Nam Theun-Hinboun turbines running, could adversely effect power output from the Nam Theun 2 dam, and may result in the calling of the guarantee.

The obvious risks associated with being dependent on a single buyer of electricity could also be indirectly responsible for a call on the guarantee. If Thailand's serious economic downturn continues to worsen, or if the current privatization of the Thai energy sector forces electricity prices down, the Nam Theun 2 project may at some point of the concession period be forced to accept a revised power purchase agreement with a lower price. If this happens, the commercial banks will still have first call on the revenue, while equity holders will get reduced returns. If the Lao government equity yields no income, then they may feel justified in seeking higher royalties or other income to compensate. The World Bank calls this a sovereign risk.

In other words, the guarantee can be called if any subsequent government of Laos over the next 25 years seeks to change any aspect of its relationship to the Nam Theun 2 project.

To qualify for the guarantee, the Lao government will have to provide a counter-guarantee to the World Bank, in effect agreeing to reimburse the Bank if the guarantee is ever called. So if the government defaults on commitments between itself and the private sector, the Bank will pay off the private sector out of its own funds. After that the Lao government must pay back the Bank any and all outstanding costs, plus a penalty payment. For this the government would have to take an IDA loan from the Bank, at an interest rate three times higher than for guarantees to richer IBRD countries. This effectively means that the World Bank will be providing commercial lenders with a guarantee "on behalf of" the Lao government, on the basis that the Lao government is not considered trustworthy. Through this mechanism, the World Bank takes on a policing and enforcement role, and puts itself in a position where it can exert enormous influence on government policy and economic direction, obviously further in the direction of privatization.

***The Theun-Hinboun and Nam Theun 2 dam sites.***

Guarantees represent a major shift in the Bank's role. The Bank does not enter this arrangement as a neutral broker in negotiations between the IDA country and a transnational corporation. It is there to calm the anxiety of the investors. By distorting and hiding real risks and costs, guarantees are inconsistent with the market forces so zealously promoted by the Bank. Risk guarantees are a blatant form of global corporate welfare at the expense of the public, while allowing the World Bank to be even less accountable, less democratic and more insensitive to the concerns of local communities.

By requiring counter guarantees from host governments, this mechanism effectively transfers a range of project risks from foreign investors and developers to national governments. What guarantees and legal recourse would be available to host governments and local people if the projects failed to deliver promised benefits? Why does the Bank place so much emphasis on reducing and managing risks for foreign corporate investors, rather than on reducing risk and exposure to the governments and people in some of the world's poorest countries?

The way in which these projects will impact on national sovereignty is a critical issue. How will countries recognized by the Bank to be institutionally weak be expected to negotiate and monitor an extremely complex set of contracts in a way that upholds the interests of the government and its people? If the Bank's role will be to act on behalf of foreign investors to ensure compliance by IDA country governments — what are the implications of this on sovereignty and the right to economic self-determination? As the agreements associated with these projects will restrict the actions of the present and future governments for many decades, how will the Bank ensure that there is a sufficiently wide understanding of, and debate about, the consequences of the guarantee?

With a project the size and complexity of Nam Theun 2, no amount of studies will ever be able to anticipate or predict all possible risks or future events. Commercial banks and investors understand this well, and are not prepared to expose their shareholders' funds to a project of this kind unless safeguards are in place. What legitimacy does the World Bank have in claiming to be better able to assess and mitigate these risks? The Bank's record with hydroelectric projects is hardly reassuring on this count.

Laos has a sovereign right to find its own path of development. The roles of, and relationships between, the state, local people and the private sector are all critical in this process. Globalization, privatization and unfettered market forces are not only disempowering and uprooting local people and communities, but are also increasingly marginalizing the rights of nation states. As the Lao government seeks to insist on its right to proceed with the Nam Theun 2 project, it is sadly ironic that the project, if it goes ahead, threatens to undermine the very basis of a sovereign state in Laos.

1. A "call" on a guarantee is a demand by the investors whose financial investments have been guaranteed by the World Bank to be repaid their investment, if at any time investors believe that the government has violated the terms of its agreement with corporate investors.