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FOREIGN DIRECT INVESTMENT FOR INFRASTRUCTURE DEVELOPMENT: CHANGING NATURE OF RISKS AND CHALLENGES FOR DEVELOPING COUNTRIES

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DEDICATION

To the three persons I hold dearest to my heart, whose, love, laughter and inspiration gave me the passion, endurance and patience to succeed.

To all indigenous communities who suffer the most due to exploitation of their traditional homelands and whose traditions, rights and culture are compromised in the race towards development.

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Summary

This thesis focuses on the fact that, with the economic liberalization in developing countries, the traditional methods of financing infrastructure development projects have changed, making way for more innovative investment mechanisms such as Build Own Operate ("BOO") and Build Operate Transfer ("BOT") models, more commonly knows as "project financing".

Traditionally, foreign direct investment (FDI), which refers to international investment where an investor obtains a lasting interest in an enterprise in another country, was restricted in the public utility and physical infrastructure sectors due to nationalist sentiments and concerns of foreign economic and political influence over strategic public utilities and state assets. Thus, the necessary finances for infrastructure development projects in developing countries were found by making allocations from the national budgets and by accepting grants from international development agencies such as the World Bank and from developed countries.

Further, traditionally, the development of Infrastructure has been the province of the public sector. However, in recent years the private sector has begun to be involved in developing infrastructure projects and in providing utility services to the public, mainly as a result of the fiscal constraints on the public sector and the lack of technology and know-how with the public sector to develop and manage modern infrastructure facilities. As a result, innovative investment mechanisms such as project financing are being increasingly used in developing countries to develop infrastructure projects.

In project financing, infrastructure projects in developing countries are developed with the direct and active participation of the private sector in partnership with public sector entities in host countries and international development agencies. The public sector entities in host countries participate in projects mainly as granters of concessions to develop projects and as regulators of developed projects. International development agencies participate in projects mainly as lenders

and/or advisers. The private sector entities participate in several different key roles such as investors, project developers, construction contractors and project operators. In addition, there are several other participants such as end-users, underwriters and suppliers in modern day infrastructure development projects financed and developed with project financing. These several parties have diverse interests in participating in development projects and they are all required to be risk takers. As a result, the risks associated with project financing are some times more complex compared to those associated with traditional forms of developing infrastructure development projects, where, although part of the funding for developing projects come from external sources such as international development agencies and developed countries, the most active participant and the key risk taker is the host country in which the development project takes place.

For example, as unlike in traditional foreign investment, in project financing, the private sector is involved in financing, development and management of infrastructure projects, the end users of infrastructure facilities, mainly the general public, usually do not benefit from government subsidies. As a result, in many developing countries, there is public hostility towards private sector participation in the development of infrastructure. Such hostility sometimes result in long drawn anti-development campaigns by the public and legal battles between governments and private sector project participants on one side and the members of the public and various public interest groups supporting them (for example, Non Governmental Organisations (NGOs)) on the other side. Such opposition to development activities often result in costing time and money for the investors, host governments and other profit seeking project participants. Sometimes such opposition can even lead to projects being abandoned.

Further, there is growing demand for political and administrative decentralization in some developing countries, where state, local, or subordinate governments are demanding, inter alia, more power over state assets. Caught in this web of power struggle are the profits seeking international investors and project developers who prefer to deal with central governments rather than with the local governments. Also caught in the web are the end users of utilities who prefer

central government development and administration of infrastructure facilities to private sector participation or local government control. Unlike in traditional forms of project development, in project financing, as there are several key project participants who invest, lend money to, develop and, operate projects, the power struggle between central governments and subordinate governments over control of assets directly affect all such parties.

The demand for complete separation and political autonomy in some regions in some developing countries adds another twist to the problem. As there are no time tested solutions available to the developing countries, investors and other project participants who may be adversely affected due to project locations falling under the jurisdictions of new powers due to political separation, it is an issue that needs to be considered by all parties interested in engaging in development projects located or likely to be located in disputed regions.

In some developing countries, there is the risk of failure to balance the sometimes conflicting interests between the need for infrastructure development and the duty of protecting the rights of indigenous communities and ethnic minorities who may be sometimes adversely affected due to development projects. This happens when, projects are intentionally developed ignoring the adverse implications they might have on the environment and society. Unlike in traditional FDI, in project financing, there is more room for the rights of indigenous communities and ethnic minorities being undermined and compromised, mainly due to profit seeking motives of the private sector actors and corrupt government officials.

As the duty to protect indigenous rights and minority rights has grown to become a global phenomenon, the protests and possible legal battles that may ensue from the violation of such rights could affect several participants in modern day infrastructure development projects. For example, in addition to cost overruns and delays that may be experienced in connection with development projects which may affect all project participants, the bad publicity that may result from such actions might have a severe adverse impact on the image and goodwill of multinational companies

participating in projects financing as investors, project promoters or in various other capacities. In addition, such bad publicity might also harm the image of international organizations participating in projects as lenders and/or advisers.

Despite the complex nature of the aforesaid risks associated with modern day infrastructure development projects, it is undeniable that private sector participation in development of infrastructure facilities could provide a boost to the economic growth in developing countries. Therefore, it is of common benefit to investors, host countries and other project participants' to ensure that an investment climate which balances the conflicting interests between making profits and achieving sustainable development exists.

In the circumstances, this thesis investigates some aspects of the key issues surrounding project financing methods used by most developing countries to attract much needed foreign investment and technology for infrastructure development. More particularly, the thesis attempts to resolve issues relating to the changing nature of risks associated with FDI with the growing use of project financing techniques to develop infrastructure development projects in developing countries. The thesis aims to argue that the key participants in project financing need to consider the nature and effects of these changing risks as such changes are not traditionally considered by parties to infrastructure development projects. Further, since the existing studies have not given substantial consideration to the perspective of the end-users and of those such as indigenous groups and ethnic minorities who may be adversely affected due to infrastructure facilities developed with private sector participation, this thesis aims to present their respective perspectives which needs to be considered in order to ensure the success of development projects.

The thesis argues that if sufficient attention is not given to recognising the changing nature of risks associated with FDI, and steps are not taken to mitigate them, the future success of project financing as an innovative and more beneficial mechanism for developing infrastructure projects cannot be guaranteed. The thesis therefore, explores measures to address these concerns and seeks

to make suggestions and recommendations aimed at mitigating the key risks associated with modern day infrastructure development projects.

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Chapter 1- Introduction

1.1. General Statement

Until about the mid 1970s, the provision of utility services and administration of physical infrastructure in developing countries were tightly guarded by the public sector, with government departments or statutory corporations enjoying a monopoly. Foreign direct investment (FDI) was restricted in the public utility and physical infrastructure sectors due to nationalist sentiments and concerns of foreign economic and political influence over strategic public utilities and state assets. The fact that many developing countries were under the colonial power of Western European states until the early or middle part of the last century may have contributed towards this fear that FDI may serve as a new form of economic colonialism in which, foreign companies might exploit the resources of the developing countries. In the circumstances, during the period prior to 1970s, the necessary finances for development and maintenance of infrastructure projects were met mainly by national budgetary allocations.

In recent years, however, restrictions on FDI in many developing economies have been substantially reduced as a result of international treatises, external pressures from the World Bank, and due to unilateral actions on the part of the developing country governments which have realised the importance of FDI for economic growth. The global and political development has contributed towards removing or radically altering some perceptions about the control and distributional function of utilities. Further, the generally poor performance of public utilities and changing views on the role of the state in the economy have contributed to the public provision of infrastructure falling from grace. Growing demand for increased as well as quality infrastructure services has not allowed developing countries to curtail the need for infrastructure development even when

budgetary constraints limit the scope of government funding, thus providing a further impetus for the change in the developing country governments' approach towards FDI.

From another angle, financial deregulation in the capital markets has introduced new suppliers of equity capital into-cross border investment, thus, making room for private sector provision of utility services.[1] Finally, technological developments in telecommunications and electricity generation industries have reduced capital intensity and the lead times involved in the provision of infrastructure services, thus, expanding the potential for competition in activities that were once dominated by state monopolies.

In sum, the aforesaid changes have resulted in one of the swiftest and dramatic changes of context for utilities and infrastructure industries in developing countries. Intense global competition between large multinational companies (MNCs) (both in terms of operations and ownership) with deep roots in the capital markets have replaced a landscape of national, over-regulated monopolies in fragmented markets, financed primarily through budgetary sources, mostly, deficits.[2] With MNCs competing with each other to access new and developing markets, and with developing countries becoming more and more adoptive towards open economic policies, FDI has grown as one of the most important forms of international capital flows for developing countries during the last three decades.

With FDI gaining popularity as the most preferred sources of finance for development of infrastructure in developing countries, many bilateral assistance programmes and international development banks have started to move away from direct financing of infrastructure projects toward programs and actions that facilitate the mobilization of bilateral and international investment from non-government sources. The private sector (domestic and international) is thus, increasingly sought after by developing country governments as a partner in infrastructure development. A

1 Nestor, S. and Mahboobi, L., "Privatisation of Public Utilities: the OECD Experience", (OECD, 1999).
Online: http://www.oecd.org/dataoecd/48/24/1929700.pdf

2 Ibid.

related aim of governments in this context has been to free scarce home-grown capital resources to fund other development necessities, such as, education, health care, and social welfare (which fall into the category of social infrastructure development) as these sectors are hardly the preferred playing fields for profit oriented MNCs.

The process by which governments are turning increasingly to market mechanisms and the private sector for the development of infrastructure projects which inherently involves the transfer of risk from the government to the private sector is popularly known as "project financing".[3] The most sought after project financing techniques for infrastructure development such as Build Own Operate (BOO) or Build Operate Transfer (BOT) models focus on financing projects with a combination of debt and equity from several key players including international financing organizations and private sector project developers, thus, making it s a complex arrangement where several parties with diverse interests come together to develop projects.

Although innovative, project financing is not flawless. The risks associated with project financing are some times more complex than those associated with traditional forms of FDI. Project financing techniques are not old and have not been sufficiently tested as they have been around only for little over three decades. Most of the projects financed with project financing techniques have a life term of 20-30 years. As a result, there are not many projects around that have run their full life cycle to serve as examples of successes or failures. Thus, the ways of identifying risks and sharing them between governments, investors, lenders, and other private sector project participants are still being explored on a trial and error basis. Trying to harmonise the diverse interests of all project participants, whilst, also trying to achieve project success is a challenge all project participants.

Another important issue concerning project financing and associated industry deregulation is their national affordability or in other words, the impact privately financed infrastructure projects

3 Ljung, P., Head, C., Sunman, H., Trends in the Financing of Water and Energy Resources Projects, Thematic Review III.2 prepared as an input to the World Commission on Dams (World Commission on Dams, Cape Town, 2000). Online: http://www.dams.org/kbase/thematic/tr32_scp.htm

have on the consumer, particularly, in low-income developing economies. As new project-financing processes necessarily result in the need for cost-recovery tariffs, this in turn requires special attention to tariff structures in developing economies, and policies on affordable ("life-line") rates for low-income consumers. This poses a challenge to the developing country governments who faces the dilemma of having to satisfy investors as well as consumers at the same time.

Sometimes, given the need for the developing countries to develop infrastructure projects in order to cater to the increasing demand for utility services, there seems to be a tendency towards compromising the interests of some ethnic, indigenous or minority groups. This has some times resulted in causing severe and irreparable damage to the interests of project participants as well as the victims of such compromise. Thus, issues such as land acquisition policies of the host country, payment of compensation to the displaced persons, and protection given to indigenous groups are important concerns relating to modern day infrastructure development projects that need to be addressed.

From the investor perspective, the uncertain economic and political conditions in developing countries are the major risk factors that need careful consideration when decisions are made concerning financing of infrastructure development projects. With the growing demand for political liberalisation in some developing countries and the increasing interest in regional integration, there is no guarantee that political structures and borders of autonomy in developing countries would remain static. In the circumstances, the nature of the risks associated with traditional forms of FDI have either assumed a new face or are likely to assume a new face in relation to infrastructure development projects with long concession periods, some times running into 20 -30 years.

Many argue that project financing techniques such as BOO/BOT methods are “win-win” options for developing countries as well as investors, lenders and other project participants. The main arguments that are put forward to argue the benefits for the developing countries include the

inability of the public finance to meet the growing needs for infrastructure development and the limited or non-recourse nature of project financing which reduces or removes the burden of servicing debt and equity from the developing countries. The main argument supporting the view that project financing techniques are equally beneficial to the investors, lenders and other project participants is that markets previously under state monopolies could now be accessed by the privates sector.

Theoretically speaking, project financing techniques such as BOO and BOT have some what removed the burden of servicing debt and equity from developing countries by transferring that burden to purpose specific project companies which are set up to run the projects during their agreed life terms. The non-recourse or limited-recourse nature of project financing, which will be discussed in detail later, means that the lenders and investors do not look beyond the project assets and project income for their loan payments and profit earnings. However, in practice, these theoretical benefits only looks convincing on paper as in some developing countries, due to the unique nature of the risks associated, many development projects that are financed with techniques that are in fact not limited or non-recourse in nature. For example, many low income countries with political and or economic instability continue to be burdened with the obligation of servicing debt and equity with government pay-back guarantees.

Further, although it is theoretically correct to say that project financing techniques has opened the doors for the private sector to invest and participate in previously inaccessible sectors, the actual situation is somewhat different. Due to policy and regulatory inadequacies as well as hostile reaction of end-users towards private sector involvement in certain utility service sectors, project developers, investors and lenders do not find their entry into many developing countries easy.

To ensure that all the project participants in infrastructure development projects benefit from the use of project financing techniques, it is extremely important that all risks associated with

the projects are identified at the earliest, and, measures taken to minimise them. It is also important to ensure that projects are actually developed in the interest of the public and not due to any corrupt motivations or political interests of the law makers or project developers. In other words, it is important that investment agreements are harnessed to become essential engines for sustainable development. Further, investment agreement negotiations should be opened to the scrutiny of all interested stakeholders. Only then would there be a realistic possibility of achieving investment agreements that are truly in the public interest.

At present, international investment law provides extraordinary rights and remedies for foreign investors simply because they are foreign owners of property. The investors also argue under international law that they cannot be held liable in their home states for acts or damages caused by their foreign owned investments because of the same foreign property status. Thus, it is important that the negotiators of investment agreements for the developing countries find clear and precise ways to hold the investors liable and accountable in the event of any default. For example, an international agreement which does away with the *forum non convenience* rule could ensure that the right to make a profit is coupled with the liability for how that profit was made.[4] The reshaping of the purpose of investment agreements from protecting foreign investors to agreements which contribute towards sustainable development would provide a proper basis for protecting the inherent obligation of states to act in the best interest of their people.

In order to ensure that risks associated with infrastructure development projects are duly assessed, investment promotion policies of developing countries as well as foreign investment agreements should be subjected to a conceptual shift from the promotion and protection of any investment towards promotion and protection of sustainable investment. The tools needed to do this include: environmental and social impact assessments, environmental managements systems, corporate codes of conduct, measures for the protection of the rights of end-users and the parties

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4 Mann, H., "The Corporate v. Public Agenda: Protecting Foreign Investors in the Post-NAFTA Experience" (October, 2002), International Institute for Sustainable Development. Online: http://www.maxwell.syr.edu/campbell/XBorder/Mann%20Oped.pdf.

who may be adversely affected due to investment projects, stable political and regulatory environment and an effective and efficient dispute resolution mechanisms.[5]

In the circumstances, in summary, the aim of this thesis is threefold: (1) to describe the transition of investment needs of developing countries from direct financing by foreign investors to project financing methods; (2) to identify the various traditional and non-traditional risks associated with project financing measures and to analyse the practices in use and new practices that could be proposed to negotiate and allocate risks among the project participants in order to achieve sustainable development; and (3) To review the key implications to developing countries from the use of project financing, including the influences the changing project financing climate has on the policy, regulatory, planning and decision-making frameworks of developing countries; and to propose measures that could be adopted by key project participants for future success of project financing.

1.2. Purpose and Justification of the Study

As noted in the previous section, with the opening up of closed economies and providing access for private sector to participate in development activities, FDI has grown steadily in its importance, relative to other forms of international investment. According to UNCTAD, during the last three decades FDI has accounted for about 3/4th of total International Capital Flows. Thus, it is most likely that FDI flows would continue to dwarf official sector financing, and would remain the most important engine of growth in a majority of the developing countries. According to Professor Kregal, FDI should be considered as an *"investment in "domestic bricks and mortar" which once*

5 See generally, Mann, H., "The Right of States to Regulate and International Investment Law", A Comment at the Expert Meeting on the Development Dimension of FDI: Policies to Enhance the Role of FDI in Support of the Competitiveness of the Enterprise Sector and the Economic Performance of Host Economies, Taking into Account the Trade/Investment Interface in the National and International Context, (November 2002, Geneva, Switzerland).

installed, cannot be easily repatriated and represents a permanent contribution to a country's resources".[6]

However, although private sector led FDI and more particularly, new and innovative FDI methods such as the use of project financing techniques is seen as a catalyst for economic growth of developing countries, it is important to note that the nature and the effects of some of the risks associated with traditional forms of FDI have changed considerably or in recent times, especially, when it concerns infrastructure development projects. Three main factors have contributed to the said changes. These being (1) the changing political culture among developing countries (2) the multi-party participation in the development of infrastructure projects with the use new and innovative FDI methods such as project financing techniques and (3) international as well as national recognition of the rights of the indigenous communities.

The risks that have assumed a new out look as a result of the factors mentioned above and in response to the complex nature of project financing techniques include risks such as the demand for political decentralisation; demand for separation of unitary states; unlawful invasions and foreign occupations; terrorist activities and war situations; social objections and judicial obstacles for development; challenges posed by parties adversely affected due to infrastructure development projects, i.e. the indigenous communities, all of which are risks falling under the broad definition of "political risks".

With the growth of FDI, the number of studies devoted to FDI too has grown. However, the number of issues that require further legal as well as economic research and analysis does not seem to have decreased. Many books, articles and papers have been written extensively on the advantages and disadvantages of FDI, the modes of project financing and the allocation of risks associated with them. However, no substantive studies have been done to identify the changing nature of some of

6 Jan Kregel, "Comments on Implications of Financial Globalization for Development Policy", Seminar on East Asian Development (Kuala Lumpur, Malaysia, March 1996).

the risks associated with FDI, especially the above mentioned risks which fall under the category of risks broadly defined as political risks, which have in recent times shown signs of challenging the growth of project financing as an innovative and effective mechanism for development of infrastructure projects in developing countries.

Further, while the existing studies have concentrated amply on the perspectives of the host nations, investors and project developers, very little attention has been given to the perspectives of the end-users of the facilities developed using new FDI measures such as project financing. Similarly, very little attention has been given to the interests of those who may be adversely affected due to infrastructure development projects, for example, indigenous groups.

In addition, there are several other issues relating to the use of new and innovative methods of FDI which remain unanswered or partially answered. These include questions such as: How good are the new and innovative methods of FDI? How is FDI affected by the growth of newly created assets in emerging markets? How is the immergence of new risks likely to change the patterns of competitive advantage of firms and location advantage of countries? What is the impact of FDI on minorities and indigenous groups in host countries? Should governments and international institutions control FDI flows and, if so, how can they influence them?

This thesis investigates some aspects of the aforesaid key issues surrounding the use of new and innovative methods of FDI such as project financing. Particularly, it attempts to resolve issues relating to FDI attraction policies of the host country governments and the changing nature of traditional risks associated with FDI. Further, the thesis seeks to analyse measures already in use and new measures that could be used to mitigate and or avoid such risks which threaten the ability techniques such as project financing to respond to the infrastructure development needs of developing countries.

The thesis identifies some legal and regulatory measures that have been taken by some developing countries as well as model laws and guidelines that are being promoted by some international organizations to mitigate the effects of risks associated with infrastructure development projects. Further, the thesis analyses various lacunas in these measures and propose improvements that are necessary to ensure that the use of FDI mechanisms such as project financing benefits all project participants without compromising or adversely affecting the rights of those parties who are not direct beneficiaries of investment projects.

The thesis concludes that if sufficient attention is not given to recognising the changing nature of traditional risks associated with FDI and minimising those, the future success of project financing as an innovative and effective mechanism for developing infrastructure projects cannot be guaranteed. The thesis submits that, as a result, project financing may fail to make a positive impact towards sustainable development. The thesis therefore explores measures to address these concerns and, in addition seeks to make suggestions and recommendations aimed at reducing the key risks associated with modern day infrastructure development projects.

1.3. The Scope of the Study

The thesis provides a brief overview of the key features of traditional forms of foreign investment and examines in more detail the recent trends, policies, and practices for financing infrastructure projects involving various mixes of government, private sector, commercial bank and international financial institution participation. The manner in which the different emerging financing techniques promise to influence traditional government, private sector and community roles in the planning, project selection, design, construction and operation stages of infrastructure projects is also assessed, whilst, focussing in detail on traditional and non-traditional risks which threaten the progress of such financing techniques. Finally, whilst discussing the advantages and disadvantages of project financing techniques for infrastructure development projects, suggestions and proposals concerning measures that should be taken by primarily, the developing countries,

investors, and international organizations, for future success of project financing are made. In addition, the thesis will also look at issues concerning infrastructure development with project financing techniques from the perspective of indigenous and minority groups who are often adversely affected due to development activities in the interest of the majority.

The study is not limited to any geographic boundaries. However, the main focus is on developing countries in Asia, Africa and the Americas. The developing countries from these three regions are used to pick examples and for the purpose of case studies to support the analysis in the thesis. The political, social and economic environments of developing countries in the said regions in general set the foundation for the analysis of changing nature of traditional risks and emerging new risks that developing countries as well as investors and other key project participants have to, or may need to, face in future, in connection with infrastructure development projects. Although the study's temporal focus is on present and future challenges to infrastructure development through project financing, historical events are discussed to the extent that they are relevant or related to the analysis made in the thesis.

The main arguments presented in the thesis are as follows:

I. developing countries need FDI for infrastructure development due to their incapacity to cater to the growing demand for increased and modern infrastructure facilities with home grown finances or by raising external finances following traditional methods;

II. Since the 1980's various "project financing" techniques have gained popularity among developing countries, foreign investors and lenders as both innovative and better project development mechanisms when compared to traditional FDI methods for developing infrastructure projects;

III. Due to the multi-party participation in project financing transactions, the complex nature of risk sharing and contractual structuring involved in project financing and, the changing political, economic, and social conditions in developing countries,

some of the traditional risks associated with FDI have assumed a new out look in recent times;[7] and

IV. If the developing countries and other key project participants such as foreign investors and lenders fail to recognize: 1) the changing nature of some of the risks associated with FDI given their association with infrastructure projects developed with project financing mechanisms; and 2) the risks that have shown signs of affecting the progress of infrastructure development projects in developing countries; and take appropriate measures to identify and mitigate them to the best of their ability, project financing might fail to lead developing countries towards sustainable development and provide a win-win option for all project participants.

1.4. Definition of Key Concepts used in the Thesis

The thesis deals with five key concepts, namely, "developing countries", "FDI", "project financing", "infrastructure development" and "sustainable development". Of these, the concepts of "FDI" and "project financing" are defined and explained in Chapters two and three respectively, where they are dealt with in detail. In the circumstances, Sections 1.4.1 – 1.4.3 below concentrate on providing definitions to the other three key concepts.

1.4.1. "Infrastructure Development"

The term "Infrastructure" is a broad concept and could be linked to every facet of the economy and human life. According to one definition, "the term infrastructure has been used since 1927 to refer collectively to the roads, bridges, rail lines and similar public works that are required for an industrial economy or a portion of it, to function".[8] According to another definition, the term "infrastructure" as a noun has two meanings. Firstly, it means the basic structure or features of a

7 These aspects are dealt with in detail in Chapters 4 and 5 of this Thesis.

8 Online:http://www.answers.com/topic/infrastructure

system or organization. Secondly, it means the stock of basic facilities and capital equipment needed for the functioning of a country or area.[9]

For the purpose of this thesis, the term "infrastructure" has been used to identify and refer to the physical assets of a country that provides utility services to its public or contribute to the national income of the country by providing services to the users of such assets. Such assets include infrastructure facilities such as roads, ports, power generation facilities, telecommunication facilities, dams and water related development projects, to name a few. These systems tend to be high-cost investments and location-specific so that they cannot be moved from place to place. Although, a country's infrastructure development activities also includes the development of welfare systems and services such as health care and education, I have categorized development related to such services as social infrastructure development in order to distinguish them from the project development activities relating to project financing transactions.

1.4.2. "Developing Countries"

The term "developing country" is often used to refer to low-income and middle-income countries as the use of the term is convenient. The term is also sometimes generally used to refer to countries which have not achieved a significant degree of industrialization relative to their populations, and which have a low standard of living.[10]

If one is interested in a technical definition of the term "developing country" it is interesting to note that the development of a country could be measured with statistical indexes such as income per capita (GDP), life expectancy, the rate of literacy, et al.[11] The United Nations (UN) has

9 Online:http://www.answers.com/library/WordNet-cid-1190203284

10 Online:http://en.wikipedia.org/wiki/Developing_country

11For more detailed technical information about these indicators, please see the Human Development Report Website: http://hdr.undp.org/statistics/understanding/resources.cfm.

developed the Human Development Index (HDI), a compound indicator of these statistics, to gauge the level of human development for countries where data is available.[12]

In addition to the term “developing country” terms such as less developed countries (LDCs), least economically developed countries (LEDCs), "underdeveloped nations" or "undeveloped nations", “third world nations”, “the South” “emerging market economies” and "non-industrialized nations" are popularly used to refer to developing countries. In recent times, international organizations have started to use the term least developed countries (LDCs) for the poorest nations which can in no sense be regarded as developing.

In my view, the terms used to refer to developing countries depends on the intent and to the constructs of those who utilize the terms. The WTO for example, allows each nation to decide for itself (self designation) whether it will be designated as "undeveloped" or "developing". As a result some countries which may be designated as developed according to particular criteria may be designated as developing according to different criteria. A good example is the case of Singapore, which could be classified as developed nation since it is ranked among the top 25 nations in the world according to the HDI used by the World Bank, but is considered a developing country by self designation at the World Trade Organization (WTO).[13]

For the purpose of this thesis, the term “developing countries” is used for its convenience to identify countries which have undergone a period of transition from closed economies to open economies since their independence from colonial rule and are attempting to attract FDI for physical infrastructure development in order to cater to the increasing demand for modern and increased infrastructure services by the people. For the purpose of showing various examples and,

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12 The UN Human Development Index (HDI) is a comparative measure of poverty, literacy, education, life expectancy, childbirth, and other factors for countries worldwide. The index was developed in 1990 by the Pakistani economist Mahbub ul Haq, and has been used since 1993 by the United Nations Development Programme in its annual report. See: UN Human Development Index Report (2005). Online: http://hdr.undp.org/reports/global/2005/pdf/HDR05_HDI.pdf

13 More than two-thirds of the WTO’s 144 members (including Singapore) are considered to be developing countries by virtue of their self-designation as such. See: A Glossary of Agricultural and World Trade Organization Terms - http://www.fas.usda.gov/itp/wto/cancun/wto_a2.htm

for case studies, countries have been selected using researcher's discretion on the availability of examples and cases and the appropriateness of those examples and cases, for supporting the arguments presented in the thesis. However, it should be noted that all of the countries referred to in this thesis as developing countries fall under the category of developing countries according to the Human Poverty Index (HPI) used in the UN Human Development Index Report of 2005.[14] Further, the countries identified and referred to as developing countries in this thesis also fall under the category of "developing countries" according to the OECD.[15]

1.4.3. "Sustainable Development"

There are many definitions of the terms "sustainability" and "sustainable development". The best known is the definition given by the World Commission on Environment and Development. In its report, famously known as the Brundtland Report (1987), it is suggested that sustainable development is a process of developing land, cities, business, communities, etc. that "meets the needs of the present without compromising the ability of future generations to meet their own needs".[16] Accordingly, development is sustainable where the exploitation of resources, the direction of investments, the orientation of technological development, and institutional change are made consistent with the future as well as present needs.

According to some sources, the precise meaning of sustainable development is widely debated. For example, "two years after the Brundtland Commission's Report popularized the term, over 140 definitions of sustainable development had been catalogued".[17] However, the term "sustainability" has since been defined with reference to scientific principles. For example, the Swedish scientist, Karl-Henrik Robèrt had defined the term setting out four scientific principles

14 UN Human Development Index Report, supra note 12, p. 229.

15 Online:http://www.icml9.org/public/documents/pdf/es/OECD.pdf

16 The report titled "Our Common Future" of the World Commission on Environment and Development (1987), also known as the Brundtland Commission, which called for strategies to strengthen efforts to promote sustainable and environmentally sound development.
Online: http://www.un.org/documents/ga/res/42/ares42-187.htm.

17 Online: http://sustainable-development.wikiverse.org/ and http://en.wikipedia.org/wiki/Sustainable_development

based on laws of thermodynamics for the sustainability of the planet Earth (the "Natural Step's Definition").[18] The Natural Step's definition of sustainability includes four system conditions that lead to a sustainable society. The Natural Step Framework holds that "in a sustainable society, nature won't be subject to systematically increasing:

1. Concentrations of substances extracted from the earth's crust;
2. Concentrations of substances produced by society;
3. Degradation by physical means;

And, in that society,

4. human needs are met worldwide."[19]

For the purpose of this thesis, I have used the term "sustainable development" to refer to development initiatives of the developing countries which are consistent with their future as well as present development needs. In other words, to refer to development projects which have been initiated after careful analysis of: the prevailing development needs of the countries; the risks attached to development projects designed to cater to such needs; the interests of the affected parties; the level of confidence that the project participants could place on the success of projects which carry long concession periods; and the present and future benefits to the developing countries from such projects.

1.5. Methodology

The principal research method followed in this thesis is based on surveying the existing academic literature on foreign direct investment and project financing to establish theoretical and practical principles and guidelines for resolving the pertinent policy and structural questions raised thereof in connection with investment promotion, risk allocation, and securing national interests.

18 Robèrt, Karl-Henrik. (2002). The Natural Step Story: Seeding a Quiet Revolution. Gabriola Island, BC: New Society Publishers.

19 Source: Natural Step US (2002). Online: www.naturalstep.org

The second research approach used in this thesis is the analysis of case studies from several developing countries with the intent of showing examples of how the ignorance of or intentional overlooking of risks associated with infrastructure development have led to failure of investment initiatives. The case studies are also used to draw conclusions on measures for avoiding future failures and highlighting the initiatives necessary for future success of FDI and more particularly project financing, in development of much needed infrastructure in developing countries.

The third research approach concerns empirical research conducted by way of discovery and analysis of existing policy initiatives and policy structures in several developing countries towards promotion of FDI and using innovative methods such as project financing for development of infrastructure facilities.

The fourth research approach concerns pragmatic historical review and analysis of issues concerning FDI and project financing in particular. This approach is used to gain an understanding of how the practices in developing countries have evolved over the years in connection with infrastructure development and draw lessons for the future from the learning experience of past practice.

The final research approach concerns active engagement and communication with policy makers, investors, general public as well as parties such as indigenous groups and minorities who are adversely affected due to FDI.

1.6. Organisation of the Work

Chapter 1of the thesis introduces the aims of the thesis by providing a general summary of the research undertaken and its importance. In addition it details the purpose of study, its justification, the scope, and the methodologies used.

Chapter 2 deals with the nature and historical background of international capital flows and distinguishes FDI from the other sources of international capital flows. In addition, this chapter sets the scene for what follows by defining FDI and briefly detailing recent trends in FDI.

Chapter 3 introduces the concept of Project Financing as a new and innovative method of financing infrastructure projects. It deals with the key features of the concept and explains the complex contractual structure of project financing transactions. It also deals with the complex mechanism of risk allocation in Project Financing.

Chapter 4 deals with the changing nature of traditional risks associated with project financing and analyses the effects of such changes given the transformation of basic FDI into more complex contractual arrangements in project financing structures. The chapter deals with issues such as decentralisation, cessation of states, and hostile taking of property during foreign invasions which are issues that have not been the subjects of detail study or analysis in connection with innovative methods of FDI such as project financing.

Chapter 5 deals with the social and judicial obstacles to the use of project financing as an innovative method for sustainable development of infrastructure in developing countries. The chapter also suggests measures that could be adapted to balance the interest between development needs and social and judicial concerns.

Chapter 6 deals with the issue of the rights of indigenous groups and the effect development of infrastructure projects have on such rights. This chapter provides several examples by way of case studies to highlight the importance of giving due consideration to the rights of minorities and indigenous groups when taking development related decisions.

Finally, Chapter 7 formulates general conclusions and recommendations, and proposes issues for further study and analysis.

Chapter 2 – FDI: Definition, Nature, Historical Aspects and Current Trends

2.1. Definition and Classification of Foreign Investment

The definition of foreign investment can be best made based on balance of payments transactions between residents and non-residents of a country. Accordingly, foreign investment is investment made by individuals or enterprises that have their centre of economic interest in an economy other than the economy in which they invest.

The classification of foreign investment or in other words international capital flows is possible on a variety of bases.[20] Under the definition and classification of international accounts presented by the International Monetary Fund (IMF) Balance-of-Payments Manual, foreign investment is classified into the following components:[21]

- Commercial loans - These primarily take the form of loans by banks to foreign businesses or governments.
- Official flows - This category refers generally to the forms of development assistance given by developed countries to developing countries.
- Foreign Direct Investment (FDI) - This category refers to international investment in which the investor obtains a lasting interest in an enterprise in another country.
- Foreign Portfolio Investment (FPI) - FPI is a category of investment instruments that are more easily traded, may be less permanent, and do not represent a controlling stake in an enterprise. These include investments via equity instruments (stocks)

20 Feldstein, M., International Capital Flows, (Chicago: The University of Chicago Press, 1999)

21 International Monitory Fund, IMF Balance of Payments Manual (5th ed.), (Washington D.C.: IMF Publications, 1993).

or debt (bonds) of a foreign enterprise which does not necessarily represent a long-term interest.[22]

Table 2.1below sets out another possible classification scheme based on the agents involved in the transaction, namely private or public (government), and on the basis of the transaction itself. On the basis of the agents involved in the transaction, the investment can be classified as either private or public. On the basis of the transaction, it can be divided into credit type (e.g. short or long-term borrowing and lending) and non-credit type, such as investments, grants, or contributions.

Table 2.1 – Classification of Capital Flows

Base of classification	**Types of flows**	**Examples**
Transaction agents	Private Public	Investment abroad by individuals Loans between governments
Type of transaction	Credit Non-credit	Borrowing; lending Investments; grants
Investor's aims	Portfolio investment Direct investment	Individuals buying stocks of foreign companies Joint ventures; investment in infrastructure projects overseas

As noted above, foreign investment can come into a country in various forms. However, the composition of these flows has changed dramatically over the years with FDI and FPI taking the largest shares of total net resource flows to developing countries.[23] In 1985, international bank

22 Portfolio investment includes investments by a resident entity in one country in the equity and debt securities of an enterprise resident in another country, which seek primarily capital gains and do not necessarily reflect a significant and lasting interest in the enterprise. The category includes investments in bonds, notes, money market instruments and financial derivatives other than those included under direct investment, or in other words, investments which are both below the ten per cent rule and do not involve affiliated enterprises. In addition to securities issued by enterprises, foreigners can also purchase sovereign bonds issued by governments. According to the IMF's 1996 Coordinated Portfolio Investment Survey Guide the essential characteristic of instruments classified as portfolio instruments is that they are traded or tradable.

23 Information on total net resource flows to developing countries as reported by the Development Assistance Committee of the Organization for Economic Co-operation and Development (OECD) shows that in 1985, official development finance still accounted for 56 percent of total net resource flows to developing countries, while in 1997 it accounted for only 23 per cent of the total. Source: United Nations Conference on Trade and Development (UNCTAD), Foreign

lending accounted for more than 50 per cent of total private flows to developing countries, FDI for 22 per cent and FPI for 18 per cent; in 1997, their respective shares were estimated at 8 per cent, 43 per cent and 48 per cent (the remainder being grants from non-governmental organisations).[24]

This changing pattern of foreign investment flows is the result of the process of globalisation of production through the internalisation of transactions within the MNEs (inducing more FDI activities) and the increasing securitisation of financial transactions (inducing more cross-border FPI in equities and bonds). Both types of flows have different characteristics and might have different implications for the development strategies of recipient countries.

Although there are several forms of foreign investment as noted above, what has been most influential in developing the infrastructure facilities in developing countries is FDI. Therefore, for the purpose of this thesis, concentration will be on FDI and, project financing as a more innovative and advantageous form of FDI. A distinction has to be made however, between FPI and FDI.

FDI and FPI have different characteristics. A better understanding of the specific attributes of the FDI and FPI flows could be made by assessing the impact of these flows on recipient economies and defining policy approaches towards investment flows.[25] FPI can be defined as investment in foreign shares, bonds and money market papers, on a financial basis, with the primary intention of the owner of the capital to maximize his utility, which is the risk-adjusted return on his asset portfolio. Portfolio investors are passive holders of assets who do not aim at majority ownership of the company or project in which they hold shares. They do not take part in the management and decision making process. In other words, the objectives of portfolio investors are more of a short-term speculative nature. In that, they can quickly reorganize their portfolios through buying or selling, responding only to higher returns offered elsewhere or higher risks in the host

Portfolio Investment (FPI) and Foreign Direct Investment (FDI): Characteristics, Similarities, Complementarities and Differences, Policy Implications and Development Impact, (Geneva: UNCTAD, June, 1999).

24 Id.

25 Id.

economy. Therefore, portfolio investors are usually regarded by researchers as being far more sensitive to changes in the country's investment climate as compared to direct investors.

As opposed portfolio investment, FDI is medium to long term investment aimed at obtaining direct managerial controlling power over the use of the capital. As noted earlier, FDI is the category of international investment in which a resident entity in one economy obtains a lasting interest in an enterprise resident in another. A lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. The criterion used is that *"a direct investment is established when a resident in one economy owns 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise, or the equivalent for an unincorporated enterprise. All subsequent transactions between affiliated enterprises, both incorporated and unincorporated, are direct investment transactions"*.[26]

The fundamental difference between FDI and FPI is that the direct investors are direct and active participants in the decision-making process over their capital, despite the fact that in the long run their objective, just like those of the portfolio investors, is maximization of return on the capital. Foreign direct investors often make investments into concurrent or co-operative foreign firms. To shape a successful business venture, they provide not only financial, but also professional and technological support. Thus, FDI involves not only international transfer of capital, but also such resources as technology, management, information, organisational and marketing skills.

Furthermore, FDI is a long-term commitment to engage in economic activities in the host country and has been proven to be less volatile compared to other forms of international capital

26 This is the definition of FDI utilized in the IMF's 1993 Balance of Payments Manual (see supra note 21) and also in the OECD, Detailed Benchmark Definition of Foreign Direct Investment (2nd ed.) (France: OECD Publishing, 1992). Although the IMF and OECD specify the 10 per cent criterion, a survey conducted jointly by these institutions on foreign direct investment statistics in 1997 indicated that about three-fourths of the 96 OECD and non-OECD respondent countries analyzed in the survey applied the 10 per cent rule. Many countries do not use a predetermined threshold and many non-OECD countries rely on investment approval authorities for the collection of their FDI statistics. See "Foreign Direct Investment: Survey of Implementation of Methodological Standards", Financial Market Trends, OECD, November 1998.

flows.[27] In other words, foreign direct investors are not reacting as drastically to changes in the investment climate as others do. They usually aim at long-term profit and are unlikely to withdraw investment in short period due to high transaction costs. The nature of the market for FDI favours those investors who have the patience and capacity to actively work through the problems associated with the businesses in which they invest. The time between making an investment and its realisation can often take years as a result of many factors, including detailed and complex negotiations with the host country government and other parties involved.

The decision to undertake FDI in any particular country is influenced mainly by that country's determinants, while FPI can be affected by factors external to host economies such as financial policies in capital exporting countries, the state of liquidity in international capital markets and, changes in the pattern of diversification of international portfolio.[28] Furthermore, FDI is firm and sector specific while FPI is not. FPI is more fungible. FPI has a greater macroeconomic impact (through changes in asset prices and liquidity in the financial sector), while FDI can have a significant impact at the microeconomic level, shaping the productive structure of a host country. FDI can transfer technology and improve market access, while FPI can help to strengthen the process of domestic capital market development.[29]

FPI is more volatile than FDI. Volatility is characterised by the high frequency of the reversibility of FPI flows or by the high variability in the volume of capital inflows. Reversibility and variability result from the fact that FPI flows are highly sensitive to changes in their determinants. Volatility of capital flows can create an unstable investment environment detrimental to growth and development.[30] There are many channels through which volatility exert a negative impact on the economy. The first is through unexpected changes in the availability of finance, and

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27 International Monetary Fund, Effects of Financial Globalization on Developing Countries: Some Empirical Evidence, (Washington D.C.: IMF Publications, 2003).

28 See supra, note 20.

29 UNCTAD, Trends in FDI and Ways and Means of Enhancing FDI Flows to and among Developing Countries, in particular LDCs and Countries Receiving Relatively Low FDI Inflows, with a view to Increasing the Benefits they Entail, and Taking into Account the Factors which Play a Part in Private Sector Firms' Choices of Investment Locations, Commission on Investment, Technology and Related Financial Issues (Fourth Session, Geneva, 4-8 October 1999), TD/B/COM.2/21

30 Id.

consequential changes in its cost and in asset prices. This will induce high variability in expected profits, and making investment planning difficult. The second is through the effects of compensatory adjustment in monetary, fiscal, and exchange rate policies in the face of rapid changes in the availability of external finance. And finally, capital volatility has an impact on consumption, and consequently on growth.[31]

FDI flows are generally sustainable. FDI is made in recipient countries through the establishment of production lines or long term development projects, which would be difficult to dissolve in a short time. Therefore, disinvestments or reversibility is much more difficult to undertake than in the case of portfolio investment, which can be easily sold off on financial markets.[32]

The policy regimes governing these two types of foreign investment are also different. Policies to attract FPI would have to proceed in a more cautious way, as the volatility of FPI flows could have a negative impact on recipient economies. In this respect careful consideration could be given to the question of including or excluding portfolio investment from investment agreements. Countries should be allowed to adopt measures (other than fiscal and monetary measures) to "fine-tune" capital inflows and outflows in order to avoid sudden and unexpected boom-bust cycles of capital flows, especially of portfolio investment. It would be preferable that such measures are market-based as the cost involved might be minimised.

Finally, it could be said that there seems to be a pattern whereby FPI becomes an important source of capital for higher-income countries, whereas, FDI remains the significant source of capital for development activities of the developing countries. Using IMF balance of payments data on capital flows, it can be shown from figure 1 below that over the period 1991-1998, FDI and FPI

31 Id.

32 UNCTAD, Report of the Commission on Investment, Technology and Related Financial Issues (Third Session, Geneva, 14 - 18 September 1998), TD/B/45/9, TD/B/COM.2/15

represented about 90% (respectively 51% and 39%) of total capital flows to emerging markets. It is interesting to note that, on a regional basis, countries in Latin America, in the Middle-East and Europe and countries in transition relied mostly on FPI as a source of capital flows. In Asia, for the five more advanced East Asian countries (Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand) FPI was the most important source of capital, in contrast to the rest of Asia.

Figure 2.1

Net Capital Flows 1991-1998in Emerging Market Economies[1]

(Billions of U.S. dollars)

	Total Capital Flows	Direct Investment	%	Portfolio Investment	%	Other Investment (including Bank Loans)	%	Net Official flows	%
Total	1368.5	692.9	50.6	532.7	38.9	-29.4	-2.1	172.1	12.6
Africa	121.9	33.1	27.2	7.4	6.1	30.0	24.6	51.6	42.3
Asia	426.1	324.9	76.2	48.6	11.4	-53.7	-12.6	106.6	25.0
of which: East Asia[2]	238.9	60.8	25.4	76.6	32.1	41.1	17.2	60.5	25.3
Middle East and Europe	211.2	22.1	10.5	97.8	46.3	93.0	44.0	-1.7	-0.8
Latin America	464.9	232.2	49.9	281.3	60.5	-47.0	-10.1	-1.8	-0.4
Countries in Transition	144.3	80.8	56.0	97.8	67.8	-51.6	-35.8	17.1	11.9

Source: IMF, *World Economic Outlook* May 1999.

[1] Emerging markets, as defined by the IMF, include developing countries, countries in transition, the Republic of Korea, Singapore, Taiwan Province of China, and Israe

This observation is broadly confirmed by a country breakdown. Figure 2 below reports detailed information on capital flows over the period 1993-1997 for 29 countries (for which a consistent set of data is available). The ten countries that attracted more FPI than FDI are in the higher income bracket (with per capita GDP exceeding US$ 2,500), with the exception of India and the Philippines. For eight of them, the volume of external finance raised through bonds was higher than that raised through equities.[33]

33 These countries are: Argentina, Brazil, India, Mexico, the Philippines, the Republic of Korea, Russia, South Africa, Thailand and Uruguay. For Mexico, FDI and FPI are of equal importance.

Figure 2.2

Net Capital Flows: 1993-1997, 29 Emerging Market Economies
(Millions of U.S. dollars)
(In percent of Capital Flows,net)

Country	GDP per capita 1997	Total Capital Flows	Direct Investment	%	Portfolio Investment	%	Equity Securities	%	Debt Securities	%	Other Investment (including Bank Loans)[1]	%	Capital Flows 1993-97 *(in percent of GDP)*	Market Capitalization *(in percent of GDP)*	GDP average annual growth (%)
Egypt	1252.8	9639.5	3603.4	37.4	3930.1	40.8	3057.1	31.7	873.0	9.1	2106.0	21.8	3.2	17.0	4.8
Morocco	1227.2	2179.0	2713.3		461.8		461.8		..		-996.2		1.4	21.1	3.0
Nigeria	338.1	8890.0	7516.8		-366.4		..		-366.4		1739.0		6.0	8.8	3.3
South Africa	3179.4	19176.0	712.6	3.7	16732.0	87.3	7548.1	39.4	9183.9	47.9	1729.0	9.0	3.1	183.6	2.9
Tunisia	2055.0	4771.0	1805.1	37.8	228.3	4.8	121.5	2.5	106.8	2.2	2737.0	57.4	5.5	16.2	4.5
Bangladesh	335.02	833.4	180.2		-34.0		-34.0		..		686.7		0.4	4.8	6.6
China	735.00	174543.0	168490.2		32735.8		22463.4		10272.4		-26683.0		5.1	13.2	10.3
India	396.48	39787.0	8892.2	22.3	14952.4	37.6	14952.4	37.6	..		15940.0	40.1	2.4	36.8	7.1
Indonesia	1072.88	32999.0	16984.0	51.5	12155.0	36.8	7458.0	22.6	4697.0	14.2	3860.0	11.7	3.4	27.3	7.3
Korea	9622.38	57069.9	-8128.1		57205.1		21129.5		36075.6		7992.9		2.7	33.1	7.6
Kuwait	16789.70	-10198.0	-84.3	0.8	-8881.6	87.1	..		-8881.6	87.1	-1231.0	12.1	-7.5	64.6	2.5
Malaysia	4544.82	31953.0	23709.7		-3309.5		..		-3309.5		11553.0		7.6	247.3	8.8
Philippines	1117.38	31235.0	5653.0	18.1	7315.0	23.4	1746.0	5.6	5569.0	17.8	18267.0	58.5	8.7	74.6	5.1
Saudi Arabia	6995.73	33585.0	1287.9		-7784.4		..		-7784.4		40083.0		5.2	35.4	1.0
Singapore	31035.51	-20530.0	17802.4		-42651.1		-39875.4		-2775.5		4320.0		-5.1	166.5	8.3
Thailand	2539.67	56601.0	8375.5	14.8	19922.9	35.2	8982.8	15.9	10940.2	19.3	28302.0	50.0	7.3	68.2	5.9
Czech Republic	5049.9	20071.5	6510.8	32.4	5537.4	27.6	3185.4	15.9	2352.3	11.7	8054.0	40.1	8.7	26.3	3.8
Hungary	4502.7	15390.9	11476.4		7141.5		1574.7		5566.7		-3227.0		7.1	11.6	2.4
Poland	3509.9	17327.0	16468.0		2952.0		1733.0		1219.0		-2093.0		3.1	5.4	6.4
Russia*	3034.4	-2132.0	7528.0		53643.0		3364.0		50279.0		-63303.0		-0.1	9.3	-4.7
Slovenia	9164.8	2185.9	885.8	40.5	829.7	38.0	51.7	2.4	778.1	35.6	470.4	21.5	2.6	4.8	4.0
Argentina	9109.9	46277.0	22055.0		59330.0		1683.0		57647.0		-35109.0		3.2	15.4	3.4
Brazil	5011.8	107258.0	36588.0		105161.0		26377.0		78784.0		-34491.0		3.3	27.7	3.9
Chile	5271.7	22677.9	11521.0	50.8	5141.4	22.7	3376.8	14.9	1764.9	7.8	6016.0	26.5	7.6	108.2	7.9
Colombia	2391.1	24075.2	10266.3	42.6	3024.8	12.6	..		3024.8	12.6	10784.9	44.8	6.2	20.1	4.1
Mexico	4271.0	82135.0	46550.8		43685.2		21334.8		22350.4		-8101.0		4.5	37.2	1.8
Peru	2619.9	21313.0	11053.2	51.9	1338.4	6.3	1170.3	5.5	168.1	0.8	8901.0	41.8	7.7	20.0	7.0
Uruguay	6114.8	1945.0	675.4	34.7	830.1	42.7	..		830.1	42.7	439.4	22.6	2.2	1.2	3.3
Venezuela	3840.7	-6715.0	6595.0		765.0		3642.0		-2877.0		-14075.0		-1.9	11.4	1.5
TOTAL Emerging Market Economies		**960600**	**495100**	**51.5**	**408000**	**42.5**					**57500**	**6.0**			

Source: IMF, *Balance of Payments Statistics, various issues;* IMF, *World Economic Outlook May 1999*; World Bank, *Global Development Finance 1999*; World Bank, *World Development Indicators 1999*; Natic
* Data for Russia covers the years 1994-97.
[1] Other Investment includes official flows.

2.2. The Growth of FDI and its Effects on Development during the Pre-World War 2 Period

The international capital movement is not a new phenomenon. It has been taking place among Western European countries and their colonies for several centuries. FDI is also not a new concept. It has existed for thousands of years since Sumerian and Finician traders started to build their own branch houses abroad to store their commodities before selling them. From the late 16th century, investing in trading branches abroad became a common practice for European traders, especially the English and Dutch East Indies companies.[34]

However, Capital movement at international level became prominent only after the Industrial Revolution in Western Europe in early 1800s.[35] At first, the movement of capital was dominated by British investors purchasing foreign securities. This foreign capital was attracted by generally higher returns abroad and investment successes in France, Prussia, Austria and Russia in the early 1800s.[36] But this provoked a speculative boom which in the early 1820s ended up in a major series of defaults on foreign loans by Latin American and Southern European countries. This was followed in the 1830s by a similar speculative boom in the American loan market which collapsed by 1840.[37]

The arrival of the Industrial Revolution brought about significant changes in the nature of FDI. Investors started to build industrial enterprises overseas seeking a variety of opportunities.[38] For example, American companies set up factories and banks in the relatively less industrialized Canada and Mexico to take advantage of the close proximity to their emerging markets. At the

34 Wilkins, M., The Emergence of Multinational Enterprise, (Cambridge, MA.: Harvard University Press, 1970).

35 Mathias, P., The First Industrial Nation (New York : Routledge, 1995).

36 Id.

37 Id.

38 See supra note 34.

same time, they built factories in relatively more Industrialized England to get closer to suppliers, skilled labour and probably to learn from their English colleagues' experience. At the same time, European firms took advantage of the rapidly growing U.S. market.[39]

Beginning of the1850s saw a major acceleration in the international movement of capital with the development of the railway industry in continental Europe.[40] Before 1870, the majority of foreign investment was made by one European country into another, with the rest going predominantly to the U.S., but in the last quarter of the century there was a rapid build-up of investment in places such as India, Canada, and Argentina, followed by a moderate flow of investment into Africa and South-East Asia. The majority of capital went into the purchase of foreign government securities, as well as portfolio investments in transportation, mining and manufacturing companies.[41]

The role of FDI was negligible until 1890s, when huge multi-unit industrial oligopolistic firms appeared suddenly in Europe, U.S., and Japan, and almost immediately started to invest abroad in marketing.[42] These firms, though limited to few sectors including: petrochemical, electrical, and transportation, started to invest overseas in early 1900s. As a result the world economy continued to grow between the periods 1900 to1914. By 1914, the stock of foreign capital held by the British reached ₤ 4 billion and those by the French ₤ 1.8 billion.[43] For the British, dividends and interest from foreign investment became an essential source of national income which for many years compensated them for a trade deficit.[44]

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39 See generally, Ashworth, W., The International Economy since 1850 (London: Longmans, 1967), Ch.2.

40 Teichova, A., M. Levy-Leboyer, and H. Nussbaum (Eds.), Multinational Enterprise in Historical Perspective (Cambridge: University Press, 1989), Ch.2.

41 Id.

42 Id.

43 Obstfeld, M. and Taylor, A., Globalization and Capital Markets, Working Paper N8846 (2002), Cambridge M.A.: National Bureau of Economic Research.

44 See Ashworth supra note 39.

In the early 19th century, financial institutions comprised a small sector on the periphery of the economy. But by 1914, they had developed into a sophisticated global network with an ever-expanding range of involvement in all sectors of the economy.[45]

World War I brought about significant changes in the international economy as Europe began to import its capital to finance its war related activities.[46] At the end of the war, the U.S. emerged as the largest international creditor on current account, while the British and French investments abroad had been reduced dramatically, and the German investment had virtually vanished.[47] Further, the outbreak of World War I led to a breakdown of the gold standard, but it also led to a sharp fall in trade. The situation was exacerbated further in the 1930s by the Great Depression. By the mid-1930s the international movement of factors of production virtually ceased. Things only began to improve only after World War II.[48]

2.3. The Growth of FDI and its Effects on Development during the Post World War 2 Period

Capital mobility was recovered gradually, under the control of the International Monitory Fund (IMF), in the 1950s and 1960s, although the banks continued to be reluctant to lend to the developing countries after the defaults of the 1930s.[49] Its growth, however, accelerated in the 1970s and 1980s after the revival of bank lending by the recycling of petrodollars in the 1970s, the collapse of the Bretton-Woods system, and introduction of floating exchange rates in major

45 Ibid.

46 Ibid

47 Ibid.

48 Rogoff, Kenneth S., *"Disinflation:An Unsung Benefit of Globalization?"*, Finance & Development (December 2003), pp 54 -55.

49 Brenner, R., *"Uneven Development and the Long Downturn: The Advanced Capitalist Economies from Boom to Stagnation, 1951-1998"*, New Left Review (1998), pp. 229 - 265;

industrialized countries.[50] But it was still on a much lesser scale in comparison to the early years such as 1913 and 1929.[51]

The continuous spread of FDI and international business around the world has been one of the major developments of the post-World War Two era. MNCs (mainly American multinational companies) dominated just after the war with the number of their subsidiaries tripling between 1950 and 1967, but the economic growth in other industrialized countries led to increasingly many of their companies becoming global.[52] MNCs were constantly shifting their facilities to conquer new markets and seeking the most efficient, low cost production sites.[53]

The end of the Cold War in the late 1980s and early 1990s and the arrival of globalization saw an unprecedented growth in trade and investment in an increasingly integrated and interdependent world economy.[54] Figure 2.3 below, shows the changes in accumulated stock of capital since World War II. As can be seen from this figure, the value of foreign capital had increased by a substantial amount during this period.

50 Id.

51 Gordon, D.M., Stages of Accumulation and Long Economic Cycles, in T. Hopkins and I. Wallerstein (Eds.), Process of the World System, (California: Sage Publications, 1980) pp. 9 - 45.

52 Porter, M., The Competitive Advantage of Nations, (London: Macmillan, 1990) pp 284 - 307.

53 Id.

54 Obstfeld, M. and Taylor, A., see supra note 43.

Figure 2.3

ACCUMULATED FOREIGN CAPITAL AFTER 1945, (CURRENT $U.S. BILLION)

Year	USA	UK	France	Germa-ny	Japan	Nether-lands	Other	Total
1945	15.3	14.2	-	-	-	3.7	2.0	35.2
1960	63.6	26.4	-	1.2	-	27.6	5.9	124.7
1980	775	551	268	257	160	99	186	2,296
1985	1,300	857	428	342	437	178	755	4,297
1990	2,180	1,760	736	1,100	1,860	418	2,214	10,268
1995	3,350	2,490	1,100	1,670	2,720	712	3,494	15,536

Source: Obstfeld and Taylor (2002).

As a result of the aforementioned developments during the post world war period, there are no more self-sufficient countries in the modern world. With regionalisation and globalisation in full swing, countries are dependent on each other more than ever before.[55] Although there was a time that one could argue that foreign investments were made by developed countries in developing countries, this is no longer an accurate statement. Even developed countries such as USA, France, Britain, Germany and Sweden to name a few, rely on foreign investment. As a result, foreign investment can no longer be interpreted narrowly as an investment made by a rich country or an international entity in a poor country.

A far as developing countries are concerned, the nature of foreign investment has changed over time. The policies in developing countries that favoured import substitution in the 1950's and 1960's surrendered in the 1970's to policies that favoured natural resource based development.[56] Then came the transition into free market economies in the 1980's and the

55 See generally, Walter A., World Order For A New Millennium, Walter, A. (ed.) (New York: St. Martin's Press, 1999). Also see, Tammilehto, O., Globalization and Dimensions of Poverty, A research paper published by Ministry for Foreign Affairs of Finland (Helsinki: Department for International Development Cooperation, 2000). Online: http://global.finland.fi/english/publications/ pdf/tammilehto_globalisation.pdf .

56 United Nations Economic and Social Commission for Asia and the Pacific, Implications of Globalization on Industrial Diversification Process and Improved Competitiveness of Manufacturing in ESCAP Countries (UNESCAP, 2001), Ch. IV.

increased private sector involvement in development activities in the 1990's. In 1996, global flows of FDI increased for the fifth consecutive year amounting to US$349 billion.[57] The global stock of FDI climbed to about US $3.2 trillion, double its level of three years earlier.[58] According to UNCTAD, the total FDI flow reached almost US$370 billion in l997, compared to less than US$100 billion per year, on average, during the decade of the l980s.[59]

However, although FDI has grown over the years the benefits of increased investment flows have not been spread evenly, as over 60% of all FDI flows into developed countries.[60] Whilst the share of FDI flowing to developing countries is increasing (about 37% as of 2000), it tends to be concentrated in a few countries.[61] Direct investment flows to China now exceed those to the rest of developing Asia which itself accounts for two-thirds of developing country investment.[62]

However, as a result of its growth during the last two decades, today FDI has become an important source of capital, technology, know-how and other valuable resources for developing countries, that otherwise would be unavailable. It also contributes to political power as democratic societies in developing countries prefer governments which seek to guide their counties towards development. In other words, to the transition economies whose internal sources of finance dried up due to economic recessions and collapse of government budgets, FDI has become a fundamental factor in their modernization efforts.

57 International Consumer Organizations Union, Global Policy and Campaigns Unit, Global Trends in Foreign Investment (London: ICOU Publications, October 1997).

58 Id.

59 UNCTAD, World Investment Report 2000 (New York and Geneva: United Nations, 2000).

60 Id.

61 Id.

62 OECD, Recent Trends in FDI: Financial Market Trends (France: OECD Publications, July 1997).

Not all development economists agree that FDI contributes to economic growth.[63] To the contrary, it is argued by some that FDI tends to block the spread of skills and technology as well as other opportunities for domestic enterprises, while the excessive profits made by foreign companies are repatriated and not made available for host country's taxation and/or domestic investment.[64] Even if they contribute to growth, this growth may be biased as MNCs distort consumption patterns, generate enclaves of capital, technology, skilled labour and infrastructure incompatible with the domestic economy, and widely generate negative externalities which reduce welfare of host countries.[65]

Further, MNCs have become an object of criticism for academics, as well as mainly left wing politicians for the reason that profit oriented MNCs are becoming an expensive a source for development. Over exploitation of host country assets, the international division of labour, and the hierarchy created by MNCs which some perceived to be a cause for widespread poverty, are some arguments put forward by the critics. The loss of state subsidies in basic infrastructure due to MNC participation in the provision of these services too has contributed to this growing criticism of MNCs.

The history of relationships between governments and MNCs has not been easy and involved both periods of conflict and those of cooperation. Most developing countries imposed severe restrictions and performance requirements on foreign direct investors during the 1960s and 1970s and large amounts of investment were nationalized. But severe debt crises and financial meltdowns during the 1980s and 1990s left many developing country governments with no alternative but to lift the barriers, establish investment promotion agencies, and compete with other countries for more FDI.

63 Lall, S., and P. Streeten, Foreign Investment, Transnationals and Developing Countries (London: Macmillan, 1977).
64 Frank, A., Dependent Accumulation and Underdevelopment (London: Macmillan, 1978).
65 Id.

However, although many countries, including, some former socialist countries have reformed their policies and legislation to invite and accommodate FDI, the openness to FDI still remains partial in some countries such as Iran, Saudi Arabia, and North Korea. While there has been a growing acknowledgement of the role that FDI can play in stimulating economic growth and development, there still remains considerable scepticism as to inevitability or universability of the benefits from FDI among some countries. In fact at a Global Investment Forum hosted by UNCTAD, it was expressed by some representatives from developing countries that more research and analysis is needed about the critical issues at stake in a multilateral framework on investment.[66] Further, it is reported that many speakers at the forum stressed on the complexity of the issues related to the effects of economic policy liberalisation on the quantity, quality and distribution of FDI, and its impact on development.[67]

Another fear among some developing countries, concerning the growth of FDI, is the belief that it will kill the local industry, as local industrialists will not be able to compete with MNCs. This has been a view point expressed by many left wing politicians in developing countries such as India and Sri Lanka. Particularly, in India, due to the strength of the left wing politicians in the Parliament, laws directed at whole hearted liberalisation of FDI have not been forthcoming.

Despite this scepticism among few developing countries, the broader picture is that, in their bid to attract more and more foreign investors, countries compete with each other to offer the most liberal investment regimes and the largest incentives. For example, out of the 114

66 UNCTAD, Press Release, 11th October 1996.

67 Id.

changes of FDI laws of 65 countries in 1996, 98 were of a liberalising nature.[68] For the period of 1991-1996 as a whole, only 27 out of a total of 599 FDI law changes were in the direction of greater control.[69] This competition and interest in foreign direct investment has strengthened the hand of MNCs that are using their home country governments to persuade other countries to create risk-free environment for their activities with no governmental interference or regulations.

In addition to the growing competition among developing countries to attract FDI, in recent times, there has been increased activity at both international and regional levels to promote FDI. For example, the Uruguay Round agreement on international trade[70] contains a number of provisions relating to investment liberalisation and protection,[71] although these measures are considered insufficient because they confine themselves to the interface between trade and investment. Further, there has been pressure for a comprehensive investment regime, with the International Chamber of Commerce (ICC) at the helm, even before the Uruguay Round was completed. This pressure is still on, although the subsequent initiatives to formulate a Multilateral Investment Agreement (MAI)[72] failed with the unsuccessful conclusion of the third Ministerial Conference of the WTO held in Seattle in November/December, 1999.[73]

Another development that has given a boost to a new trend in foreign investment is the growing interest among countries for regional integration. This concept has grown in a piecemeal fashion all over the world with the EU setting the trend for the creation of fully-fledged regional

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68 OECD, Recent Trends in FDI, supra note 62.

69 Id.

70 General Agreement on Tariffs and Trade 1994.

71 The bulk of these provisions are found mainly in the Agreement on Trade-Related Investment Measures (TRIMs Agreement) and the General Agreement on Trade in Services (GATS). Other parts containing relevant provisions include the Agreement on Subsidies and Countervailing Measures, the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs Agreement) and the Understanding on Rules and Procedures Governing the Settlement of Disputes.

72 The MAI was a new international economic agreement negotiated at the Organization for Economic Cooperation and Development (OECD) an international body comprised of the worlds 29 wealthiest nations. The MAI was designed to ease the movement of capital across international borders by limiting the powers of national governments to restrict and regulate foreign investments.

73 The move to establish a legally binding Multilateral Agreement on Investment (MAI) in the World Trade Organization was met with unexpected and huge opposition coming from both underdeveloped countries and various other non-governmental pressure groups.

trading blocks. Foreign investors advocate for greater regional integration because of the opportunities it affords for more efficient production and grater sales. Successful integration efforts are likely to be accompanied by a rapid increase in FDI inflows and in cross-border investments within the region and by greater rationalisation and consolidation of firms and sectors. According to a survey done in Argentina of manufacturing investors, the existence of Mercosur[74] has been identified as one of the main reasons for investing, after prospects of domestic market and stability of macroeconomic policy.[75] In ASEAN, and SAARC, too foreign investors have shown keenness to take advantage of the growth triangles and other sub-regional zones. Regional trade has been growing as a result.

One key advantage of regional integration from the perspective of developing countries is that, countries which have not yet received sizable attention from foreign investors either because of small domestic markets or lack of awareness on the part of the investors as to investment opportunities stand to gain by being a part of a regional market. From investor prospective, regional integration allows MNCs to reorganize their activities on a regional or global basis, rather than on a country-to-country basis, and thereby expand their investment network.

Rationalisation and consolidation through FDI help to bring about the structural adjustments towards a more efficient allocation of economic activities within the region. The benefits which accrue are those stemming from integration itself, but FDI plays a critical role in accelerating and enhancing those benefits.[76] Globalization and Regionalization thus, present a number of trends which should in principle be very positive for FDI in developing countries.

74 The Mercosur was created by Argentina, Brazil, Paraguay and Uruguay in 1991 with the signing of the Treaty of Asuncion. It originally was set up with the ambitious goal of creating a common market/customs union between the participating countries, on the basis of various forms of economic co-operation that had been taking place between Argentina and Brazil since 1986. The Treaty of Ouro Preto of 1994 added much to the institutional structure of Mercosur and initiated a new phase in the relationship between the countries, when they decided to start to implement/realize a common market.

75 Chudnovsky, D., Lopez, A., and Porta, F., "New Foreign Direct Investment in Argentina: privatization, the domestic market and regional integration", In Agosin, M (ed.) Foreign Direct Investment in Latin America, (Washington D.C.: Inter American Development Bank, 1995) p. 66.

76 OECD, Foreign Direct Investment and Economic Development, Lessons from Six Emerging Economies (France: OECD, 1998) p. 25.

These include: the emergence of globally integrated production and marketing networks; the associated reduction in transactions costs arising out from the spread of information and communication technologies; and a policy environment that is now more favourable to foreign investors.[77]

As a reasonable consequence of the trends discussed above, the world should have experienced a boom in FDI in developing countries in recent times. Yet, the last 3-4 years have seen a declining trend in FDI.[78] Recent data released from UNCTAD in its World Investment Report (UNCTAD, 2003b) [79] and the World Bank (Global Development Finance 2003)[80] clearly suggests a downturn in FDI inflows. Global FDI inflows, already down by over 40 per cent in 2001 to 823.8 US$ billion, fell by 20 per cent to US$ 651 billion in 2002. In the case of the developing world in particular, the overall picture is gloomier since there was a 23 per cent decline in 2002 (US$162.1 billion as compared to US$209.4 billion in the previous year).[81]

The main factor behind this decline has been the slow economic growth in most parts of the world and dim prospects for recovery, at least in the short term. Also important were the falling stock market valuations; lower corporate profitability; a slowdown in the pace of corporate restructuring in some industries; and winding down of privatization in some countries.[82]

However, despite this downturn, with its enormous potential to develop infrastructure, create jobs, raise productivity, and enhance transfer technology, FDI is a vital factor in the long-

77 Brooks, D., Xiaoqin Fan, E., and Sumulong, L. R., "Foreign Direct Investment: Trends, TRIMS and WTO Negotiations", Asian Development Review, vol. 20(1) (2003), pp. 1 - 33.

78 See generally, Addison, T. & Mavrotas, G., Foreign Direct Investment, Innovative Sources of Development Finance and Domestic Resource Mobilization, Revised Paper for Track II, Global Economic Agenda, Helsinki Process on Globalization and Democracy (Helsinki: UNU-WIDER, August 2004).

79 UNCTAD, World Investment Report 2003 (New York and Geneva: United Nations, 2003)

80 World Bank, Global Development Finance 2003 (Washington DC.: World Bank, 2003)

81 Id. See also World Investment Report 2003, supra note 79.

82 World Investment Report 2003, supra note 79.

term economic development of the developing countries. In the circumstances, a prediction could be made that decline of FDI during the last few years is unlikely to be a continuing trend. Given that traditional sources of financing such as budgetary contributions and foreign loans for infrastructure development in developing countries is unlikely to take an upward trend in the years to come, the future of development for poor countries lie in sustainable development through FDI.

2.4. Importance of FDI for Development

By its very nature, FDI brings into the recipient developing country, resources that are otherwise not freely available in that country. These include modern technology, management know-how, skilled labour, and some times even access to international production networks and major markets. These assets can play an important role in the modernisation of the national economy and in the acceleration of economic growth. In addition, FDI can make a contribution to growth in a more traditional manner. That is by raising the investment rate and expanding the stock of capital in the host economy.[83]

It is widely recognised by governments as reflected in paragraph 36 of "A Partnership for Growth and Development" adopted by UNCTAD IX in 1996 that *"foreign direct investment (FDI) can play a key role in developing countries that FDI can play a key role in the economic growth and development process. The importance of FDI for development has dramatically increased in recent years. As noted earlier, FDI is now considered to be an instrument through which economies are being integrated at the level of production into the globalising world economy by bringing a package of assets, including capital, technology, managerial capacities*

83 UNCTAD, Foreign Direct Investment and Development (UNCTAD/ITE/IIT/10 (vol. I)), Series on Issues in International Investment Agreements (New York and Geneva: United Nations, 1999).

and skills, and access to foreign markets. It also stimulates technological capacity-building for production, innovation and entrepreneurship within the larger domestic economy through catalysing backward and forward linkages."[84]

FDI can increase growth in two ways. It increases total investment by attracting higher levels of domestic investment. Further, through the interaction of advanced technology with the host country's human capital, FDI can be more productive than to domestic investment.[85] The most significant channel through which FDI contributes to productivity growth is perhaps through increased access to technology through market transactions such as joint ventures, licensing, and goods trade.[86]

FDI has the potential to rapidly restructure industries at a regional level or a global level and to transform host economies into prodigious exporters of manufactured goods or services to the world market.[87] In so doing, FDI can serve to integrate national markets into the world economy far more effectively than could have been achieved by traditional trade flows alone.

In an environment characterised by open economic policy, free trade, effective competition policy, macroeconomic stability, privatisation and deregulation, undoubtedly the benefits from FDI will be enhanced, as in such an environment, FDI could play a significant role in improving the capacity of developing countries playing host to FDI to respond to the

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84 Ibid at p 5.

85 Kyaw, S., "Foreign Direct Investment to Developing Countries in the Globalised World", Paper Presented at the DSA Conference 2003 (University of Strathclyde, Glasgow, 10-12 September, 2003).

86 Id.

87 Ribeiro, M.S., "Contemporary Issues on Foreign Direct Investment Statistics and Promotion Policies: a Research Report", The George Washington University, The School of Business and Public Management (Washington DC, April 2000), p.10. Online: http://www.gwu.edu/~ibi/minerva/Spring2000/Ribeiro.pdf

opportunities offered by global economic integration. This is a goal which is increasingly recognised by as one of the significant aims of any development strategy.[88]

However, it needs to be understood that integration with the global economy will not come through by the mere presence of MNCs in the export sector of a country. The MNCs will have to be present in the sectors providing services to the national economy of the country. Thus, the presence of MNCs in the provision of infrastructure is important, as the availability of a solid infrastructure will be the foundation on which any national economy could be built or rebuilt. The physical infrastructure needs of most developing countries are well beyond the funding or construction capacity of their governments as scarce public funds are utilised to provide basic social infrastructure like free education and health to the public. Thus, the presence of MNCs would enable the developing country governments to divert scarce home-grown funds towards developing social infrastructure whilst FDI will drive the development of physical infrastructure.

There has been extensive research on the determinants of FDI.[89] There are areas in which the impact of FDI can be negative, for example, in cases where competition is stifled, restrictive business practices are used or transfer prices are manipulated. Furthermore, Small economies may need to guard against too much FDI too quickly: flows of FDI that are too large for the absorptive capacity of the host economy are likely to bring about negative side effects such as the appreciation of the exchange rate, which in turn has a negative impact both on export development and import substitution.[90] In fact this is one of the major concerns of those who still tend to moot the need to attract FDI for the development of national economies.

88 Cho, Joong-Wan., "Foreign Direct Investment: Determinants, Trends in Flows and Promotion Policies", Investment Promotion and Enterprise Development Bulletin for Asia and the Pacific (United Nations Economic and Social Commission for Asia and the Pacific, 2002).

89 The World Investment Report 1998 in Chapter IV contains a detailed analysis of FDI determinants. Discussion in the present report summarizes this analysis.

90 Supra, note 62.

Further, external finance can become a real burden for the host economy if the cost of such finance exceeds the benefit derived and weighs heavily on the balance of payments. Such cost takes the form of interest and dividend payments in the case of FPI, repatriation of earnings and profits, either openly or through transfer prices, and imports of capital and intermediate goods, in the case of FDI. Negative impact can also arise when foreign investment flows displace domestic savings through a substitution effect or when foreign investment crowd out domestic firms through unfair competition or monopolising domestic savings (as could happen in the case of FDI). Furthermore, volatility or rapid reversal of investment flows can be detrimental to economic development as it increases risks and uncertainties and induce high instability in macroeconomic variables.

FDI entails a loss of control on domestic production, and even possibly on domestic development options. As FDI is firm and sector specific, the development of particular sectors of production will be left to foreigners' choice and not to deliberate domestic options. Furthermore, FDI can crowd out domestic enterprises through unfair competition and through raising important sums of local savings.[91] FDI can also have a negative impact on the balance of payments if production by affiliates requires important volumes of imports, the more so if production is geared towards host country's domestic markets and not towards export markets.[92] FDI can be costly in the long run, as repatriated earnings and royalties tend to increase with the maturity of affiliates.

91 Parris, B. Economic Policy Officer, World Vision, 'Foreign Direct Investment and Corporate Codes of Conduct in National Development Strategies: Costs, Benefits and Policy Options', Paper presented at the OECD Global Forum on International Investment (Mexico, November 2001). Online: http://www.oecd.org/dataoecd/25/5/2421494.pdf

92 Id.

2.5. The Emergence of Project Finance as an Innovative Technique for FDI

2.5.1. Failure of Traditional Sources of Finance

Traditionally, infrastructure needs in countries have been financed both by internal and external resources. Internally, the financial needs to develop infrastructure was found through equity provided by the central or the local governments. Any insufficiency in such funding was usually supplemented by direct borrowing from external sources.

The external sources of funding for major infrastructure development needs have been primarily, Multilateral Development Banks and Bilateral Aid Agencies. However, on occasions governments have also borrowed directly from developed countries and from private sources such as bond markets and commercial banks or supplemented financial needs for development through equity offerings for investors and contractors.

In recent years Multilateral Development Banks have been severely criticised for failing to support sustainable development in developing countries.[93] Such criticism has come from a variety of sources including politicians, scholars, lawyers, and non governmental organisations (NGOs), and even some officials of the Multilateral Development Banks. These critics have, among other things, charged the Multilateral Development Banks, of supporting several

93 World Bank, World Development Report 1994, (World Bank Publications, August 1994); and Guyett, Stephanie C., "Environment and Lending: Lessons of the World Bank, Hope for the European Bank of Reconstruction and Development", 24 New York University Journal of International Law and Policy (1992), p. 889 at 902.

environmentally and economically unsuitable projects, promoting development policies that adversely affect the environment and not helping the poorest developing countries.[94]

In a recent review of 40 years of World Bank experience in infrastructure development, the World Bank itself noted that a significant number of its infrastructure projects suffered from "institutional failures."[95] The main reason cited as being responsible is that such failures stem from heavy dependence on public financing, when money has flowed through channels where scrutiny has often been limited because public sponsorship has provided high levels of comfort to lenders.[96]

Another argument supporting the view that Multilateral Development Banks have failed to satisfy the infrastructure developments needs of developing countries is that these institutions have had the tendency in the past of forcing conditions on borrowing countries and compelling changes in their administrative networks and financial and investment policies, which have not yielded successful results as expected.[97] Further, such campaigns by the Multilateral Development Banks to change the established structures and frameworks within borrowing countries have resulted in some developing countries retreating from looking for finances from these institutions. One example that has been cited is that the World Bank has been, despite rhetoric within the articles of agreement instituting policy of non-interference in member states political affairs, instrumental in rearranging the constitutional frame work of certain borrowing nations by exploiting their financial leverage and imposing restrictive conditions on loans given.[98]

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94 Id.

95 Id. World Development Report 1994 p. 108.

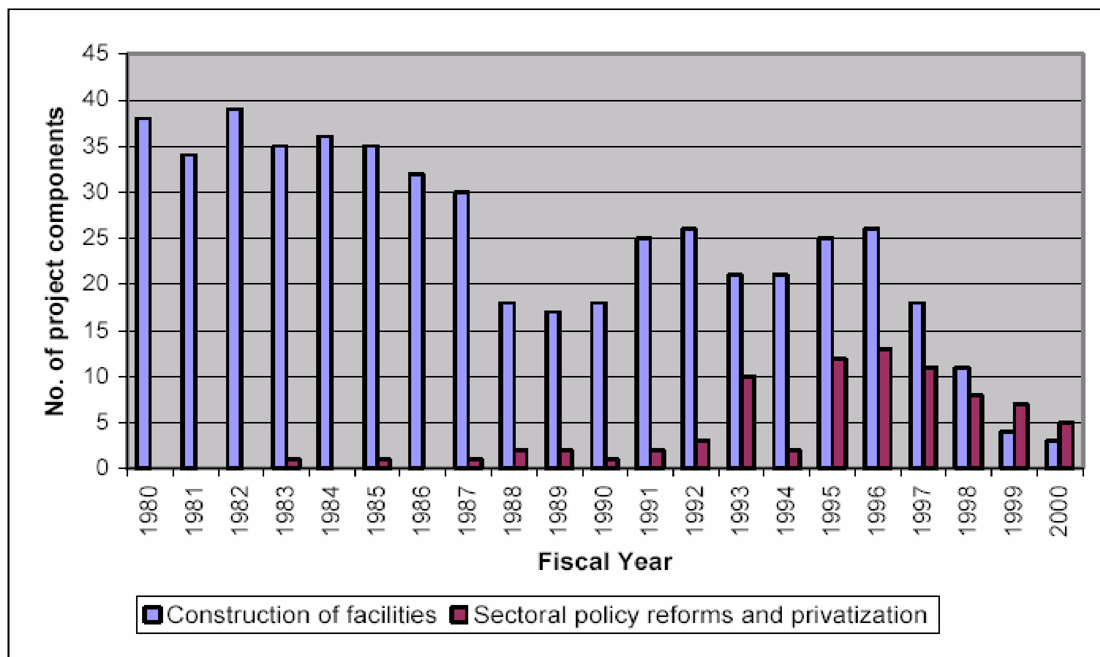
96 Id.

97 Cahn, J., "Challenging the New Imperial Authority: The World Bank and The Democratization of Development", 6 Harvard Human Rights Journal (1993), p. 159 at 160.

98 Id.

In any event, multilateral debt financing from traditional financing agencies has proven during the last couple of decades to be inadequate to effectively manage the risks connected with financing large infrastructure projects in developing countries. As a result, multilateral agencies have drastically reduced the direct funding (loan) availability for infrastructure projects. This is mainly due to the reason that unlike in the case of traditional foreign loans which are denominated in foreign currency, infrastructure development projects usually rely upon revenues from domestic consumers' payable in local currency to service debt. Thus, if exchange rates fluctuate, infrastructure projects financed with such international loans can be directly affected. [99] The following figure shows how the debt financing of development projects have been reduced by the World Bank in the power sector during the period 1980 – 2000:[100]

Figure 2.4



99 Lietard, P. and Santos, Evertte J., *"On The Move: Privatization of Infrastructure Services: privatization in Latin America"*, 54 Latin Finance (March 1994).

100 World Bank, Private Sector Development Strategy – Directions for the World Bank Group (Washington D.C.: World Bank, April 2002).

Like in the case of funding from Multilateral Development Banks, funding from Bilateral Aid Agencies too has failed to achieve the anticipated success, mainly due to "tying of aid" or in other words due to the requirement that funds be spent on goods and services purchased only from specified countries. Such aid tying prevents international competition in procurement and thus, can have the tendency to lower overall quality of project developers bidding on a project for infrastructure development.[101]

The aforesaid failures of traditional sources of funding for infrastructure development have been further aggravated by the diminishing role that the governments in developing countries play in financing infrastructure projects. Due to the precarious public finances in these countries, which is the result of both internal and external shocks such as political instability, civil wars, international trade imbalance and ever increasing budget deficits, funds from public sources are not forthcoming for much needed development.

Further, there has also been an increasing global experience of widespread dissatisfaction with the role of the State in the development of infrastructure in developing countries and, a corresponding increase in private sector participation in infrastructure development since the beginning of the late 1980's. The main reasons behind this dissatisfaction have been the inability of developing country governments to provide modern and technologically advanced infrastructure facilities, and their inability to cater to the growing demand for basic utilities such as water, power and telecommunication. However, the aforementioned global dissatisfaction of the role of governments in developing and managing infrastructure facilities should not be misunderstood to mean that the general public of the developing countries are totally dissatisfied with public sector control of infrastructure facilities and would like them to be replaced with the private sector. As explained later in detail in Chapter 5, the general public of the developing

101 World Development Report 1994, supra note 93, pp. 91 - 92.

countries are not totally in favour of whole scale privatisation of state infrastructure. Instead, they want the developing country governments to play an effective role in developing infrastructure facilities with private sector participation, as this brings necessary finances for development and modern technology. However, they do not desire that developing countries loose overall control over the manner in which infrastructure facilities are developed and services are provided. The main reason for this is the fear of loosing subsidised infrastructure services usually provided by the government.

While public funding for infrastructure development has been reduced, infrastructure investment requirements have remained high. In 1994, the World Bank estimated them at $200 billion a year for developing countries.[102] Since then other World Bank studies have increased these estimates. In East Asia and Latin America alone average annual investment requirements through 2005 have been estimated at US$150 billion and US$ 60 billion respectively, thus, further strengthening the case for FDI in infrastructure development.[103]

Further, until the 1980s, most foreign direct investment projects funded by international funding agencies took place in highly regulated economies, which were oriented toward producing for protected domestic markets or exploitation of their natural resources.[104] There were no investments in non-tradables such as infrastructure. The policy environment in these countries also influenced the ownership structure of projects, with few wholly foreign-owned ventures. However, since the 1980s, a policy shift had occurred in these countries with more and more developing countries opening their

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102 Id.

103 Dailami, M. and Klein, M., 'Government Support to Private Infrastructure Projects in Emerging Markets', paper presented at the Conference "Managing Government Exposure to Private Infrastructure Projects: Averting a new-style debt crisis" (Cartagena, Colombia, 29-30 May 1997).

104 International Finance Corporation (IFC), Lessons of Experience Series No. 5, Foreign Direct Investment (Washington D.C.: IFC, 1999).

economies and relying on FDI for development of all aspects of their economies, including development of physical infrastructure with private sector participation.

As a result, projects are increasingly based on production for global markets or provision of non-tradables and reliance on contractual marketing arrangements has grown.[105] Foreign control has increased, with more projects majority owned by foreign investors and more wholly foreign-owned projects. Further, privatization has brought foreign investors into many previously local enterprises.[106]

In this background "Project Financing" techniques have become the front runner in modern day infrastructure development projects. They appeal to the governments of developing countries because such schemes reduce or eliminate the need for governments to use precarious public funds or to borrow funds from traditional lenders such as the World Bank and the Asian Development Bank (ADB) by transferring the funding obligation to private investors. This is especially important where governments have reached borrowing limits whether such limits are imposed by the governments themselves or by the lending agencies; or the available borrowings need to be allocated into social infrastructure development.[107] Further, given the failure of the traditional sources of funding for infrastructure development, developing countries have welcomed project financing as an innovative forms of financing infrastructure development which brings into their countries funds as well as efficient private sector management know-how and modern technology.

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105 Id.

106 Id.

107 Harder, P., "Infrastructure Privatization in South Asia", Construction Lawyer (April, 1995), pp. 34 - 39.

2.5.2. Emergence of Project Financing

Project financing as a new and modern form of FDI emerged during the beginning of 1980s and continue to remain to date the most innovative and beneficial mode of financing infrastructure development needs of developing countries. Thus, although there has been an overall decline in the FDI available for development, the new infrastructure projects in developing countries continue to attract foreign and private sector investors. For example, in recent times, the Middle East region[108] has become an oasis of project financing opportunity. Lenders have closed an estimated US$ 27 billion in project loans during the period 1998 – 2003, with another US$ 54 billion of loans in various stages of development or financing.[109] In Asia, Africa and Latin America too, project financing remains a viable and effective means of financing infrastructure development.

Several factors have contributed to the dramatic growth in project financing. Many countries have sought a greater role for the private sector, including investment areas once seen as the domain of the public sector. This shift called for major regulatory reforms, which governments, by and large, rightly embarked on. Encouraged by the availability of long-term foreign capital and with strong backing for policy reforms from international financial institutions, project financing has expanded. By sector, telecommunications has taken the lead, with investments amounting to 43 per cent of flows to all infrastructure sectors, while energy's share was 36 per cent.[110]

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108 For the purposes of this thesis, the "Middle East region" includes the area from North Africa to the Gulf region (i.e. Morocco, Algeria, Libya, Egypt, Lebanon, Syria, Jordan, Israel, the Gaza Strip, Saudi Arabia, Iran, Iraq, Kuwait, Qatar, Bahrain, Yemen, Oman and the United Arab Emirates).

109 See generally, Wilde Sapte, D.W., A Guide to Project Finance, (London: Euromoney Publications, 2004)

110 World Bank, PPI Project Database.

Furthermore, financing most large scale infrastructure development projects are beyond the capacity of many developing countries due to budgetary constraints. Thus, developing country governments continue to woo the participation of foreign and private sector investors in development of infrastructure facilities by opening their markets and by various regulatory reforms intended at providing easy access to investors. In addition, the traditional financing agencies for development such as the World Bank and the ADB also continue to promote project financing as a more suitable source of funding for infrastructure development in developing countries.[111]

The explosive growth of the economies with the corresponding mass migration of the rural population into the cities in search of employment and other financial and social benefits like better schooling and health facilities have resulted in an overloading of the often antiquated infrastructure systems found in most developing countries. According to the United Nations (UN) population forecasters, 75% of the people in Asia live in the countryside and by the year 2004 an extra 1.5 billion people will be added to the one billion odd people now living in Asia's main cities.[112] Adding to this concern is the public outcry against government ignorance and neglect with regard to the development of infrastructure in areas outside the capitals and other few main cities in these countries.

The physical infrastructure needs in developing countries include all forms from low technology highways to installation of high-technology power generation and telecommunication facilities. According to a research done by a Singapore based research company in 1994 the estimate for Asian regions infrastructure requirements alone for the decade up to 2004 was over

111 See generally, Osius, Margaret E. and Carlson, C., "International Financing Sources in Support of "Pro-Poor/Pro-Growth" Infrastructure Development", Paper prepared for US AID Povnet Conference (Berlin, October 27, 2004).

112 News Week (Asia Edition), "Asia's Choking Cities" (May 9th 1994) p. 17.

US$ 3 trillion.[113] Particularly acute in the developing countries is the need for new power generation. With the increasing population the need for electricity plants has reached a crisis level. The South Asian region's need alone for new power generation capacity has been calculated as much as 460,000 megawatts (MW) in the ten years (1994 - 2004) which was equal to about 75% of the capacity in whole of Asia in the year 1993. [114] The predicted cost is between US$ 50 billion to US$ 60 billion.[115] Lack of access to safe water by a reasonable percentage of the people is another major problem faced by most developing countries while telecommunication too requires immediate attention.

Table 2.2 below shows some indication as to how acute is the problem of lack of infrastructure facilities in four selected Asian Countries.

Table 2.2 Access to Basic Infrastructure: Lack of Infrastructure in four South Asian Countries

Country	Power Generation Capacity (MW/million people)	Telephones (Per 1000 people)	Road Density (Km/million people)	Access to Safe Water (% of population)
Sri Lanka	75	7	536	60
India	86	6	893	73
Pakistan	77	8	229	55
Bangladesh	22	2	59	78

Source: World Development Reports 1994 - 2003.

The underdevelopment in these countries with regard to physical infrastructure can be best understood when compared to some of the better-developed countries in the Asian region. Table 2.3 below shows a comparison of Sri Lanka with Malaysia and Thailand with regard to access to safe water, electricity and telephone facilities.

113 The Australian, "Asia Discovers the Spiraling Price of Change" (March 9th 1994) p. 15.
114 The Asian Wall Street Journal, "Electric shock" (April 18th 1994) p. 59.
115 Id.

Table 2.3 Access to Safe Water in Sri Lanka, Malaysia, and Thailand

Indicator	Sri Lanka	Malaysia	Thailand
Population with Safe Access to Drinking Water (%)	60	78	77
Households with Access to Electricity (%)	33	64	43
Telephone Density Lines (per 1000 people)	12	111	31

Source: Background Information Document, Private Sector Infrastructure Development Company Ltd., Sri Lanka.

The demand for development of infrastructure grows daily around the world where economies are springing to life with an unexpected sense of urgency. Investors are signalling a desire to participate in these changes by identifying investments that provide predictable international earnings for the long term. The traditional modes of financing infrastructure are no longer freely available or efficient, and thus, there is a growing competitiveness among developing countries to finance their infrastructure needs through project financing techniques.

Chapter 3 - Project Financing: The New Face of FDI

3.1. What does "Project Financing" mean?

There is no universally accepted legal definition for "Project Financing". An article that was published in the Wall Street Journal few years ago on the Enron Corporation defined project financing as: *"…a term that typically refers to money lent to build power plants or oil refineries",*[116] thus, ignoring the fact that there are various other types of infrastructure projects such as highways, ports and telecommunication facilities to name a few, which are financed using project financing techniques. This example illustrates the confusion that exists in defining project financing.

What then is project financing? In essence, it is an innovative technique by which finances are raised for a particular project and in which several project participants distribute project risks and responsibilities among them to ensure the project's success. Clifford Chance, an internationally renowned law firm with significant expertise in project financing describes the term as follows:

> *"Project Finance is a term used to refer to a wide range of financing structures. However, these structures have one feature in common, that is, the financing is not primarily dependant on the credit support of the sponsor or the value of the physical assets involved. In project financing, those providing senior debt plays a substantial degree of reliance on the performance of the project itself".*[117]

According to Hoffman:

" (t)he term is generally used to refer to the arrangement of debt, equity, and credit enhancement for the construction or the refinancing of a particular facility in a capital - intensive industry, in which lenders base credit appraisals on the projected revenues from the operation of

116 Pacelle, M., Schroeder, M. and Emshwiller, J., *"Enron has one-year restructuring target"*, Wall Street Journal (13 December 2001), p. 3.

117 Clifford Chance, Project Finance, (Clifford Chance Publications, 1991) p. 1.

the facility, rather than on the general assets or the corporate credit of the promoter of the facility, and in which they rely on the assets of the facility, including the revenue producing contracts and cash flow, as collateral for the debt".[118]

Peter K. Nevitt gives the following definition to Project Financing:

> *"A financing of a particular economic unit in which a lender is satisfied to look initially to the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan."*[119]

Accordingly, project financing is a financing and project development mechanism which involves the creation of a legally independent project company financed with non-recourse or limited recourse debt, for the purpose of investing in a capital asset, usually with a single purpose and a limited life. The lending for the project is based on the merits of the project rather than credit of the project sponsor. From the point of view of the participants in a project (from the project promoter to the end-user of the utility produced by the project), project financing is a mechanism by which risks associated with it are shared and negotiated between several participants. Project financing is accordingly, an innovative and timely financing and risk sharing technique that is used on many high-profile corporate projects[120] and for various infrastructure development projects in both developed and developing countries.

Modern project financing techniques first emerged about three decades ago, mainly in mining, oil and gas sectors, aiming to attract foreign funding for development.[121] Even at that time, the provision of public utilities such as power, water, and telecommunication, as well as developing infrastructure projects such as ports, roads, and highways were treated as the domain of the public sector, and thus, were not open for private sector financing or participation.[122] The

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118 Hoffman, S.L., *"A Practical Guide to Transactional Project Finance: Basic Concepts, Risk Identification, and Contractual Considerations"*, 45 The Business Lawyer (1989), p. 181.

119 Nevitt, P., Project Financing (4th ed.), (London: Euromoney Publications, 1993) p. 9.

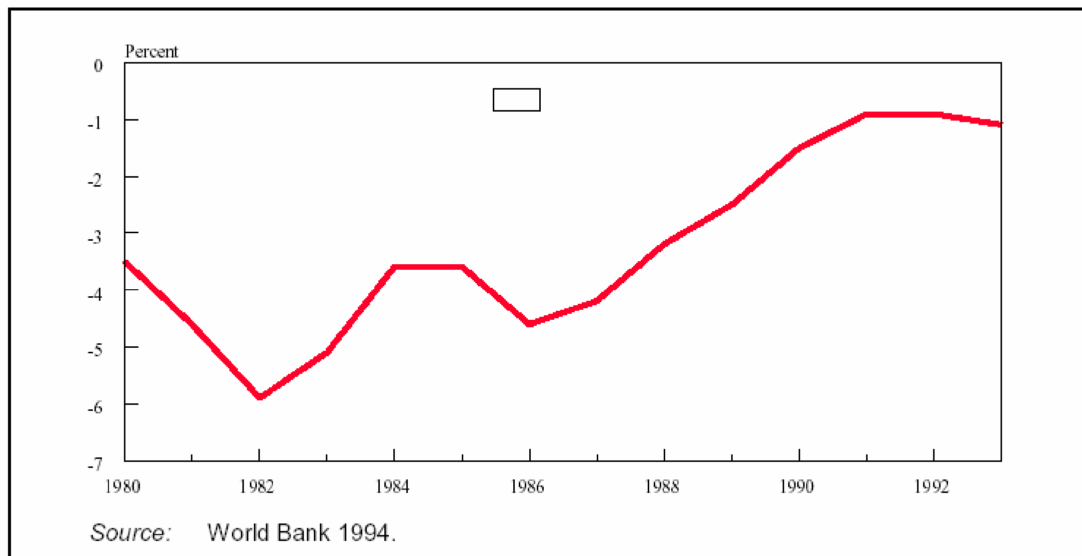
120 Euro Disneyland and the Euro tunnel projects are two good examples.

121 Adefulu, A., *"Downstream Energy Financing in Developing Countries: Are BOTs the Answer?"*, CEPMLP Annual Review (1999) p. 3.

122 Id.

moneys for development of such facilities were raised by direct borrowing by governments from international funding agencies such as the World Bank or raising funds by issuing, for example, government bonds. However, following the debt crisis of the early 1980s, developing countries significantly restricted public borrowing (see figure 3.1 below), and as a result public funding available for infrastructure development got drastically reduced, although the infrastructure investment needs remained high.

Figure 3.1

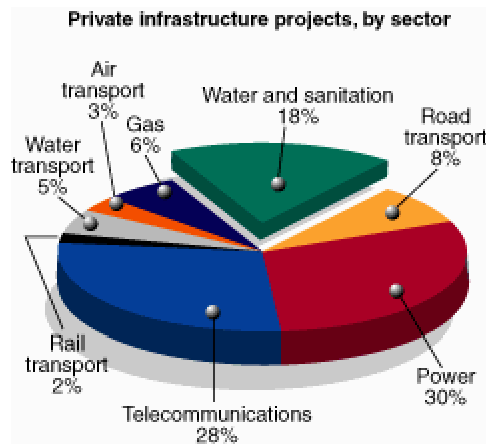


As a result governments were compelled to open access to infrastructure facilities such as highways, telecommunication facilities, airports and seaports, water, and power, which were traditionally thought to be the domain of the public sector to the private investors.[123] Accordingly, project financing started emerging as the preferred alternative to conventional methods of financing infrastructure and other large-scale projects worldwide and as a result, in recent years, reforming the provision and financing of infrastructure services in developing countries have focused on project financing techniques.

123 Dailami and Klein, see supra note 103.

Project financing is seen as a better alternative to public financing as it allows countries to both minimize the deficiencies of public administration and to avoid the need for external borrowing.[124] Further, it is also seen as a solution for the failure of traditional sources of funding for infrastructure development. Governments have found that the scarce resources available internally are better allocated to social programmes like health, education and poverty alleviation to name a few. Thus, the private sector is being sought to develop new infrastructure projects, and in many parts of the world, government funded and operated infrastructure is increasingly being replaced by privately financed schemes. The following figure shows how the project financing has been adopted for infrastructure development in different sectors of development as of year 2001.

Figure 3.2



Source: World Bank, Private Infrastructure Project database.

Project financing should be distinguished from traditional corporate lending. Traditional corporate lending is where the primary source of repayment for investors and creditors is the sponsoring company, backed by its entire balance sheet, and not the project alone. Although even

124 Erichengreen, B., *"Financing Infrastructure in Developing Countries: Lessons from the Railway Age"*, The World Bank Research Observer, Vol.10 (1995), p. 75.

now, creditors usually seek assurance of the economic viability of the project being financed so that it is not a drain on the corporate sponsor's existing pool of assets, an important influence on their credit decision in corporate finance is the overall strength of the sponsor's balance sheet as well as business reputation. Depending on this strength, creditors will still retain a significant level of comfort in being repaid even if the individual project fails. In corporate finance, if a project fails, its lenders do not necessarily suffer as long as the company owning the project remains financially viable. On the other hand, in project financing, if the project fails, investors and creditors can expect significant losses. However, as will be noted in detail later in this chapter, project financing, as we understand today, can either be full recourse, limited recourse or non-recourse, the latter two being more popular; recourse here meaning the availability of security or other similar comfort to the party who makes finances available to a project, in the event of default by the borrower.

The two basic principles discussed above which differentiate conventional financing from project financing are actually rather old ideas and go back a few hundred years.[125] Centuries ago primitive forms of project financing were used in various countries. For example, in the fifth century B.C.E., the Commercial Code of Athens acknowledged a form of project financing to finance shipping ventures. Lenders agreed to look only to the future sales of the cargo and the ship for repayment. If the ship was lost at sea, the debt was in effect discharged without any liability to the vessel or cargo-owners.[126] The Devon silver mines in southwest England in the thirteenth century relied on a form of project debt supplied by a Florentine investment banker, a precursor of the non-recourse future flow projects of today. In both instances, sponsors of these commercial ventures formed special purpose companies and relied on limited or non-recourse debt to fund many of the start-up and operating costs of the enterprise. Given that, debtors faced

125 Standard and Poor's Infrastructure Finance, 29.8.2000

126 Id.

the possibility of imprisonment (or worse) at the hands of their creditors, the concept of non-recourse debt must have seemed enticing, at least from the debtor's view.[127] In the 18th and 19th centuries, large pubic works and infrastructure projects, such as roads, canals, water, electricity, and coal gas, were often financed through private sector funding sources. Public debt financing, therefore, as a vehicle to fund public works and infrastructure, is a trend that began in the late 1800's.[128]

Even today, if one looks at any infrastructure project financed with project-financing techniques, at the very core is a government concession to a private project developer. When a concession is given, it is mostly for the use of some natural resource in a country. The concession grantee will bare fruits from the concession so long as the concession stands and the government that granted the concession would usually benefit from profit sharing or taxes. The main difference between the historical concessions and modern day concessions is that, in modern day concessions, the host governments incorporate various contractual provisions in the concession agreement and other related subsidiary agreements to ensure that they will continue to benefit from the resource during and after the concession period.

3.2. Key Features of Project Financing

3.2.1. "Non-Recourse" or "Limited Recourse" Nature of Project Financing

A key feature of project financing is that it allows a project sponsor to avoid providing lenders with "recourse" to its general assets in case of project failure, as the concentration for loan repayment is restricted mainly to project cash flows and project assets. This feature is

127 Id.

128 Id.

generally refereed to as the “non-recourse” nature of project financing. Thus, if project financing is non recourse in nature, then, a direct legal obligation is not imposed on the project sponsor to repay the debt or to make interest payment when the cash flow is too low. This is because the lenders prefer to consider the project revenue flows as collateral to the loans.[129]

It is also important to note that this non-recourse nature of project financing in tern allows the sponsor to finance the project off its balance sheet. The “off-balance sheet financing” characteristic is a significant part of project financing. From the borrower’s point of view, it means that the loan either does not appear in the balance sheet at all, since it will be repaid by the cash flow of the project itself or it does not appear as a debt. The result being that the borrower is saved from the appearance of a big financial exposure which otherwise would affect the financial ratios of the borrower.[130]

Although project financing is mainly characterized as “non-recourse financing”, situations in which creditors have absolutely no recourse against the project sponsors (the real beneficiaries of the credit transactions) are rare. More commonly, lenders demand “limited recourse” against the project sponsors until certain stipulated milestones in the project are reached or require the sponsors to assume certain project-related risks. Thus, project financing is "limited-recourse" when the lenders may look to cash or assets outside the project as additional support for the loan. An example of extra security would include a guarantee from a project sponsor, a performance warranty from the operator, or additional equity contributions from investors.

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129 See generally; Beidlemen, C.R., Fletcher, D., Veshosky, D., *“On Allocating Risks: The Essence of Project Finance”*, Sloan Management Review. Vol.: 31 Spring (1990), pp. 47 - 48.

130 However this concept of off - balance sheet financing can sometimes be some what of a misnomer. While the liability might not be required to be shown in the balance sheet as a loan or a debt, it invariably appears indirectly in the balance sheet or as a note to the accounts by reason of it being a contingent liability. Another point is that, although the most desirable situation from the borrower point of view is that the liability not appear at all, this can only be achieved by the actual borrower being an entity which is not a subsidiary of another principal entity desiring finance and when the said principal has not given a guarantee or other form of support to the borrower. See generally; Owen, G., *“The Role of Banks in Project Financing”*, Law Institute Journal (October 1984), pp. 1172 - 1174.

3.2.2. Public Sector and Private Sector Partnership

Project financing brings together governments on the one hand and investors, lenders and private sector project developers (sometimes also referred to as sponsors or promoters) on the other. Theoretically speaking, it enables host governments to attract private capital investment without guaranteeing payment of project costs and without completely rearranging internal economic frameworks through direct privatisation. From the lenders point of view, they may be more than willing to lend on project-specific basis, in situations, where, developing countries would present an otherwise unfavourable credit risk due to political unrest or other similar non-economic factors. For private investors and project sponsors, project financing opens up markets, which are otherwise dominated by public sector entities.

The most compelling reason for the private sector project promoters or sponsors to use project financing techniques is that risks associated with a new project will remain separate from their existing businesses.[131] Thus, if a project were to fail, that would not jeopardize the financial integrity of the project sponsor's main business. Further, proper structuring of the legal and financial features of the project can protect the sponsor's capital base and debt capacity. This is so because as noted earlier, in project financing, projects are financed without requiring much sponsor equity or guarantee as in traditional corporate finance.[132]

For developing countries, project financing gives the hope that a well structured and economically viable project will attract long term financing even if such project may dwarf its sponsor's own resources or entails risks they the sponsor is unable to bear alone. With a

131 International Finance Corporation (IFC), Lessons of Experience Series No. 7, Project Finance in Developing Countries (Washington D.C.: IFC Publications, 1999) p. 7.

132 Id. at p. 6.

mechanism for sharing costs, risks, and rewards of a project among a number of unrelated parties, a privatisation of infrastructure improvement program will have a greater chance of raising the volume of funds it requires.[133] Further, developing countries will have the advantage of benefiting from modern technology and efficient management practices when infrastructure projects are developed by the private sector and foreign investors. Governments in developing countries will thus, normally require foreign investors to transfer important technology to local institutions and train local staff in the operation and maintenance of the technology as necessary prerequisites of enabling foreign investment.

Table 3.1 below identifies the most significant advantages and disadvantages in the public private partnerships formed in project financing:

133 Id.

Table 3.1 Advantages and Disadvantages in Public-Private Partnerships in Project Financing

Some Significant Advantages and Disadvantages of Public Private Partnership in Project Financing	
Advantages	**Benefiting Party**
Moulding a project in a form which is compatible with government policies	Host Government
Maximising national sovereignty	
Receiving subsidised or risk-free participation	
Sharing in the rewards of value added services	
Training of labour and inheritance of modern technology	
Minimising any perceived adverse effects of FDI	
Improving predictability and stability of operational conditions and acceleration of infrastructure provision	
Access to new and previously restricted markets and sources of new profit	Investors, Lenders, Project Sponsors
Minimising political risk and better allocation of risks	
Availability of tax or other investment incentives	
Disadvantages	
Exposure to risk of incompatibility with foreign partners	Host Government
Need to grant long term concessions over national assets	
Need to contribute capital or other assets	
Need to provide undertakings, guarantees and buy-back agreements to provide comfort to the investors and lenders	
Need to offer tax and other incentives	
Possibility of political and public criticism resulting from giving access to private sector to previously subsidised public utility sectors	
Exposure to business risks	
"Soft" value of host country's capital contributions	Investors, Lenders, Project Sponsors
Less efficient decision-making and financing Structures	
Exposure to risk of loss of confidential commercial information and know how	
Exposure to risk of incompatibility with government bureaucrats	

3.2.3. Syndicated Debt and Equity Contributions

Most developing countries have annual budget deficits running into billions of dollars. With the cost of social infrastructure services increasing every year, allocation of scarce public funds for physical infrastructure is becoming increasingly difficult. As a result, infrastructure projects are increasingly initiated by the private sector and tend to be complex and expensive.

The competitiveness of the financing package is becoming an overwhelmingly important component in the acceptability of the overall project package. The ability to bring together multi-source competitive financing has become a critical factor in winning international projects. Success involves being able to bring together a mix of local, foreign and multinational private and public sector sources.

The funds for infrastructure projects through project financing are provided through the arrangement of debt and equity. Equity contribution for a project can take various forms including stock purchase and general and limited partnership capital contributions. These form the basis for project economies since the amount of equity determines, in part the amount of debt the project can service, and the amount of funds available for contingencies and unexpected expenses.[134] Also, the amount of equity contribution is sometimes indicative of the value placed on the project by the project sponsor and decreases the burden placed on the project to service debt, thereby reducing the risk of repayment which gives the sponsor and the investor an incentive to make the project work by placing equity at risk.[135]

134 See Hoffman, supra note 118 at p. 182.

135 Id.

In project financing, debt too can take various forms, the two main categories being senior debt (loans secured by a lien in the assets of the project and by other security agreements)[136] and subordinate debt (often provided by the sponsors or the host government and used as an alternative for capital contribution). The distinction between these two types is that: former is the first priority to be served from the cash flow of the project or in the event of borrowers default.[137] The most important financial component of project financing is, of course the senior debt which is the largest funding source for the infrastructure projects under this mode.

In a project financing structure, various potential sources of finance should be considered in relation to each project participant's objectives; the financing cost of the project; possible sources of plant, equipment and services; probable currencies; and estimated earnings after the project completion.[138] The final structure and the terms of the financing are dependant upon such factors as the amount of financing needed, the degree of risks involved, and the cost associated with allocating risks among the project participants.[139]

The current trend in developing countries is for private sector project developers to act as project promoters and, after making the initial representations to the host government or after winning a preliminary bid, to make representations to the relevant host governments with a financing and construction plan after considering financial and project viability tests. Once these initial steps are concluded, the project negotiations usually commences with the participation of all the main parties to the project (who usually include the Government Representatives, Project Promoter, Equity Investors and Debt Financiers).

136 However, occasionally even senior debt can be unsecured where the sponsors are held in high esteem as credit worthy by the lenders.

137 Emerson, C., Project Financing, (London: Financial Times Business Enterprises Ltd., 1983) p. 34.

138 See Hoffman, supra note 118 at p. 191.

139 Id.

Private sector project promoters who usually take the initiative to develop infrastructure projects are likely to obtain the necessary funding for infrastructure projects from a variety of sources mentioned earlier. However, in the first instance, it may be necessary to provide a high proportion of equity finance to start the project with a low debt/equity ratio unless the parties or other guarantors can guarantee loans. Arguably the most difficult element in private infrastructure is likely to be the provision of sufficient equity or guarantees. Usually most infrastructure projects are high cost undertakings and the equity percentage the equity investors even collectively undertake does not exceed 40% of the investment cost. Thus it is normal to see most infrastructure projects being financed on a 60-40 or 70-30 debt–equity ratio.

The equity for the project basically comes from the parties to the project company who are the equity investors. In addition, other parties may also participate in the project by making equity contributions. These other parties will usually include the host government who will take a share in equity as a royalty share for the concession it has granted. Other project participants such as managers, contractors, suppliers and utility purchasers may also make equity contributions in addition to their separate interests in the project.[140] When part of equity is raised by listing the project company in capital markets and by the issuance of bonds and certificates, other commercial investors may also participate by investing in the project expecting financial returns, independent of any other interest in the project.

The debt portion of the project investment generally comes from international multilateral funding agencies such as the International Finance Corporation (IFC), Asian development Bank (ADB), Commonwealth Development Corporation (CDCC), and Japan International Investment Corporation (JAIC) to name a few. In addition, bilateral funding

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140 The motivation for such participants to provide financing for the project can vary. The contractor; equipment vendor; and the raw material supplier; for example, may be motivated by the declining market for their goods and services where they can by participating in the project create a new market for their goods or services. See generally Nevitt, supra note 119 at pp. 9 - 20.

agencies, export credit agencies, international and domestic banks, and other financial investors such as trust funds may also become creditors of infrastructure development projects by lending to the debt portion of the project investment.

3.2.4. Multilateralism

Another unique feature in project financing is that project participants include governments and public sector entities, private sector companies, international funding agencies, international and domestic banks, contractors, suppliers and insurers, to name the key parties, all of whom have diverse interests and come from different fields. These different players are brought together by their public or commercial needs and they team up for achieving the individual goals by cooperating with each other. For example, a government or a public sector entity may have the need to improve a public utility service such as power supply but, might lack the necessary funds and modern technology required for the development. A private sector company might have the skills and technology to develop the project and have the need to spread its operations globally. However, it might lack the funds to undertake a mammoth operation on its own. The banks and other financial agencies which invest on investment projects may have the funds to invest but, might lack the resources or the enthusiasm to develop and manage large scale long-term projects. The construction contractors, suppliers and other service providers such as insurers and technical experts may wish to participate in a large scale project for commercial reasons. Thus, if these parties get together as a team they could collectively work towards making the needed project a success, although their individual needs and/or expectations may be different.

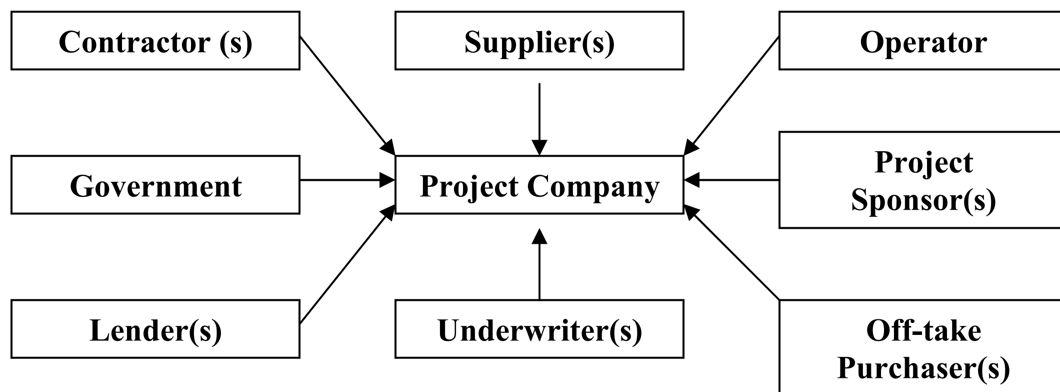
Accordingly, a consortium of interested and inter-locking partners come together and pools their resources to see a particular project through and hopefully to profit from the venture.

Apart from the host country, investors (with usually one of the investors being the project's sponsor or promoter) and lenders who play the key roles in negotiating and developing infrastructure projects, there are several other participants who play important roles in any given project financing structure. These parties include material and input suppliers, contractors, operators, consumers, under-writers to the debt and equity offerings, credit enhancing and rating agencies, and insurers.

The creation of a special purpose vehicle or a special purpose corporation and trustees to connect the different players together is an essential requirement in project financing.[141] The following figure shows how the special purpose vehicle (Project Company) connects the different parties in a typical project financing structure:

Figure 3.3

Parties to a Project Financing Transaction



Each of the aforesaid parties has a critical part to play, often at different stages of a project's life. Because, project financing is non-recourse or limited-recourse to the project sponsor, financial responsibility for various risks must be allocated to parties that will assume

141 Sellahewa, G.R., 'Financial Techniques for Private Infrastructure Development', Paper presented at the National Law and Economy Conference, Colombo, Sri Lanka (1995).

recourse liability and who posses adequate credit to accept the risk allocated. The allocation of risks can vary from transaction to transaction and is largely dependent on the bargaining position of the participants and the ability of the project to cover risk contingencies with the underlying cash flow and reverse accounts.

Many scholars have written on the characteristics of the main participants in project financing and their often different roles in a typical project that is financed and developed using project financing techniques.[142] Thus, in this section, this thesis does not undertake a detailed discussion on the characteristics of each project participant; rather brief descriptions are given on the roles played by each key project participant.

a. Concession Granter (the Government)

The role of the host government in a particular project will depend on the nature of the project. In an ideal world the host government would prefer to act as regulator of an infrastructure project developed with project financing and have minimum involvement with the funding and the management of the project. However, it is usually the case that host governments are expected to play a greater role.[143] As a result, in some developing countries in addition to the concession contract the host governments may be required to enter into a support agreement that confirms their continued commitment towards the development of the project. At a minimum, the host government is likely to be involved in the issuance of a concession to develop the project and in addition in the issuance of consents and permits on a periodic basis throughout the duration of the project. In some cases, the host government may actually be the purchaser or off-taker of the produce of the project. In some cases the host government may even be a shareholder of the

142 For example see Sapte, D.W. supra note 109.; Nevitt, P., and Fabozzi, F.J., Project Financing (7th ed.), (London: Euromoney Publications, 2000); and Tinsley R., Advanced Project Financing, (London: Euromoney Publications, 2000).

143 Sapte, D.W., supra note 109 at p. 24.

project company, when it had contributed to the capital or had secured a "golden share" during the project negotiations in consideration of the concession it had granted and as security for parting with the management and control of a state asset to the private sector.[144]

The power of government agencies to enter into contracts associated with infrastructure projects and performs obligations there under and, the capacity in which they enter into such contracts (agent of the government or otherwise) is a critical issue in project financing. The doctrine of *ultra vires* is largely irrelevant to companies, as the law relating to corporations in all countries usually provide that they have the powers of a natural person, subject to any express exclusion in a company's constituent documents. However, this is not the case with statutory authorities. It is settled law that a statutory authority constituted under legislation has only the powers given to it under the relevant statute that created it.[145] Therefore, statutory powers and functions exercised by statutory authorities must, without doubt, be wide enough to empower them to enter into each of the project contracts to which they become parties. If the authorities do not have the requisite powers, their actions may be *ultra vires* and therefore void.

b. Project Promoter (Project Sponsor/Project Developer)

A project needs a leader who can take the initiative to drive the project from the start-up stage to its completion. In project financing, such leader can be a single entity or a joint-venture. A Project promoter will have to resort to its own resources for the equity injections required by its

144 The popular definition of the term "golden share" used in the financial circles is that it refers to a type of share that gives its shareholder veto power over changes to the company's charter (see for example the glossary of financial terms used by NASDAQ - http://ir.nasdaq.com/glossary.cfm.) In project financing, the golden share could entitle the government to va veto over major dispositions of assets, a change of control, mergers or other major corporate changes. With the protection of the golden share, the government could relinquish majority ownership over state assets, yet still retaining a measure of control to appease the political opposition to private sector participation in the development of infrastructure projects.

145 In *Trustees of Dundee Harbour v D & J Nicol* [1915] AC 550 at p. 570, Lord Parmoor stated: *"It is settled law that a body .....constituted by statute, have no authority except such as Parliament has conferred upon them, and that they must find a sanction for any powers which they claim to possess in their incorporating statute or statutes. These powers may be expressly authorized or implied as fairly incidental to what is expressly authorized."*

position of authority.[146] Depending on the project, there may also be investors who come in either for the anticipated returns or for a combination of purposes, including the possibility of being suppliers to the project. Such investors may provide either pure equity or quasi-equity financing such as subordinated loans (with an equity kicker), i.e. a loan with a right to convert all or part of it into common stock, or as a success fee.[147] Thus, usually investors take a stake in the project company, which is normally a single purpose company (SPC)[148] established for the ownership and or operation and management of the project.

Project promoters can come into the scene of a project in two different ways. Sometimes they act as sponsors of a project by bidding for a project already identified by a host government as an infrastructure project to be developed with private sector participation. There are other instances where the project promoter identifies a commercially viable project and make representations to the host government to obtain a concession to develop it.

It is not uncommon for the project promoter to find a local partner, who may or may not be a government entity. In most developing countries, the current trend is for government entities to join the project promoter in forming the project company. The reasons for this are twofold:

i. The host governments not wanting to transfer 100% control of physical infrastructure services to foreign controlled private sector consortiums;

ii. The foreign investors feeling that local participation in equity would protect the investment from arbitrary and unfair treatment, and would ensure local commitment for project success.

146 Sapte, D.W., supra note 109 at p. 24.

147 Id.

148 Some time referred to also as the Special Purpose Vehicle (SPV) in some texts dealing with project financing.

c. Lenders

The largest share of project financing normally consists of debt, which is usually provided by lenders who have no direct control over the management of the project. Lenders invest in debt, either on their own or as part of a group of banks providing syndicated loans. The lenders usually come into the project after the preliminary negotiations of the contract between the project sponsor and the government are concluded and at the stage the host government would be interested in examining the financial plan of the sponsor. Although the lenders do not participate in the initial negotiations prior to the drafting of the main contract documents for consideration, they play a very active role once the main negotiations begin between the parties.[149]

For a party that may not have any management control over the project company except for interests over its project assets, the role played by the lenders during negotiations of the project is very significant. The lenders, in my view, hold the key to successful negotiations as it is the lenders who finance major protein (usually about 60% to 70%) of the project cost.[150] Due to the financial contributions made, and in their typical role as bankers, lenders are reluctant to assume any risks and thus the major interest on the part of the lenders during the negotiation process is to ensure that risks that may affect the project are minimised to the maximum extent and balance risks are allocated among other parties as much as possible avoiding the lenders. Lenders can thus, delay the process of negotiations, as they will object to risks, which have not been hedged adequately by their standards. There are several guarantee structures to get around this, but the transaction costs associated with these are high, in both time and money.[151]

149 See generally, Sapte, D.W., supra note 109 pp. 9 - 15.

150 Id.

151 Id.

Lenders try to protect their investment in the project through collateral and contracts broadly known as the security package.[152] The quality of the security package is closely linked to the effectiveness of the project's risk mitigation and allocation. More risks the project reflects, more demanding will be the security package. As a practice in international project financing, debt financiers will undertake a review of all core project documents to assess the allocation of risks and how that allocation impacts upon their credit approval.[153]

Due to the limited or non-recourse nature of project financing, normally, the lenders will have to be cautious and ensure that necessary protections are in place for their investments as the sponsors will not be usually liable for debt beyond the assets of the project company. Accordingly, they would want to ensure that the project contracts include a security package that would provide assurance to the lenders that their loans will be paid effectively, efficiently and as scheduled. A typical security package will include a mortgage over available land to the project and its fixed assets, sponsors commitment to the project including a share retention agreement and a project fund agreement, assignment of major project agreements, including construction, supply, and off-take contracts to the lenders.[154] In addition, the security package would include financial covenants ensuring prudent and professional project management and assignment of insurance proceeds to the lenders in the event of any project calamity.[155]

A key issue for the lenders will be the nature of the security that would be given by the project company to secure the repayment of debt. Where the project company defaults in repayment, ideally, the lenders would wish to be able to take over the project and dispose of it to a third party. Thus, the lenders will insist on having appropriate security interests over all project

152 IFC, Lessons of Experience Series No. 7, supra note 131.

153 Id.

154 Id.

155 See generally, Scriven, J., Pritchard, N., Delmon J., A Contractual Guide to Major Construction Projects (London: Sweet & Maxwell, 1999), Ch.3.

assets and also the project contracts. In the premises, in addition to creating security in favour of the lenders on the project assets, the project company will also have to agree to the assign all the project contracts to the lenders in the event of default in re-payment.

In practice, most lenders insist on direct agreements governed by the law applicable to the financing documents from each of the parties contracting with the project company. The main purpose of these direct agreements is to ensure that the project contracts will not immediately fall away if the project company is in default of its obligations under them. Further, to ensure that, if the lenders enforce their security, the project could continue either under the control of the lenders or, or if the lenders transfer it, under the control of a third party purchaser.

Further, the law governing the financial arrangements is most likely be one chosen by the lenders, who will seek as far as possible to insulate them selves from the effects of local law in relation to financing arrangements. However, this would need clever negotiation on the part of lawyers representing the lenders as usually it will be necessary for the law governing some of the securities, for example; land, to be that of the country in which the secured assets are located.[156]

d. Construction Contractor

An infrastructure project can be negotiated between a host government that grants the concession, a project sponsor who is willing to accept the concession and develop the project and the lenders who will finance the major portion of the project cost. However, if the project is to be successful it is also necessary to have a qualified contractor who will undertake the construction of the project. Sometimes, the contractor who undertakes the construction of the project may also be the sponsor of the project.

156 Id.

In project financing careful consideration is given to the selection of the construction contractor to ensure that the chosen contractor is capable of completing the construction within the agreed time period; within the allocated construction cost; and to satisfy the commercial requirements of the project.

The main objective of the contractor in a project financing is thus, to limit the risk of any change in the cost of the project; to complete the project in time; and to provide sufficient time to satisfy performance guarantees. The construction contractor will be concerned with the underlying financing structure of the project, including, whether the sponsor has arranged sufficient financing to pay the contractor for the work performed.

e. Operator

Most infrastructure projects usually deal with sophisticated and modern technology in the provision of public utility services. The Operator is charged with the operation of such facility. Quite frequently the construction contractor and the operator of the project is a single entity, which constructs and operates the project. Sometimes the operator forms part of the sponsor group as well.

The operator will be expected to sign a long term contract with the sponsor for the operation and maintenance of the facility. The operators tend to accept little risk in the form of up-front capital or expenditure. An operator simply anticipates making a profit from operating the infrastructure more efficiently than an equivalent government run project.[157]

157 Hoffman supra note 118 at p. 194.

The successful operation of the project facility is clearly vital to the generation of the cash flow necessary for the economic viability of the project. Thus, a key issue will be whether the operator of the facility is prepared to guarantee certain operation levels, for example, in terms of production or efficiency or whether it is only prepared to commit to more general operating obligations such as a duty to operate the facility in accordance with good industrial practices.

The sort of undertaking to be obtained from the operator will usually depend on the type of facility to be provided by the project. If the facility is new and uses new and hither to untested techniques, the operator will be hesitant to give guarantees on specific levels of achievements. On the other hand if the project is in control of a facility previously provided by the public sector, it will be in the interest of the host government to insist on improved levels of achievement, as otherwise, the very purpose of private sector participation in the project will be lost.[158]

f. Suppliers

The suppliers range from suppliers of goods such as fuel, raw material and equipment to suppliers of services such as insurance, banking,[159] electricity and telecommunication to the project. The suppliers are concerned with the objective of delivering to the project, the necessary goods and services in exchange for a price. The other project participants will seek firm price; quality; and delivery commitments with a minimum of uncertainly in the price, terms, and time of supply from the suppliers. Suppliers on the other hand would want to maximize profit and thus, may some times even form the sponsor group in order to ensure continued demand for their goods and services.

158 Id.

159 The reference made to banks here is to commercial banks which will provide banking services to the project. Thus, they are different to the banks which will provide the necessary debt for project financing transactions.

g. Output Purchasers (off-takers or end-users)

Infrastructure services may be purchased by a single customer (e.g. power supplied by an independent power producer to an electricity utility) or by many users (e.g. the users of a toll road). In any event, at the heart of the viability of a project is the revenue stream generated by the commercial operation of the facility. In the circumstances, the off-takers who enjoy the end product or the facility are essential for project success.[160]

The off-takers desire firm price and quality as the market will permit and a reliable source of output at an acceptable price. On the other hand the project promoters will expect a steady market for the out put in order to service loans and generate profits.

Unless the project involves the construction and operation of a facility in which sufficient income returns can be projected with reasonable accuracy, for e.g. like in the case of a port facility with an already established clientele, the project company, its investors and lenders will be more comfortable in entering into an off-take contract with some state sector utility purchaser. For example, most power projects in developing countries include power purchase contracts between the project company and the government owned power supply agency. The agreed price and the agreed period will usually depend on the project life term specified in the project contract and would usually allow sufficient time for the payment of debts and equity and also for the return of reasonable profits to the investors.

160 Bond, G. and Carter, L., Financing Infrastructure Projects; Emerging Trends from I.F.C. Experience, Discussion Paper No: 23 (Washington D.C.: IFC Publications, 1994) at p. 15.

h. Insurers and Underwriters

Insurance companies and underwriters will be brought into a project to cover those risks that the parties accept but wish to mitigate. Lenders will wish to ensure that the insurer is of reputable standing and able to pay out quickly after a claim is made. From this stand-point, local insurers may not be as acceptable to lenders due their limited resources and exposure to complex project financing transactions. The lenders will wish to ensure that all insurance is maintained with insurers whom they have approved beforehand. In circumstances, where having local insurers is a legal requirement even when they do not have adequate financial standing or reputable claims settlement history, lenders may mitigate the risk of failure to perform by such insurer by requiring (if the project company has not already done so) that the risks are reinsured with international insurance companies of adequate calibre; and by requiring an assignment of such reinsurance proceeds.

While it is in the best interest of lenders and investors of a project to insure the project against various risks, the host governments too will have an interest in ensuring sufficient insurance cover is obtained as project failure will have drastic impacts on its eventual ambition of inheriting a fully operational project. Besides, project failure will also expose the host government to both political and public criticism and thus, will be a discouraging feature to prospective future investors.

Insurance companies on the other hand may be motivated in providing such insurance covers due t high premiums they can charge. However, as the payments involved will be huge in the event of covered incidents happening, there are very few local and international insurers who could provide sufficient cover to various risks involved in infrastructure projects. As a result the present trend is for insurance syndicates to collectively cover various risks involved in project

financing. Some times, the multilateral agencies who participate in projects as lenders would also provide insurance cover through their subsidiary arms.

i. Project Facilitators

Project facilitators are the financial analysts, lawyers, and engineers etc. who are not main participants in a project. However, they play a vital role during the negotiation of projects and also throughout their life cycle by providing various services including advice and analysis. Although not having any stake in the project as investors, lenders or off-takers, the facilitators are responsible for designing of legal, financial, and engineering structures to suit all parties, and thus, are very important for the project success.

j. Technology Owners

Although not falling within the category of the main participants in project financing, the technology owners too are important actors for most projects. Technology Owners are important because the project sponsor or the contractor will normally have an exclusive license agreement with the technology owner for the use of the technology and its continued availability for the project.[161]

161 For more details on the role of technology owner see Hoffman supra note 118 at p. 196.

3.3. Identification and Mitigation of Risks Associated with Project Financing

Most of the risks associated with project financing are conceptually similar to the risks associated with traditional FDI. For example, commercial risks such as completion risk, credit risk, cost overrun risk, exchange risk, miss-management risk, and non-commercial risks such as environmental risk, *force majeure*, and political risks such as expropriation, and the change of government investment policy, to name a few are common to both traditional FDI and project financing.

The main difference between traditional FDI and project financing when it concerns risks is the fact that unlike in project financing, in traditional FDI, the risks are manly shared only between the host nation and the investor, with, in most cases, the host nation providing undertakings and guarantees protecting the interests of the investor and thus, shouldering the major portion of the risks. In project financing the risks are allocated among the multitude of parties who participate in projects.[162]

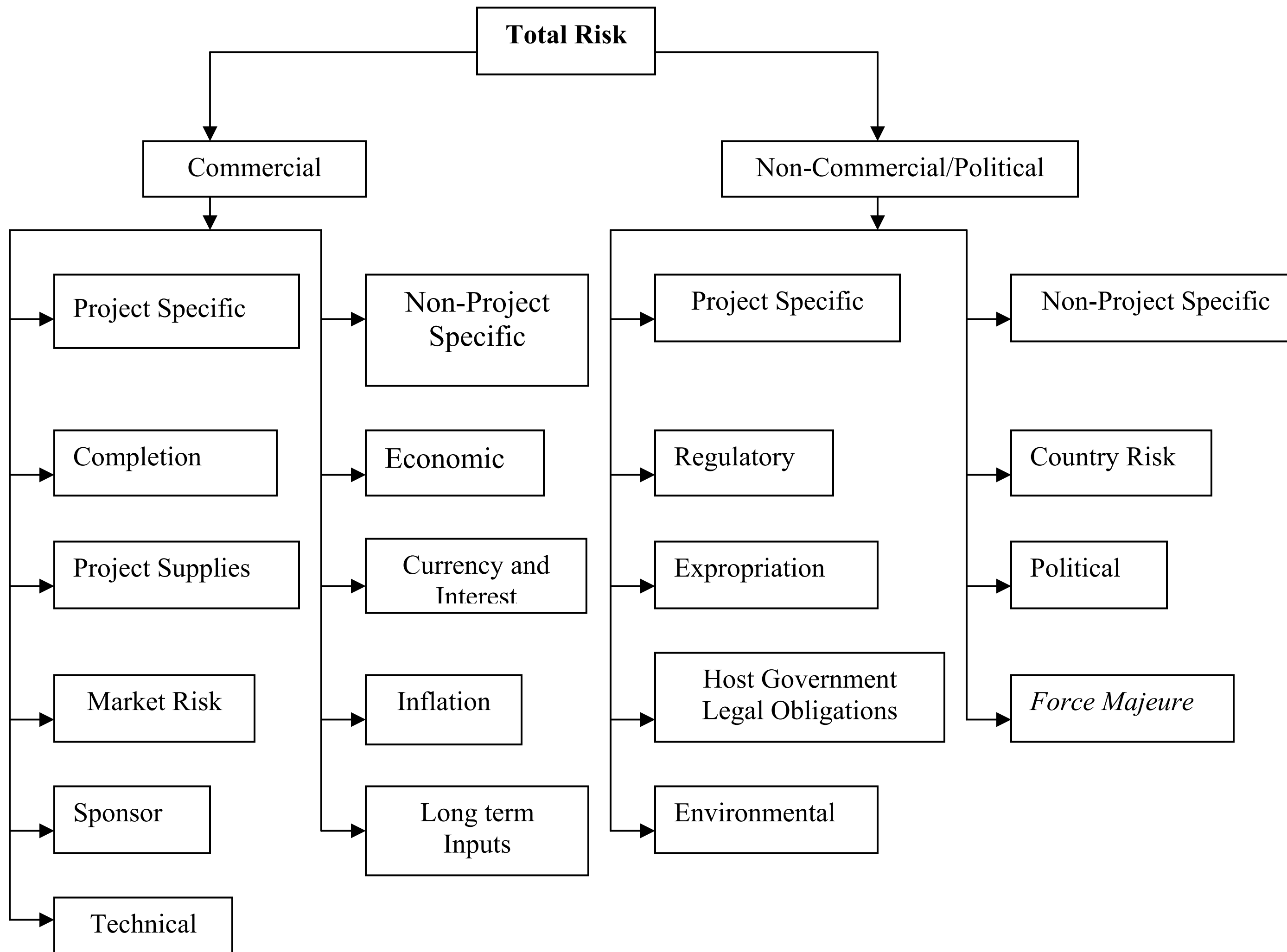
In project financing one of the key considerations is the assessment of which party will be affected by a particular element of risk, and in what way, and which party is best able to bare a particular risk. However, this is complicated and difficult since many project participants typically assume several project roles.[163] Moreover, due to their diverse interests, the capacity of the parties to absorb project risks will be very different. The risks in the project should thus, be spread between the various parties; the party, which can most efficiently and cost-effectively control or handle it, usually assuming each risk.

162 See Chapter 2, Section 2.5 for a more detailed discussion on traditional FDI.

163 For example, the construction contractor may also be one of the shareholders of the project company and/or operator. The concession granter some times may have direct or indirect link with the out put purchaser who might have a contract with the project company to purchase the project output.

There are a number of ways to categorize project financing risks. If ten project financiers were asked to categorize project financing risks, they would in all probability produce ten different categorisations. The point is that categorisation itself is arbitrary and is a matter for jurisprudential debate; it is the actual identification, allocation and mitigation of that risk that is important. The following figure presents a full list of commercial and non-commercial risks associated with project financing:

Figure 3.4 Structure of Risks Associated with Project Financing



All the risks shown in the figure above can be further chronologically grouped according to the projects life cycle, namely, the development phase, construction phase, and the operation phase and, risks associated with the entire life cycle of the project.[164]

3.3.1. Risks Associated with the Development Phase

It is during the development phase that technical and environmental studies of a proposed project are carried out. Usually such studies may consume a period of time generally between one to three years.[165] The funding used during this phase of the project is purely venture capital from the sponsors as the bankers are unlikely to provide any money during this period, mainly due to unawareness of the project viability.[166]

During this period, the main actor usually is the project promoter who has been given permission by the host government to do the necessary feasibility studies. During this phase the main risk from the project promoter's perspective is having the project proposal rejected by the host government or financiers. The main risk from the host government perspective is the selected promoter's inability to mobilise finance. There are generally three types of risks involved during the development phase of a project:

a. Technology Risk

The Technology Risk is that a new technology proposed for a project may prove to be economically or structurally not feasible. Further, the laws regulating the use of some technology may change making such usage illegal. This is a risk borne by the project promoters through their

164 See generally, Beidlemen, C.R., Fletcher, D., Veshosky, D., supra note 129 at p. 49.

165 Id.

166 Id.

equity contribution. Generally, the lenders will not favour any new technology being used in the project since they rely on cash flows from the project to service debt, and thus, expect the project to be similar to other fully functional projects with proven technology and engineering.[167]

b. Credit Risk

The Credit Risk concerns the creditworthiness of the project promoter. If after the feasibility studies have been undertaken, the project promoter is unsuccessful in securing the necessary finances by way of co-financing and/or debt, then the project promoter will not be able to proceed with the development of the project. Generally, credit enhancement devices are used to improve the most severe equity and lender risks within a spectrum of identified project financing risks.[168] These credit support devices take the form of guarantees given by the project promoter or other project participants to the financiers to ensure that there is no credit risk or that even if there is a credit risk, the promoter and or other participants would ensure protection to the financiers.

The project promoter would have to convince the lenders that the project is technically sound and commercially viable. The lenders will undertake a thorough due diligence exercise in relation to the project. In addition experts will be commissioned to produce a feasibility study and a financial model detailing the projected costs and revenues. The initial expenses associated with the production of such experts report is usually the responsibility of the project promoter. Such costs are at risk if the project is considered to be untenable by the banking community.

From the perspective of the project promoter, this risk is a commercial reality, which cannot be avoided. However, this risk can be mitigated or reduced to some extent if the lenders

167 Nevitt, K. P., Criteria for a Successful Project Financing , (London: Euromoney Publications Ltd. 1993) p. 15.

168 See Hoffman, supra note 118 at p. 205.

are identified at an early stage. In such situations, sharing of information and a feasibility study with the lenders participation and or knowledge may limit the possibility of lenders insisting on a separate feasibility study at a latter stage.

The lenders would usually welcome the inclusion of other financial contributors such as additional working capital lenders and project promoters into the project's financing structure.[169] However, they would insist that all such other interests are clearly and comprehensively subordinate to their own claims on the project assets. While lenders will wish to insert specific provisions prohibiting the repayment of any junior debt while any senior debt is outstanding, they may allow carve-outs in respect of repayments made contemporaneously with a proportionate prepayment of senior debt. The negotiation of these subordination provisions is often time-consuming and arduous but they are a fundamental part of the financing negotiations.[170]

c. Bid Risk

The Bid Risk concerns the successful launch of a bid for a particular project. This risk is shared by two groups involved in the bidding process; namely the project promoter and the project facilitators such as financial and other advisors who get paid for their services based on the success of the bid. As the relevant regulations governing the submission and consideration of bids can be very technical with lot of procedural requirements, parties submitting the bids will have to be extra cautious to ensure that all necessary requirements have been met prior to the submission of the bid. What is advisable is that the project promoter obtains the assistance of domestic experts from the host country who could advise the project promoter on the regulations, laws and procedures that needs to be followed in submitting the proposal.

169 Id.

170 Id.

3.3.2. Risks Associated with the Construction Phase

The construction period is very crucial for the project as any problems at this stage would prolong the date of completion of the project and delay the expected cash flow from the project causing delays in the repayment of debts. This period has a very high degree of risks for both investors and lenders since they have provided funds to a project which has not achieved completion.[171] From the host government point of view, the timely completion of the project is important for providing the required infrastructure services. In the circumstances, the host governments and lenders would normally require the project promoters to submit sufficient financial guarantees, insurance and other undertakings to ensure that construction risks are adequately managed.[172]

Construction risks are usually passed down to the construction contractor, who is often required to sign a fixed sum design/build construction agreement. Inclusion of a provision in the construction agreement that provides for liquidated damages in the event of any delay in completion is a common practice. In addition, completion guarantees and performance guarantees are normally required from the construction contractors in infrastructure development projects. Such guarantees normally take the form of a performance bank guarantee since the use of bonding companies for this proposes is not widespread among developing countries. It is important to note that these requirements provide an excellent opportunity for foreign contractors to participate in infrastructure development projects in developing countries as the local

171 See generally, Rendell, R.S., Niehnss, J.M., International Project Finance, in International Financial Law: Lending, Capital Transactions and Institutions. Rendell R.S. (ed.) (London: Euromoney Publishes Ltd., 1983) at p. 32.

172 See Harder, supra note 107 at p. 39.

construction companies will often lack the credit standing or financial capacity to provide adequate guarantees to the satisfaction of the lenders.[173]

There are three main categories of risks that may be encountered during the construction phase of a project:

a. Completion Risk

The Completion Risk is that a project may never be completed successfully or that there may be delays in completion. Delays may occur due to various reasons such as a failure in technology, cost overruns, work variations, shortage of raw materials and shortage of available workforce. In addition, sometimes, delays may be caused due to inefficiency of the constructor or the lack of commitment and supervision by the project company or due to the combination of both. There may be times where delays are caused due to arbitrary action taken by host government which affect the project completion, for example, cancellation of building permits. Whatever the cause may be for the delays, it should be understood that delays could be avoided with proper planning and by securing full commitment of the project participants towards completion of the project. [174]

The lenders to a project, and sometimes, even the host governments, will usually regard completion risk as the domain of the project promoter. The project promoter would wish to pass risk to the construction contractor by negotiating a construction contract that is as detailed as possible. If there is defective or inadequate construction work, the project company will look to the contractor for redress. In the circumstances, it is likely that in most project financing

173 Ibid. p. 40.

174 Rainier, S.E., *"Project Finance: A Risk Spreading Approach to the Commercial Financing of Economic Development"*, 24 Harvard International Law Journal (Summer 1983), p. 158.

transactions, the completion risk or at least a major portion of it will eventually come to rest on the construction contractor.

Delays in construction can be mitigated by incorporating specific clauses in the construction agreement that would make the contractor liable in liquidated damages for any delays within his control. Having penalty clauses which would encourage the contractor to complete the work on schedule would also help.[175] "Turnkey" contracts contract with an experienced contractor who would provide liquidated damages if the contractor fails to complete and hand over the completed construction as agreed on the due date and which have specific performance obligations are ideal to minimise this risk. In addition, the project company would normally obtain business start-up and other kinds of standard insurance, and would also include a construction contingency in the total cost of the project, and build in some excess capacity to allow for technical failures that may prevent the project from reaching the required capacity.

Delays beyond the control of the contractor, for example, delays in obtaining necessary approvals and licenses for the project can be avoided by requiring the host government to issue them in an efficient manner. Project promoters and lenders will usually insist that the host government or one of its line agencies acting as the concession granter should look into this aspect. Sometimes, project sponsors and lenders would insist that the host government provide guarantees to the effect that such approvals and licenses are duly issued.[176]

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175 Id.

176 Id.

b. Cost Overrun Risk

The Cost Overrun Risk is often considered to be the most important risk and most common threat to project financing. It means that the project will cost more than the amount of funds available from debt and equity. In other words, if the costs significantly exceed the initial financing plan, then it is most likely that the costs will affect the project's financial rate of return.[177] In this situation, even the possibility of those involved in the project abandoning it cannot be overruled. A cost overrun can occur due to various reasons including problems with start-up, in accurate engineering plans and inflation. The effects of such risks are likely to cause an increase in the debt services costs during the construction phase due to additional debt that may be required and the increased interest rates.[178]

The usual method of avoiding this type of risk is to have fixed price turnkey contracts, where the risks involved in the construction phase are pushed on to the contractor. There are also other ways of covering cost overruns risks. One possibility is that, when there is cost overrun, the project sponsor and other equity participants could provide more funds through additional equity contributions. Inclusion of a renegotiation clause in the contract; use of stand-by-credit facility under which additional funds can be obtained from the original lenders; and having an escrow account with funds provided by the sponsor for the completion of the project, are the other possibilities.

177 See Hoffman, supra note 118 at 198.

178 Id.

c. Political Risks

Several scholars have claimed that there is no single universally accepted definition of political risk.[179] On the other hand, Schmidt (1986) defines political risk precisely as "the application of host government policies that constrain the business operations of a given foreign investment". He subdivides risk into three main categories: "transfer risk", concerning risk to capital payments; "operational risk", with threats over local source or content; and "ownership control risk", highlighting possibilities of expropriation or confiscation.[180]

Although there seem to be some disagreement among various scholars on a universal definition for 'political risks" in practical terms he term encompasses a wide range of risks that mainly revolve around governmental action that may adversely affect the development or performance of the project. These include expropriation or nationalisation of project assets;[181] imposition of taxes and planning controls by the host government; mandatory government or local participation in project development and operation; changes in the applicable legal system and or regulatory regime; arbitrary revocation or amendment of any concessions or licenses granted to the project company; and the imposition of exchange controls by governments preventing foreigners from liquidating local financial assets. On a smaller scale, political risks also include regulatory measures taken by the host government that will have an effect on the work force or other property of the project company. A good example is the revocation by a host government of visas given to the foreign workforce of the project company.

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179 Formica, S., *"Political risk analysis in relation to foreign direct investment: A view from the hospitality industry"*, The Tourist Review, Vol.51, No.4 (1996), pp. 15-23; Kobrin, S.J., *"Political Risk : A review and reconsideration*", Journal of International Business Studies, Vol.10 (1979), pp. 67~80; Robock, S.H., *"Political Risk Identification and Assessment"*, Columbia Journal of World Business (July-August 1979), pp. 6-20; Sethi, P.S. and Luther, K.A.N., *"Political Risk Analysis and Direct Foreign Investment: Some problems of definition and measurement"*, California Management Review, Vol. 28, No. 2 (Winter 1986), pp. 57-68.

180 Schmidt, D.A., *"Analyzing Political Risks"*, Business Horizons, Vol.29, No.4 (1986), pp. 43-50.

181 Like the wave of nationalization and expropriation in Algeria, Iran, Nigeria, Kuwait, and Venezuela in the 1970's.

It should be noted however that in addition to the wide range of risks mentioned above, the concept of political risk associated with infrastructure development projects in developing countries has a much broader and subtler manifestation. This is because, in addition to what has been mentioned above, corruption and cronyism, bureaucratic delay, lack of transparency in the bid process, competitive interests in the government, micromanagement of the economy, lack of proper dispute resolution systems, government hostility towards neighbouring countries, change of government and lack of confidence in the government, to name a few, makes political risks one of the major concerns in connection with infrastructure development of projects.

Further, in addition to the risks mentioned above which revolve mainly around direct governmental action, it could be argued that political risks associated with infrastructure development projects financed with project financing techniques would also include the following risks which have in recent times shown signs of undermining the advancement of project financing for infrastructure development projects in developing countries:

i. Decentralisation of political power in developing countries;[182]

ii. Internal and/or external political instability;[183]

iii. Succession of States and creation of New States;[184]

iv. Wars and Invasions;[185] and

v. The sometimes conflicting interest between development needs and protection given to minorities and indigenous groups.[186]

182 This risk is dealt with in detail in Chapter 4.2. of this Thesis.

183 These risks are dealt with in detail in Chapter 4.3. of this Thesis

184 This risk is dealt with in detail in Chapter 4.4. of this Thesis.

185 This risk is dealt with in detail in Chapter 4.5. of this Thesis.

186 This risk is dealt with in detail in Chapter 5 of this Thesis.

It is important to note that political risks affect not only the construction phase of a project. For example, an expropriation during the operational phase of a privately funded infrastructure project could affect the lenders expectation of repayment out of the project cash flow. Furthermore, as noted earlier in Section 3.3.2 of this Chapter, the nature of political risks associated with modern day project financing transactions is some what different to the political risks that were associated with more traditional FDI transactions.

From the investors and lenders point of view, in order to mitigate political risks, it is necessary to insist that host governments establish legal safeguards to protect the investment projects from arbitrary decisions, especially in respect of future legislation affecting the project or the status of concessions, permits and licenses. Guarantees from the host government assuring that there will be no expropriation of the project or change in the status quo of the applicable laws and regulations under which the project was negotiated, are thus, very important.[187] Similarly, it is important to obtain assurance from the host government that adequate compensation will be paid in the event of any adverse effect to the project due to political decisions and actions of the government.

Offering the host government or its agencies an equity stake in the project or entering into a joint venture with an agency of the host government is another approach to overcome the political risks. In fact, in most developing countries, the host governments usually have an equity stake or joint venture stake in infrastructure developmental projects in order to mitigate the political risks. Further, taking insurance covers such as political risks insurance provided by the Overseas Private Investment Corporation (OPIC) is another measure that can be taken to mitigate political risks.[188] Furthermore, obtaining the necessary financing for infrastructure development

187 See generally Harder, supra note 107 at p. 40.

188 See Rainier, supra note 174.

projects from multilateral agencies such as the IFC and the ADB would also reduce political risk to a great extent as due to the fear of international criticism and withdrawal or reduction of development assistance, developing countries may avoid taking political actions detrimental to infrastructure development projects financed with project financing techniques.

From the developing country perspective, it is important to understand that fear of political risk might distract potential investors from undertaking development projects. Further, the presence of political risks would also prevent necessary finances for development projects being obtained from the lenders. Unlike in the case of traditional loans or grants given to developing countries for their development needs where payback of such moneys were backed directly by the developing country governments, in project financing, the recovery of moneys put into a project by the lenders relies mainly on the success of the project and its steady revenue stream. In the circumstances, it is important that the developing countries take all possible initiatives to reduce and mitigate the political risks present in their jurisdictions, if they are to attract investors and lenders for development projects.[189]

d. Environmental Risk

Environmental risk in the context of project financing means risks to the main project participants that result from conditions relating to the environment. The parties who may be worst affected due to the environmental risk are the lenders and the investors, especially, if due to an environmental risk a project is prolonged or abandoned halfway after the investors and lenders have put in their moneys for the project development. Environmental risk can be characterised in two ways:

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189 Some of the key risk mitigation measures that could be taken by the developing countries are discussed in detail in Chapters 4 and 5 of this Thesis.

i. Direct Risk: Direct environmental risks can occur when a project involves development activities that may cause contamination or other types of environmental harm to the natural resources of the host country or might endanger the public health of the host country. Direct environmental risks may also occur when environmental regulations prevailing in a host country is amended to introduce new environmental standards or when new environmental regulations are introduced which directly affect infrastructure development projects due to such projects not meeting the required environmental standards.

ii. Indirect Risk: Indirect environmental risks occur when countries tighten their environmental regulations and public interest groups become active and the pressure increases on project developers and or operators to minimize the environmental impact. This may increase the projects capital and operating costs in order to comply with environmental regulations. As a result this too can have adverse effects on cash flow, and consequently, in the project's ability to service the debts with its revenue.

From the perspective of the investors and lenders, the risk is that, when environmental damage occurs or the threat of environmental damage is present, the regulators of the host country environmental protection agencies and some times even the public or other interest groups may take legal actions that may adversely affect the project progress. For example, injunctive actions that may be obtained against a project suspected of causing environmental damage may delay the progress of that project, thereby affecting the expected progress and the cash inflow. Further, the regulators taking administrative action such as reviewing and cancelling licenses issued to the project developers is also a risk.

Environmental risk may also arise as a result of public opposition against projects viewed as adversely affecting living and working conditions of the people. Public opposition may stop projects going ahead or may significantly delay their implementation.[190] Actions taken to overcome public opposition, even if successful, may impose tremendous costs on the projects significantly affecting their financial viability.

It is very important therefore to assess environmental performance and management as part of the normal credit evaluation process. Environmental risk is therefore one of several kinds of risks that the main non state project participants, i.e. the lenders and the investors should take into account when assessing new lending or investment opportunities. The general aim should be to focus on environmental issues associated with project development and to increase the opportunities for environmentally acceptable sustainable development.

From the development country perspective, it is important to ensure that proper project feasibility studies are carried out and the possibility of any environmental or public health risk is ruled out before taking a decision to invite project developers to initiate development projects and inviting investors and lenders to finance the development of such project.

An international survey carried out by the European Bank for Reconstruction and Development (EBRD) in 1993 provides evidence of the extent to which environmental risks have affected banking practices throughout the U.S., Western Europe and Southeast Asia. The survey which incorporates the experiences of 56 lenders from 7 countries provides the following findings:

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190 The shelving by the Sri Lankan Government of the idea to develop the Port of Galle as a regional hub port and rejection of the offer to develop the same on BOT basis by a group of promoters led by Mot McDonald Group, in the wake of hostile objections by environmental activists, is a good example.

- Over one-third of the banks had experienced significant losses resulting directly or indirectly from environmental risks.
- The most common sources of loss were defaulted loans, written off in preference to exercising rights over collateral which could have exposed lenders to the costs of undertaking remedial works.
- Large numbers of financial institutions also reported losses arising from remedial works undertaken by the lender after foreclosure and from loans which defaulted as a result of environmental upgrading or costs for remedial works incurred by the borrower.
- Smaller but significant numbers of banks testified to reduced share values and dividend payments, resulting from environmental violations or costs incurred by customers, together with increased volatility of share prices as a result of increased environmental risk across their equity portfolios. [191]

Another survey sponsored by United Nations Environment Program (UNEP), identifies similar trends with respect to the environmental credit risks and loss exposure of many financial institutions.[192]

During project negotiations, environmental liability will attach primarily to the project operators. However, this can all too easily be transferred to lenders if lenders' exercise security over the project as in such a case they may be obliged to assume responsibility for the environmental damage. In any event, even in such circumstances, where liability remains with the project operators, environmental damage could still impact dramatically on lenders in terms of increased project costs and delays. As a result, nowadays the international lenders for project financing transactions are extremely cautious before making a financial commitment to a project.

191 Bisset, D., *"Managing Environmental Risk: A New Responsibility for Banks"*,. Bankers Magazine (March/April 1995).
192 UNEP, Global Survey on Environmental Policies and Practices of the Financial Services Industry, (Nairobi: UNEP Publications, Summer 1994).

For example, IFC requires environmental assessment (EA)[193] of proposed projects for IFC financing to help ensure that they are environmentally sound and sustainable. [194]

Proper environmental impact assessment and careful evaluation of the existing legislation in host countries on environmental protection would help to mitigate the environmental risks associated with project financing to some extent. However, although an extensive environmental audit can give parties to a project with some comfort, and, although proactive steps such as the establishment of environmental management systems can be taken, the most effective way in which the parties could mitigate the risk is by obtaining comprehensive insurance. Even though commercial insurers will seek to introduce into insurance policies a number of exclusions that would severely restrict their liability, insurance for environmental damage should still be a sine qua non for infrastructure development projects.[195]

3.3.3. Risks Associated with the Operation Phase

Once the project development phase and construction phase are successfully concluded an infrastructure project becomes operational. When the project becomes operational, mainly three parties will look to the project for benefits. The host government will look to the project for the expected services. The lenders will look to the project for repayment of loans and interest thereof. The investors (shareholders) of the project will look to the project for profits.[196] Thus, the

193 EA is a process which's breadth, depth, and type of analysis depend on the nature, scale, and potential environmental impact of the proposed project. EA evaluates a project's potential environmental risks and impacts in its area of influence, examines project alternatives, identifies ways of improving project selection, sitting, planning, design, and implementation by preventing, minimizing, mitigating, or compensating for adverse environmental impacts and enhancing positive impacts, and also includes the process of mitigating and managing adverse environmental impacts throughout project implementation.

194 IFC database: http://www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/pol_EnvAssessment/$FILE/OP401_EnvironmentalAssessment.pdf

195 Sine qua non or conditio sine qua non was originally a Latin legal term for "without which it could not be" ("but for"). It refers to an indispensable and essential action, condition, or ingredient.

196 Shareholders will include the project promoter and all other parties who have made equity contributions to the project company. In some instances, the host-government may get a golden share without any equity contribution, and this would be in addition to lease payments it would charge from a project company for the concession given.

project will have to start bringing in sufficient revenue for servicing all these needs in order to make the main project participants happy. Therefore, during the operation phase, the main risk is that the forecasted cash flow from the project operations might be lower than what was expected due to operational mishaps.

Operational risks are general risks that may affect the cash-flow of the project by increasing the operating costs or affecting the project's capacity to continue to generate the quantity and quality of the planned output over the life of the project. Operating risks include, for example, the lack of experience and resources of the operator, inefficiencies in operations or shortages in the supply of skilled labour and, the risks relating to market rejection of the project output, thus affecting the expected revenue.

The effect of this risk is generally lower compared to the risks associated with the development phase and the construction phase of a project. This is because during this phase, the project outlook is less uncertain and the project assets are in place.[197] Further, it may be possible to re-finance senior bank debts in the capital markets with cheaper and less restrictive bonds.[198] Raising capital in the capital markets as a mode of refinancing is generally easier than raising capital initially from the capital markets. A completed construction project is likely to attract more players in the capital markets who would be interested in investing during its operation phase.

Lenders are traditionally prepared to accept operating risk on the basis that debts are serviced by the proceeds from the project. However, this risk is sometimes passed to the end-user of the service provided by the project. For example, in some power generation projects, the end

197 State Bank of Pakistan, Banking Policy Department, "Draft Guidelines for Infrastructure Project Financing" (2004, November).
198 Id.

use is the host government and the lenders would require the host government to buy the project output at an agreed price during the entirety of the project life.[199] As long as the host government could recover tariff from the public, sufficient to cover the cost at which it has to buyback the project output from the project company there will be no loss. However, due to political and or economic reasons, most developing countries are compelled to provide infrastructure services to their public at subsidised rates. As a result, the burden of shouldering this operational risk falls on the shoulders of the host governments. Sometimes, the risk is covered by proceeds retention accounts which are aimed at controlling cash-flows by requiring the proceeds of the sale of project out-put to be paid into a tightly regulated proceeds account to ensure that funds are used for approved operating costs only.

The extent to which project lenders are forced to accept operating risk depends to a large degree on the definition of completion of the project and the time at which any support provided by the project promoters fall away. Given that most completion tests require the project to be running at a specified level for a given period of time before a completion test is satisfied, complete failure of the project and consequential complete assumption of operating risk by the lenders is unlikely during the post-completion phase. Lenders can therefore mitigate operating risk by effectively delaying it through strict definition of "project completion".

The extent to which the operational risks are accepted by the lenders depends on the managerial competence of the project company. If the lenders have complete faith in the managerial capabilities of the project company, they would feel comfortable in accepting operational risks. Lenders will however, expect to see share retention provisions in the loan documentation pursuant to which the existing shareholders of the project company will be obliged to maintain a certain shareholding level during the operational phase.

199 For further information on this aspect see below under Market Risk.

In contrast, project sponsors will wish to see maximum flexibility so as to allow for divestment of their minority interests which would in turn allow for future investment by third parties and corresponding growth of the project company. One point that lenders should bear in mind is that, where project promoters or other shareholders are obliged to inject additional equity funds into the project company pro-rata to their shareholdings from time to time, the ability of such parties to divest themselves of any minority shareholding interests will mean a potential reduction in the obligations of those entities with regard to any injection of funds. Lenders and their advisers should therefore take care to avoid such a consequence by providing that the funding obligations will remain with the original shareholder notwithstanding any divestment of shares.

The main concern in relation to the risk of project performance falling short of expected levels during the operational phase would be the lack of commitment from the project promoter. The best manner in which this could be mitigated would be to select a qualified and experienced project promoter by following an impartial and competitive selection procedure and by carefully considering its creditworthiness, past performance, capacity, managerial capability and technological know-how, before the final selection is made. To ensure continued efficient performance of the project, it is prudent to require technology assurance and technology transfer agreement from the project promoter.

From the point of view of the lenders, to mitigate the operational risks, the main requirement is to have a strong and an experienced project promoter with a significant equity stake. In addition to this, several other precautions may have to be taken. Thus, the lenders would prefer the use of tested technologies for the project rather than the use of new. New technologies may receive lender approval if the obligation to repay the debt is supported by a guarantee of

technological performance form the project participant who owns or holds the licence for the technology. The lenders may also insist on performance bonds and guaranties from equipment suppliers to the project on quantity and quality. These guarantees may have to be assignable to the lenders.

Obtaining the project promoters' agreement to train local staff so that after the handover of the project to the host government it could continue to perform smoothly should be a consideration from the host government point of view. However, this requirement may be dispensed with contracts that do not involve a hand back provision.

During the operational phase of a project, the expected revenue could be threatened due to the existence of one or more of the risks briefly discussed below.

a. Supply Shortages

This risk usually occurs when after the construction phase is completed, the project does not get the necessary supplies to fulfil its operational requirements. For example, if the project is for power generation by the use of hydropower, the absence of torrential rains would cause a supply shortage.

The operational cost of a project which is crucial for the calculation of the cash flow could be affected by cost overruns in the payments for raw material and personal wages and by inefficient telecommunication and transportation facilities.[200] This would result in the project being incapable of servicing the projected market and in turn failing to earn the expected revenue. However, this type of project risk can be effectively avoided if necessary precautions are taken.

200 See Hoffman, supra note 118 at pp. 200 - 201.

For example, measures such as long term supply contracts with the raw material suppliers and long term operating obligations with suppliers of facilities such as telecommunication and transportation should be taken to mitigate such risks.

b. Mismanagement

It is not uncommon for a new operation, perhaps in an emerging market environment unfamiliar to the project promoter, to run into managerial difficulties. The danger here is that due to mismanagement, the project will not be able to function efficiently to its full capacity and accordingly will fail to earn the expected revenue. In a worse case scenario, mismanagement could even lead to the project promoter or the project operator being ousted from control and the lenders stepping-in. In some instances it could even lead to government interventions with the intention of taking over the project or complete renegotiation of the project contracts.

In order to mitigate this type of risk, it is necessary to obtain sustained management and technical assistance from an expert technical and management partner by having a management agreement included in the project documentation. It is common in most project financing transactions for infrastructure development projects for the project promoter to issue a letter of comfort to the creditors and the host government at very early stages of the project negotiations ensuring that the project company, when established, will be run efficiently in a professional and business like manner.

c. Market Risk

Inadequate demand or the reduction in demand for the services to be provided by the project is one of the major causes of revenue and profitability problems concerning most

infrastructure projects. For example, the successful negotiations for the development of the Colombo Port in Sri Lanka in 1997–1998 between a private consortium led by the P&O Ned Lloyd Group and the government were concluded only after all the main parties were satisfied as to the project viability based on a detail study of expected market growth and demand for container handling in the region.

In the circumstances, it is clear that the quality of the market analysis, and of accompanying revenue and margin forecasts matter when market risk is considered by the project participants. However, if after completion of the development, the expected market growth is proved to be a mere illusion, then the project company would face the risk of not being able to service the debts and equity.

One method adopted to alleviate this risk is to secure a market for the output through the conclusion of long term, price specific, sales contracts with customers, before production begins.[201] Risks related to marketing the product or output can also be minimised by having the host governments agree to underwrite revenue streams by means of "take-or-pay" or "take-and-pay" contracts backed by the full faith and credit of the government.[202] These contracts usually take the form of long term contracts to make periodic payments, in certain minimum amounts for the supply of services or goods.[203]

It should be noted that "take-or-pay" conditions are not suitable for all types of projects. While such arrangements may suit typical power generation or other utility production projects,

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201 See Rainier, supra note 174 at p. 171.

202 See Harder, supra note 107 at p. 40.

203 The take-or-pay agreement involve a long term contract in which the purchaser agree to make periodic payments in return for a product/ service, regardless of whether the product/ service is delivered. In a take - and - pay agreement the purchaser only pays for the product / service when it is actually delivered. The distinction being that in the former, payment obligation of the purchaser is unconditional where as in the later there is no stipulation for an unconditional payment.

such arrangements cannot be employed to minimize market risk for example, in port development and road development projects. This is because the host government is incapable of purchasing the utility and redistributing it to the consumer unlike in a power project.

In addition to the above, "put-options" too are employed as an instrument to protect lenders and investors in project financing operations. Under this option, specified parties (for e.g., the investors) are given the option to require another party (for e.g. the project promoter) to purchase certain project assets they own (for e.g., equity or debt instruments) at a special price and at the occurrence of certain events (for e.g. after a certain period of time). A put-option also gives a project company the option to sell its output at a fixed price at some point of time in the future. This option provides the investors with the comfort that they can recover directly from the project promoter, part or all of their investment under certain conditions.[204] One limitation of this type of agreements, however, is that new project companies may have to reach a stable level of output before they are able to enter into them. In addition, product options in the market usually do not go beyond two years in maturity. Thus the options may not be feasible for longer term hedging in many projects.[205]

It should be noted that market risk is difficult to hedge against unless there is a single buyer or small group of buyers for the output. Projects where the final end product is some thing which's price may vary regularly, as is the case in the mining sector, the market is particularly vulnerable to changes in demand and need.

Mitigation of market risk is important mainly to project promoters who have to service the debt obligations from the proceeds of the project output; and to the lenders, who want their

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204 Benoit, P., Project Finance at the World Bank: An Overview of Policies and Investments, Technical Paper No. 312, (Washington D.C.: World Bank, 1996), p. 14.

205 See IFC, Lessons of Experience No. 7, supra note 131 at p. 47.

debts serviced from the project cash flow. It is extremely important to the host governments as they would not wish to be burdened with unsuccessful projects which would result in public and political backlash in addition to putting a black mark on the investment portfolio of the country.

d. Cost Increase Risk (for Consumer)

Another operating risk is the risk of cost increase for the consumer. The cost to the consumer is usually extremely important to any government as costs need to be reasonable from the consumer point of view. Thus, once the rates to the public have been approved by the government, it will often be extremely difficult to obtain approval to increase such rates.[206]

In most developing countries, infrastructure facilities to the people are provided on subsidised rates. Thus, there will be public hostility towards any price increases even if such increase can be justified from the lenders' and investors' point of view. Thus, it is important to agree in advance to a formula for future rate increases, taking into account the effects of inflation.

Forward sales or purchase contracts are a means that could be used for hedging cost increase risk. A project company may wish to enter into forward contracts to stabilise the price of key raw materials. However, this could also have negative impacts as the project company is bound to loose on such forward purchase contracts if the raw material prices drop in the future.

e. Foreign Exchange Risk

This is a major risk that may occur during any time of the project life. However, it is most harmful during the operational phase, especially in the eyes of the lenders. The risk involved here

206 Harder, supra note 107 at p. 41.

is that, the value of the currency in which the project revenue is earned might depreciate in value against International currencies, especially against the currency with which the debts have to be serviced. Macroeconomic stability, the balance of payment situation, and the foreign exchange rate policy in the host country are therefore important factors to consider in assessing the currency risks.

Like all other risks in project financing, the goal in foreign exchange risk management should be to minimize the risk and allocate it to the party who is willing and able to manage it. One way of minimising foreign exchange risk is by denominating everything in one currency. For example, the Sikap Power Sdn. Bhd. $1.5 billion gas-fired power project in Lumut, Malaysia, was financed entirely by Malaysian sources and all cash flows during operations, including debt repayment, were in Ringett. A different approach was used the Mammonal project in Colombia (200 MW) where the debt and equity financing was raised in the U.S. in U.S. dollars, and the electric revenues were also denominated in U.S. dollars.[207] However, these two examples are probably anomalies. For example, in most international power projects, the project is built with finances raised in hard currency (dollars, yen, deutsche marks, pounds, francs, etc.), and then operated where cash flow is generated in local currency. Thus, in the event of devaluation of local currency, repayment of loans in foreign currency will be extremely costly. The following measures could be adapted to mitigate the exchange rate risk:

i. Mix local currency and foreign currency loans: All projects involve local costs. Thus, the overall currency risk can be reduced to some extent by covering the local costs with local funding to any possible extent. Mixing of local and foreign funding in this way will ensure that the project does not rely excessively on foreign funds.

207 World Cogeneration Magazine, *"Foreign Exchange Risk Analysis*", March/April Issue (1998). Online: http://www.cogeneration.com/

ii. Index output prices to the exchange rate: This method will help shield the project from exchange rate risk as project charges will be linked to the exchange rate applicable at the given time. However, this arrangement can still be very vulnerable to situations of dramatic changes in the exchange rate. This vulnerability was clearly demonstrated during the Asian financial crisis in the late 1990's where many host governments and other contracting partners of project companies expressed unwillingness to honour such indexing since it would have amounted to passing significant local price increasers to the end-user, i.e. general public.
iii. Swap Currency: When a local currency swap market exists, local currency can readily be swapped with major foreign currencies to remove a project's currency risks. However, unfortunately, many developing countries have no such markets.
iv. Reserves: Can be raised from financing or from cash flow during operations. Reserves can be held in the country or off-shore in a special escrow account. In addition to having sufficient reserves, an escrow account will also help the borrower, i.e. Project Company, to avoid potential repatriation difficulties.
v. Insurance: Rate protection includes derivatives (e.g. swaps and forward contracts). Insurance can come from private or government sources or multilateral institutions and can cover convertibility, availability, and repatriation, but not rate.
vi. Guarantees: Can be sovereign, corporate, bank or by letter of credit. They can address all or some of foreign exchange risks.

f. Interest Rate Risk

The normal practice in international project financing is to grant long-term debt on floating (variable) interest rates. This however, is risky as the international interest rate

environment can change dramatically during the loan maturity period. Thus, if the interest rate risk is not properly hedged, financial projections for the project based on initial rate assumptions can be significantly affected. Thus, the project promoters who are most likely to get affected by varying interest rates can adopt the following measures to mitigate such risk:

i. Negotiation of a fixed rate: Although theoretically this is a good measure, most commercial banks relying on short term funding sources are reluctant to lend their moneys on fixed interest rates for long term projects. However, clever negotiation may convince the commercial banks to fund the projects on a mix of floating and fixed interest rate loans. Some international institutions like the IFC and ADB too provide fixed rate financing for long term infrastructure projects.

ii. Conversion of the interest rate: Some project promoters prefer to borrow the necessary funding at floating interest rates with the hope of taking advantage of any future drop in the interest rates. However, in such situations they are most likely to incorporate an interest rate conversion clause in the contract documents giving them the option to fix the interest rate in an environment where there is a steady rise in the rates of interest. Most international financial organizations that fund long term infrastructure projects have been accommodating such options.

3.3.4. Risks Spread Across the Whole Project Cycle

Some risks associated with project financing transactions are present during more than one phase of the project. For example, political risks and environmental risks which have been dealt with earlier, can be present during both construction and operation phases. In addition to these two risks, there are other risks that can cause problems during the entire life span of a project. The risk of *force majeure* is a good example.

Generally speaking, the *force majeure* risk is a risk where a party's performance of contractual obligations will be rendered impossible by events not within the performing party's reasonable expectation or control. *Force majeure* events could halt the project during different phases of its cycle and include natural and technical disasters to acts of terrorism and war.[208] As neither the developer nor the host nation can control such risks, neither party is capable of bearing the risk alone. In the circumstances, such risks may be mitigated to some extent through the purchase of commercial insurance coverage which extend to all stages of a project and cover both asset loss and business interruption. However, it should be noted that such insurance covers tend to be very expensive.

Traditionally, the *force majeure* risk has been treated as including both "acts of god"[209] and other unexpected events not within the control of the contracting parties. Thus for example, events such as terrorist attacks, war, strikes and labour unrest, events that could not be reasonable foreseen by the contracting parties have been part of the risk. However, as far as developing countries are concerned, it has become a practice in most modern day project finance contracts to restrict *force majeure events* to "Acts of God" and allocate other unforeseen risks such as those mentioned above to a project participant, most likely the host government. The bargaining power the investors and lenders have in project negotiations play a key role in such risk allocation as the investors who finance the equity portion and develop projects and the lenders who finance the major portion of the project development fund, i.e. the debt portion, would like to minimise the risks allocated to them.[210]

208 Ellinidis G. T., *"Foreign Direct Investment in Developing and Newly Liberalized Nations"*, 4. Journal of International Law and Practice (1995), p. 299 at pp 314 - 316.

209 A natural event, not preventable by any human agency, such as flood, storms, or lightning. Forces of nature that no one has control over, and therefore cannot be held accountable.

210 According to two key negotiators of the Sri Lankan Government (who wished not to be named) who negotiated the Queen Elisabeth Quay (Colombo Port) BOT Development Project with the private sector project development consortium led by the P&O Group and the lenders which included IFC and Common Wealth Development Corporation (CDC), due to the desperate need of the government to attract FDI for the project, the requisition by the investors and the lenders to leave out events such as war, terrorism, strikes and civil strife from *force majeure* events and allocate them to the government had to be tolerated.

Unlike the other risks involved in project financing transactions, *force majeure* risks are the ones which are most difficult to mitigate. From the developing country perspective, this is one of the most undesirable risks. In addition to running the risk of having to abandon projects in the event of any *force majeure* incident, many developing countries find themselves being pushed into accepting financial paybacks to lenders and investors even in the event of *force majeure*. The Build Operate Transfer (BOT) contract signed between the Government of Sri Lanka and the P&O Group led consortium to develop the Queen Elisabeth Quay of the Colombo Port, which was mentioned earlier in this chapter, has such a provision in the concession agreement.[211]

Traditional methods of mitigating force majeure risks have usually involved proving the reliability of engineering, procurement and construction (EPC) contracts, operation and maintenance (O&M) contracts, sovereign guarantees given by the host country governments, resource studies, equipment performance data and setting sufficient sinking funds to cover "expected" problems. However, this process can be time consuming and expensive. Further, and at the end of the day, just one detail can foul the entire process and send the project sponsors packing.

However, in recent times some new (and some not so new) specialized risk mitigation products developed by the insurance industry have surfaced offering a variety of measures for mitigating *force majeure* related risks.

211 The final draft of the Contract was examined and studied by me in 2001 at the Department of Attorney General in Sri Lanka.

"Some of these unique products include:

- *Cover for Technology Risk: a new form of an old idea of providing warranty coverage to new technology. These products are highly individualized and negotiated on a specific need and financial capability basis.*
- *Debt Service and Credit Enhancement: these are highly specialized contracts designed to transfer the risk from the lender to the insurance company balance sheet effectively giving the project triple "A" credit.*
- *Weather Risk: insurance and weather derivatives that provide a risk levelling resource guarantee for any measurable force of nature.*
- *Political Risk: all manners of political or cross boarder risk can be provided for with the most prevalent coverage being Contract Repudiation.*
- *Commodity Hedges: like the commodity market itself, these products serve to level the risks while placing a cap on positive gains. The product allows for a pre set long term contract, backed by triple "A" paper. The advantage over a self managed commodity fund is it takes the uncertainties out of the equation. The various products in this class include: Fuel prices, currency exchange rates, market risk, transmission risk, counterparty risk, generation risk and any risk that comes from dependency on the future price or cost of an item."*[212]

212 Cook, Michael A., New Hope for Project Finance Unique Products Mitigate Risk, Green Pages (September 1999). Online: http://www.eco-web.com/editorial/03889.html

3.4. Structure of Project financing

3.4.1. Considerations for Selection of the Structure

As already noted, project financing transactions usually involve several parties with diverse interests. For the purpose of successful completion of a project as well as for fulfilling their individual expectations, the participants from input suppliers to output buyers in a project financing transaction are united in a vertical chain through numerous contractual agreements. According to the Australian Contractors Association, the Melbourne City Link Project, an A$2 billion road infrastructure project, had over 4,000 contracts and suppliers.[213] This explains the complexity involved in a multi party project and the importance of ensuring that the contractual structure of an investment project financed with project financing techniques is closely knitted, minimising room for any delays to the project completion and operation and losses to the parties involved.

Since project financing as a contractual arrangement involves several agreements between various participants, these several and different agreements provide the legal framework within which the whole project functions. The main legal framework of the project will also depend on the specific financing structure that is selected. Once the sponsor, lender, purchaser, suppliers and other potential participants are identified, it is possible to develop several financing structures for the project for consideration and selection of the most suitable by the main project participants, i.e. the host government, the lenders, investors and the project promoter.[214]

213 See the 2002 award finalists online at www.constructors.com.au

214 For a detail discussion of this aspect see Emerson, C., supra note 137 at p. 34.

In theory, the range of potential financing structures for any given project is considerable and can embrace the establishment of trusts (which shift ownership and consolidation requirements), subsidiaries, nominee or jointly owned corporations, limited or general partnerships and joint ventures. In practice however the variety and number of such structures will depend on the degree to which:

i. Potential participants in the project are willing to commit themselves financially and contractually and to accept the transferred risks and obligations entailed.
ii. Potential lenders are prepared to accept the proposed structure of the project and are satisfied with government assurances given concerning the continuity of the project and the safety of the investments made.[215]

Once the best possible financial structure is identified, the facilitators of the project, i.e. the financial advisors, legal advisors, engineers etc. are called upon to appraise the credit worthiness of the potential share holders in the light of the guarantee structure proposed to the lenders. In addition, a legal review of the drafts of all the proposed contracts including, the contract between the project company and the lenders and the project company and the government will have to be undertaken.[216]

Once the above appraisals are done to the satisfaction of the parties, the proposed project company formation agreements should be documented. The project company is generally a single purpose entity dedicated to the completion and operation of the project. According to Emerson,[217] such company formation agreements should generally contain provisions covering:

i. The scope, objectives and time scale of the project;
ii. The projects legal entity;

215 Id. at p. 36.
216 Id.
217 Id. at pp. 36 - 37.

iii. Ownership / share holder interests, provision for transfers from the original participants to new participants;[218]
iv. The proposed methods of financing;
v. The authority wielded by shareholders through the Board of Directors;
vi. The management of the project; and
vii. Procedure to resolve disputes.

Two key elements missing from the provisions identified by Emerson as being important are the project deliverables with their time schedules and the agreed payment mechanism. It is important that the project agreements clearly identify and list the project deliverables according to the agreed expectations of the parties. Likewise, it is important that the agreed payment mechanism covering payments for investors/shareholders and the lenders are clearly identified.

In a typical project financing arrangement, there are six categories of contracts. Namely:

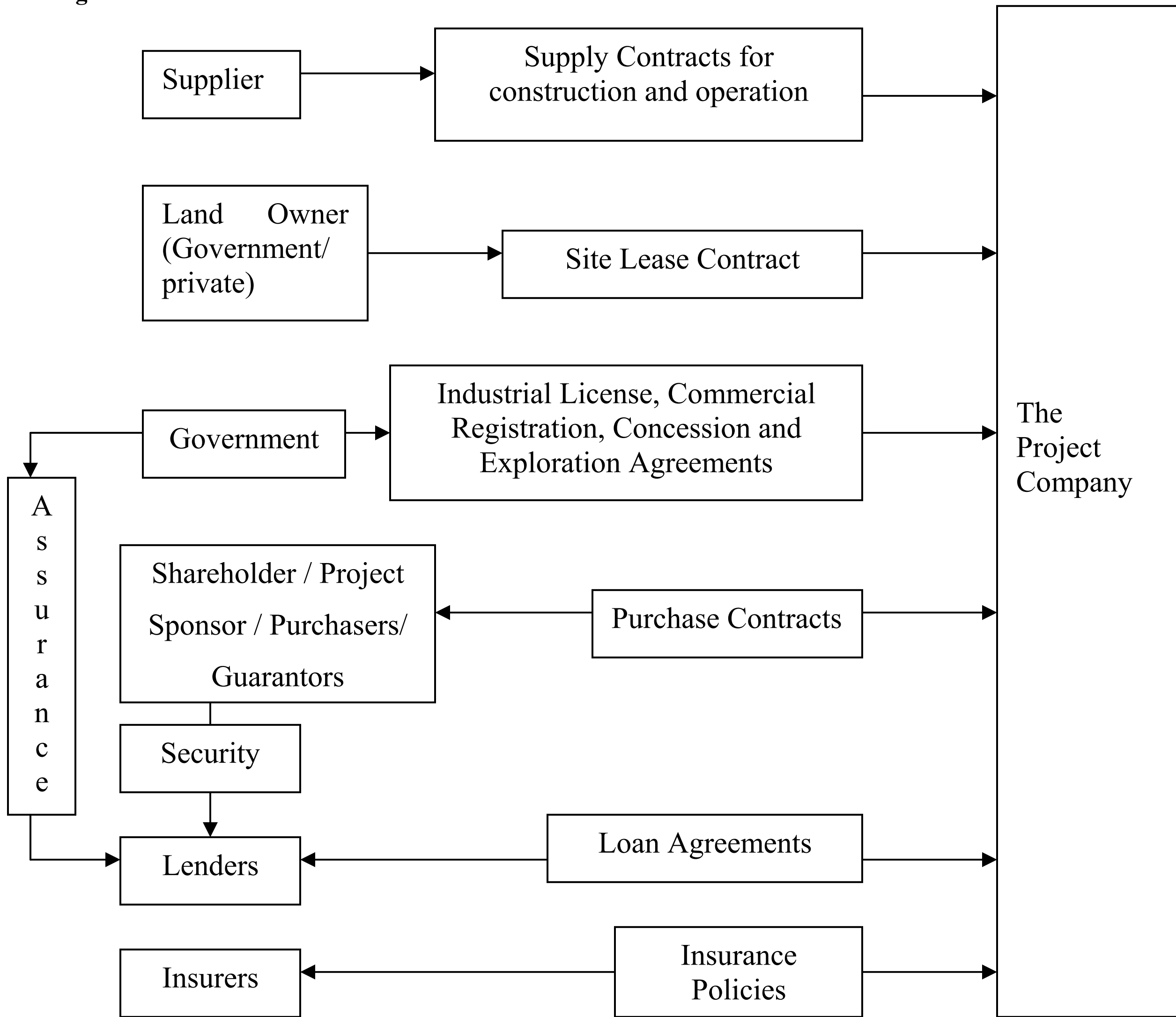
i. Site acquisition/Lease or Concession
ii. Construction and completion.
iii. Fuel and raw material supply.
iv. Off-take (output or service sale contract).
v. Operation and maintenance; and
vi. Financing and equity contribution.[219]

The resulting key legal and contractual relationships are shown in figure 3.5 below:

218 For example, in a BOT project the private developer is entitled to operate the project for a number of years before transforming the same to a public entity. See Chapter 3 for a detailed discussion on BOT projects.

219 Hoffman, S. L., "The Law and Business of International Project Finance: A Resource for Governments, Sponsors, Lenders, Lawyers, and Project Participants", , (The Hague; Boston: Kluwer Law International, 1998) p. 231.

Figure 3.5



3.4.2. Project financing Structures widely used by Developing Countries

All models of project financing will generally include the common features described in the previous section. However, the selection of a specific contractual structure for an infrastructure development project in a developing country would depend on the following factors:

i. The extent to which the developing country government is willing to entertain a public-private partnership for infrastructure development;
ii. The extent to which the developing country is willing to liberalise the existing policy concerning the provision of utility services to the public and state control of physical infrastructure facilities in favour of foreign investor and private sector participation in infrastructure development; and
iii. The extent to which the investors and lenders are willing to commit their resources in a developing country.

The most commonly used models of project financing in recent years by the developing countries are the Build Own Operate (BOO) and Build Operate Transfer (BOT) models. These two models involve a consortium submitting a proposal to finance, design, build, operate and sometimes transfer the project back to the host government after the end of the concession period. However, there are several other models that are rarely used but having almost similar contractual features.

a. Build Own Operate (BOO) Contracts

BOO is a technique which combines private finance, design and construction with private operation after completion of a project. Operation and ownership of the project is usually continued with no transfer back to the government. However, the government is usually entitled to a certain amount of shared revenue within a specified period.[220] Thus, under the BOO scheme, the project remains in the hands of the private sector without any requirement of transfer to the host government. Thus, this is very close to the free market ideal. BOO allows the investors to recover its total investment, operating, and maintenance costs, plus a reasonable return by collecting fees and other charges from output purchasers.

BOO types of contracts are mainly used to develop projects such as limited time power generation facilities which are not meant to be permanent fixed assets of the host country. These contracts (usually 10-15 years) are more like stop-gap measures to facilitate medium term requirements in the provision of infrastructure facilities to the people. In the circumstances, BOO type of contracts are not used in projects such as highways and port constructions as such projects would continue to exist and provide services even after the concession period is over.

b. Build Operate Transfer (BOT) Contracts

BOT is also a technique which combines private finance, design and construction with private operation after completion of a project. However, unlike in BOO, ownership of the project does not rest with the private entity. Only the development and operational rights of the project will be given to a private entity during an agreed period of time (concession period). During this time (usually 20-30 year concession period), the private entity is expected to recover the project

220 See Harder, supra note 107 at p. 36.

investment, operation and maintenance costs, and a reasonable profit. The project has to be transferred back to the host government at the expiry of the concession period.

BOT contracts are mainly used for infrastructure projects which involves high investment cost and modern technology and are thus beyond the capacity of host countries to finance and develop. Such projects include, highways, ports, water sanitation facilities, and sometimes even hospitals and universities, which usually end up becoming a permanent fixed assets of the host country when the project construction and operation periods are completed.

c. Other Variants of BOO/BOT

It is important to note that sometimes the term 'BOT' itself is used generally to identify most of the project financing models which involve a private sector led consortium financing, designing, building and operating a project either for a specific period of time or permanently.[221] However, there are several other variants of BOO/BOT models that are currently in use. These include: BLT (Build Lease Transfer), BT (Build Transfer), BTO (Build Transfer Operate), RLO (Rehabilitation Lease Operate), and BOOST (Build Own Operate Subsidize Transfer).[222]

Although the popular use of BOO/BOT and other similar models commenced in the 1980's, it really cannot be regarded as a new development as often stated. In contrast it should be identified as a reawakening of an old concept. The earliest use of the concept can be traced back to 1782 A.D. in France where the Perrier brothers were granted a concession similar to a BOT for water supply.[223] Further, during the 19th century, this type of arrangements was adopted for water

221 Id.

222 United Nations Industrial Development Organization (UNIDO), BOT Guidelines, (Vienna: UNIDO, 1996) at p. 3.

223 Roth, G., The Private Provision of Public Services in Developing Countries, (Oxford: Oxford University Press, 1987).

supply projects in Germany, Spain and France and for privately owned 'turnpike' roads, similar to the present day toll roads in the U.S. and Britain.[224]

The modern use of the concept came about in the 1980's with its introduction as a prominent method of financing infrastructure in Turkey as a part of the government strategy to raise off-balance sheet financing.[225] This was followed by the success in Europe in using the concept to finance the Euro-tunnel project.[226] Since then, this type of project financing has become an instant hit with both developed and developing countries which look to private financing as a method of reducing public sector debt expenditure in infrastructure development.

Today, the BOO/BOT models of project financing are true hybrids representing an intermediate stage between state monopolies and private enterprises. It can be conceptualised as a mid-point on the continuum between state monopolies and free market and which may help to introduce free market concepts gradually to a transitional society.[227]

For both BOO and BOT projects and the other 'BOT' variants, project financing is the cornerstone. This means, essentially and technically speaking, the lenders look to the projects assets and revenue stream for repayment rather than to other sources of security such as government guarantees or the assets of the project sponsors. However, as already noted, in real life, most developing countries continue to offer payback guarantees to lenders and investors in order to attract their interest.

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224 Id.

225 See Generally Barret, M., *" Project Finance Develops New Risks"*, Euromoney Magazine (October 1986) pp. 75 - 76.

226 See Tiog, R.L.K., *"Project Financing as a Competitive Strategy in Winning Overseas Jobs"*, International Journal of Project Management (May 1993), pp.75 - 86.

227 Levy, David, A., *"BOT and Public Procurement: A Conceptual Frame Work"*, 7 Indiana International and Comparative Law Review (1996) p. 95 at pp. 97 -99.

3.4.3. Main Contractual Arrangements in a BOO/BOT Project

Although there are several contracts that are entered into between various project participants, the main contracts which form the backbone of a BOO/BOT projects are the concession contract between the host government and the project promoter; the construction contract between the project promoter and the construction contractor to build the project; and the off-take contract between the project sponsor and the host government or one of its nominated agencies for the out-put buy back to provide stability to the return of revenue from the project.

a. Concession Contract

A concession is described in the Oxford Companion to Law as the "*grant by a public authority to a person of authority to do something, such as to work the land, extract minerals, operate an industry, or the like"*. Under English law, a concession is essentially a contractual licence. This disparity in legal classification perhaps explains why there are now so many different labels for what is fundamentally the same form of agreement; "project agreement", "development agreement", "implementation agreement" (at least in certain respects), "franchise" are all largely interchangeable terms. Their use is sometimes preferred in order to avoid the confusion that "concession" can give rise to given its different meanings and categorisations from jurisdiction to jurisdiction. Many civil law (and civil-law based) jurisdictions, including France and several Latin American countries, place them in legal categories of their own, often within the area of public administrative law, with clear statutory definitions, whereas, English law and other common law jurisdictions do not treat them as a separate species of contracts distinct from ordinary commercial agreements.[228]

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228 The Channel Tunnel Concession Agreement signed in the late 1980s, was one of the first, well-known examples in the UK in recent years of a concession agreement for a major project. (There have since been numerous others in the PFI field.) If the agreement ever has to be litigated (at least to a judicial

In conceptual terms, concession agreements can be difficult to classify. One of the first tasks for a lawyer advising on a concession-related project would be to establish whether the local jurisdiction has a recognised jurisprudential concept of "concessions".

A concession agreement codifies the credit/financial structure in the legal documents to create what should be a watertight set of provisions acceptable to all parties to the transaction. It is very important that every detail is understood and negotiated so that the project has reasonable goals and clauses. In infrastructure development projects, it is the most important document to be negotiated and should be addressed at the very beginning. Several key provisions should be included in the concession agreement as outlined below.

A concession allows the project sponsor to take control of the entire system: operations, maintenance, user fee collection and investment. The developer's role is to retain the right of control, the right to use the assets of the system, the right to collect user fees, all for a period of time long enough to regain costs and make a return.

Under the concession agreement, the government retains ownership of the asset[229] and ensures that the asset is maintained and used well. Additionally, the concession agreement would also provide that the government will act as regulator of the service sector related to the infrastructure facility developed under the project to oversee its performance and user fees. This is vital to protect users in terms of quality and quantity of the service to be provided by the project as well as to assure lenders and investors of adequate revenue streams to service their debts and investments. The level of independence such a regulatory body will have varies greatly

conclusion), it will be interesting to see what consequences flow from the differing legal classification of concessions under English and French law, given that both systems of law seem to apply to it.

229 Except in the case of projects developed under the BOO scheme.

depending on the country, its political situation, and the associated level of risk. It is extremely complex and time consuming to clearly arrange a concession contract with the appropriate levels of risks and rewards and the requisite guarantees for all parties.

Regulatory issues addressed in a concession agreement usually include:

i. The willingness of the public to pay for services;

ii. Whether regulations will allow the operator the freedom to setup an appropriate pricing strategy;

iii. Whether and when the concession will revert back to the public sector;

iv. The policy of competing infrastructure providers; and

v. Whether the legal framework for awarding concessions and related issues are well defined.

The operation period provided in the concession agreement must be long enough to pay off the project debt and provide a reasonable return on investment. Provisions should be made to enable an extension of the operating period due to reasons such as defaults by the parties in their obligations; *force majeure* events; and political risks.[230] Adequate termination conditions should also be present along with proper compensation.[231]

The operator may not be able to fulfil its obligation because of a host of technical factors (i.e. equipment performance, poor design, etc.). The concession agreement must thus address these factors and provide some ways to mitigate these risks without abandoning the project. The

230 World Bank, "Build-Operate-Transfer Arrangements: Legal, Financial, and Regulatory Issues, Toolkits for Private participation in Water and Sanitation, Toolkit 3 - What a Private Sector Participation Arrangement Should Cove" (1997). Online: http://www.worldbank.org/html/fpd/water/wstoolkits/.

231 Id.

implementation of an operation/maintenance manual and the use of performance bonds can ensure proper operation.[232]

Concession should also include dispute settlement procedures to deal with potential conflicts between the parties to the contract, for example conflicts between the regulatory requirements and the concessionaire's financial viability. In order to resolve eventual disputes on a neutral stage, it is important that the concession agreement includes alternative dispute mechanisms (arbitration-mediation) by a neutral body outside of the host government's legal system. This is important as most foreign investors, lenders and project operators are usually reluctant to subject themselves to the national jurisdiction of host nations. One of the key reasons behind this reluctance is the lack of confidence in the neutrality and effectiveness of adjudication by local courts of disputes between the government and foreign parties.

Although the concession contract is basically a contractual arrangement between only the host government and the project sponsor, the lenders as the main financial contributor to projects (due to more debt less equity based financing mechanisms) have a significance influence in the finalisation of the concession contract. Lenders will usually review the clauses in the concession contract that affect the project's ability to generate revenues. As a first step, they will ensure that the facility generates the revenues and is built on time and within budget and is operated properly, usually by demanding the appointment of an independent engineer to review construction progress and operating efficiency.[233]

The concession contract must also address default situations such as, when the borrower is unable to make a loan payment on time or is declared bankrupt. The contract should allow the

232 Id.

233 Lenders may also be given the right to request changes in the concessionaire's contractors, including its operating contractor. This usually occurs when, in the lender's opinion, the contractor cannot comply with the terms of the contract and the non-compliance will substantially increase the project's cost.

lenders to "step-in" and assume control of the concession until the default event is remedied or a substitute concessionaire is appointed. The concession contract should allow the substitute to enter into the same contract. This gives the lender control and the ability to improve management, company profitability, and thus the chances of loan repayment. A more appropriate vehicle for step-in rights is of course a direct agreement between the lenders and the host government,[234] but direct agreements can sometimes be extremely difficult to negotiate with governments. If any step-in rights are contained in the concession agreement, the lenders may be able to place at least some reliance on them by virtue of the strength of their security package.

b. Construction Contract

The construction contract assigns the project construction to a chosen contractor. This contract will also include provisions clearly allocating most of the construction phase risks to the contractor. The construction contract is typically a turn-key design and construct at a fixed price contract intended to reflect the back-to-back arrangements necessary to match up with the interdependent off-take agreement, operation and maintenance agreement, and other agreements constituting a BOT project.

There are number of construction contract considerations peculiar to BOO/BOT projects as they typically involve a long construction period. The costs of delays in such construction contracts are always significant. It may be possible that the government would be prepared to accept a negotiated date for delivery of the project. It is extremely unlikely; however, that the government would accept any potential obligation to pay extra costs arising out of construction

234 An example of this is the Second Stage Bangkok Expressway project in Thailand, where the lenders step-in rights were created, and not just referred to in the concession agreement. However, for this to be feasible, local law will of course have to permit enforceable third-party rights to be created by contracts to which the third parties are not signatories.

delays. The Government's obligation, in relation to construction of the facility is to buy the product on completion (not to pay the construction cost). Likewise, the project promoter would not typically be in a position to make extra payment. The lenders will not usually accept this risk either. For these reasons, the risks associated with construction delays are borne as follows:

i. Extension of Time: borne by the government;

ii. Delay Costs: borne by the construction contractor.

As far as the lenders are concerned, reliance is placed on the performance of the project as it is from the revenue earned from the project that the debts obligations towards the lenders will be mostly serviced. In the event of underperformance, this security may be diminished. Accordingly underperformance will have to be expressly catered for in the construction contract. Therefore the minimum performance requirements will have to be spelt out.

The limitation of liability of the contractor is another consideration when finalising a construction contract. The need to limit a contractor's liability is not unique to BOT projects. The amounts involved in BOT contracts however are so large, to deserve special attention. The construction contractor in a BOT project is potentially exposed to damages far beyond the value of the construction contract. In particular, the construction contractor has potential liabilities for:

i. Damages to the project promoter for underperformance of the project;

ii. Damages to the project promoter or for delay in delivering the project;

iii. Damages to the project promoter in rectifying defects;

iv. Damages to the project promoter for consequential losses under the off-take agreement; the operation and maintenance agreement; and the finance agreement.

The construction contract should also provide room for termination and "step-in" rights. The host government and the lenders must have the ability, in the event that the project promoter

is in default to the point where the take-or-pay agreement and/or the finance agreements are terminated, to "step-in" and take over the obligations of the project promoter under the construction contract (and the operation and maintenance contract) to ensure continuity of the project, provided, however, that it is the viable option, given the circumstances. The agreements with the construction contractor and the operation and maintenance contractor, therefore, must include provisions obliging the construction contractor and the operation and maintenance contractor to comply with that regime.

c. off-take Contract

The off-take contract is normally the key revenue contract in many infrastructure projects. It is the agreement between the host government and or one of its agencies with the project promoter. It is the contract under which the former agrees to purchase from the latter the out-put of the project at an agreed price and volume.

The critical element of the off-take agreement from the host government perspective is the performance warranties to be given by the project promoter. The performance warranties should deal with both the quantity and quality of the output. The government or its agency will also require the off-take agreement to detail the consequences of a failure to meet the performance standards, for example, provisions enabling the charge of liquidated damages and/or the right to call for an event of default.

The viability of the project and in particular its bankability will depend upon the reliability of the cash flow under the off-take agreement and the host government and project promoter/operator performing their respective obligations. The aim of the project promoter in negotiating the off-take agreement with the government is to minimize its market risk. This may,

to a certain extent be achieved by structuring the cash flow in two parts, namely, an availability fee and a usage fee. The availability fee is a fee payable by the government agency to the project promoter in consideration of the project promoter making the infrastructure facility available irrespective of actual throughput. The usage fee regulates the price per unit that the government will pay for the actual amount of the product supplied to it. The sponsor will want the availability fee to cover all or at least a substantial part of its fixed costs. The usage fee will cover the balance of fixed costs (if any) and the variable costs.

While the project promoter will push for a high availability fee to minimize its market risk, it must be careful in so doing, because if all market risk is shifted to the government agency this may undermine the ability of the private sector to obtain tax deductions.[235] The government agency would want to structure the transaction so that the sponsor has the maximum incentive to attain the pre-agreed performance standards. To do this, it would want the ability to reduce the tariff payable or impose liquidated damages if the performance standards are not achieved.

Lenders, on the other hand, would want to restrict the ability of the government agency to interrupt the cash flow under the off-take agreement (especially if this could affect the sponsor's ability to meet repayments on the bank debt). The lenders will firstly argue that non-performance related defaults should not have any impact on the tariff as the government agency would in such circumstances still be receiving what it bargained for, namely, a high quality product. They will also argue that, provided, any default is being promptly rectified, the cash flow should not be interrupted and other remedies such as liquidated damages may be more appropriate. The obvious consequence of an interruption of cash flow will be that the financiers will not have a source of revenue through which to repay their debt. However, as stated above, the government's ability to

235 See generally, United Nations Commission on International Trade Law (UNCITRAL), Legislative Guide on Privately Financed Infrastructure Projects, (New York: United Nations, 2001); and UNCITRAL, Legal Guide on Drawing up International Contracts for the Construction of Industrial Works, (New York: United Nations, 1998).

reduce tariff is its principal weapon to ensure that the project promoters strives to achieve the performance standards.[236]

The off-take agreement must also provide for part of the tariff stream to escalate during the probable long term life of the agreement. The base tariff is normally negotiated prior to the start of construction. The base tariff must be regularly indexed in accordance with the Consumer Price Index ("CPI") or some other agreed formula to ensure that the tariff stays in line with the movement in costs over the life of the project. Furthermore, there must be provisions enabling the tariff to be adjusted in the event of unforeseen circumstances occurring. For example, the project promoter would require the ability to increase the tariff in the event of its costs increasing due to a new law or regulation that affects the costs of operating the project. The government agency would also want the tariff to be reduced if costs decrease due to an unforeseen event.

The formula regulating the indexing of the tariff and the events entitling either party to seek an adjustment to the tariff will therefore be heavily negotiated. For example, the host government is unlikely to accept an increase to the tariff if a tax change affects the sponsor's return on its investment.

A further issue which might impact upon the escalation of the tariff is the cost of funds. The finance arrangements may provide a right to the lenders to increase the costs it charges from the borrower if certain events occur, for example, change of law, and changes in capital adequacy etc. The lenders would normally like these increases to be matched by an increase in the tariff payable under the off-take agreement. The host government will normally resist such demands.

236 Id.

3.5. Key Advantages and Disadvantages of Project financing

As is the case with any form of investment, in project financing too, it is critical that the parties identify the advantages and disadvantages associated with it. The main advantage in project financing, from the point of view of developing countries is the transfer of the responsibility of financing, constructing, maintaining and providing an infrastructure service to the private sector. Use of private sector financing provide a new sources of capital, which reduces public borrowing and direct spending and which may improve host government's credit rating. In addition, this enables developing country governments to accelerate the development of projects that would otherwise have to wait for and compete for scarce sovereign resources. Further, sometimes, the governments' not only get to transfer the responsibility of financing and providing infrastructure services to the private sector, but also get the benefit of inheriting a fully operational project after the agreed concession period is over.[237] Another important factor is that project financing gives access to private sector technology. Furthermore, project financing allows the allocation to the private sector of project risk and burden that would otherwise have been borne by an already encumbered public sector. Finally, Public sector can measure its efficiency against the benchmark established by the private sector in respect of similar projects and associated opportunities to enhance management of infrastructure facilities.

From the project promoters' point of view, project financing is ideal when their creditworthiness or the borrowing power is less than adequate to take over the responsibility of financing and completing an infrastructure project. Further, the ability to avoid having the project debt reflected on their balance sheets (off balance sheet aspect) is another advantage. Project financing, especially, BOO/BOT projects enable the investors to have access to markets which were previously not liberal and/or open to them. Furthermore, project financing often provide a

237 For example, when a infrastructure facility is developed as a BOT project.

solution whereby a tailor-made financial package is developed together with a supporting security structure that will enable the project promoter to participate in a project which could otherwise be beyond their capacity. Further, Project financing allows financing on a higher debt to lower equity ratio (e.g. 70% - 30%) and because debt is traditionally less expensive than equity, the overall project cost and the tariff necessary to repay the debt and provide an acceptable return on equity can be less.

The end users of project outputs will also find project financing arrangements much to their advantage as they will be the recipients of quality and up-to-date infrastructure services provided by technologically and managerially efficient private sector led utility providers. However, the strength and acceptability of this advantage will rely on the nature of the service provided and the tariff charged from the end users. If the end user is the host government (for example, the off-taker in a power project) it would have an efficient and modern power generation facility to its advantage. However, if the government is incapable of providing the generated power to its public at an affordable price, then the public perception of the advantages of the infrastructure facility would be different to the theoretical advantage.

Although the advantages of project financing outweighs the disadvantages, if project financing is to work to the satisfaction of all the parties concerned, then the potential disadvantages too needs consideration. The degree of risks involved with regard to all project participants and the complex nature of the transactions involving participants with diverse interests, which in turn requires lengthy technical; financial; and legal analysis are the biggest disadvantages of project financing.[238] In other words it is not a simple operation. The risk allocation issues between the parties and doubts concerning the project viability and financial

238 Sozzi, C., *"Project Finance and Facilitating Telecommunication Infrastructure Development in Newly Industrialized Countries"*, 12 Santa Clara Computer and High Technology Law Journal (1996), p. 435 at 457.

security result in protracted negotiations and increased costs. The documentation involved too is lengthy and complex.

The degree of supervision that the lenders will impose on the management and operation of a project too can be disadvantageous from the point of view of the investors and the host governments. Also, the regulatory control from the host government can be a disadvantage from the point of view of the investors as they will desire the freedom to manage and operate a project without public sector interference.

Untested risk allocation among the project participants in project financing, is another concern. As project financing methods are relatively new, no definite analysis of the successful or the unsuccessful nature of the risk sharing is available. Thus, the various risks that exist through out the projects life should be carefully identified, defined, allocated and provided for within the contractual package that defines the project. This process would requires highly effective lawyering and financial and technological know-how on behalf of all the project participants as clear evaluation of each party's capacity to bear the risks and the extent of such risks is necessary. This process can be both time consuming and costly.

Chapter 4 - Changing Face of some Traditional Risks Associated with FDI

4.1. Changes and Reasons

As noted in previous chapters, during the last two decades most developing countries have developed a growing interest in the development of infrastructure facilities with the use new modes of FDI such as project financing. In other words, developing countries have advanced from the stage of using FDI mainly for natural resources exploitation to the stage of using project financing techniques for the development of infrastructure facilities such as dams, roads, ports, electricity, water and telecommunication facilities. In line with this transition, developing countries have implemented institutional and regulatory reforms essential to foster suitable environments for investor participation in development of infrastructure facilities previously tightly controlled by state monopolies. These reforms have so far been reasonably successful, as private sector project developers have keenly accepted the roles of both the promoter and the provider of infrastructure facilities.

In order to ensure the future success of project financing in infrastructure development, developing countries as well as the other major project participants need to understand the nature of the risks associated with FDI when financing mechanisms such as project financing is used for infrastructure development. Most of the risks associated with modern day infrastructure development projects in developing countries are not new. They are similar to traditional risks associated with FDI. These risks and how they are allocated among project participants were briefly dealt with in the previous chapter.

It is important to note that whilst most of the risks associated with modern day infrastructure development projects look similar to the risks associated with traditional FDI, due to the key reasons discussed below in sections 4.1.1 and 4.1.2 of this Chapter, some of the risks have assumed a new out look. The most significant changes have occurred in connection with political risks. For example, the demand for political decentralisation and political autonomy in some developing countries have given a new dimension to the political risks associated with modern day infrastructure development projects, when compared to traditional FDI projects. These changes have occurred partly due to the nature of project financing mechanisms used in modern day infrastructure development projects where there is now more than one risk taker and partly due to the changing political as well as economic culture in the developing countries.

4.1.1. How the use of Project Financing have Contributed to the Changes

As noted in Chapter Two of this thesis, most developing countries gained independence during the two decades that followed the Second World War. Since gaining independence, until about the early 1980's they went through a period of closed economic administration, and thus their economies had only limited exposure to FDI and particularly to private sector led development. During this period they relied mainly on direct financial aid from developed countries and international funding agencies such as the World Bank for their development activities. These funds came in as direct loans or grants for the developing countries who then allocated them to various development initiatives totally within their control. As such borrowings were guaranteed by the recipient developing countries, the developed countries or the international funding agencies did not have to directly bare the risks associated with any investment activities to which such funds were utilised.

Although during this period some developing countries provided foreign investors with access to their natural resources, there was no private sector participation in the development of infrastructure facilities which were under the total control of the public sector entities in developing countries. Concerning the concessions they had to develop natural resources, nationalization and expropriation of their assets became the greatest fears for the foreign investors. Consideration of other types of political risks such as, for example, demand for decentralisation or political separation hardly came into play when investment decisions were made during this era.[239]

However, with the introduction of FDI methods such as project financing, infrastructure development initiatives in developing countries are led by the profit seeking private sector entities who act as equity investors and project developers. Further, international funding agencies that traditionally financed development needs of developing countries on the security of payback guarantees provided by such countries now act as lenders to development projects who seek to recover their loans and interest thereof from project revenues. As a result, the political risks associated with infrastructure development projects are no longer the sole burden of developing countries.

Risk sharing goes to the very root of the concept of project financing. Therefore, private sector project developers as well as international funding agencies who are key participants in project financing initiatives are required to seriously consider the political risks associated with infrastructure development projects and participate in the sharing of such risks. Generally, the private sector is better at managing commercial risks and responsibilities such as those

239 Fatehi-Sedeh, K. and Safizadeh, H. M., *"The Association Between Political Instability and Flow of Foreign Direct Investment"*, Management International Review, Vol.29, No.4 (1989), pp.4-13.

associated with construction, operation, and financing. Further, in reality, the developing country governments, in order to attract investors in a highly competitive infrastructure development market, continue to offer to undertake political risks and compensate the investors and lenders in the event of such risks occurring. However, investors and lenders cannot afford to ignore political risks. This is because the credibility of the government to uphold contractual obligations and the willingness and ability to provide compensation for political risks are key issues for project finance. Although as noted above, governments generally agree to compensate investors for political risks, in practice, justifications for government actions may be cited to delay or prevent such payments. Thus, private investors generally assume the risks associated with dispute resolution and the ability to obtain compensation should the government violate the concession agreement.[240]

In the circumstances, unlike in the past where investors were able to almost completely disregarded any type of political risk, except for the country risk it self,[241] if they lacked confidence in the ability of the country in which they invested to keep up with its contractual obligations, in modern day infrastructure development projects, the investors and lenders are required to take note of, consider, and take mitigatory measures against various types of political risks. These include risks such as the volatility of the political system in developing countries and the measures taken in developing countries to decentralize the political administration, thus giving more powers, including the powers to regulate and take charge of administrating foreign investment projects. The situations that may result in a developing country as a result of, for example, a regional or

240 The issue of meeting financial obligations while disputes are resolved may be achieved through a requirement of debt service reserves, escrow, or standby financing.

241 Country Risk here means a country's ability to honour contractual obligations.

local government being given the power to regulate and administrate infrastructure development projects in its local jurisdiction, would directly affect the investors and lenders who have participated or who intended to participate in a development project in such jurisdictions. They will lack the comfort of dealing with the central government in such developing country and having more secured government guarantees offered by the central government to protect their investments.

In the circumstances, the nature and the effects of the political risks of the type mentioned above appear to have changed in relation to modern day infrastructure development projects as they affect not only the host country, but other commercial and international project participants. In the past, central governments in developing countries dealt with such risks on their own, for example by taking affirmative action to deal with political unrest or taking military action to crush political opposition. Although such actions met with international criticism, as far as investment projects were concerned, there was no change in the risks as the risk taker continued to be the developing country it self, so long as it carried out its contractual obligations. The situation is not the same anymore as foreign investors and international lenders are now direct participants and stake holders in development projects and thus get directly affected due to the occurrence of any political risk events. Further, the way they react to and take precautions and or mitigatory measures against such risks is different to the way developing countries would deal with such risks. For example, investors and lenders would rely on political risk insurance against such events when the developing country governments could take political and/or military action to control the effects of such risk events.

4.1.2. How the Changing Political and Economic Culture have contributed to the Changes

Another key factor that has contributed to the changing nature of some of the political risks associated with modern day infrastructure development projects is the changing political and economic culture in some developing countries.

Compared to the number of independent countries at the time of the Second World War, there are many more independent countries in the world today, which could be grouped as the countries which gained independence from their colonial masters during the two decades that followed the Second World War and the countries which gained independence after the break-up of the former communist regimes in the 1980's. As has been already noted in the previous section, the first group of countries mentioned above went through a period of closed economic administration and started opening up their economies and started adopting market based economic reforms only in the 1970s and the 1980's.

As noted in Chapter One of this thesis, in most developing nations more than 70% of the total population live in the urban areas.[242] The rural communities in many developing countries have hardly seen any light of development during the time these countries practised closed economic policies as most of the economic activity was centred only in and around the capital city and couple of big cities. In countries where significant control of the economy is

242 UNCTAD, World Development Report 1996, (New York and Geneva: UNCTAD, 1996)

concentrated in the centre without any substantial financial and/or administrative autonomy to the local authorities, the distribution of the riches of the economy has not reached out side few big cities. As a result, most rural areas remain under-developed. For example, except for Colombo in Sri Lanka, Islamabad in Pakistan, and except for few affluent cities like Mumbai and Gujarat in India, most other districts and regions in these countries have not benefited much from FDI until recently.

The introduction of open economic policies and transparent democracies has solved the problem of development not reaching the rural areas to some extent. With these developing countries opening their doors to foreign investors, investment has started reaching the rural areas. Further, the development of essential infrastructure facilities and creation of new employment has uplifted the lives of the rural communities. For example, the implementation of the "Expedited Mahaweli River Development Project" in Sri Lanka in the late 1970's with World Bank aid, after the country adopted open economic policies, led to many in the rural communities finding employment in project work. In addition, the project provided much needed infrastructure for irrigation in the rural areas of the North-Central Province in Sri Lanka and was also instrumental in boosting the national grid and there by strengthening the power infrastructure in the country.[243]

Whilst opening of economies has boosted development and has paved the way for the development to reach the under developed areas, it has also resulted in encouraging the growing demands for political reform in many developing countries especially by sharing of political power by decentralisation. The main factors behind these demands appear to be related to the following trends:

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243 Mahaweli Authority of Sri Lanka (MASL), The Brochure on Mahaweli Program, (Colombo: MASL, 1994); Werellagama, D.R.I.B., Lessons Learned from Communities Displaced by the Mahaweli Multipurpose Development Project Sri Lanka, (Kandy: Department of Civil Engineering, University of Peradeniya, 2003); and Personal Communication with the rural communities in Raja Rata area of the North Central Province of Sri Lanka.

i. Worldwide trend towards a realisation that development should not be a top down process but rather that it requires community involvement and motivation. This has spilled over into demands by local governments and local populations for a greater share of resources and decision making power to affect their own development.

ii. The realisation in many countries that centralisation of the planning and allocation of resources has led to only limited flows of resources to the peripheral levels with much of the funds being drained off centrally. In some cases, at least on paper, governments are decentralising with the aim of improving public-sector/local government administration and performance and in an attempt to be less bureaucratic.

iii. Realisation that centrally administered programs do not always provide for effective program delivery at the local level as they do not take into account local needs and characteristics.[244]

In addition to the aforesaid demand for political reforms, in some developing countries, either due to lack of economic and political reform in some regions or due to the confidence certain regions have got because of successful economic and political reforms of self management, there seem to be growing tension for complete political separation from the central governments and for creation of new political regimes.

There is no doubt that such tension would affect infrastructure development initiatives in developing countries and that investors and lenders who are crucial for development initiatives of developing countries will be discouraged to commit their resources to countries in which such

244 United Nations Population Fund (UNFPA), *"UNFPA and Government Decentralization: A Study of Country Experiences, Evaluation findings"*, Office of Evaluation and Findings, Issue 30 (June 2000).

tension is seen.[245] It is important to note that since this type of tension became visible in most of the developing countries in which there are such demands for political reforms or complete political separation only during the last two or three decades, such tensions have not been identified as risks associated with traditional FDI.[246] Further, as some of the demands for political reforms have received international recognition, these are not issues the developing countries could internally deal with any longer. As a result, investors and lenders who participate in infrastructure development projects in developing countries with such political tension are directly affected by them.

In addition to above the growing interest in infrastructure development projects which reach beyond the national boundaries of a single developing country (such as highways and tunnels between landlocked countries) and the tension relating to border disputes between countries, especially among some of developing countries falling within the second group of independent countries mentioned above, have also contributed to the changing nature and effects of political risks that are associated with modern day infrastructure development projects when compared to traditional FDI.

Further, events such as the unlawful invasion and occupation of Kuwait by Iraq in early 1990's and the resulting damages to investment projects and, events such as the September 11, 2001 terrorist attacks in New York demand another look at the political risks that are associated with infrastructure development projects in countries with the active participation of foreign investors and international lenders as, events such as those had not been seriously associated with traditional risks attached FDI. In fact, there is hardly any written analysis in the existing texts on

245 Moran H Theodore, *"Political and Regulatory Risk in Infrastructure Investment in Developing Countries: Introduction and Overview"*, Georgetown University Electronic Journal (March 1999).

246 For example, the demand for political separation in the Kashmir province in India commenced in the mid 1970's. In Sri Lanka, the demand for political separation by the Liberation Tigers of Tamil Elam commenced in the early 1980's.

modern day infrastructure development projects which concentrate on the analysis of risks such as those mentioned above and their effects on the project participants.

4.1.3. The Key Political Risks that have changed their traditional Outlook.

The key political risks which have changed their traditional outlook in recent times include the risk of decentralisation, risk of political instability, risk of separation of states or creation of new states and the risk of invasion and hostile taking of property. The changes that have occurred in connection with these risks and the measures to mitigate them are not areas of study that have been fully explored. They do not have a long recorded history of supporting data that acknowledges their incidence and impact, and are not a part of the usual project preparation working agendas of the parties involved in project development negotiations. In other words, the changing nature of these risks are rarely discussed and dealt with as a part of preparation for a project, although they can be a key impediment to investor and lender participation in infrastructure development in developing countries.

The aforesaid political risks could affect the profitability of projects and hold back the development of infrastructure projects in developing countries. Thus, in-depth study of these risks to find ways to mitigate their effects is crucial for the future of project financing in infrastructure development to be successful. The following sections of this Chapter attempt to analyse the changes that have occurred in connection with the aforesaid political risks.

4.2. Risk of Decentralisation of Political Power

4.2.1. Demand for Decentralisation and Levels of Decentralisation

In an era where project-financing is used as the most innovative FDI method to bolster and stimulate unproductive and sagging economies in developing countries, one of the major obstacles to economic development is the growing demand for decentralisation of administration. Whilst, the policy-makers and economists pursue FDI and private sector participation for economic salvation, some others look at decentralisation of political power as the path for better administration of the state and improving the quality of life of the people.

Although reasons for the demand for decentralisation can be spelled out with ease, decentralisation is not easily defined. It refers to governance processes of different forms and dimensions offering different levels of power transfer as shown in See Table 4.1 below:

Table 4.1 Different Levels of Decentralisation

Level	Definition	Characteristics
De-concentration or administrative decentralisation	The dispersal of decision-making and some executive power from central administration to its appointees at a sub-national level.	A de-concentration of functions to improve efficiency. Local government representatives are accountable to their seniors in the hierarchy who decide the overall allocation of responsibility to different tiers of government. There is implicit political subordination and prevalence for confrontation with decision-making based on national rather than local preferences. There are no mechanisms for downward accountability.
Delegation	A transfer of authority from an administrative service to a semi-public or private company.	Responsibilities are transferred out of the regular bureaucratic system, but the accountability ultimately rests with central government. There is little if any downward accountability.
Devolution or democratic/ political decentralisation	The total or partial transfer of power from a larger to a smaller jurisdiction.	Devolution imbues local governments with total or shared responsibility for service delivery, but also gives local governments a wider role to act as the mouthpiece for local interests. The centre shifts into the role of adviser and supervisor. It is underpinned by the concept of subsidiary wherein decisions are made at the lowest possible level according to capacity as such those responsible for developed power have a high degree of political autonomy. Accountability is mostly downward through mechanisms such as elections, consultation, referenda, and plebiscites.
Deregulation	The transfer of previously regulated activities out of the public service.	Responsibilities are transferred out of the regular bureaucratic system.
Privatisation	Delegation involving the transfer of ownership and/or management of resources from public sector to private entities, either directly or through parastatals.	The role of privatisation and public private partnerships will clearly grow in the move towards sustainable development. Public private partnership is likely to be the preferred measure for decentralisation of government power rather than pure privatisation.

Sources: Litvack et al 2000, Mayers and Bass 1999, Nickson 1998, Osmani 2000[247]

247 Litvack J, Ahmad J and Bird R., Rethinking Decentralization at the World Bank, World Bank Discussion Paper, (Washington D.C.: World Bank, 1999); Nickson A., 'Where is Local Government going in Latin America?: a comparative perspective', A paper presented at the Annual Conference of the Society of

Of the levels of power transfer or decentralisation shown in the above table, not all levels threaten the progress of FDI in developing countries. For instance, under De-concentration or administrative decentralisation, the central government of a state does not surrender absolute discretion regarding promoting FDI to a local government. As a result prospective investors will continue to deal with central governments concerning obtaining concessions for development and in securing central government undertakings to protect investments, although at sub-national level they will have to cooperate with local authorities in carrying out investment projects. Same is the case under delegation, and deregulation as the central governments are unlikely to surrender key responsibilities such as physical infrastructure development in countries through FDI to local governments. Total privatisation on the other hand is a level of power transfer where the governments will totally part with ownership and/or management of resources from public sector to private entities either permanently or for a certain fixed period of time.[248]

Privatisation is a level of decentralisation that usually takes place pursuant to a successful investment negotiation. In the circumstances, decentralisation in the mode of privatisation is conceptually not a threat to promoting FDI, although opposition to privatisation may result in threatening developing country initiatives to use project financing techniques to promote infrastructure development. In the circumstances, the mode of decentralisation that in effect directly threatens FDI is political decentralisation.

Latin American Studies (1998), University of Liverpool; Osmani S., Participatory Governance, People's Empowerment and Poverty Reduction, SEPED Conference Paper Series No. 7 (New York: UNDP, 2000).

248 For example, a government concession to a private sector investor to run its telecommunication infrastructure under a BOT project for a 20 year period is a situation in which the government parts with its ownership and/or management of a resource for a fixed period of time.

4.2.2. Current Trends in Political Decentralisation

Political decentralisation is an evolving political and administrative process rather than a particular form of organisational structure or institutional arrangement. As such, the characteristics of decentralisation in any particular country are dynamic and are subject to rapid change depending on the government in power and popular trends. Because decentralisation is such a new concept in many countries, it becomes a learning process and hence, structures may be tried and discarded as unworkable.

In the cases of developing countries such as India, Nigeria, Philippines and Mexico, decentralisation is based on the political/legal structures (e.g. the Constitution, specific laws or government bills covering decentralisation) of each country. In these countries, the states or provinces form a federation, which generally has its own elected government with a wide range of fiscal and programming powers and responsibilities. In contrast, countries such as Viet Nam, Bolivia, Sri Lanka and Ghana are unitary states, with political sub-divisions generally at the departmental level or at the provincial level.[249] In these countries, decentralisation often takes a more administrative and operational character, regulated through decrees or directives from the central government. In the latter group of countries, decentralisation is also defined by the extent to which fiscal powers have been decentralised. In most countries the federal/central authority represents the highest level of governance with first priority over fiscal resources. It is only when the federal or central authorities agree to share their resources that true decentralisation can proceed.[250]

249 See Litvack supra note 247.

250 Id.

The current trend among most developing countries is to decentralise political power by sharing executive and administrative responsibilities with state, local or provincial governments, while sharing the duty of providing utility services to the public with the more efficient private sector. Many developing countries such as Bolivia, Ghana, India, Mexico and Viet Nam have adopted measures of effective power sharing between the central administration and state or provincial governments as the case may be, following the examples set by developed countries such as USA, Canada, and Switzerland in successfully sharing power between the centre and state or provincial governments in the distribution and allocation of investments and assets.[251] For example, India, although having a very strict and effective central screening and monitoring system with regard to investments coming into the country, has allowed several state governments to deal directly with centre approved investors in developing infrastructure facilities. On the other hand there are developing countries, which are reluctant to allow the provincial or local governments deal directly with foreign investors. Sri Lanka is a good example. There are also several other developing countries which have continued to resist any move towards decentralisation, although the demands for decentralisation by various ethnic and political groups have continued to grow.[252] Countries such as Central African Republic, Democratic Republic of Congo, Rwanda and Kenya which have highly centralized systems of governance are good examples for this last group.

251 See generally UNFPA and Government Decentralization, supra note 244.

252 See generally Brosio, G., Decentralisation in Africa, (Washington D.C.: IMF, October 2000). Online:http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/brosio.pdf

4.2.3. Risks to Infrastructure Development Projects due to Decentralisation

As far as infrastructure development projects are concerned, the main obstacle decentralisation poses is the possibility of conflict between the central administration and the state, provincial or local authorities in sharing the responsibility of infrastructure development. Where the responsibilities of the central administration and the state, provincial or local authorities are not clearly defined, there bound to be conflicts of interest and administrative confrontations. In addition to slowing down the progress of development activities, the lack of definition of functions may also cause confusion and uncertainty in the minds of investors, lenders and project developers. Thus, although decentralisation may be a good thing for developing countries, when it comes to sharing of political power, if policies are not clear and respective functions and powers of the administrative authorities are not clearly defined, it is likely that decentralisation will not compliment sustainable infrastructure development with the use of FDI.

Another obstacle decentralisation may pose to infrastructure development projects is that, although decentralisation may be preferred by some politicians, and some sections of the public, it might find strict opposition from some end-users of infrastructure facilities developed with FDI mechanisms such as project financing, which may allow private sector infrastructure service providers to increase rates. The reason behind such opposition being, the lack of confidence the public might have on the regulatory and administrative ability of state, provincial or local government administration of such facilities. Most central governments will have the capacity to ensure that even after development projects are completed with foreign and/or private sector participation, the end product is offered to the public at affordable rates. A state, provincial or local government in a developing country may not have the financial or administrative capacity to

do this. Further, a central government will have the capacity to provide sufficient comfort to investors of projects, by way of securities or other risk comfort mechanisms built-into the contract documents relating to projects.

The investors who would undertake to develop infrastructure projects may prefer to work with the central administration rather than with the local authorities.[253] Although urban infrastructure needs will keep rapidly growing in a decentralised administration, obstacles faced by investors who participate in infrastructure development will be different and more complex when compared to participation in development projects under the control of central governments. Some of the obstacles will derive from the fact that, relevant industry decisions rest on state, provincial or local, making the political risk attached to the development projects different from those associated with the central government.

In some developing countries, the absence of title right of the provincial or local governments to land, and other assets, may also cause problems when it concerns infrastructure development with project financing techniques in a decentralised administrative environment. If the local governments lack substantive powers in relation to land and various state assets that might be the focus of foreign investment, then, there bound to be conflicts when it concerns the control and regulation of investment projects concerning such assets. In some countries, although general administration may be decentralised, the ownership of major state assets including land remains with the central government. Sri Lanka is a classic example. Although the 13th amendment to the constitution that was introduced in 1987,[254] established provincial councils (a limited decentralised system of administration), some of the key assets of the state, including state

253 In a survey I conducted in March 2004, in the Central Province of Sri Lanka, which is the islands most developed province after the Western Province, only 17 out of 200 interviewed stated that they feel comfortable if the basic infrastructure services such as power, water and telecommunication comes under the full control of the provincial council. 22 were reluctant to choose between the central government and the provincial council. The rest confirmed that they prefer that the services continue to be provided by the central government.

254 Certified on 14th November 1987.

land, remain under the control of the central government.[255] The provincial councils do not have the capacity to make use of state land for any infrastructure development project without the concurrence of the central government.

The possibility of the functions of the central and local governments often overlapping is another risk. Local authorities may enter into agreements with the private investors to develop various infrastructure projects; however, the responsibility of setting up the necessary rules for the provision of such services to the end-users will be in the hands of the central government. This may give rise to overlaps and regulatory conflicts. The problem tends to get more complex when different political parties are in control of the central government and the provincial or local governments, as has been the case in Sri Lanka, several times during the period 1990 to date. The following two paragraphs taken from an ADB publication provides a good summary of the complexities that are found in Sri Lanka concerning infrastructure development due to overlapping of functions and responsibilities between different governmental and provincial authorities:

> *"Administration of urban areas is complex. At the national level, two ministries are responsible for providing technical support to local governments for planning, appraisal, procurement, management, and allocation of budgetary resources. In addition, several agencies are responsible for construction, operation, and maintenance of some of the urban services. Ministry of Provincial Councils and Local Government (MPCLG) is in charge of the overall provincial and local administration framework including budgeting and human resource development. MPCLG's administrative and implementation capacity is very weak. Ministry of Urban Development, Housing and Construction is responsible for urban planning and development control through Urban Development Authority (UDA) provides technical guidelines and standards directly to other agencies under it."*

> *"Policies are also fragmented between ministries and between the central Government, provincial councils, and urban local authorities. There is poor coordination of the relevant*

255 While Land, including rights to or over land, land tenure transfer and alienation of land, land use, land settlement and land improvement was designated a provincial subject, thus, a subject falling under the provincial government, Appendix 2 to the amendment stipulated that "State land shall continue to vest in the Republic" and may be acquired, in consultation with the provinces, in respect of a reserved or a concurrent subject. Further, "Alienation or disposition of the State land within a Province to any citizen or to any organization shall be by the President, on the advice of the relevant provincial Council".

institutions in the urban sector, e.g. Road Development Authority, Ceylon Electricity Board, Sri Lanka Telecom, and National Water Supply and Drainage Board, and there is total lack of planning and coordination with UDA. The ambiguous division of responsibilities between the center and the provinces makes it difficult to move decisively to improve administrative capacities at provincial and local levels. As a result, institutional capacities and capabilities at the urban local authority level are very limited. There is genuine lack of enforcement capacity especially for land management and environmental laws."[256]

4.2.4. Conflicts between Central Governments and Provincial/Local Authorities

The following examples provide a good insight as to the confusion that can be caused in relation to investment contracts when the specific roles of the central administration and the state, provincial, or local authorities are not properly spelled out in a decentralised system of administration.

a. Metalclad Corporation v. The United Mexican States

The following is a brief summary of the dispute that arose between Metalclad Corporation, a Delaware company, and the United Mexican States, and the finding of the ICSID arbitration tribunal on the issue involving the steps taken by the state government to stop an investment project authorised by the central administration in Mexico.[257]

The dispute arose from the construction of a landfill in Guadalcazar in the central Mexican State of San Luis Potosí, by an enterprise owned and controlled by Metalclad. The construction was designed for the confinement of hazardous waste from the area. Approvals having been obtained at the federal and state level, construction of the landfill were completed in

256 Asian Development Bank , Sri Lanka Urban Development Sector Study, (Manila: ADB, July 2000).

257 *Metalclad Corporation v. The United Mexican States*, ICSID Case No. ARB (AB)/97/1.

March 1995. However, demonstrations that took place at the inauguration of the landfill kept it from opening.

In November 1995, Metalclad concluded an agreement with federal environmental agencies setting forth the conditions under which the landfill would operate. A month later, in December 1995, the local municipality issued a denial of a construction permit for the landfill that had been requested thirteen months earlier and then challenged the agreement Metalclad had concluded with federal agencies and obtained a judicial injunction, which prevented the operation of the landfill through May 1999.

At the hearing, it was argued on behalf of the United Mexican States, that local government actions are generally not subject to the standards of protection required from NAFTA[258] member states towards the property and investments by other member states. It was argued that Article 105 of the NAFTA does not use the term "local governments" in describing the extent of the obligations set forth in the Agreement. According to this argument, the NAFTA Parties deliberately excluded the term "local governments" from Article 105 to signal a departure from otherwise applicable customary international law, which provides that a state is liable for the acts of all its political subdivisions, including local governments.

The United States argued *inter alia* that:

(a) There is no general exclusion from the NAFTA standards for local government action. It was the U.S. belief that the Parties intended that except where specific

258 NAFTA (North American Free Trade Agreement) is a trade agreement, negotiated among three federal governments, namely United States of America, Canada and Mexico, which came into operation on 1 January 1994. It is the first agreement ever to include services as well as goods. The full content of the NAFTA agreement is available online: http://www.nafta-sec-alena.org/english/nafta/nafta.htm.

exception was made, actions of local governments would be subject to the NAFTA standards.

(b) Article 105 provides that "[t]he Parties shall ensure that all necessary measures are taken in order to give effect to the provisions of this Agreement, including their observance, except as otherwise provided in this Agreement, by state and provincial governments." Article 201(2), part of the NAFTA Chapter entitled "General Definitions," plainly defines any reference to a state or province to include the local governments of that state or province. Absent any treaty language to the contrary, the natural meaning of these provisions, taken together, is that Article 105's reference to states and provinces includes a reference to their local governments.

(c) NAFTA, both in Chapter 11 and elsewhere in the Agreement, makes it clear that local government measures, including municipal measures, are subject to the NAFTA standards. For example, Article 1108(1) (a) (iii) specifically exempts existing local government measures from the reach of Articles 1102, 1103, 1106 and 1107. If the argument proposed by the United Mexican States at the hearing were correct, no exemption would be necessary because these articles would not address the actions of local governments at all.

The Tribunal held in its award that the actions of the Mexican State and municipal authorities entailed a breach by Mexico of its obligation to afford Metalclad's investment treatment in accordance with international law, including fair and equitable treatment, under NAFTA Article 1105. By permitting the actions of the municipality, Mexico had taken measures tantamount to expropriation of Metalclad's investment under NAFTA Article 1110, since those actions "effectively and unlawfully prevented the Claimant's operation of the land-fill."

The Tribunal further held that, although not necessary for its finding of an expropriation, an Ecological Decree issued by the State Governor in September 1997, also had the effect of preventing the landfill's operation, and was thus also a measure tantamount to expropriation. In the award, the Tribunal set forth its understanding of the meaning of direct and indirect expropriation. The award also noted that the reference in NAFTA Article 1110 to measures "tantamount to" expropriation did not create a category different from direct or indirect expropriation.[259]

This example clearly shows that in a decentralised system, local governments may sometimes act in violation of international, regional or bi-lateral treaty undertakings of the central government and that this would result in the central governments having to defend themselves against actions brought by investors or home countries of the investors under agreed contract or treaty terms.

b. Samatha v. State of Andhra Pradesh

The dispute that arose in the Andra Pradesh in India concerning a move by the state government to alienate lands traditionally held by various tribes to private companies is a good example of a situation where regional governments may take policy initiatives and action that is contrary to the interests of the central government.

The dispute involved the issue of transfer of tribal land to corporate entities in violation of the Fifth Schedule to the Indian Constitution which provides protection to the Adivasi

259 The award gives an account of the facts on which the Tribunal found a breach of the obligation to grant fair and equitable treatment. The award thus contains one of the first rulings ever to apply the standard of fair and equitable treatment under a treaty governing investment matters.

(indigenous) people living in the Scheduled Areas.[260] Samatha, a non-governmental organisation, filed action against the state government of Andhra Pradesh alleging *inter alia* that essentially the Fifth Schedule is a historic guarantee to indigenous people on the right over the land they live in and that the state government has violated this right by granting mining leases in this area to several non-tribal persons.

The Fifth Schedule to the Indian Constitution deals with administration and control of areas and tribes specified in it and provides protection to the Adivasi (indigenous) people living in the areas specified in the schedule. The Fifth Schedule covers Tribal areas in nine states of India namely Andhra Pradesh, Jharkhand, Gujarat, Himachal Pradesh, Maharashtra, Madhya Pradesh, Chattisgarh, Orissa and Rajasthan. The Borra reserved forest area along with its environs consisting of fourteen villages is the notified scheduled area in Ananthagiri Mandal of Visakhapatnam District of Andhra Pradesh. The aforesaid mining leases were granted in this scheduled area.

The action later went up to the Supreme Court of India which led to a historic judgement. The following is a brief summary of the dispute, issues and the judgement of the Supreme Court that was delivered on 11.07.1997: [261]

Two of the main questions which arose before the Court were: whether the government can grant mining lease of the lands situated in scheduled area to a non-tribal; and whether the Borra Reserve Forest area was part of the domain of the Rajah of Jeypore and from time immemorial, it was a tribal area occupied by tribal villages.

260 This Fifth Schedule is still under threat of being amended to effect transfer of tribal lands to non-tribals and corporate bodies. There have been several mass campaigns in recent times protesting against any move to amend this schedule and alleging that the very survival and culture of 80 million tribal population of India is under threat.

261 The full judgment is available online: http://www.mmpindia.org/samatha%20vs20%AP.htm

The Court referring to several colonial statutes observed that it was clear that from the inception of the Colonial administration, the tribal areas were treated distinctly from other areas. Tribes were protected from exploitation; their rights and title to enjoy the lands in their occupation and their autonomy, culture and ecology were preserved; infiltration of the non-tribals into tribal areas was prohibited.

It was further observed that, Chapter VI, Part X of the Indian Constitution deals with "Scheduled Tribes and Tribal Areas". Article 244 provides that the provisions of the Fifth Schedule shall apply to the administration and control of the Scheduled Areas and Scheduled Tribes in any State other than the State of Assam, Meghalaya, Tripura and Mizoram. Part V of the Schedule gets attracted to its administration and control, with Paragraph (2) envisaging that subject to the provisions of the Schedule, the executive power of a State extends to the Scheduled Areas enumerated therein.

In the circumstances, the Judgement declared *inter alia* that:

(a) All lands leased to private mining companies in the scheduled areas are null and void.

(b) Transfer of land in Scheduled Area by way of lease to non-tribals, corporation aggregate, etc stands prohibited.

(c) Renewal of lease is fresh grant of lease and therefore, any transfer stands prohibited.

(d) In the absence of total prohibition in some States with scheduled Areas, Committee of Secretaries and State Cabinet Sub committees should be constituted and decision taken thereafter.

(e) Conference of all Chief Ministers, Ministers holding the Ministry concerned and Prime minister, and central Ministers concerned should take a policy decision for a consistent scheme throughout the country in respect of tribal lands, need they be subjects of development.[262]

The above example shows that certain actions that may be taken by the state or provincial governments to attract investors in a decentralised administrative system can sometimes violate the constitutional and statutory protections guaranteed by the central government to its people.

c. The Confusion caused by Regional Autonomy Law (1999) of Indonesia

The Regional Autonomy Law (RAL) was promulgated to pattern in the political, economic and social paradigm shift in Indonesia, particularly since the onset of the Asian financial crisis. The RAL seeks to decentralize and democratize the governance structure in the context of FDI; the following features of the RAL are noteworthy:

i. The Central government is fully responsible for conduct of matters relating to foreign affairs, defence and security, administration of justice, religion and further, shall coordinate the policies on national planning and macro national development control, financial balance fund, state administration and state economic institutional systems, human resources development, natural resources utilization, strategic high technology, conservation and national standardization;[263]

262 Emphasis added.

263 Article 7 of the RAL.

ii. Regencies and municipalities shall be responsible for the administration of the public works, health, education, culture, agriculture, communication, industry and trade, capital investment, environment, land affairs, and cooperative/manpower affairs;[264]

iii. The provinces are responsible for economic activities that cross the borders of regencies and municipalities, and shall also assume responsibilities for all activities that cannot be undertaken by the respective regencies and municipalities;[265]

iv. The central government shall grant principal business permits for the petroleum sector (oil and gas), electricity exploration, and investment in strategic high technology;[266]

v. The central government may cancel regional regulations or decisions of a regional head that contravene public interests or higher regulations and/or other regulations.[267]

Although RAL was passed with best intention and with the aim of facilitating good governance and sharing of responsibility of political as well as fiscal power with the regional governments, the failure to specifically and precisely separate the functions of the centre and the regions leads to confusion, especially concerning FDI.

For example, confusion and uncertainties prevail over investing in natural resources. Effectively, Article 10 of the RAL cedes the management of natural resources to the regions, but Government Regulation 25 No. of 2000 which was subsequently passed seems to do just the reverse. Article 2, paragraph 3(3) of this regulation enumerates that ‘principal business permits’ for oil, gas, and electricity shall be granted by the central government.

264 Article 11 of the RAL.

265 Article 9 of the RAL.

266 Article 2, paragraph 3 of the Govt. Reg. No.25 of 2000

267 Article 114 of the Govt. Reg. No. 25 of 2000.

Further, under Article 8 of the Government Regulation No. 25 of 2000, *"licensing and cooperation agreements of the Government with third parties, based on the Government's authority prior to the determination of this Government regulation are declared valid up to completion of the licensing agreements"*. However, as the RAL does not specifically restrict the rights of the regions in connection with the status of investment licenses and concessions granted by the central government prior to the RAL coming into force, there is confusion as to whether the regencies and municipalities could unilaterally annul or repudiate any of the existing investment licenses and concessions. Understandably, this is a paramount concern for foreign investors.

Thus, the RAL and Government Regulation No. 25 of 2000 are causing a legal quagmire. On the one hand, the RAL seems rather comprehensive and generous in empowering the regions to take charge of various economic activities. On the other hand, Government Regulation No. 25 of 2000 seems to divert the said powers back to the central and provincial government.

The uncertainty that developed among investors after the introduction of the 'do-it-yourself' (DIY) taxation by a provincial government in Indonesia following the aforementioned RAL and the Fiscal Balance Law (1999)[268] is another classic example of a situation where decentralisation can hinder modern day development projects with the participation of foreign investors.

268 After over 30 years under a highly centralized national government, Indonesia decided to implement a policy of decentralization that became effective on January 1st 2001. The new policy of decentralization is outlined in Law No. 22, 1999 concerning "Local Government", and Law No. 25, 1999 concerning "The Fiscal Balance between the Central Government and the Regions". Law No. 22, 1999 transfers functions, personnel and assets from the central government to the provincial, as well as the district and the municipal governments. Law No. 22, 1999 on "Local Government" has devolved central government powers and responsibilities to local governments in all government administrative sectors except for security and defense, foreign policy, monetary and fiscal matters, justice, and religious affairs. This law is quite unusual since almost all powers and responsibilities are ceded to local governments without conditions and limitations. Consequently, local governments have to reform their internal structures to accommodate the huge increase in responsibility that has been passed on from the central government.

The provincial and district level DIY revenue-raising started in 1999, when regional governments began to claim their share of past revenue payments never transferred from Jakarta.[269] In November 1999, members of the South Sulawesi Provincial Assembly (DPRD) demanded that the central government pay Rp. 6 billion (then nearly US$ 900,000) in outstanding royalties from the PT Inco Nickel Mine.[270]

The central government was accused by newly assertive local governments of delaying payments and helping itself to more than its share of royalties, leaving the producing areas poor and underdeveloped. Local authorities tired of waiting for the central government to pay started imposing new taxes on companies operating in their areas in order to prove their areas were economically viable.[271]

This practice became so widespread that in June 2000, the Regional Autonomy Minister, Ryaas Rasyid, was moved to complain about the impact on Indonesia's investment climate. He reported that Singapore had added several provinces and districts in Indonesia to its negative investment list and that at least 13 foreign oil companies had stopped operating in Indonesia due to the levies demanded by local officials.[272]

4.2.5. Measures for Mitigating Risks due to Decentralisation

It goes without saying that deregulation by the central governments and efforts initiated at attracting private sector investment are important for developing the political and economic stability of countries. However, one should not forget that once decentralisation is done, the local

269 Down to Earth, Foreign Investment and Regional Autonomy, Vol. No. 46 (August 2000).

270 Ibid.

271 Ibid.

272 Jakarta Post, 20 June 2000.

or provincial governments are responsible for the majority of the utility services that may require foreign investment. If the local governments are to meet this challenge, then following key measures could be suggested as those that may have to be taken to ensure that they are competent to take over the dual role of utility provider and regulator:

i. Preparing future visions of the infrastructure sector based on an understanding that foreign and private sector investors would play a role;
ii. Meeting the needs of the foreign and private sector investors and developing relationships between investors and local governments by the central governments actively participating in development initiatives taken by local governments. This could be done by the central governments playing the role of a facilitator;
iii. Harmonising the local laws with those of the central government and ensuring that the room for conflict is minimised;
iv. Improving the credit rating of the local government to the extent that necessary financial securities could be given to the investors on request;
v. Assistance from the central government concerning the recruitment of qualified personnel;
vi. Establishment of an effective policy and a plan of action for attracting foreign and private sector investors;
vii. Establishment of a mechanism for information exchange with foreign and private sector investors; and
viii. The development of support facilities which complement infrastructure development activities in local jurisdictions in order to facilitate and encourage investors to deal with local governments.

Usually, in order to avoid or minimize the risks attached to large-scale long-term infrastructure development projects, investors need assurance from the host governments about

economic stability of the country, in addition to various other concessions and pay-back guarantees. The local governments may not be capable of giving such assurance or security to investors. As a result, the investors may not be keen to see the political power in a country where they have already invested going through a process of decentralisation.

In the circumstances, in order to reduce risks and remove obstacles for infrastructure development in a decentralised political culture, central governments will have to take the initiative to ensure that the regulatory framework will specify the functions of the central and local authorities clearly and precisely. In countries where the power to grant concessions, licences, or even the power to enter into management contracts over national assets vests with the local governments, contract credibility and flexibility will have to be improved. This may be done through the enactment of new legislation or amendment of existing legislation that will establish the procedures and rules to be followed to ensure that there will be no overlap and conflicting interests.

The central governments will also need to address the issue of investor concerns with regard to the adequacy of local government guarantees for the investment projects. If the central governments decide to provide adequate guarantees to the investors by themselves, then issues such as, to what extent the central government should exercise control over a development project within the jurisdiction of a local authority will need to be addressed.

Decentralisation may be a solution to growing political demand for political autonomy and devolution in some developing countries. However, due to reasons discussed above, it may not be the best solution for much needed economic development. The World Bank in its report in 2000 titled, “Quality of Growth” emphasizes the importance of public governance as the keystone

of a country's development.[273] In other words, good governance appears to be a key condition for attracting FDI. For instance, Lehmann argues that a country like India could increase its share of US affiliates' physical investment by 50% if it were to eliminate all political uncertainty.[274]

Decentralisation of political power can be an important vehicle in modernizing the public sector in developing countries and in ensuring that the riches of the state and the basic utility services provided to the people reaches the majority of the people without being limited to those who live in big cities. However, in order for decentralization to be effective, the risks of excessive fragmentation of service supply and of overspending and corruption should be minimized.

Developing countries which are decentralizing their political power or those who intend to do so in future should ensure that decentralization initiatives would not hinder the integrity of the national fiscal consolidation strategy, and weaken the quality and cost-efficiency of public services. Although some sections of the people may at a given time support the notion of political decentralization, if in a decentralized administrative structure, the public services are going to be more costly and less efficient than when they were provided under the central administration, they may be stiff opposition to the transfer of utility service provision duties to local authorities from the central government. To avoid these outcomes, developing countries should try to take steps to amalgamate small municipalities for the provision of public services as this would enable them to avoid over fragmentation public service supply. The developing countries could also consider joint provision of services, i.e. the central administration and the local administration sharing the duty of providing public services to the people within the jurisdiction of a decentralized administrative area. However, this may require additional fiscal rules to ensure better coherence between central and sub-central fiscal policies.

273 World Bank, The Quality of Growth (Oxford University Press, New York (2000)).

274 Lehmann, A., Country Risks and the Investment Activity of US Multinationals in Developing Countries, IMF Working Paper, No. 99/133 (1999).

Developing countries should also realize that intensified efforts at transfer to regional partners (designation of counterpart staff, training in project management) will enable them to overcome risks of decentralization. Thus, gradual decentralization instead of expedited decentralization would enable reliable project management by the local governments in a decentralized administrative structure.

The main issue that stems from the move towards political decentralisation that concerns FDI for infrastructure development is the lack of interest on the part of the private sector and foreign investors to work with regional or local governments. In the premises, in instances where decentralisation is put into motion in a country, simultaneous steps will have to be taken to ensure that present and future investors of economic development activities of that country will not be discouraged with the new political development. Thus, as noted above, the main initiative to be taken will be to build confidence among investors that the local or regional governments are capable of stepping into the role of concession granter and regulator of investment projects.

4.3. The Risk of Political Instability

Political instability is another key risk that can undermine the advancement of project financing and private sector led development initiatives in developing countries. Not only will it discourage prospective foreign investors from coming into a country, sometimes, it may also influence the investors to abandon projects that have already been undertaken. Abandonment of ongoing projects can be either voluntary or forced. It may be voluntary, if due to fear of instability in the country or the region the investors pull out of a country. The abandonment may be forced, if it is the result of direct action taken by the perpetrators of political instability.

Whatever may be the cause, such abandonment is likely to put breaks on the progress of a country's economy.

According to couple of Interviews and surveys that have been conducted with executives of MNCs in the 1960's and in the 1970's, political instability is regarded as one of the most important factors in foreign investment decision making. In particular, the executives who have been interviewed have cited the stability of the host government and the attitude of the host government towards foreign investment as the most important considerations in the investment decision making.[275]

Although political instability is not a new risk, as far as FDI mechanisms such as project financing are concerned, it has assumed a new outlook. In traditional FDI, international financing agencies which funded development projects in developing countries were some times willing to write-off investments or make various concessions to provide comfort to developing countries when projects became failures. However, in project financing, the capital investments are not made by international financing agencies. They are made by project developers who are usually profit oriented MNCs. They will not be willing to take the risk of loosing their investments or sacrificing their targeted profits. In the circumstances, they will always look at the possibilities of passing any risk based on political instability to the host country.

As noted in Chapter Two, international financing agencies have changed their role in connection with infrastructure development in most developing countries. From being capital providers to investment projects, they have become lenders who provide money for investment projects developed and managed with private sector participation. Thus, money lent by them will

275 Aharoni, Y., The Foreign Investment Decision Process, (Boston, Harvard University Press 1966); Schollhammer, H., Locational Strategies of Multinational Firms (Los Angeles, Pepperdine University, 1974).

be directly tied to projects due to the "non-recourse" or "limited recourse" nature of project financing as was discussed in detail in Chapter Three. In the circumstances, even international financing agencies acting as lenders would be reluctant to lend money to investment projects in countries in which there is political instability, unless, at the minimum, they can ensure that the host country is contractually tied to bear any project risk emanating from political instability.

4.3.1. Risks due to Internal Political Instability

A favourable investment climate is based on many factors that make investing in a country more profitable and less risky than in another country. Political stability is one of the most important of these factors. Investors and lenders in project financing would be discouraged by the threat of political upheaval, and by the prospect of a new regime that might change its policy towards investors, for example, by imposing punitive taxes or by expropriating capital assets. Falling into the vicious circle of political instability can seriously impede efforts to boost economic development and reduce poverty. It is a cyclical cycle, in which poor areas are often in turmoil, making them less appealing to investment, which in turns makes them even poorer and even more apt for turmoil. Capital very quickly leaves nations thought to be unstable. The effect of even a hint of instability is usually not ignored by investors.[276]

Unlike in the old days when countries could rely on international funding agencies to finance both social as well as physical infrastructure development needs, in the current environment it is the private sector that has taken the lead in physical infrastructure development due to the growing use of project financing. In this environment, internal political instability

276 For a good example as to how shaky foreign investment can be, one need only look at the United States. In 1995, after House Speaker Newt Gingrich threatened to default on the United States' debt (in a political effort to force President Clinton to balance the budget on republican terms), in the course of a single day, the interest rate on US government bonds rose from 6.46 to 6.55%, while the exchange rate fell from 102.7 to 99.0 yen. If the United States, a stable economy and political unit is that susceptible to capital flight, the risk is obviously greater for the developing nations.

could be one major factor that would result in some developing countries not benefiting from private sector led development initiatives.

The countries that have suffered most from lack of investment due to political instability are in Africa and in Asia. As the following examples show, Somalia and Sierra Leone are two African countries that have not been able to attract any significant foreign investments during the last two decades due to internal political instability. Indonesia and Sri Lanka are two good Asian examples of countries that have lost many opportunities of attracting foreign investment due to the internal political instability.

a. Somalia

During the Siyaad Barre regime from 1969-1991, Somalia had a fairly functioning state apparatus. It deteriorated over time, however, as Siyaad used his power to repress opponents and enrich his own clan, the Darood.[277] After frequent challenges from other clans, riots broke out in 1989-1991, which led to a collapse of the State and fleeing of Siyaad. The army dissolved into competing groups loyal to deferent clan-tribal leaders. Being armed during the cold war, Somalia still had lots of weapons that the deferent clans could use to fight each other. Both political instability and social waste increased after 1991.[278] Due to the volatile state of the economy and long history of political instability there have not been any significant investment projects in Somalia.

277 See generally Braathen E, M. Bøås, and G. Sæther (ed), Ethnicity Kills? The Politics of War, Peace and Ethnicity in Sub-Saharan Africa (London: Macmillan, 2000).

278 See generally, Collier, P., and Hoeer, A., Greed and Grievance in Civil War, Policy Research Working Paper 2355. (Washington D.C.: World Bank, 2000).

b. Sierra Leone

In Sierra Leone, multiparty democracy was disrupted by a rebellion lead by the Revolutionary United Front of Valentine Strasser, a movement of exiles. Strasser's coup in 1992 was met by revolts of the Revolutionary United Front and civil war broke out two years later. Although with the participation of the United Nations, the situation has been now defused, the country is yet to attract any significant investments as scars of political instability can still be seen.[279]

The situation in Rwanda and Burundi in the last forty years is also tragic. Due to internal power struggles and communal violence, these two countries have also failed to attract any foreign investment during the last decade.[280]

c. Indonesia

In Indonesia, the cities of Jakarta and Medan were struck by a number of bombings in 1998 and 1999. The Jakarta Stock Exchange, diplomatic facilities and Indonesian government buildings were targeted. A massive bombing campaign struck churches throughout Indonesia on Christmas Eve in 1999, leaving 16 dead and over one hundred injured. Further, in the midst of all this, East Timor voted for independence from Indonesia in an August 30, 1999 referendum and was subsequently successful in establishing an independent nation in May 2002, under the patronage of the United Nations' Transitional Administration in East Timor (UNTAET). Although stability returned to the territory following the arrival of international forces, crime and

279 Id.

280 See generally, Mehlum, H. and Moene, K., 'Contested Power and Political Instability', Paper presented at the Berkeley University (October 2000), Online: http://globetrotter.berkeley.edu/macarthur/inequality/papers/MoeneContested.pdf

lawlessness remain a major problem.[281] As a result, there was a drop in the foreign investment during the period 1999- 2003 when compared to the period in the 1980's when the economy in Indonesia was booming along with the other "tiger economies".[282] However, signs of improvement have been observed in recent times, starting around 2003.[283]

d. Sri Lanka

In Sri Lanka more than 60,000 people have been killed in the fighting, while approximately another 800,000 people, mostly members of the ethnic Tamil community have been displaced during the last two decades due to the conflict between the Government of Sri Lanka controlled by the majority Singhalese community and the Liberation Tigers of Tamil Elam (LTTE), a group representing the ethnic Tamils and fighting for a separate nation within the boundaries of the present day Sri Lanka.

The war effort has drained the government treasury and raised inflation to nearly 20 per cent by 2001.[284] The strife has discouraged foreign investment, and the FDI plunged to USD 80m in the year 2001 from a record USD 231m in 2000, after a major LTTE attack on the country's only international airport.[285] The Government and the LTTE signed a ceasefire agreement in February 2002, and are currently negotiating a peaceful settlement brokered by the Norwegian Government since June 2003. Since the ceasefire agreement in February 2002, things have improved and the inflation rate fell under 9% in 2003. The FDI figures also have improved since the ceasefire agreement. In 2004, Sri Lanka recorded USD 234 million in FDI.[286]

281 The American Indonesian Chamber of Commerce, 'Investment Climate Statement' (2001), Online: http://www.aiccusa.org.

282 The East Asian countries of Malaysia, The Republic of Korea, Taiwan, Hong Kong, and Singapore are generally identified as the "Tiger Economies".

283 Source: Indonesia's Investment Coordinating Board, Online: http://www.bkpm.go.id/en/

284 Central Bank of Sri Lanka, Annual Report 2002 (Colombo: Central Bank, 2002)

285 Source: Central Bank of Sri Lanka (various publications).

286 Source: Central Bank of Sri Lanka, Annual Report, 2005.

The above examples show how as a result of civil strife, civil wars and political unrest, the mentioned countries failed to attract sufficient foreign investment in the recent past. In addition to the causes mentioned, internal political instability may also be caused due to various disagreements that may exist between different political parties in a country, although such disagreements may not lead to armed conflicts. For example, disagreements between a ruling political party and opposition parties may lead to situations where the opposition parties may openly accuse the ruling party of being corrupt and pledge to overturn, among other things, foreign investment projects that have been already negotiated. Whether or not such corrupt practices have taken place, there is no doubt that allegations and counter allegations about such practices would send unfavourable signals to investors. No investor would like to invest in an environment in which a country's leading opposition political parties openly pledge to overturn investment projects started by their political opponents. A good example of this situation concerns a project that has been a hot topic in Sri Lanka lately, namely the sale of controlling share of the national air career, i.e. Air Lanka, to Emirates, which was a competing airline in the region.[287]

4.3.2. Risks due to External Political Instability

Many factors could contribute towards external political instability. For example, traditional rivalry between two or more neighbouring countries or incompatible and competing trade, economic or military policies among countries could contribute to strained relations among

287 Emirates in 1998 bought 40 percent of Sri Lankan Airlines for US $ 70 million with an initial payment of US $ 45 million. It enjoyed a concession to pay the balance in 30 months. The United National Party, which was the main opposition in the Parliament at the time, made allegations that the contract between Emirates and Sri Lankan Air is detrimental to the interests on Sri Lanka and that the agreement has been reached through the use of corrupt practices. The UNP also promised that when they come to power, the Government would review the agreement with Emirates to ascertain whether they enjoy a monopoly in the region and whether the contract has been the result of any corrupt practices. The UNP came into power in 2001, and as promised, appointed a special commission to review the contract documents. However, before the expiry of their full term of office, a fresh election called by the President, H.E. Mrs. Chandrika Kumaranatunga was held in 2004 and the results sent the UNP back to the opposition folds.

them and making the external political environment of the countries having such strained relations unstable.

As pointed out in Chapter two, FDI is no longer the case of a single foreign investor investing in a country where the country's political instability might pose a threat to the investor. For example, project financing involves several actors and at times infrastructure projects developed with project financing techniques are not restricted to a single jurisdiction.[288] As a result, cross border movement of services, goods, labour and assets is not uncommon in modern day infrastructure development projects. Further, with the current trends of globalisation of international trade and investment and the creation of common markets, the future of project financing lies not in the investment of a single country but in cross-border or regional investment projects. Although cross-border or regional infrastructure projects could be more complex due to cultural and political differences between countries, most developing countries would benefit from such projects. For example, projects such as building of highway networks connecting countries; building channels to facilitate sea and water based transport infrastructure; and development of energy based infrastructure projects could contribute towards national as well as regional development. In the circumstances, external political instability could adversely affect infrastructure development projects.

However, such projects are likely to raise several interesting issues as, the concessions to develop the projects will have to be given by two or more countries, and the investors and lenders

288 The proposed tunnel project connecting the Argentine San Juan province and Chile's Region IV is a good example as both Argentina and Chile will actively participate in the development of the project. Currently the two countries are joined by the Agua Negra border pass, which is located 4,000 meters up in the Andes mountain range. Unfortunately Agua Negra is not able to stay open year-round, as the tunnel will, due to dangerous conditions during wintertime. The new tunnel would span 14 kilometers and would ensure easy transportation between Argentina and Chile in their central-north regions. At a projected cost of $250 million, the tunnel will most likely be financed via concession and will also include a dual-purpose access tunnel for use in maintenance and as an emergency exit. The tunnel's construction is expected to begin before the end of 2005. (Source: Latin Trade - http://www.latintrade.com)

will have to deal with the issue of such project being subjected to two or more jurisdictions[289] and therefore the need to deal with regulators in more than one country over the same project. In the circumstances, political instability in neighbouring countries or in the region could adversely affect cross-border or regional investment projects.

The following case studies show the adverse impact external political instability has on infrastructure development projects and the complexity of issues that needs consideration.

a. Gabcicovo-Nagymaros Case

The Gabcicovo-Nagymaros project relating to a water reservoir between Hungary and present day Slovakia dates back to 1963. It was at this time the idea of a joint Hungarian-Czechoslovak project of the Gabcicovo-Nagymaros barrage system was first considered by both Governments.[290] However, no steps to implement the project were taken until 1977.

The case arose out of the signature, on 16 September 1977, by the Hungarian People's Republic and the Czechoslovak People's Republic (The names of the two contracting States have varied over the years and hence hereinafter they will be referred to as Hungary and Czechoslovakia), of a treaty "concerning the construction and operation of the Gabcicovo-Nagymaros System of Locks" (the "1977 Treaty").[291]

289 In addition to the national jurisdictions of the two countries, the project may also end up being subject to local and provincial laws of the Southern State of Tamil Nadu in India and the Northern Province of Sri Lanka.

290 Slovakia was a part of Czechoslovakia at this time. After the vent popularly known today as the "Velvet Divorce" in 1993, Slovakia and Czechoslovakia went separate ways.

291 Case concerning the Gabcicovo-Nagymaros Project, Decided by the ICJ on 25 September 1997 (General List No. 92) – Full text of the judgment is available online: http://www.icj-cij.org/icjwww/idocket/ihs/ihsjudgement/ihs_ijudgment_970925.html)

The 1977 Treaty provided for the construction and operation of a System of Locks by the parties as a "joint investment". According to its Preamble, the barrage system was designed to attain "the broad utilization of the natural resources of the Bratislava-Budapest section of the Danube River[292] for the development of water resources, energy, transport, agriculture and other sectors of the national economy of the Contracting Parties". The joint investment was thus, essentially aimed at the production of hydroelectricity, the improvement of navigation on the relevant section of the Danube and the protection of the areas along the banks against flooding. At the same time, by the terms of the Treaty, the contracting parties undertook to ensure that the quality of water in the Danube was not impaired as a result of the Project and that, compliance with the obligations for the protection of nature arising in connection with the construction and operation of the System of Locks would be observed.

Following the conclusion of the 1977 Treaty, work on the Project started in 1978. However, since the commencement of work, the economic, political and environmental positions within both countries changed dramatically. In particular, the Project became a source of increasing apprehension for Hungary. Doubts as to the economic viability and the environmental impact of the project surfaced leading to public criticism and political opposition. Consequently, in the October of 1989, Hungary, responding to domestic pressure, abandoned its works at Nagymaros.

A series of negotiations between Hungary and Czechoslovakia ensued. Czechoslovakia, frustrated by the lack of progress in the negotiations, decided to proceed and develop its own solution to the problem. This initiative which later became known as 'Variant C' (the ‘provisional

292 The Danube is the second longest river in Europe, flowing along or across the borders of nine countries in its 2,860-kilometre course from the Black Forest eastwards to the Black Sea. For 142 kilometres, it forms the boundary between Slovakia and Hungary. The sector with which this case is concerned is a stretch of approximately 200 kilometres, between Bratislava in Slovakia and Budapest in Hungary.

solution'), entailed the unilateral diversion of the waters of the Danube by Czechoslovakia in order to put the Gabcicovo dam into operation. This simply exacerbated the situation and led to Hungary terminating the 1977 Treaty on May 15th 1992. By October, Czechoslovakia had completed the closure of the Danube.

Irreconcilable differences pushed the parties firstly towards trilateral negotiations with the EC (now "EU") in 1992 and then, by Special Agreement, to a judicial determination at the ICJ. The Court was asked to decide *inter alia* whether:

1. Hungary was entitled to unilaterally suspend and later abandon the works on the Nagymaros and Gabcikovo parts of the project to which it was attributed responsibility under the terms of the 1977 Treaty; and
2. The Czech and Slovak Republics were entitled to proceed with the 'provisional solution' in November 1991 and to put this system into operation in October 1992.

The most crucial argument raised by Hungary in defence of its right to suspend and terminate the 1977 Treaty was that, Czechoslovakia's operation of Variant C had given rise to a permanent state of ecological necessity. Hungary claimed, *inter alia*, that Variant C would seriously damage the water quality of the Danube, would result in the extinction of fluvial fauna and flora in the area causing considerable danger to the inhabiting wildlife. From these 'predictions', formulated from a variety of scientific studies, Hungary claimed that a 'state of necessity' existed in 1989 thus justifying its suspension and subsequent termination of the 1977 Treaty.

The ICJ in its discussion, accepted that there did indeed exist a defence of 'state of necessity' which, in the correct circumstances, would preclude the responsibility of wrongful acts. In support of this view, the Court referred to the work of the International Law Commission

(ILC), which had in its Draft Articles on the International Responsibility of States, upheld the notion of ‘state of necessity' as a ground for precluding responsibility.

However, it should be noted that under these Draft Articles, a ‘state of necessity' may only be invoked if the criteria in Article 33 (Article 25 of the draft articles on Responsibility of States for internationally wrongful acts adopted by the International Law Commission at its fifty-third session (2001)) are satisfied. This Article provides that:

1. Necessity may not be invoked by a State as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act:
   (a) Is the only way for the State to safeguard an essential interest against a grave and imminent peril; and
   (b) Does not seriously impair an essential interest of the State or States towards which the obligation exists, or of the international community as a whole.
2. In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if:
   (a) The international obligation in question excludes the possibility of invoking necessity; or
   (b) The State has contributed to the situation of necessity.

In considering whether Hungary had satisfied these conditions, the ICJ acknowledged Hungary's concerns in connection with the environment. The Court accepted that environmental concerns may constitute an ‘essential interest'. However, while accepting that a ‘state of necessity' defence did exist within the confines of customary international law and that Hungary's concerns

for the environment constituted an ‘essential interest', the ICJ was not persuaded that the danger was certain and imminent. In highlighting the distinction between ‘perceived' peril as opposed to actual and imminent peril, the Court indicated the crucial role that uncertainty has to play within this specific area of international environmental law. The Court observed that, clearly possible peril will not suffice; it must be immediate. It was noted that in a futile attempt to establish immediacy, Hungary inadvertently overlooked the alternative means that were available to prevent the environmental damage.

In finding that Czechoslovakia had no right to put into operation Variant C and that, Hungary did not have the right to suspend and subsequently terminate the 1977 Treaty; the ICJ did not proclaim a victor in the Gabcikovo case. Instead, it ruled that the parties should begin afresh a new process of negotiations to determine how best to implement the joint plan and achieve the original objectives.

In ruling that Hungary and Czechoslovakia were under a legal obligation to co-operate, the Court stated that such negotiations should determine in what way the multiple objectives of the 1977 Treaty could be best realized. Thus, the Court simply set and defined the fundamental legal parameters that the negotiations should take place within.

The above example is useful to understand the plight of the project participants if almost a decade after committing to invest in a transnational project and, after a series of stoppages due to conflicts between the two host nations, if the two nations decide to renegotiate the project.

b. The Caspian Sea Region

The Caspian Sea region, including the Sea and the States surrounding it is important to world energy markets because of its potential to become a major oil and natural gas exporter. The region is thought to hold the world's third largest oil and natural gas reserves behind the Middle East and Russia. However, several factors threaten to complicate the region's potential. These include disagreement over new export routes, border disputes between the littoral States, and the lack of adequate export infrastructure.[293]

Many of the proposed export routes pass through areas where conflicts remain unresolved. Although new oil and natural gas export pipelines offer the hope of longer-term prosperity, the region's numerous flashpoints and ongoing instability have caused energy companies and potential investors to think twice before investing in the construction of proposed pipelines.[294]

Most of these conflicts are in the Transcaucasus part of the Caspian region, where, conflicts in Nagorno-Karabakh between Georgia and the Chechen Republic of Southern Russia have hindered the development of export routes westward from the Caspian Sea, affecting most countries in the region. On the east side of the Caspian, the unstable situation in Afghanistan following decades of war, fundamentalist governance, and present volatile political situation after the fall of the Taliban, has stifled the development of export routes to the southeast. Furthermore, the threat of Islamic fundamentalism in Central Asia, especially in Uzbekistan, has stalled any new export pipelines involving that country.[295] The threat of war between Pakistan and India serves as a further deterrent to Caspian export pipelines running southeast, either via Iran or

293 Energy Information Administration, Country Analysis Brief, The Caspian Sea Region, (August 2003), Online: http://www.eia.doe.gov/emeu/cabs/caspian.html.
294 Id.
295 Id.

Afghanistan. In addition the questions surrounding the legal status of the Caspian Sea following the fall of the Soviet Union in 1991 has hindered development of the Sea's mineral resources.[296]

c. Western Balkan States

While there has been some improvement during the last couple of years in the amount of foreign capital flowing into the Western Balkans, political instability in the former constituent republics and the provinces of the Socialist Federal Republic of Yugoslavia (SFRY), continues to hinder urgently needed FDI.[297]

In the year 2000, it was estimated that only around US$ 1.2 billion, was invested in the entire region. Of that sum, the US$ 898 million invested in Croatia was three times larger than the combined investments made in Serbia and Montenegro, Former Yugoslav Republic of Macedonia (Macedonia), and Bosnia-Herzegovina together.[298] Moreover, in these cases investments were concentrated on several large projects, rather than a range of small investments that would indicate wider confidence. For example, Macedonia's biggest investment came from the sale of 51 per cent of Macedonian Telecom to MATAV, the Hungarian telecommunication company. Similarly, a large percentage of Serb Telecom had been sold to an Italian company and the Greek state telecommunications firm, OTE.[299]

There are several of problems and concerns over promoting FDI in the Western Balkans. Any hope of preventing a resurgence of fresh fighting between the Serbs, Croats and Muslims of

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296 The fall of the Soviet Union in 1991 led to the independence of three new countries bordering the Caspian, Azerbaijan, Kazakhstan and Turkmenistan. These three countries and Iran and Russia have been so far unable to agree on a legal framework governing the use and development of the Sea's oil and natural gas reserves, Online: http://www.eia.doe.gov/emeu/cabs/casplaw.html.

297 Civilitas Research, Regional Business Integration in the Western Balkans (May 2002). Civilitas Research is a website providing precisely tailored information, analysis and forecasts on business and politics in South East Europe to clients operating in both private and public sector, Online: www.civilitasresearch.com.

298 Id.

299 Id.

Bosnia requires the strong and continuing presence of an international peacekeeping force. At the same time the 'marriage of convenience' between Serbia and Montenegro continues with no clear answers as to what will happen at the end of the mandated three-year period of partnership that will come to an end in late 2005.[300] Similarly, there are uncertainties about the future status of Kosovo. Similar concerns also exist with regard to Vojvodina, albeit to a far lesser degree. Although the NATO peacekeeping mission in FYR Macedonia has explicitly denied rumours of another offensive by the National Liberation Army (NLA), the separatist Albanian movement, it is evident that the Slav-Macedonians and Albanians of the country still deeply distrust each other.[301]

Given this range of issues, it is hardly any surprise that many foreign investors, although encouraged by action taken by countries in the region to open their economies and invite foreign investment, remain cautious about committing to invest in the region. However, a positive factor to be observed in this region is that, commercial ties are being supplemented by political ties and economic integration initiatives. After a decade of deadly conflict and destruction following the dissolution of Yugoslavia, its constituent parts are slowly starting to restore the broken business bonds and lost markets.

Furthermore, according to the Memorandum of Understanding on Trade Liberalisation and Facilitation signed under the auspices of the Stability Pact by the end of year 2002, a network of twenty-one bilateral Free Trade Agreements have been negotiated among the countries of the Western Balkans and the rest of South East Europe. This network targets the creation of an

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300 An EU brokered agreement (“Belgrade Agreement”) was signed between Serbia and Montenegro in March 2002 establishing new political relations between the two former Yugoslav Republics. The agreement provides for two semi-independent states. Upon the finalization of a constitutional charter, the two states are to share common defenses and foreign policies, but have separate economies, currencies and customs practices. The agreement is to stay effective for three years, at which point either party is entitled to hold a referendum on independence. See, Institute of European Affairs, “Balkan Update” (2002), Issue No. 3, November 2002,

301 Source: Civilitasresearch.com. See supra note 297.

economic area of 55 million consumers.[302] Several of these agreements have been implemented since the beginning of 2003.[303] Hopefully, this will attract more FDI to the region. However, the success of these new trading arrangements will depend upon whether the governments of the countries involved will actually put the required agreements into force.

d. Sethusamudram Shipping Channel Project

This ambitious shipping canal project has been on the drawing board for over fourteen decades and is billed as India's Suez. The idea for a canal at India's southern tip originated during the 1860's when the country was under the British colonial rule. During the last fourteen decades, 14 committees, nine of which were set up by the British, have examined and shelved the project for various reasons.[304] Finally, it has started showing signs of becoming a reality since year 2004, as the Governments of India and Sri Lanka have started holding a series of negotiations on the project.

According to the proponents of the project, if the project becomes a reality, it is expected to cost approximately US$ 550 million and will cut through a chain of islands between India and Sri Lanka, reducing the transit time between India's east and west coasts and cutting shipping costs as well as the government's fuel-import bill.[305] The canal is expected to be 167 km long and 300 meters wide and would cut the distance between India's east and west coasts by 424 nautical miles, saving ships a 30 hour southern detour. If the negotiations between the two countries are successful, and the project becomes a reality, it is expected to be functional in 2008.[306]

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302 Bogoevski, J., Chairman, Special Co-coordinator of the Stability Pact for South Eastern Europe Nations, Presentation made before the International Forum on Trade Facilitation (Geneva, May 2002).

303 Wijkman, P. M., A Free Trade Area in South Eastern Europe? Prospects and Problems, Research Paper (Tirana: Albanian Centre for International Trade, 2003).

304 Ramakrishnan, V., *"India-Sri Lanka Channel Project Looking Up"*, Business Week, August 13 (2005).

305 Id.

306 Id.

Although the Sri Lankan Government appears to have given the initial consent to the project as it would not want to upset its more powerful neighbour, the project has run into opposition from some key politicians and environmentalists in Sri Lanka. The basis for the political opposition is the fear that ships travelling between India's east and west coasts which have to circumnavigate Sri Lanka and other large vessels passing the region would bypass the Colombo Port; i.e., Sri Lanka's hub-port which brings in the highest foreign income to the country. The Sri Lankan Government has assured the opponents that if the project poses adverse effects to the country, it would take steps to safeguard the countries interests including, bringing legal action before the International Court of Justice.[307] However, the opponents to the project in Sri Lanka argue that prevention is better than cure. The environmentalists oppose the project on the basis that the digging of the seabed will endanger over 400 species, including sea turtles, whales and corals. Further, some have expressed concern that the dredging of the seabed may affect the flow of currents, water temperature, marine life, and the livelihood of fishermen.

Given this background, if the Government of India decides to move forward with the project and to raise the financing for the project by using project financing techniques, steps will have to be taken by the project participants to ensure that the external political instability would not cause any obstacles to the project.

e. South Africa

South Africa is a regional super power. However, political concerns in Zimbabwe, civil wars in neighbouring countries (for example, Angola, and Congo) have been threatening its investment prospects during the last two decades. South Africa's plight that can be called a "bad

307 Id.

neighbourhood" syndrome is likely to cause problems even for the prospective future investment projects unless there is some stability in the region.[308]

4.3.3. Measures for Mitigating Risks due to Political Instability

Political instability in many developing countries add an element of hazard to any long term development project as stability can be ensured only so long as governments remain in power, captive markets or monopolies are left in place, and consumer remain satisfied with the project out-put and the price there of.[309] Even events such as termination or material alteration of a permit or license for a project, imposition of new taxes, or currency exchange restriction could have serious implications for the success of an infrastructure project. Thus, developing countries need to take steps to ensure that investors and lenders have confidence in the political stability of the country and that their capital or debt investments will not be at any undue risk.

The developing countries will have to satisfy the prospective investors and lenders that legislative measures will be taken to ensure that political changeovers will not affect investment projects. Steps will have to be taken to ensure transparency in the procurement process in infrastructure development projects, so that room for political opposition and criticism will be minimised. Having an investment law in place which cannot be amended without the due process of majority parliamentary approval would definitely give comfort to investors and lenders. Similarly, getting all political parties in the host country to be represented in some reasonable manner in the procurement process for investment projects would ensure that even if a ruling political party is ousted from power, a new government might find it difficult to undermine an investment project approved by the former regime, since their own representatives have been

308 African Business, "Jo'burg catches Zim flue", June 2000.

309 See Harder, supra note 107 at p. 41.

involved in the procurement process. Unfortunately, none of the developing countries have so far taken such initiatives.

Further, not only that the political instability in a country will matter, the key actors in project financing should be concerned about the political stability in the geographic region in which host countries are situated. Furthermore, they should also be concerned about the bilateral and multilateral relationships between countries as external political instability emanating from strained relations between countries could affect the development initiatives undertaken in developing countries with the use of project financing techniques.

The most effective measure for minimising the risks due to external political instability would be the promotion of regional cooperation among countries. This would be an achievable task however, only when the countries are in good economic and political relationship with each other. For example, Promoting regional cooperation between India and Pakistan or between Syria and Lebanon for the benefit of infrastructure development in the respective regions would be a Herculean task given the current status of political conflict between these countries.

The lack of realisation among the developing countries that infrastructure development in one country could be used to boost the development of the entire region is one of the main contributing factors towards lack of cooperation between developing countries. The fact that none of the regional integration movements started by the developing nations in South Asia and Africa have so far been successful compared to regional groups such as the EU, NAFTA and the ASEAN, supports this argument.[310] Thus, the developing countries should be encouraged to take a regional as well as a global view concerning their development strategies. Further, they should

310 Gunawansa, Asanga, 'Regional Integration in South Asia: Prospects and Challenges' (1996), Research Thesis submitted in support of LL.M in International Economic Law, United Kingdom: University of Warwick.

be encouraged to recognize the importance of regional and global dimension in their economic development planning.

4.4. Risks due to Succession of States and Creation of New States

4.4.1. Nature of the Risk

Generally speaking, the break-up of a state can be characterized as either a continuation or dissolution. In the case of a continuation, a sub-entity (some times more than one sub-entity) breaks away from the predecessor state and forms an independent state. When this happens, what remains of the predecessor state is referred to as a continuator state.[311] It generally retains the rights and obligations of the predecessor state. In the case of dissolution, the predecessor state dissolves into a number of successor states with none of them being considered the continuator state.[312]

Although the division of a unitary state into more than one independent political unit is not a new political concept, in recent times, there has been an increasing demand, especially in several developing countries in Asia, Africa and the former communist block for political autonomy and self-governance of certain regions. These demands are being made by various ethnic and/or political groups on grounds, including ethnic and religious discrimination. In fact, some of these demands have met with success and as a result, several new countries have joined the international community. The break-up of the former Soviet Union and the break-up of the

311 The establishment of East Timor is a good example of this situation where Indonesia remained the continuator state.

312 The case of SFRY is a good example where it ceased to exist and Bosnia and Herzegovina, Croatia, Macedonia and Slovenia emerged as successor states.

former Socialist Federative Republic of Yugoslavia (SFRY) and, the resulting emergence of several newly independent countries in the early 1990s could be cited as an example.[313]

With the emergence of new states, both the newly established regimes as well as the international community in general are confronted with the many problems of state succession as there is no customary international law that could be applied to different types of succession. Further, any existing international law in this area has not been codified successfully.[314] In the absence of established international legal principle, the manner in which the international community actually behaves in matters of state succession varies according to the circumstances of each individual case.[315] In other words, a new state can be created by the succession of an old state or the separation of an existing state into two or more distinct political and legal regimes. While the political relevance of the recognition of new states is beyond doubt, the rules of law that apply to this aspect of public international law remain uncertain. As a result, succession or separation of states could pose many complex problems in relation to FDI and in particular, in relation to infrastructure development projects in the former regimes.

Due to the presence of several parties with diverse interests in modern day infrastructure development projects, developing countries as well as investors, lenders, and other key project participants need to consider critically, the effects of a cessation or division of a unitary state. For example, the effectiveness of the obligations and undertakings of a government over a project which subsequently falls within the jurisdiction of a newly created state should be considered if

313 like for instance, in the case of SFRY, the emergence of Bosnia and Herzegovina, Croatia, Macedonia and Slovenia.

314 Shihata, F. I. Ibrahim , 'Matters of State Succession in the Practice of the World Bank', Development and International Cooperation, Vol. XII, No. 23, December 1996, p. 7.

315 Mrak, M., Apportionment and Succession of External Debts: The case of the SFR Yugoslavia, (September 1998). Online: www4.worldbank.org/legal/legen/legen_state.html

the presence of such risk is visible at the time the project negotiations are done and investment decisions are made.

Some would argue that the risk of cessation of states is not entirely a new as the existing public international law covers this aspect. I would argue that the existing public international law on this issue is not fully tested and that it does not comprehensively cover the rights and liabilities of every party to an investment contract in the event of cessation of the political power in a host country. For example, although it is accepted that a successor state would automatically inherit the assets as well as obligations of the old state,[316] the position is not very clear with regard to the status of new states created over part of a territory previously under the jurisdiction of a different state. Likewise, the position with regard to the obligations of a new state during the period between its creation and its acceptance to the international community is also not clear.

4.4.2. Current International Legal Position on State Succession

The integration of a new state into the international community does not take place automatically, but through co-optation; that is, by individual and collective recognition on the part of the already existing states.[317] Recognition of a new state is an act that confers a status; as a result of recognition, the recognised entity acquires the legal status of a state under international law. In this sense, a new state is not born, but chosen as a subject of international law. By the procedure of recognition, the existing states exercise their prerogative to determine in advance whether the newcomer, in their judgment, is able and willing to carry out all its obligations as a

316 Vienna Convention on Succession of States in Respect of State Property, Archives and Debt. UN Doc. A/CONF. 114/14 (7. April 1983), Article 36.

317 Hillgruber, C., *"The Admission of New States to the International Community"*, 9 European Journal of International Law No. 3 (1998), p. 491 at 509.

subject of international law, whether it will be a reliable member of the international community.[318]

On admission as a member of the United Nations, the new state then becomes part of the globally organised community of states by way of co-optation. After the decision has been taken to admit a state to the United Nations, its statehood cannot be called into question with the effect of contesting the validity of mutual rights and obligations arising from co-membership.[319]

The constitutive and legally operative effect of the recognition of new states is clearly illustrated by state practice with regard to Bosnia-Herzegovina. Right from the beginning Bosnia-Herzegovina did not constitute a functioning national body. Its recognised government only controlled a very small part of the national territory. However, international recognition of Bosnia-Herzegovina in April 1992 conferred on it the status of a state under international law by way of a legal fiction.[320]

If a new state fails to get international recognition, even though it might have all other features of a state, i.e. state population, state territory and an effective government, it may lack legitimacy when it comes to international transactions. Sometimes, even its national actions may warrant the intervention of the international community that might even include the use of force.[321] For example, Rhodesia underwent a period of self-existence without international recognition during which time both the various acts performed by the government were not recognised by the international community as actions of legitimate nations. In fact the

318 Id.

319 Etat, R.B., *"(Creation, Succession, Competences), Genese et Disparition de L'Etat a L'Epoque Contemporatne"*, 38 AFDI (1992) 153 at p. 163.

320 See Hillgruber, supra note 317.

321 Id.

international community did not recognize Rhodesia as an independent state and continued to regard the United Kingdom as internationally responsible and accountable.[322]

International non-recognition sometimes might even result in a new state ceasing to exist. The case of Biafra offers a very good example.

The Case of Biafra

In the mid-1960s economic and political instability and ethnic friction characterised Nigerian public life. In the mostly Hausa north, resentment against the more prosperous, educated Igbo minority erupted into violence. In September 1966, some 10,000 to 30,000 Igbo people were massacred in the Northern Region, and perhaps 1,000,000 fled as refugees to the Igbo-dominated east.[323] The Non-Igbos was then expelled from the Eastern Region. Attempts by representatives of all regions to come to an agreement were unsuccessful. On May 30, 1967, the head of the Eastern Region, Lieutenant Colonel (later General) Odumegwu Ojukwu, with the authorisation of a consultative assembly, declared the region a sovereign and independent republic under the name of Biafra.[324] General Yakubu Gowon, the leader of the federal government, refused to recognize Biafra's secession. Biafra made several unsuccessful representations to the United Nations and its neighbouring countries seeking international recognition as an independent state. Biafra ceased to exist as an independent state in January 1970.[325]

322 By regarding and treating the independence of the homelands Transkei, Bophuthatswana, Venda and Ciskei as invalid under international law, the United Nations continued to consider these entities as integral parts of the state territory of the Republic of South Africa, to which the prohibition of intervention and the use of force applied. See supra note 244.

323 Online://www.onwar.com/aced/data/bravo/biafra1967.htm

324 Id.

325 Id.

4.4.3. Powers of the New State after Succession

As Jennings remarks, the law of state succession *"is a subject which presents such a rich diversity of practice as to give some plausibility to a surprisingly varied range of theoretical analysis and doctrine"*.[326] The succession of states theory asserts that all possessions and territory held by a state are automatically transferred to the state which succeeds it. For example, if the Government of Singapore is overthrown, and replaced by the newly formed Kingdom of X, all of the previously controlled territory, weapons, and wealth of the former Singapore Government would fall under the control of the Government of the new kingdom. One recent example is what happened when the USSR dissolved in 1991. The Russian Federation was named the successor of USSR and acquired the USSR's seat as a permanent member of the United Nations Security Council. This logic has been frequently used in the past by revolutionary Governments such as Cuba and the former Soviet Union to assert authority over the assets, powers and rights of the former regime.

In general, the theory that is followed by the world community is that, a new government might be distasteful to others but pragmatically it must be recognized if it de facto controls the territory. However, there are several fairly recent examples where this theory has not been put into strict practice:

i. When the Democratic Kampuchea regime of Pol Pot was militarily displaced by the Vietnamese-backed People's Republic of Cambodia, the United Nations seat continued to be held by Democratic Kampuchea for many years.
ii. The Taliban State (Islamic Republic of Afghanistan) in Afghanistan became the de facto government of nearly all of the country; but the Northern Alliance was still recognized by many nations and retained the United Nations seat.

326 Jennings, I. *"General Course on Principles of International Law"* , 121 RdC (1967) p. 437

Given that there exists a vast amount of literature on the subject of state succession;[327] the matter has been considered extensively by the International Law Commission;[328] and further that two international conventions on the law of state succession have been adopted[329] it is surprising that there is no agreed theoretical structure of state succession.[330]

The lack of common agreement on some of the central issues in the law of state succession has become particularly evident in the wake of the territorial/ political changes in Central and Eastern Europe,[331] particularly following the `dissolution' of the USSR,[332] SFRY,[333] and Czechoslovakia,[334] and the unification of Germany.[335] It remains unclear, for example,

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327 Some of the most prominent works are O'Connell, D., State Succession in Municipal and International Law, Vols. I and II, (Cambridge: University Press (1968); Feilchenfeld, E., Public Debts and State Succession (New York: Macmillan, 1931); Keith, A., The Theory of State Succession with Special Reference to English and Colonial Law (London: Waterlow & Sons, 1907); Udokang, O., Succession of New States to International Treaties (New York: Oceania Press, 1972); Hershey, A., *"The Succession of States"*, 5 AJIL 285 (1911); and Jenks, W., *"State Succession in Respect of Law Making Treaties"*, 29 BYbIL (1952), p. 105

328 The problem of state succession was placed on the ILC's agenda at its first session in 1949, following the recommendation of Lauterpacht in his survey (UN Doc. A/CN.4/1/Rev.1, 10 Feb. 1949), 1 Yearbook ILC (1949) 53, UN Doc. A/CN.4/Ser.A/1949.

329 Vienna Convention on State Succession in Respect of Treaties, 17 ILM (1978) 1488; Vienna Convention on State Succession in Respect of Property, Archives and Debts, 1983, 22 ILM (1983) p. 306.

330 The ILC commented, for example, that `[a] close examination of State practice afforded no convincing evidence of any general doctrine by reference to which the various problems of succession in respect of treaties could find their appropriate solution'. Yearbook ILC (1974 - II, part I), at 168, para. 51. Castrén remarks similarly that: `The elucidation of this question is rendered difficult by the absence of general international treaties and in view of the great instability in the practice observed by different States in different periods. It is, therefore, not surprising to find that differences of opinion, even with regard to certain fundamental aspects of the problem, prevail in the doctrine of the law of nations.' See Castrén, E., *"Obligations of States Arising from the Dismemberment of Another State"*, 13 ZaöRV (1951) 753.

331 See, Shaw, M., *"State Succession Revisited"*, 6 Finn.Y.I.L. (1995), p. 34; Schachter, O., *"State Succession: The Once and Future Law"*, 33 Va. J. Int'l L. (1993), p.253; Martins, M.A., *"An Alternative Approach to the International Law of State Succession"*, 44 Syr.L.R. (1993), p.1019; Lloyd, D.O., *"Succession, Secession, and State Membership in the United Nations"*, 26 N.Y.U.J.I.L.P. (1994), p.761; Scharf, P., "*Musical Chairs: The Dissolution of States and Membership in the United Nations"*, 28 Cornell Int'l L.J. (1995), p. 29; Williams, P.R., *"State Succession and the International Financial Institutions: Political Criteria v. Protection of Outstanding Financial Obligations"*, 43 ICLQ (1994), p. 776.

332 See, for example, Koskenniemi, M., and Lehto, M., *"La succession d'Etats dans l'ex-URSS, en ce qui concern particulièrement les relations avec la Finlande"*, 38 AFDI (1992), p.179; Love, L., *"International Agreement Obligations after the Soviet Union's Break-up: Current United States Practice and its Consistency with International Law"*, 13 Van.J.T.L. (1993), p. 413; Müllerso R., *"New Developments in the Former USSR and Yugoslavia"*, 33 Va. J. Int'l L. (1993), p. 299; Williams, P.R., *"The Treaty Obligations of the Successor States of the Former Soviet Union, Yugoslavia, and Czechoslovakia: Do They Continue in Force?"* (1994), 23 Denv. J.I.L.P. 1; Bunn, G., and Rhinelander, J., *"The Arms Control Obligations of the Former Soviet Union"* (1993), 33 Va. J. Int'l L. 323; Beato, M., *"Newly Independent and Separating States' Succession to Treaties: Considerations on the Hybrid Dependency of the Republics of the Former Soviet Union"*, 9 Am.U.J.I.L.P. (1994), p. 525.

333 See, for example, Williams, supra; and Beato, supra.

334 See, for example, Malenovsky, J., *"Problèmes Juridiques Liés à la Partition de la Tchécoslovaquie"* , 39 AFDI (1993) p.05.

335 See, for example, Randelzhofer, A., *"German Unification: Constitutional and International Implications"* (1991), 13 Mich. J. Int'l L. 122; Oeter, S., *"German Unification and State Succession"* (1991), 5 ZaöRV 349, at 352-3; and Tomuschat, C., *"A United Germany within the European Community"* (1990), CMLR p. 415.

whether and to what extent the Federal Republic of Yugoslavia (Serbia-Montenegro) remains bound by the treaties of the former Yugoslavia.[336] [337]

Unlike many other areas of law, the law of state succession benefits little from codification.[338] In its conventional form, the law of state succession is ultimately self-regarding - the question whether a new state is bound by particular conventional norms of succession is contingent upon a recognition that it has, indeed, succeeded to those norms. This point was not lost on the ILC which, when drafting articles on state succession to treaties, admitted that the adoption and general ratification of a relevant treaty would itself do little to resolve legal difficulties.[339]

4.4.4. Status of Investment Contracts and Succession of States

Since the succession of states in most cases brings into existence a new state, a convention on the law of succession in respect of treaties would for example may not be binding on the successor state unless and until it takes steps to become a party to that convention. Even then, the convention would not be binding upon it in respect of any act done before the date on which it became a party to the convention.[340] Likewise, other states would not be bound by the convention in relation to the new sate until the latter had become a party. The problem here is that, even assuming widespread ratification of the Vienna Conventions, in most cases those states

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336 The `Summary of Practice of the Secretary-General as Depositary of Multilateral Treaties' of 1996 described the FRY as the `predecessor state' whose treaty obligations remained unaffected by the secession of the various Yugoslav republics. UN Doc. ST/LEG/8, paragraphs. 297-8 (1996). The US, Germany and Guinea all objected to these paragraphs (UN Docs. S/1996/251; S/1996/263; S/1996/260) and an errata was issued.

337 Craven, Mathew C.R., *"The problem of state succession and the identity of states under international law"*, European Journal of International Law (2001), Online: http://www.ejil.org/journal/Vol9/No1/art5-02.html#P87_33237.

338 See O'Connell, supra note 327 at pp. 729-733.

339 Yearbook ILC (1974, II, pt. i) at 170, para. 62. This point is further bolstered by the principle of non-retroactivity embodied in Article 7.

340 Id.

specifically affected will, ex hypothesis, not have ratified the Convention nor will there necessarily be any evidence of `extensive' and `uniform' practice.

Some argue that newly emergent states would be automatically bound by the terms of a general international law of succession. The traditional justification for this lies in the supposition that, in seeking entry into the international legal community, new states impliedly accept the terms of existing general international law.[341] Leaving aside the question-begging nature of such resort to `tacit' consent (it clearly not being the same as consent to the creation of a legal norm), it may be argued that there is a big difference between the acceptance of obligations where there is evidence of an existing general practice and on the other hand and, the acceptance of rules whose application is directed specifically and exclusively to new states as they emerge onto the international plane, on the other.[342] The point is that, new states do not enter into a legal community in which the rules of succession govern the relations between states on a day-to-day basis but, are rather subjected to the application of a particular conditional set of rules that lays down the legal circumstances that are to accompany their `birth'. This is not to say that the creation of rules of this type is an impossibility, but rather that their justification cannot be based upon the traditional processes of tacit consent, acquiescence or estoppel.[343]

In this background, an important issue that needs consideration is the issue concerning the future of foreign investment contracts when state succession occurs. The question will arise as to whether which state (the old state or the newly independent and or autonomous state) is responsible for investment contracts entered into before the separation for development projects coming within the area controlled by the new regime.

341 See, for example, Westlake, J. International Law, (Cambridge: University Press, 1895) at 49; and Oppenheim, L., International Law: A Treatise, (2nd. ed.), (London: Longmans, 1910) p. 18.

342 See Craven, supra note 337.

343 Id.

As far as infrastructure projects developed with project financing techniques are concerned, state succession is a risk that the main project participants' should take into serious consideration. For example, if an investor invests on a long term power project in the northern province of Sri Lanka, or in the troubled Kashmir province of India, where ethnic groups are fighting for the creation of separate states, the issues that necessarily stem from the situation in the event of cessation of political power of the host country over the disputed area are whether:

i. the project participants anticipated such risks;
ii. such risk could be allocated to any project participant;
iii. the new autonomous regime is bound to honour an investment agreement to which it was not a party; and
iv. the old regime will be held responsible for project guarantees it had given over a project now under the control of a new regime.

In this regard it is important to note that under existing international law, state debt obligations are generally divided into "national debt", i.e., debt contracted in the general interest by the national government of a state and "localized debt", i.e., debt contracted by the national government of a state for identifiable projects in a specific region; and "local debts", i.e., debts of local governments.[344] An alternative classification of state debts distinguishes between "allocated" debt, where final beneficiaries are from a clearly identifiable part of the state and "non-allocated" debt, meaning those debts used for the state's general purposes.

The International law on state succession in the area of state debts is governed by both the 1983 Vienna Convention and the legal practices experienced through cases in individual countries. The Vienna Convention draws no distinction between cases of

344 Shaw, M.N., The Succession Revisited, FYBIL, 1994, p. 93 and the ILC Report, ILC Yearbook, part 2, 1981, p. 74.

continuation and dissolution or between "allocated and non-allocated" debt.[345] It therefore does not provide much guidance with respect to these issues. Further, although the Vienna Convention provides a definition of state debts, i.e. that state debts *mean "any financial obligation of a predecessor State arising in conformity with international law towards another State, an international organization or any other subject of international law"*[346] this definition does not cover debts owed to private creditors and thus, does not offer protection to non-state actors such as investors.

Thus, succession of states and separation of states is an issue that all project participants in project financing transactions will have to take into consideration. Although in the past, separation of a state has not caused any major investment concerns, the risk is not some thing that could be ignored any longer. In the past, investors have been either lucky to pull out before the risk became a reality[347] or there was no major investment project that fell into the hands of a new regime. However, the future may not be so bright. A good example can be drawn from the current political crisis in Sri Lanka.

The case of Sri Lanka

In Sri Lanka, things have returned to near normalcy since the Government and the Liberation Tigers of Tamil Ealam (LTTE) signed a cease-fire agreement in February 2002. Since then, the Government has taken several initiatives towards developing the north and the eastern provinces of Sri Lanka. These initiatives include a proposal to build a bridge across the Polk

345 Williams, R. Paul, *"State Succession and the International Financial Institutions: Political Criteria v. Protection of Outstanding Financial Obligations"*, International and Comparative Law Quarterly, Vol. 43 (October 1994), p. 787.

346 Vienna Convention on Succession of States in Respect of State Property, Archives and Debt. UN Doc. A/CONF. 114/14 (7. April 1983), Article 36.

347 For example, Delta Airlines, which as early as in 1991-92 considered entry into Czechoslovak Airlines, withdrew its bid as the separation of Czechoslovakia was anticipated.

Straight connecting the South of India and the North of Sri Lanka, and the building of a coal power plant in the eastern province of Sri Lanka with the use of FDI.

Both Sri Lankan and foreign political observers have repeatedly sated that the two parties are long way off from establishing permanent peace in the country. Although, after the destruction caused to the country by the Tsunami in December 2004, with greatest difficulty, the two parties reached an agreement concerning the sharing of foreign aid for reconstruction and rehabilitation, the relationship between the two parties hit a new low since the assassination of the Sri Lankan Foreign Minister in July 2005. The Government has come out strongly blaming the LTTE for the killing, an allegation strongly denied by the LTTE. Thus, the risk of political division in Sri Lanka is very much alive.

Given this background, if the Government proceeds with the planned Indo-Lanka bridge project and the power project in the Eastern Province, and eventually, if these areas fall under the total control of the LTTE, and like East Timor if the area is recognised as a independent and autonomous state by the international community, then the destiny of the investment project will be unpredictable. In such situation, whether the foreign investors and lenders could hold the Government of Sri Lanka responsible for any obligations under the contracts even when the Government had effectively lost control over the project areas is an issue that needs consideration. The other important issue to consider is whether the new regime would be obliged to assume control and honour the investment agreement to which it was not a party. These are matters that should be taken into consideration in making future investment decisions in relation to countries or regions that pose such risks.

4.4.5. Measures for Mitigating Risks due to Succession or Creation of States

The most favoured solution to the demand for political separation is to bring about a political and mediated settlement that promotes political decentralisation in lieu of political separation. Although initiatives to mediate such settlements will be in the best interest of the countries concerned, it is important to consider and address what implications would arise in the event of eventual separation of a country into two or more autonomous units.

As far as foreign investors are concerned, it would no longer be sufficient to undertake only a study of projects environmental and economic viability before investment decisions are made. Investors will also have to carefully consider the political stability of the country as well as the region before investment decisions are made.

In the circumstances, the developing countries will have take steps to ensure that political instability would not hamper their development initiatives and, be willing to offer legislative and regulatory protection, and financial guarantees, to investors to boost their confidence, if investment projects in politically volatile areas are to be promoted. However, if the risk of political division is so imminent, then the countries should take precautions. Inviting the political, ethnic or religious groups campaigning for political separation to enter into a mutually acceptable agreement to allow the infrastructure development in the conflict region would be a prudent measure. This may prevent such parties from subsequently trying to disown any responsibility towards investment projects. The aforesaid post-tsunami agreement reached between the Government of Sri Lanka and the LTTE is a good example.

4.5. The Risks of War and Foreign Invasions

4.5.1. Nature of the Risk

The risk of war has always been a factor that is given a great deal of consideration before undertaking any major investment project. For some developing countries, due to volatile political relationships with neighbours, the risk of war has been one of the major reasons for failing to attract sufficient FDI for development. War is not a new risk and over the years various war risk insurance mechanisms have been developed to pay compensation to the affected parties in the event of war. However, in recent times, a war related incident that has sent investors, project developers and host nations back to the drawing board is the risk of invasion. The invasion of Kuwait by the Iraqi forces in 1990, which subjected the infrastructure facilities in Kuwait to massive destruction and caused serious and sometimes irreparable damage to contractual relations between parties in international investment contracts, is a classic example.

Although, traditionally, effects of war on contracts were treated as *force majeure* events, thus, excluding liability from all parties involved in an investment contract, over the years the scope of the principle of *force majeure* has been trimmed giving it a very narrow meaning as far as international investment contracts are concerned. Nowadays, in most infrastructure development contracts, disruption of contractual obligations due to war situations is no longer covered by a *force majeure* clause. Instead, expensive underwriting arrangements are used by the contracting parties against such risks.

Although, various underwriting schemes are now available to provide cover to war related risks, the insurers face the uphill task of having to compensate for massive destructions caused by the hostile acts if the type of war risk related damage and destruction that is covered if

ever occurs.[348] Due to this reason, although various underwriting arrangements to cover war related risks are freely available, the premiums the parties seeking such insurance have to pay are very high.

As far as modern day infrastructure development projects in developing countries are concerned, as the financing and project development structures, especially when a mechanism such as project financing is used, are structured to ensure that the investors and lenders take minimum risk in the event of destruction of property or disruption of a project due to war or invasion related events, the burden of shouldering the risk, i.e. the weight of destruction and or disruption is likely to fall heavily on the host governments.

As noted in chapter three above, it is a well known fact that MNCs would not commit to investments in developing economies without a relatively stable revenue stream. Investors need to be assured of payment, whether from government, consumers or donors. It is usually the capacity of a project to generate adequate local revenue that determines the ability of investors to find the finance needed for the development of a project. This is especially the case with project financing transactions where projects are financed off-balance sheet.

In the circumstances, for investors, an investment is more attractive if it is less risky. This means that developing countries need to compete with ach other to provide a less risky investment environment for investors in order to attract them. As a result, developing countries which have a less stable security environment compared to others, in other words, developing countries which are facing the risk of war or invasion will most definitely find it difficult to attract foreign investors for their development projects unless the investors are provided with

348 According to the records of the United Nations Compensation Commission that was established by the Security Council to assess claims for losses arising as a direct result of the Iraq's invasion and occupation of Kuwait during the period 1990 – 1991, claims of non-Kuwaiti corporations related to construction and engineering, excluding those involved in the oil sector, alone was a total of approximately US$10 billion (http://www2.unog.ch/uncc/claims/e_claims.htm).

sufficient guarantees to ensure that in the event of any risk incident happening, any losses to the investors would be comprehensively compensated by the host government.

Although, theoretically speaking one could argue that risk sharing in project financing demands that the risks should lie with the party best able to manage them, in practice, this is not the case when it concerns certain risks such as war risks associated with developing countries. Even if a developing country is unlikely to be the instigator of any hostile action that would lead to a war or an invasion and, is likely to be incapable of absorbing any related risks, due to their desperation to attract foreign investors for much needed development projects, they are likely to be under pressure to provide investment payback guarantees to the investors.

For example with take-or-pay contracts which are widely used in infrastructure projects in developing countries all such risks usually lie with the governments even though it is far from clear that the governments have much control over the risk events.[349] However, if governments do not shoulder the burden of carrying these risks, their infrastructure development needs would suffer.

In some instances, the host governments may even have to agree, to compensate the investors and payback the lenders even when the war situation was not instigated by the host country. For example, the Colombo Port, Queen Elisabeth Quay development contract which was mentioned in chapter three has such a provision.[350] This type of arrangement is usually arrived at not due to the free will of the host state in assuming such risk but, due to most developing countries lacking any forceful bargaining power when negotiating international investment

349 See Chapter 3.4.3.

350 The Contract Structure that was finalized in 1999 includes the main concession (BOT) contract in which specific provision has been included at the insistence of the lenders and the investors to ensure that the Government of Sri Lanka is responsible for compensating the investors and paying back the lenders in the event of project interruption or termination due to war, terrorism, insurgency or other like event.

contracts. Several key negotiators appointed by the Government of Sri Lanka to negotiate the Colombo Port, Queen Elisabeth Quay development project with the P&O Group led consortium and the IFC led team of lenders confirmed this fact.[351] In the circumstances, it could be argued that Risk allocation is the result of bargaining and negotiation rather than the ability of parties to manage the risks.

Further, although comprehensive insurance mechanisms to cover war and invasion related risks are available for foreign investors through various underwriting arrangements, due to high premiums that need to be paid to obtain them, foreign investors are in the habit of passing the whole or substantial part of the risk to developing countries by pressurising the developing countries to provide government guarantees and contractual undertakings to fully compensate the investors in the event of occurrence of such risks. It is doubtful whether most developing countries have the capacity to absorb such risks.

4.5.2. Inadequacy of Current Risk Underwriting Measures to Protect Developing Countries

Foreign investors could take out risk insurance including war risk insurance for their operations in developing countries. Such insurance is provided by Export Credit Agencies in several developed countries for investors from their countries who invest in projects outside. In addition, such insurance facilities are also available through the World Bank Group.

351 Interviews with Mano Nanayakkara and Chanaka De Silva who were members of the Cabinet Appointed Negotiation Committee for negotiating the Colombo Port, Queen Elisabeth Quay Development Project in May 2003.

One of the largest providers of such risk insurance to developing countries is the World Bank's Multilateral Investment Guarantee Agency (MIGA).[352] MIGA's mandate is to provide investment insurance and investment promotion to developing countries. According to MIGA records, from 1990-2000 it has issued 473 "Guarantees" totalling $7.1 billion and these guarantees have helped facilitate $36 billion in FDI to some of the highest risk countries.[353] A good example of an export credit agency that provides such insurance to investors is the U.S. Governments' Overseas Private Investment Corporation (OPIC).[354] In 2004 alone, OPIC provided political risk insurance for 72 projects in 42 countries, including infrastructure projects in Afghanistan, construction in Iraq, hotels in Uzbekistan, energy investments in Botswana, silver mining in Bolivia, and telecommunications in Brazil.[355]

Although agencies such as those aforementioned provide insurance facilities for foreign investors against risks to their investments in developing countries, it is a misnomer if someone holds the view that such insurance coverage removes the risk burden from developing countries. This is because, the cost of insurance premiums the investors have to pay are usually added to the cost of the tender price submitted for infrastructure development projects. Thus, the cost is ultimately passed through to the end user or to the developing country government depending on who pays for the services provided by the project once it is developed.

Further, even when in the event of risk occurrence, the investor is paid under the terms of the insurance by the export credit agency or MIGA as the case may be, the amount so paid is

352 The World Bank established MIGA in 1987 to encourage the flows of FDI to developing countries by mitigating perceived political risks that are causing investors to hesitate. The agency does this by providing political risk insurance to protect investments in developing countries against the risks of transfer restriction, expropriation, breach of contract, and war and civil disturbance. As of year 2000, MIGA has 167 member countries of which 144 are developing countries. Source: www.miga.org

353 West, G. T. and Tarazona, Ethel I., Investment Insurance and Development Impact: Evaluating MIGA's Experience (Washington D.C.: World Bank Group, 2001).

354 The Overseas Private Investment Corporation (OPIC), which began operations in 1971 was established to facilitate private investment by U.S. investors in developing countries and countries with emerging markets.

355 Overseas Private Investment Corporation, OPIC Annual Report 2004 (New York: Overseas Privative Investment Corporation).

eventually becomes part of the national debt of the developing country.[356] For example, In 2001, the Government of Indonesia had to agree to pay OPIC US$ 260 million on account of a payout made by OPIC to the US firm, Mid American Holdings, following the suspension of two geothermal power projects owned by American firm CalEnergy by the Indonesian Government.[357] Similarly, In June 2000 MIGA made its first ever payout on a claim for political risk insurance, a payment of US$15million to Enron on account of a power project that was cancelled by the Indonesian Government. Afterwards, MIGA insisted that the Indonesian Government had to reimburse the payment. As an incentive, MIGA refused to issue any more coverage for business in Indonesia until the money was paid. Once the Government had agreed to repayment terms, after lengthy negotiations, MIGA announced that it was prepared to provide insurance coverage for investors in Indonesia again.[358]The above examples clearly show that even though insurance mechanisms have been developed to protect investments made in developing countries against risks such as wars and invasions, such measures do not provide sufficient protection to the developing countries except for providing a platform to attract investors. If the risk events eventually occur affecting an investment project covered by such insurance, the burden of bearing the cost of payments made to the investors eventually fall on the developing countries as they will have to compensate the insurers.

356 See for example, Export Credits Guarantee Department, United Kingdom, “Review of the Year and Annual Report and Resource Accounts for 2001/02”, p.25. Online: http://www.ecgd.gov.uk/ecgdannualreport0102.pdf

357 Jakarta Post, “IMF Urged to Testify in Favor of Pertamina at U.S. Courts”(June 5, 2002)

358 FT Energy Newsletters - Power in Asia, “Indonesia/Finance: MIGA Restores Risk Guarantees (March 6, 2001).

4.5.3. Measures for Mitigating War and Invasion Related Risks

As pointed out earlier, taking insurance cover as protection over this type risks will be extremely expensive and might severely burden fiscal capacity of many developing countries if eventually they have to shoulder the burden of the risks. In the circumstances, the most effective measure to provide protection to developing countries over such risks would be to strengthen the international legal regime that would cause the instigator of war or the invader to compensate for the damages resulting as a result of war or invasion. So far, the trend has been to put international political pressure on the wrong doer to withdraw its forces and pay compensation to the victim state for loss of life as well as loss of property, and that failing, to use military pressure on the hostile nation.

Such political or military actions are usually taken pursuant to Security Council resolutions of the United Nations. The resolution passed by the United Nations against the Government of Iraq following the invasion and occupation of Kuwait by Iraq[359] and the economic embargos introduced by the United Nations against the Government of Iraq are good examples.[360] Further, during the last three decades there has been couple of instances where international forums have been set up for settlement of disputes and various claims arising out warlike situations. The Iran-US Claims Tribunal and the United Nations Compensation Commission (UNCC) are two good examples. These types of forums have provided some means for investors and others who suffered losses to be compensated without burdening the host countries who were not responsible for the damage.

359 UN Security Council resolution No. 687 of 1991, Online: http://www.fas.org/news/un/iraq/sres/sres0687.htm

360 Following resolutions 687 against Iraq, the United Nations Compensation Commission was set up to evaluate compensation issues arising out of the invasion and occupation of Kuwait by Iraq, and to make recommendations to the Governing Council of the United Nations as to appropriate compensation.

However, international forums such as the UNCC or Iran-US Compensation Tribunal may not be able to always provide comfort against risks such as wars and invasion or resulting hostile taking of property, as they are temporary institutions created to serve a specific purpose. Further, not at every instance of invasion or hostile action by one state against the other has the international community been active in establishing mechanisms for dispute resolution and compensation for damages to infrastructure. The existing situation in the occupied territories of Palestine is a good example where due to repeated shelling and air strikes by Israel various infrastructure facilities in areas inhabited by the Palestinians and under the control of the Palestinian Authority have been severely damaged or destroyed.[361] [362]

In the circumstances, developing countries should campaign for more proactive measures by the United Nations and international funding agencies such as the World Bank to develop measures for protecting the investments in developing countries against risks such as wars invasions. In addition, they should also persuade the current entities that provide insurance coverage to investors to encourage them to invest in developing countries to provide more concessions for the developing countries by reducing the burden on them to ultimately shoulder the total risk relating to events such as wars and invasions. Measures such as concessionary pay back mechanisms and reduction of the amount of pay back amounts could be suggested as possible measures for reducing the risk burden placed on developing countries.

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361 Following the 1948 Arab-Israeli conflict, the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA) was established by United Nations General Assembly resolution 302 (IV) of 8 December 1949, UNRWA is a relief and human development agency, providing education, healthcare, social services and emergency aid to over four million refugees living in the Gaza Strip, the West Bank, Jordan, Lebanon and the Syrian Arab republic. Providing compensation for losses suffered by Palestine refugees or investors in Israeli occupied areas is out side its mandate.

362 To get a general idea of the type of military operations and the resulting damage see: United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA), Gaza Field assessment of IDF Operation Days of Penitence (October 20, 2004). Online: http://www.un.org/unrwa/news/incursion_oct04.pdf

Chapter 5 - Social and Judicial Obstacles to the Use of FDI for Infrastructure Development

5.1. Social Obstacles: Nature of the Problem

In modern day infrastructure development projects, the interface between the public and private sectors is an area of great opportunity and innovation. It is now recognised that much can be achieved with private finance in strategic industries. However, infrastructure projects are highly visible and necessarily involve public interest. Thus, they are open to public scrutiny. As a result, various social and judicial obstacles spring up which sometimes constrain the development of infrastructure facilities with FDI mechanisms such as project financing which involve private sector participation in strategic industries. These obstacles make public private partnership towards infrastructure development somewhat difficult.

With the steady growth of private sector participation in the provision of basic infrastructure facilities, one of the main obstacles countries face in introducing reforms is the public rejection of new initiatives. It is understood that the private sectors project promoters will not be willing to extend the same concessions given to the public by governments. Unlike the public sector, for the private sector utility providers, the ultimate attraction in participation in infrastructure development is profit making and access to previously state dominated consumer markets.

The main argument put forward by the proponents of infrastructure development with FDI mechanisms such as project financing is that private sector investment and management is necessary due to public sector failure in financing development and in the efficient provision of infrastructure services. Although generally speaking, there is substantial truth in this argument, it

should be noted that in some countries there are a number of stunning success stories of public sector infrastructure services. East Asia is a good example as in many fields the public sector provision of infrastructure services has been quite satisfactory. According to the World Bank Report (1998): *"(t)he technical performance of East Asian utilities and fields most suitable for early privatisation like telecommunications - has been satisfactory".* It is also important to note that a lot of the industrialised countries, notably France and Germany, had no private investment in crucial infrastructure facilities until recently. It was only in as recent as 1995, that private sector was allowed to participate in telecommunication in both France and Germany. France also had no private sector involvement in its power sector till recently. Germany had no private involvement in transport. Another industrialized country, Japan, even at present, has very little private sector involvement in transport and none in water and sewerage.[363]

One of the main argument of those who oppose private sector investment in infrastructure services is that public sector can provide utility services efficiently and at a profit with more effective and efficient management.[364] They argue that utilities in a lot of developing countries have not just been satisfactory in terms of their performance, they have also made money and that they have been profitable; but a lot of them are currently being privatised for other reasons such as corrupt practices, international pressure and inefficient governance.[365]

Both the aforementioned arguments hold merit. However, in Chapters two of this thesis it was pointed out that current trend among the developing countries is to attract foreign investment

363 World Bank Report 1998, (Washington D.C.: World Bank, 1998)

364 Bish Robert L., "Improving Productivity in the Government Sector: The Role of Contracting Out in Responses to Economic Change", David Laidler (ed.), Vol. 27 of the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1986) p. 217; Borcherding T. E., Pommerehne, W., and Schneider, F., *"Comparing the Efficiency of Private and Public provision: The Evidence from Five Countries"*, Nationalokonomie, Journal of Economics, Supplement 2, Springer-Verlag (1982), pp. 127-156; and also see generally, Hike, J., Competition in Government Financed Services, (New York: Quorum Books, 1992); Bird, R.M., Central-local Fiscal Relations and the Provision of Urban Public Services, (Canberra: The Australian National University, Centre for Research on Federal Financial Relations, 1980); Savas E.S., Privatizing the Public Sector, (Chatham, New Jersey: Chatham House, 1982); Hatry, H., A Review of Private Approaches for Delivery of Public Services, (Washington D.C.: The Urban Institute, 1983).

365 Id.

for the development of their infrastructure needs due to various reasons. These reasons include, the inability of public finances to cater to the growing demand for infrastructure development and the need the developing countries have to utilise limited home grown finances to the development of social infrastructure such as health and education.[366]

The biggest problem developing countries face in attracting foreign investors for project development is the public wariness to accepting changes. As already noted, physical infrastructure services have in the past been provided to the public in many developing countries either free or at substantially subsidised rates. However, when foreign investors coming into the scene it results in rates and taxes charged for infrastructure services being increased as unlike the public sector utility providers, the main attraction of private sector investors to invest in a project is profit. Thus, the likelihood of loosing the benefits in the form of subsidised rates offered by the public sector is one of the main grounds for public and sometimes political opposition to private sector led development of infrastructure facilities. In addition, corrupt practices by government officials on the one hand and by investors and project developers on the other in connection with development of infrastructure projects; the fear of losing traditional homelands; and the adverse effects on the cultural heritage are among other grounds on which usually social and political objections to private sector led development activities are formulated.

Social and political opposition to private sector involvement in development, more often than not, end up in costly and time consuming litigation. Although none would argue that such court intervention is not justified in situations where allegations made by the applicants are reasonable, there are instances in which court actions have been either too harsh or contrary to the larger interest of nations. In other words, there is the risk that, the courts in developing countries may some times try to give justice to certain affected parties without proper evaluation of the

366 See Chapter 2.4.

development needs of the country. In other words, justice will be given to those who seek it compromising the larger interest of the nation.

5.2. Main Social Objections

Based on information gathered during interviews with several public sector officials, members of the public selected at random and two key NGOs operating in Sri Lanka and Malaysia, the popular social objections to private sector led infrastructure development could be summarised as follows:

i. Private sector participation in infrastructure development may not be the appropriate answer in many situations and could compound problems of lack of accountability and transparency to the public rather than resolve them;
ii. It may make certain public goods and services inaccessible to the poor and it could further distort in equality of opportunity;
iii. It could lead to mass unemployment of labour;
iv. The weakening of its role in the provision of basic infrastructure services in a country could reduce rather than enhance a government's ability to enact and enforce effective regulation of the market in the interests of the poor and disadvantaged;
v. Privatisation of essential infrastructure services will force the governments to remove public subsidies, thus burdening the utility users with additional cost;
vi. Corrupt practices on the part of the governments and public sector officials in connection with granting of concessions to private sector developers and in regulating infrastructure services;
vii. The decisions to promote and locate private sector led investment projects in certain areas may be led by political instead of economic reasons;

viii. Violation of human rights and compromising the traditions, ethnic and cultural rights of the people due to profit driven infrastructure development.[367]

None of the above social objections to infrastructure development with FDI are unduly motivated. The world has witnessed plenty of failed investment projects in developing countries which have ended up in creating investment white elephants, i.e. investment projects with negative social surplus. The evidence relating to such projects would show that one or more of that above social concerns have been overlooked by the host governments as well as other main project participants.

5.2.1. Case Studies

The following case studies show the difficulties faced by developing country governments in striking a balance between sometimes conflicting interests of promoting FDI for infrastructure development and giving due consideration to the public concerns.

a. The Bakun Hydroelectric Project in Malaysia

I. What and where is it?

The Bakun Hydroelectric Project (BHEP) comprises of construction of a 2,400MW hydroelectric dam; the transmission of its electricity; and the building of related infrastructure including access roads. The Bakun project is one of the largest privatised projects in Malaysia. The dam is being built on the Balui River, some 37 kilometres upstream of Belaga in Sarawak,

367 Based on the interviews conducted with: several public sector employees including Legal Officers attached to the Department of the Attorney General in Sri Lanka and the Board of Investment in Sri Lanka, members of the public selected at random from the village of Eppawela in Sri Lanka during a Field Research; the Environmental Foundation of Sri Lanka, a public interest law firm dealing with environmental issues; and the Friends of The Earth Organization, Malaysia.

Malaysia.[368] Estimates of the amount of electricity Bakun will actually generate vary considerably, but the present official figure is that it would operate at an average output of 1,770 MW. At least 70% of this will be transmitted to Peninsular Malaysia, across some 1,500 km of overland wires and three or four 650 km long undersea cables.[369]

The Bakun dam is a 205-metre-high Concrete Face Rock-fill Dam (CFRD), with a length of crest of 740 metres, a base width of 560 metres and a crest width of 12 metres. This makes it one of the highest rock-fill dams in the world.[370] It is estimated to flood 69,640 hectares of land, an area bigger than Singapore.[371] This area is presently being clear-cut. Its catchment area is over 1.5 million hectares of mainly primary forest, though some 16% of Sarawak's total log production currently comes out of this area. 51% of the land of the reservoir area is Native Customary Land, meaning it is legally owned by the indigenous communities.[372]

It was originally claimed that the dam would be ready by 2003. However, the project is currently under review for its economic viability and the Government of Malaysia has acknowledged that it needs restructuring. As of May 2005, only 25.3 % of the project had been completed.[373]

II. Who is building it?

Its implementation has been given to a Malaysian company, Ekran Berhad, without tender and apparently without proper cost evaluation. The major construction contract has been given to a consortium led by the Swedish-Swiss company Asea Brown Boveri (ABB) and Brazil's

368 Sarawak is part of the island of Borneo.

369 Friends of the Earth Organization, The Bakun Hydroelectric Project – Malaysia, Briefing Sheet (Friends of the Earth Ltd. 1996).

370 Id.

371 World Wildlife Federation, "Borneo: Treasure Island at Risk", WWF Germany, Frankfurt am Main (June 2005).

372 Allison, T., "Malaysia's Bakun Project: Build and be Damned", Asia Times, 28 October 2000.

373 Reuters, 31 May 2005.

CBPO and including South Korea's Hyundai. Engineering consultants from Germany (Lahmeyer) and the US (Harza) have helped with feasibility studies, dam design and overall project supervision.[374] Although designated as a 'privatised' project, due to difficulties encountered in finding the necessary monies from the international markets have resulted in heavy direct Malaysian Government involvement in the financing of the project. The exact capital-debt ratio of the project has not been released to the media.[375]

III. Why is it being built?

In the words of the former President Mahathir, "Bakun will not only provide the cheapest source of energy but will also serve as a catalyst to the country's industrialisation programme".[376] As well as supplying electricity (mainly to Peninsular Malaysia), other benefits from the Bakun project claimed by the Government include:

i. Generating employment and valuable spin-off industries for Sarawak, which will add 3% to that state's growth per year;
ii. Bringing the indigenous peoples 'into the mainstream of development' through resettlement;
iii. Providing much-needed infrastructure to a remote part of Sarawak, which will become a valuable tourist destination.

374 Spires, C., "Public Participation in the Environmental Impact Assessment for the Bakun Hydroelectric Project, Sarawak, East Malaysia in the period from September 1993 to June 1995" (University of London, Wye College, October 1995); Insan, “Power Play: Why the Bakun Hydroelectric Project is Damned” (Kuala Lumpur: Insan, 1996); Aliran Monthly, *"Bakun Dam: Test of Sincerity"*, Vol. 14 (5) (1994); Aliran Monthly, *"The Bakun Judgment: Hope And Then Despair"*, Vol. 16(1) (1996); and Delphi International, "Bakun: High Dam: High Risk?" (July 8 1996).

375 Far Eastern Economic Review, "Bakun Dammed: Surprise Court Ruling sours Mahathir's Dream", (July 4, 1996).

376 Source: A briefing by the Friends of the Earth Organisation on Bakun Hydroelectric Project, Malaysia (1996). Online: http://www.foe.co.uk/resource/briefings/bakun_hydroelectric_project.html

IV. Who is affected?

The project requires the forced relocation of between 9,000 to 10,000 indigenous people, mainly of the Kayan, Kenyah, Kajang, Ukit and Penan ethnic groups. In addition the expected changes in the water quality and river flow patterns is likely to affect thousands of people living downstream of the dam on the Rajang River, the longest river in Malaysia.[377]

V. The reasons behind the objections

The project is opposed to by many in the indigenous communities, together with opposition political parties, a coalition of over 40 Malaysian NGOs, other NGOs and individuals. They attack the project on just about every ground. Its necessity and viability are called into question and the cost of its social and environmental impact is deemed unacceptable.[378]

Critics argue that, there is no need for Bakun's electricity as there is a current surplus in Malaysia.[379] Further that, Malaysia has an excellent opportunity to frame future power-generating projects in a properly construed, efficient and environmentally conscious National Energy Policy. It is argued that the construction of Bakun is detrimental to such a policy.[380]

Critics also point out that Bakun's electricity will be neither the cheapest nor the cleanest. They argue that the cost of Bakun's electricity will be the most expensive in Malaysia's history, and will almost certainly necessitate electricity price rises, meaning the Malaysian consumers and investors will bear the cost.[381] In the view of those opposed to the Bakun project, the building of a dam designed to supply Peninsular Malaysia with electricity in a remote part of Sarawak is highly

377 Id.

378 Id.

379 Rengah Sarawak (Sarawak News), “Bakun-Resettlement of Indigenous People”, 11 June 1999. Online: http://www.rengah.c2o.org/

380 Id.

381 Id.

controversial. Amongst other things, it means the project will rely on the transmission of electricity via long overland and undersea cables whose security and viability may be vulnerable and whose environmental impact is incalculable.

In addition to above, the viability of the project is challenged on a number of other issues. There is the perception that the official projections of Bakun's electricity output are wildly optimistic.[382] The project is based on a number of assumptions regarding, for example, efficiency of the dam, rainfall, stream flow, sedimentation rates, likelihood of earthquakes, maintenance costs, speed of construction, and downstream effects; the miscalculation of any one of which would throw the viability of the project into doubt.[383] Similarly, projections of the costs and time anticipated to complete the project are, in the light of experience of other large dams around the world, likely to be overrun, to degrees, which could destroy the economic justification of the project.[384]

The planning of the dam has been conducted with no public accessibility to vital feasibility studies, no process of public feedback on a highly controversial and subverted Environmental Impact Assessment process which was described by the mainstream press as 'an abuse' and 'a farce', and extremely limited consultation procedures with the indigenous peoples who have had little idea of what will happen to them.[385]

On an application made by the parties objecting to the project, the High Court of Malaysia found that the Malaysian Government, together with Ekran and the Sarawak State Government had subverted the basic rights of the indigenous peoples to comment on the EIA

382 Supra note 371.

383 Id.

384 Id.

385 World Commission on Dams, Resettlement of Indigenous Peoples – final Report, December 1999, (Cape Town, 1999).

before approval, a ruling that was dismissed by the authorities as 'technical'. The Court of Appeal in Malaysia later revised the High Court decision in 1997.[386]

The environmental and social impacts of the project are heavily downplayed by the authorities. There is also a risk to the safety and livelihoods of the people living downstream due to possible sudden releases from the reservoir and the potential of a dam failure, and there are many people in Malaysia who say the project should once again be scrapped, this time for good.[387]

VI. Conflict of interests

From what is set out above it is clear that the Bakun project faced public and political criticism on several grounds, most of them being based on reasonable concerns. Serious questions have been raised concerning the viability of the Project, from economic, ecological, technical, social and cultural perspectives. In particular, the dam design has not adequately addressed the dangers of overtopping, sedimentation and reservoir-induced seismicity, nor has the Government demonstrated the economic viability of the project.

Although, faced with aforesaid opposition, the Government of Malaysia has given the green light for the project to proceed. In order to ensure that future objections to the project will be minimal, feasibility studies and reports commissioned by the Government on the Bakun project have been classified under the Official Secrets Act,[388] meaning that it is a criminal offence

386 *Ketua Pengarah Jabatan Alam Sekitar & Anor v Kajing Tubek & 2 others*, [1997] 3 AMR 2521.

387 The Bakun project was first proposed in the 1980s as part of a series of dams to exploit the hydroelectric potential of Sarawak's rivers. A concerted campaign against it by local indigenous communities, together with its high costs (financial, social and environmental) led to the project being cancelled in 1990. However, in September 1993, the project was revived.

388 Malaysia's Official Secrets Act (OSA) of 1972, based on the British OSA of 1911 is a broadly-worded law which carries a maximum penalty of life imprisonment, as well as significant lesser penalties for the actions associated with the wrongful collection, possession or communication of official information.

for anyone to even have, let alone use, the information contained therein. The project proponents have refused to meet critics in any open discussion.[389] Thus the issue is whether the project is really worth it given the immense public opposition to it, and the prejudice that will be caused to the indigenous community who will be displaced as a result of the project.

From the available evidence it appears that amidst reasonable and just public objections the project has been forced on the people. Although such initiatives may not be challenged in some oppressive jurisdictions, what is important to note is that developing countries which have fair democracies may not be able to ignore the public outcry against such projects and force them on the people.

b. The Eppawala Phosphate Mining Project in Sri Lank

I. What and where is it?

The Geological Survey department of Sri Lanka in 1971 discovered a rock phosphate deposition of nearly 25 million metric tons in the north central province of Sri Lanka. Following a proposal to grant a concession to a private sector company with foreign participation to explore the possibility of digging the deposits for commercial production, an agreement with "Sarabhumi Resources (Pvt.) Limited", a company with a ninety per cent foreign shareholding, and IMC Agrico of the USA, the worlds largest producer of fertiliser and the reputed Japanese company Tomen Corporation was negotiated under a project approved by the Board of Investment of Sri Lanka (BOI). The project envisaged the exploitation of the known rock phosphate reserves at

389 See supra note 372.

Eppawala over a thirty-year period, in a high intensity mining operation that its detractors claimed would devastate the local environment.[390]

Under the proposed agreement, IMC Agrico of USA (which is a partnership between Freeport-McMoran and IMC Incorporated), and Tomen Corporation of Japan were to combine in a joint venture with the local corporation, Lanka Phosphate Ltd., to exploit the apatite mine. The project company was estimated to manufacture 600,000 metric tons of fertiliser per annum, of which 400,000 metric tons was to be exported.[391]

According to the concession agreement, the mine was to cover an area of 56 sq kilometres. The processing plant was to be built in Trincomalee, which is one of the world's most unique natural harbours and a prime destination for tourists in peacetime in Sri Lanka. Four hundred and fifty acres of land with a beach front for a jetty and terminal building was earmarked in Trincomalee for the processing plant, a phosphorous acid plant, a sulphur acid plant, a granulation plant and a support facility.[392] A further 350 more acres set apart for tourist development was to be kept on hold until a feasibility study indicated whether the project company would need more land.[393]

According to experts, the reserves are estimated by experts to last for a minimum of 200 years and a maximum of 1,000 years, and if exploited only for local use, Sri Lanka will not have to import phosphate fertiliser for many years in the future.[394]

390 The Island, "S.C. Judgment Vindicates Eppawela Objectors" (June 11, 2000).

391 Id.

392 Wanigasundara M., "Resistance Grows to Sri Lanka/TNCs Mining Deal", Third World Resurgence No. 93, (May, 1998). Online: http://www.twnside.org.sg/title/deal-cn.htm

393 Id.

394 Id.

II. The anticipated benefits from the project

The Government has spelt out the following financial benefits from the project:

i. It is expected to bring in approximately US$ 477 million in total economic benefits per year.

ii. The project company will supply high-grade fertiliser to the farmer at around 50% of the normal imported price.

iii. Government will earn approximately US$37 million from the royalty payable on rock phosphate which will be 5.5% of the Morocco International price; and

iv. In addition, the Government will earn approximately US$74 million in taxes, despite the tax holiday, under a special arrangement; dividends from the 10% free equity for Lanka Phosphate Ltd amounting to approximately US$70 million; from the defence levy approximately US$1.3 million; and earnings from the Sri Lanka Ports Authority for services rendered approximately US$137 million.[395]

III. The reasons behind the objections

According to certain public views and several of the NGO's campaigning against the project, the mining will destroy some 26 villages in the country's north-central province. The proposed joint venture to mine apatite will not only cause irreparable social and ecological damage, but also rapidly deplete the country of a valuable natural resource and contribute little in 'value-added' to the economy. According to Mr. Hemantha Vithanage, an environmental scientist of the Environmental Foundation of Sri Lanka, a public interest law firm dealing in environmental issues "within the project area in Eppawala, six schools, many homes, government buildings and infrastructure, temples, 23 new and old reservoirs for irrigation, 5 km of a newly-

395 Id.

constructed irrigation channel, 100 km of small irrigation channels, two small towns, 26 villages, and rich agricultural land would be destroyed".[396]

At present Sri Lanka imports 80,000 - 120,000 metric tons of single super phosphate and 30,000 - 40,000 metric tons of triple super phosphate per annum. These requirements, says Prof. Illeperuma, can be met by a plant manufacturing 150,000 metric tons of phosphate fertiliser, costing around US$ 21 million.[397] According to him, the IMC Agrico project would cost US$ 425 million, plus rapid there would be exhaustion of the reserves and great environmental and sociological damage.[398]

The project has been opposed also on the ground that the translational companies selected to invest and develop it have a bad track record. According to reports coming out of three countries, Freeport McMoRan has a bad reputation in relation to human rights and environmental violations.[399] These reports allege that, in Florida, where IMC Agrico runs a massive mining operation, over 200,000 acres have been strip mined leaving irreversible scars and damage on the landscape. Further, the pits, craters and gullies fill up during rain and have become flourishing breeding places for mosquitoes. Furthermore, over 20 stacks of phosphogypsum, a radioactive waste, have been piled up in Florida with no known means of disposal. In addition, Freeport McMoRan has also been cited for dumping radioactive gypsum, which according to the US Environmental Protection Agency contains radium, which breaks down into radon, which is carcinogenic, into the Mississippi River in Louisiana.[400]

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396 Views expressed during an interview held with a team of lawyers headed by Mr. Hemantha Withanage, of The Environmental Foundation of Sri Lanka, July 12, 2004.

397 O.A. Illeperuma, "Epphawala Phospate Deposit: Myths & Realities" (March 1998), Online: www.ccom.lk/mep/archive.htm.

398 Id.

399 See Wanigasundera, supra note 392.

400 Id.

Mr. Vithanage points out that there are reported incidents of human rights violations by Freeport McMoRan in New Guinea and a US$ 6 million lawsuit for dumping 130,000 tons of toxic mining waste into local rivers.[401] The indigenous peoples of Irian Jaya in Indonesia have been protesting against the dumping of waste into rivers and streams and the seizure of their lands for mining. He also cites from a report from April 1995 by the Australian Council for Overseas Aid, which accuses Freeport McMoRan of having a hand in the disappearance of 22 civilians in Irian Jaya.[402] [403]

IV. The decision to proceed

The decision to proceed with the project was shelved in 1999 due to public outrage and objections from both academic and political circles. The then Opposition party in Parliament, the United National Party, publicly announced that the project would be cancelled when they come into power. The United National Party was in power briefly during the period 2003-2004, and is now out of power and the Political Alliance of President Chandrika Bandaranayake that has held the parliament since August 2004 has not taken any initiatives to resurrect the project. Thus, it will be interesting to see whether the promise to permanently shelve the project would be kept, or whether public objections will be ignored and the project will be given the green light in the future.

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401 Supra, note 396.

402 Id.

403 In this regard also see: Chatterjee, P., "Digging Everyone's Grave: World Bank's Mining Mayhem", Earth First, 16(1): 17 (November 1, 1995); and World Rainforest Report, "Killings at Freeport Mine", No. 31 (June 1995) pp. 9-10.

5.2.2. Examples

In addition to the above two case studies, several examples could be cited to show how various development initiatives of developing country governments end up becoming investment white elephants as a result of failing to give due consideration to viability of projects and various public concerns regarding projects.

a. Activities of INDECO

Nothing is as depressing in a developing economy as the presence of white elephants. Some classic examples come from the activities of INDECO, the Industrial Development Corporation of Zambia which undertook projects on political considerations although the feasibility studies concluded that the projects would be uneconomic.[404]

The locations of the Livingstone Motor Assemblers, Kapiri Glass Products and Mansa Batteries, all subsidiaries of INDECO, were decided on the basis of providing employment outside the main urban areas. These and similar projects ran into difficulties for various reasons, partly because, being located in up-country centres, they were situated faraway from the main markets. Multi-million dollar brick factories were set up under official directive in the rural areas at Kalalushi and Nega Nega, but transporting the bricks long distances to the construction sites raised their costs to uneconomic levels, with the result that the construction industry switched to the use of concrete blocks. Because of the declining demand for its products, the brick works at Nega Nega was forced to close down in 1979 and the factory at Kalalushi incurred large losses.

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404. Tangri, R., The Politics of Patronage in Africa, (Oxford: James Currey Ltd., 1999) pp. 15-30.

Moreover, projects such as the Chinese maize mill at Chingola were started without any feasibility study being undertaken; the decision was a purely political one, which led to the already planned and evaluated maize mill in Kitwe being abandoned. Directives were also issued regarding the location of projects.[405]

Referring to above Zambian industrial projects, Tangri (1999) suggests *"not only are white elephants built, but they are built when they are understood to be white elephants and even worse, they crowd out socially desirable projects. Thus, it is not just that politicians are bad at picking winners, they actually pick known losers."*[406]

b. White elephants of Burundi

The case study evidence shows that the locations of public projects are sometimes determined by the desire of politicians to redistribute to their own geographically based groups. For example, in Burundi by the early 1970s the Government was controlled by a faction of Tutsi's from Bururi province. Nkurunziza and Ngaruko (2002), document that as a consequence huge amounts of resources were targeted at Bururi including schools, roads, and public sector investments. For instance, even though Tutsi's represented only about 14% of the population, 60% of the managers of public corporations were Bururi Tutsis.[407]

405. Robinson, James A. and Ragnar, T., "White Elephants", 89 Journal of Public Economics (2005), pp. 197– 210

406. Supra note 404 at p. 30

407. Nkurunziza, J.D., Ngaruko, F., Explaining Growth in Burundi: 1960–2000, Working Paper, (Oxford: Oxford University Centre for the Study of African Economies, 2002) at pp. 19-23.

c. White elephants of Kenya

The political nature of the creation and location of white elephants suggests that when political power changes, old investment projects ought to be terminated and new ones begun. In general terms this is the message of Barkan and Chege (1989).[408] They divide the provinces of Kenya into the Kenyatta political base and the Moi political base, each containing 33% of the population. While expenditures on road construction under Kenyatta grossly favoured the Kenyatta provinces, when Moi came to power expenditures shifted away from Kenyatta toward Moi provinces. Within one year (1980) the share going to the Kenyatta base decreased from 44% to 28% of the total, while the share going to the Moi base increased from 32% to 38% of the total. In 1986, six years after, the Kenytta base received 16% of the total, while the Moi base received 67%.[409]

5.3. Judicial Obstacles: Nature of the Problem

According to Arnab Kumar Hazra, a Fellow of the Rajiv Gandhi Institute for Contemporary Studies in New Delhi, India*, "A balanced, swift, affordable, and fair justice delivery system, besides promoting law and order, aids in the development of markets, investment (including FDI), economic growth and, therefore, in poverty reduction"*.[410] According to Kamal Hossain, a prominent Bangladeshi lawyer and the Chairman of the Advisory Board of the Non-Governmental Organisation, Transparency International, a fair judicial system is a "precondition"

408. Barkan, J., Chege, M., *"Decentralizing the State: district focus and the politics of reallocation in Kenya"*, 27 The Journal of Modern African Studies *(*1989) pp. 431– 453.

409 Id.

410 Van Zant, E., "Paying for Justice", ADB Review (May 2005).

to improving governance and thus, economic and social development.[411] As a World Bank publication (1999) concluded:

> *"The massive move by developing and transition countries toward market economies necessitated the adoption of strategies for the encouragement of private investment, domestic and foreign. Naturally, there was a general realization that such an objective could not be achieved without modifying and, sometimes, completely overhauling the legal and institutional framework and firmly establishing the rule of law, thereby creating the necessary climate of stability and predictability."* [412]

Speaking at an International Development Bank (IDB) organized a meeting between Spanish investors and Latin American government officials in Madrid in January 2004, José María Álvarez-Pallete, the executive president of Telefónica Latinoamérica stated that: *"investors should be able to count on a stable judicial environment, a regulatory context that ensures an adequate return on investment, and commercial accords that do not discriminate based on the national origin of a company."*[413]

The above views are generally shared by academics as well as main participants in project financing such as investors, lenders, project developers as well as host countries. However, unfortunately, not every developing country has a judicial system that is conducive to foreign and or private sector investment.

According to John Hewko[414] Implicit in this "general realization" is the premise that the foreign investor is a passive spectator of the reform process, hesitant to enter the fray until a modification or overhaul of the legal system has occurred. Based on this assumption, governments, multilateral institutions, development agencies, and various non-governmental organisations (NGOs) have expended considerable resources in initiating, encouraging, and

411 Id.

412 See International Bank for Reconstruction and Development, Initiatives in Legal and Judicial Reform, (Washington D.C.: IBRD, December, 1999) pp. 1–2.

413 Quesada, C., "What can Latin America do to rekindle the interest of Spanish investors?", IDB America (Magazine of the Inter-American Development Bank) (July 3, 2005).

414 A visiting scholar at the Carnegie Endowment for International Peace. He is a partner in the law firm of Baker & McKenzie.

funding a myriad of legal and judicial reform programs throughout the transitional and developing world. These actions have been taken in the belief that legal reform and the establishment of the rule of law could be accomplished in relatively short order and in the hope that, once the reform process was complete, FDI would begin to flow.[415]

Most foreign investors, when faced with attractive business opportunities, are prepared to accept the fact that in general terms, the legislation and legal systems in countries are inadequate, and that the laws pertinent to their concerns are no doubt far from ideal. However, once their investments are made, a short laundry list of specific complaints usually arises, which if rectified, would greatly facilitate the success and continued viability of their investment.[416] As a result, according to John Hewko *"the legislative reform efforts should emphasis on details (not general concepts) and on determining the specific and often mundane changes that need to occur for existing legislation to function within the cultural, political, and economic realities of the host countries while still answering the needs of the foreign investors"*.[417]

In most infrastructure development contracts, parties readily agree for neutral jurisdiction for dispute settlement. Most contracts include alternative dispute resolution clauses that provide for international arbitration and sometimes, also for other innovative alternative dispute resolution (ADR) measures such as mediation, negotiation, executive decision making and mini trial to avoid laws delays in developing countries and to ensure that disputes between the host countries and project investors, lenders and other key project participants could be resolved outside national courts.

415 Hewko, J., FDI: Does the Rule of Law Matter?, Carnegie Endowment for International Peace Working Paper Series, No.26, (Washington D.C.: Carnegie Endowment, April 2002)..

416 Id.

417 Id.

However, these measures have not been always successful in providing a settlement to the disputants without jeopardising the continuity of the investment project. The main reason for such failure has been the obvious disregard to contract provisions by local project partners who have sued the foreign investors in local courts, sometimes even obtaining injunctive relief and thus disrupting the project activity for several months or even years. In some countries, local courts have repeatedly ignored contract provisions willingly agreed between parties and have ignored the obligation of local partners to submit to international arbitration and honour international arbitral awards.

Further, in some instances, even when the disputing parties have agreed to submit to an agreed neutral jurisdiction and ADR, for example, international arbitration, to bring a dispute to a settlement, local courts intervene in preventing the enforcement of dispute settlement decisions reached between the parties by following the agreed mode of settlement. Such interventions usually take place when the successful party at the dispute settlement attempt to enforce arbitral decisions within the jurisdiction of host countries. Most of the time courts refuse enforcement of foreign arbitral awards on the grounds that such enforcement is "against the public policy" of the host country.

When courts decide to intervene in the enforcement of arbitral awards, the starting point is the New York Convention, which in Article V.2 (b) states:

> "Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that:

(b) The recognition or enforcement of the award would be contrary to the public policy of that country."[418]

It refers to "the public policy of that country". Thus, indicating that the intent of the drafters of the Convention was not to seek overtly to attempt to harmonize public policy or to establish a common international practice. Several conventions that followed have followed the same approach. For example, the 1975 Panama Convention makes reference to the "public policy of that State".[419] The 1979 Montevideo Convention goes further: it requires that the award be "manifestly contrary to the principles and laws of the public policy ['orden publico'] of the exequatur State" (Art 2(h)).[420]

The 1965 Washington (ICSID) Convention does not expressly refer to "public policy". Article 52 sets out various grounds for annulment, which include: corruption on the part of a member of the tribunal; serious departure from a fundamental rule of procedure; and failure to state the reasons on which the award is based. The first two of these would generally fall within the scope of domestic and international public policy.[421]

Although, public policy as an exception to enforcement of foreign arbitral awards is sometimes used by local courts there is a conflicting issue, which the lawmakers and the courts must resolve, namely, the tension between not wishing to authorize enforcement of awards which contravene domestic laws and values (public policy); and the desire to respect the finality of foreign awards which is important to ensure that the

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418 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, June 10 1958).

419 Inter-American Convention on International Commercial Arbitration (1975).

420 Inter-American Convention on the Extraterritorial Validity of Foreign Judgments and Arbitral Awards (1979).

421 ICSID Convention, however, provides that the enforcement of an ICSID award cannot be challenged in the courts of the enforcement country, save on grounds of sovereign immunity.

developing countries provide a stable and predictable environment for foreign investors in order to attract them development projects.

One of the worst things that can happen in most developing countries due to judicial interventions as far as infrastructure development projects are concerned is the granting of a "stay order" or an "interim injunction" which may then continue to operate till the conclusion of a long court trial. Such preventive orders will jeopardise the continuity of an investment project causing time loss and heavy costs for every participant involved in the project. More often than not public objection and/or an environmental concern by various interest groups may be formulated on baseless allegations. However, when the judicial authorities come to such conclusions, i.e. that the allegations were baseless; the damages caused to the investment project will be severe and some times irreparable.

It should be said however, that not in every instance and in every developing country, the risk of undue judicial intervention is present. For example, in some instances, the courts in developing countries have been extremely careful in analysing the cases brought before them by parties objecting to development projects, in order to ensure that whilst giving them justice, the development initiatives are not unduly disrupted. As shown in the next section of this chapter, the litigation concerning the Eppawala project in Sri Lanka is a good example.

Numerous examples could be cited to support the points made above regarding the nature of the judicial obstacles to infrastructure development in developing countries with private sector participation. For the purposes of this thesis, in the following section, two recent legal actions will be discussed in detail.

5.3.1. Examples

a. The PIATCO Case (Philippines)

The decision given by the Court of Appeal of the Philippines in the above case is a good example where the existence of an arbitration clause that obligated the parties to submit all disputes between them for international arbitration was ignored by the petitioners who were state representatives, despite the request by the investor to submit all disputes to arbitration. The case also serves as a good example to show how the courts in certain developing countries may make decisions undermining the obligations given in investment agreements.

The facts of these cases which were relevant to the issue concerning the arbitration clause are as follows:

Sometime in 1993, six business leaders consisting of John Gokongwei, Andrew Gotianun, Henry Sy, Sr., Lucio Tan, George Ty and Alfonso Yuchengco met with then President Fidel V. Ramos to explore the possibility of investing in the construction and operation of a new international airport terminal. To signify their commitment to pursue the project, they formed the Asia's Emerging Dragon Corp. (AEDC) which was registered with the Securities and Exchange Commission (SEC) on September 15, 1993.[422]

In October 1994, AEDC submitted an unsolicited proposal to the Government for the development of NAIA International Passenger Terminal III (NAIA IPT III) under a build-operate-and-transfer (BOT) arrangement pursuant to RA 6957 as amended by RA 7718 (the

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422 *Demosthenes D. Agan, Jr., et al. Vs. PIATCO, et al.*, G.R. No. 155001; *Salacnib F. Baterina, et. Al. Vs. PIATCO, et al.*, G.R. No. 155547; and *Severino C. Lopez, et al. Vs. Piatco, et al.*, G.R. No. 155661 decided on May 5, 2003, Motion for reconsideration having been denied "with finality" on January 31, 2004.

"BOT Law").[423] In December 1994, the Department of Transportation and Communications (DOTC) issued Dept. Order No. 94-832 constituting the Prequalification Bids and Awards Committee (PBAC) for the implementation of the NAIA IPT III project. In June 1996, DOTC and Manila International Airport Authority (MIAA) caused the publication in two daily newspapers of an invitation for competitive or comparative proposals on AEDC's unsolicited proposal in accordance with Sec. 4-A of RA 6957, as amended.[424]

The Bid Documents issued by the PBAC provided among others that the proponent must have adequate capability to sustain the financing requirement for the detailed engineering, design, construction, operation, and maintenance phases of the project. The proponent would be evaluated based on its ability to provide a minimum amount of equity to the project, and its capacity to secure external financing for the project.[425]

In September 1996, the consortium composed of People's Air Cargo and Warehousing Co., Inc. (Paircargo), Phil. Air and Grounds Services, Inc. (PAGS) and Security Bank Corp. (Security Bank) (collectively, Paircargo Consortium) submitted their competitive proposal to the PBAC.[426]

On September 26, 1996, AEDC informed the PBAC in writing of its reservations as regards the Paircargo Consortium, which included:

a. The lack of corporate approvals and financial capability of PAIRCARGO;

b. The lack of corporate approvals and financial capability of PAGS;

423 An Act Authorizing the Financing, Construction, Operation and Maintenance of Infrastructure Projects by the Private Sector.

424 See supra note 421.

425 Id.

426 Id.

c. The prohibition imposed by RA 337, as amended (the General Banking Act) on the amount that Security Bank could legally invest in the project;

d. The inclusion of Siemens as a contractor of the PAIRCARGO Joint Venture, for prequalification purposes; and

e. The appointment of Lufthansa as the facility operator, in view of the Philippine requirement in the operation of a public utility.[427]

The PBAC gave its reply on October 2, 1996, informing AEDC that it had considered the issues raised by the latter and that, based on the documents submitted by Paircargo and the established prequalification criteria, the PBAC had found that the challenger, Paircargo, had pre-qualified to undertake the project.[428]

Both proponents offered to build the NAIA Passenger Terminal III for at least $350 million at no cost to the Government and to pay the Government: 5% share in gross revenues for the first five years of operation, 7.5% share in gross revenues for the next ten years of operation, and 10% share in gross revenues for the last ten years of operation, in accordance with the Bid Documents.[429] However, in addition to the foregoing, AEDC offered to pay the Government a total of P135 million as guaranteed payment for 27 years while Paircargo Consortium offered to pay the Government a total of P17.75 billion for the same period. Thus, the PBAC formally informed AEDC that it had accepted the price proposal submitted by the Paircargo Consortium, and gave AEDC 30 working days or until November 28, 1996 within which to match the said bid, otherwise, the project would be awarded to Paircargo.[430]

427 Id.

428 Id.

429 Id.

430 Id.

As AEDC failed to match the proposal within the 30-day period, then DOTC Secretary Amado Lagdameo, on December 11, 1996, issued a notice to Paircargo Consortium regarding AEDC's failure to match the proposal. In February 1997, Paircargo Consortium incorporated into PIATCO.[431]

On July 12, 1997, the Government, signed the "Concession Agreement for the BOT Arrangement of the Ninoy Aquino International Airport Passenger Terminal III" (1997 Concession Agreement) with PIATCO.[432] The Government granted PIATCO the franchise to operate and maintain the said terminal during the concession period and to collect the fees, rentals and other charges in accordance with the rates or schedules stipulated in the 1997 Concession Agreement. The Agreement provided that the concession period shall be for twenty-five (25) years commencing from the in-service date, and may be renewed at the option of the Government for a period not exceeding twenty-five (25) years. At the end of the concession period, PIATCO shall transfer the development facility to MIAA.[433]

Between November 1998 and June 2001, the agreement between the parties was amended and supplemented several times, making substantive changes to the original concession agreement. These changes included amendments to Sec. 1.11 pertaining to the definition of "certificate of completion"; Sec. 3.02 (a) dealing with the exclusivity of the franchise given to the Concessionaire; Sec. 4.04 concerning the assignment by Concessionaire of its interest in the Development Facility; Sec. 5.10 with respect to the temporary take-over of operations; Sec. 5.16 pertaining to the taxes, duties and other imposts that may be levied on the Concessionaire; Sec. 6.03 as regards the periodic adjustment of public utility fees and charges; the entire Article VIII concerning the provisions on the termination of the contract; and Sec. 10.02 providing for the

431 Id.

432 Id.

433 Id.

venue of the arbitration proceedings.[434] The supplements to the contract contained provisions concerning time extensions, incremental and consequential costs and losses consequent to the existence of such structures; and some additional obligations on the part of PIATCO.

Meanwhile, the MIAA which is charged with the maintenance and operation of the NAIA Terminals I and II had existing concession contracts with various service providers to offer international airline airport services, such as in-flight catering, passenger handling, ramp and ground support, aircraft maintenance and provisions, cargo handling and warehousing, and other services, to several international airlines at the NAIA.[435]

On September 17, 2002, the workers of the international airline service providers filed before the Court a petition for prohibition to enjoin the enforcement of the aforesaid agreements claiming that they stand to lose their employment upon the implementation of the questioned agreements. On October 15, 2002, the service providers, joining the cause of the petitioning workers, filed a motion for intervention and a petition-in-intervention. On October 24, 2002, Congressmen Salacnib Baterina, Clavel Martinez and Constantino Jaraula filed a similar petition with this Court.[436]

On December 11, 2002, another group of Congressmen moved to intervene in the case as Respondents-Intervenors. They filed their Comment-In-Intervention defending the validity of the assailed agreements and praying for the dismissal of the petitions.[437]

434 Id.

435 Id.

436 Id.

437 Id.

During the time the case was pending, President Gloria Macapagal Arroyo, on November 29, 2002, in her speech at the 2002 Golden Shell Export Awards at Malacañang Palace stated that she will not "honour (PIATCO) contracts which the Executive Branch's legal offices have concluded (as) null and void."[438]

Respondent PIATCO filed its submissions to the petitions on November 7 and 27, 2002. In their response, in addition to the material defences, PIATCO raised several procedural objections to the case including the availability of provision for arbitration.[439]

The Office of the Solicitor General and the Office of the Government Corporate Counsel filed their respective submissions on behalf of the public respondents. In their consolidated memorandum, the Office of the Solicitor General and the Office of the Government Corporate Counsel prayed that the petitions be given due course and that judgment be rendered declaring the 1997 Concession Agreement, the ARCA and the Supplements thereto void for being contrary to the Constitution, the BOT Law and its Implementing Rules and Regulations.[440]

On March 6, 2003, respondent PIATCO informed the Court that on March 4, 2003 it commenced arbitration proceedings before the International Chamber of Commerce, International Court of Arbitration (ICC) by filing a Request for Arbitration with the Secretariat of the ICC against the Government of the Republic of the Philippines acting through the DOTC and MIAA.[441]

438 Id.

439 Id.

440 Id.

441 Id.

Considering the procedural issue concerning arbitration, the court held that the arbitration step taken by PIATCO will not oust the Court of its jurisdiction over the case. The court held that the petitioners in the case who have presented legitimate interests in the resolution of the controversy are not parties to the PIATCO Contracts. Accordingly, they cannot be bound by the arbitration clause and hence, cannot be compelled to submit to arbitration proceedings. Further, the Court held that, a speedy and decisive resolution of all the critical issues in the present controversy, including those raised by petitioners, cannot be made before an arbitral tribunal. The object of arbitration is precisely to allow an expeditious determination of a dispute. This objective would not be met if the Court was to allow the parties to settle the cases by arbitration as there were certain issues involving non-parties to the PIATCO Contracts which the arbitral tribunal would not be equipped to resolve.[442]

In arriving at the above finding, the court noted that in the case of Del Monte Corporation-USA, [443] even after finding that the arbitration clause in the Distributorship Agreement in question is valid and the dispute between the parties is arbitrable, the Court affirmed the trial court's decision denying petitioner's Motion to Suspend Proceedings pursuant to the arbitration clause under the contract. In so ruling, the Court held that as contracts produce legal effect between the parties, their assigns and heirs, only the parties to the Distributorship Agreement are bound by its terms, including the arbitration clause stipulated therein. The Court ruled that arbitration proceedings could be called for but only with respect to the parties to the contract in question.[444]

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442 The above decision of the Court was followed by a Government take-over of the terminal in January 2004. Currently, arbitration proceedings initiated by Fraport AG Frankfurt Airport Services Worldwide (Fraport), alleging that the Republic of the Philippines has expropriated the investment of Fraport in NAIA Terminal III in alleged violation of the Philippines-Germany Bilateral Investment Treaty signed on 17 April 1997, is pending before the International Centre for Settlement of Investment Disputes.

443 G.R. No. 136154, February 7, 2001; 351 SCRA 373, 381.

444 See supra note 422.

Although the finding of the court on this procedural issue could be technically justified in the light of the reasons given, as far as the petitioners who played no role in the concession agreement are concerned, one could argue that the court erred in its finding by ignoring the applicability of the arbitration clause to the state representatives who became petitioners by intervention. This argument is further strengthened by the fact that court went on to finally decide in sum, that in view of the absence of the requisite financial capacity of the Paircargo Consortium, predecessor of respondent PIATCO, the award by the PBAC of the contract for the construction, operation and maintenance of the NAIA IPT III is null and void. Further, considering that the 1997 Concession Agreement contains material and substantial amendments, which amendments had the effect of converting the 1997 Concession Agreement into an entirely different agreement from the contract bided upon, the court held that the 1997 Concession Agreement is similarly null and void for being contrary to public policy. It could be argued that although the arbitration clause in the concession agreement did not bind for example the workers of the international airline service providers, it should have bound the solicitor general and the other state representatives who petitioned for an order that the concession agreement is null and void following the change of policy with the change of the regime.

Outside parties such as environmental concern groups and public interest groups too have on many occasions for both valid and invalid reasons engineered the intervention of local judicial institutions to disrupt the continuity of investment projects. The Eppawela case in Sri Lanka and the Narmada case in India which are discussed in detail in the next chapter provide good examples of how judicial intervention can slow the progress of development projects.[445]

445 See Chapter 7, Sections A.1.c and B.4.a.

b. Bulankulama v. Min. of Industrial Development (Eppawala case)

The Eppawala case is a good example of a case in which the local court in a developing country, i.e. Sri Lanka, has been extremely cautious in analysing the facts presented to it and has been successful in awarding relief to the affected litigants whilst ensuring that its decision would not unduly disrupt the development initiatives taken by the Government. Some of the key arguments considered by the Supreme Court and its reasoning in this case are discussed below:

The case was filed by six owners of agricultural land and the Viharadhipathi (Head Priest) of the Galkanda Purana Viharaya (A Buddhist Temple at Galkanda in the North Central Province of Sri Lanka) (the "Petitioners"), all within the exploration area of the project called Eppawala in the Anuradhapura District in the North Central Province of Sri Lanka. The Petitioners' claimed that they were in danger of losing their lands and livelihood as a result of this government-sanctioned project which, they said was not for a public purpose but for the enrichment of a private company. Further, the Petitioners' claimed that about 2,600 families or 12,000 persons, including themselves, are likely to be permanently displaced from their homes and lands.[446] In addition, the petitioners claimed that the project was being entered into in a manner that circumvented the environmental laws of Sri Lanka and that clauses in the agreement binding the Government to assist the investment company to obtain all necessary approvals meant that any environmental impact assessment conducted thereafter (in which they as citizens were entitled to participate) was likely to be biased and not conducted in good faith. The petitioners accordingly claimed an imminent infringement of their rights under Article 12(1) of the 1978 Constitution - right to equality before the law and equal protection of the law - and Articles 14(1)(g) and (h) - right to choose their place of residence and carry on their livelihood.[447]

446 S.C. Application No. 884/99 (F/R)446. Online: http://www.elaw.org/resources/text.asp?id=163

447 Id.

One of the handicaps faced by the Petitioners' was that they were only in possession of unsigned copies of the documents relevant to prove their case and were not even aware whether those documents had subsequently been signed and/or amended by the contracting parties. As part of their prayer the petitioners asked for disclosure of the documents pending the hearing. In a significant ruling at the leave to proceed stage, the Supreme Court issued an order that the Mineral Investment Agreement, if signed, should be produced to Court within one week.[448] When the document was produced before court, it turned out that the agreements were in fact not signed. However, the respondents admitted that the copies filed by the petitioners represented the final drafts which had been agreed between the contracting parties and initialled by the Government.

In place of the detailed environmental impact assessment (EIA) procedure laid down in the National Environmental Act (NEA)[449] and the Regulations made there under, the proposed Mineral Investment Agreement provided for the project company to conduct its own "feasibility study" with the aid of a qualified foreign consultant selected by the company. It was the Secretary to the Ministry of Industries and not the Central Environmental Authority (CEA) (as permitted under the NEA) who could decide whether to give the go ahead to the project following such study. Further, according to the proposed agreement, there was no provision for public participation as was mandatory under the EIA process under the NEA. In the event of the Secretary's refusal to give approval, the company was able to take the Government to international arbitration in London.[450]

Concerning this proposed contractual arrangement, the Court held that:

448 Id.

449 National Environmental Act, No.47 of 1980 (as amended by Environmental Act No. 56 of 1988)

450 Supra note 446.

"What was being attempted by the proposed agreement was to substitute a procedure for that laid down by law. It was assumed that by a contractual arrangement between the executive branch of government and the company, the laws of the country could be avoided. That is an obviously erroneous assumption for no organ of government, no person whomsoever, is above the law."[451]

The Court was also severely critical of confidentiality clauses in the proposed agreement that would serve to keep information on the project out of reach of the people. Such clauses were, in its view, an "attempt to quell, appease, abate or even, under the guise of a binding contract, to legally put down or extinguish public protests".[452]

The respondents (including the State) argued *inter alia* that the Petitioners lacked legal standing to bring this case before court and argued that the State enjoyed the status of trusteeship over all natural resources of the State and was therefore entitled to take development decisions involving such resources in the larger interest of the nation. Rejecting this argument, the Court pointed out that Constitution places a shared responsibility on the State and its citizens to safeguard the natural environment.[453]

Concerning the question of infringement of the rights of the seven petitioners, the Court held that, it needed to be viewed in the context of the rights guaranteed: to them not only within the category of "all persons" as referred to, for instance, in Article 12(1) of the constitution, but "in particular as members of the citizenry of Sri Lanka".[454] Justice Amarasinghe, who delivered the judgement, went on to opine that:

"International standard setting instruments have clearly recognized the principle of inter-generational equity. It has been stated that humankind bears a solemn responsibility to protect and improve the environment for present and future generations. (Principle 1, Stockholm Declaration). The natural resources of the earth including the air, water, land flora and fauna must be safeguarded for the benefit of present and future generations. (Principle 2, Stockholm

451 Id.

452 Id.

453 Id.

454 Id.

Declaration). The non-renewable resources of the earth must be employed in such a way as to guard against their future exhaustion and to ensure that benefits from such employment are shared by all humankind (Principle 5, Stockholm Declaration) The right to development must be fulfilled so as to equitably meet developmental and environmental needs of present and future generations. (Principle 3, Rio De Janeiro Declaration). These inter-generational principles in my view, should be regarded as axiomatic in the decision making process in relation to matters concerning the natural resources and the environment of Sri Lanka in general, and particularly in the case before us.'[455]

A clause in the proposed Agreement that drew particular adverse comment from the Court was the provision for relocation of occupants of land affected by the project. Under that clause it was the company that would determine when relocation was necessary. Although the company was nominally committed to bear the cost of such relocation, the Government was committed to "use its best efforts to facilitate the relocation of any inhabitants of such land as requested by the company in a manner which does not create an undue financial burden on the company or delay the company's development and operation of the mining area." As the Court put it, this clause showed "not only that the petitioners and others may be affected but that if they are, the paramount consideration will be the interests of the company rather than those of the occupants of the affected areas".[456]

The petitioners had made it clear, and the Court accepted, that they had no objection to the sustainable development of the Eppawala mineral deposits, and that they were not asking the Government to "sit back and do nothing" as alleged by the respondents. Thus, after analyzing the concept of sustainable development as contained in the international Stockholm and Rio de Janeiro Declarations on the environment, the Court opined that:

"The human development paradigm needs to be placed within the context of our finite environment, so as to ensure the future sustainability of the mineral resources and of the water and soil conservation ecosystems of the Eppawala region, and of the North Central Province and Sri Lanka in general. Due account must also be taken of our un-renewable cultural heritage. Decisions with regard to the nature and scale of activity require the most anxious consideration from the point of view of safeguarding the health and safety of the people, naturally including the

455 Id.

456 Id.

petitioners, ensuring the viability of their occupations, and protecting the rights of future generations of Sri Lankans."

In its final judgment, arrived at after lengthy arguments and written submissions by the contesting parties, the Supreme Court Bench headed by Justice A. R. B. Amerasinghe, with Justices Wadugodapitiya and D. P. S. Gunasekera in agreement, held that the petitioners had established an imminent infringement of their fundamental rights. The Court noted that several scientists had pointed out the economic risks involved in entering into the Eppawala project without further studies into the extent of the reserves of rock phosphate actually available. In directing the Government that before proceeding any further with the project, it should carryout a comprehensive feasibility study in consultation with the local scientists, the Court remarked that such a study ought to have been done before the negotiating committee appointed by the President to conduct the final round of negotiations in 1997 recommended the signing of the proposed agreement.[457]

As part of its order, the Court also issued a direction that after such studies were completed and the results published, any project proponent must obtain approval from the CEA "according to law including the decisions of the superior courts of record of Sri Lanka".[458]

The judgment also set out several guidelines to be followed by the CEA. Most notable is the requirement that the CEA in its decision making should take note of the principles set out in the Stockholm and Rio Declarations. In particular the Court stressed the importance of the "precautionary principle" recognized in the latter, namely that where there is a threat of serious or

457 Id.

458 Id.

irreversible damage to the environment, lack of full scientific certainty should not be used as an excuse for postponing preventive measures.[459]

The Court also drew attention to the "polluter pays" principle, namely, that the cost of environmental damage should be borne by the party that causes the harm and not be allowed to fall on the general community, "to be paid through reduced environmental quality or increased taxation in order to mitigate the environmentally degrading effects of a project". Stressing the need for strict compliance with the EIA procedure including the provisions for public participation before project approval is granted, Amarasinghe J. stated that:

> *"I should like to remind the persons concerned, and especially the Central Environmental Authority, that an environmental impact assessment exercise can identify the potential threats of a proposed activity or project, and that this information can then be used to modify the proposed activity in order to take these threats into account."*[460]

The Court noted that in this instance, the "salutary provisions" of the environmental laws had not been complied with. The alternative project approval procedure provided in the Mineral Investment Agreement was an "attempt to contract out of the obligation to comply with the law".[461]

This judgment ought to be read carefully by the authorities in Sri Lanka who deals with development projects and investor promotions, especially the BOI of Sri Lanka, which threw its full weight behind this flawed project and the apparent attempts to bypass the relevant laws. This is important, if in future, a decision is taken to proceed with the project. In addition, the Court's directions should be studied with care by the Central Environmental Authority of Sri Lanka which was content to remain passive while its statutory powers were bypassed or disregarded in setting up a project of enormous environmental consequences.

459 Id.

460 Id.

461 Id.

In terms of development initiatives, environmental jurisprudence, and public law in general, the above judgment broke new ground in Sri Lanka. It is comparable to landmark decisions such as the Kamal Nath case in India[462] and the Oposa case in the Philippines[463] where the respective Courts showed that they were willing, in the public interest, to review decisions of the Executive regarding the management of natural resources, if the mismanagement of such resources was likely to interfere with the rights of present and future generations.

5.4. Measures for Reducing Social and Judicial Obstacles

5.4.1. Social Reforms

Shortages, service problems and price increases of infrastructure services in countries with privatized utilities have provoked furious complaints from the public. In many countries, foreign companies are being portrayed as outright villains. Changing governments have responded to public frustration by imposing rate freezes and unilaterally changing contract terms and conditions much to the dissatisfaction of the investors.

Infrastructure investments tend to be particularly sensitive to shifts in public opinion. When private companies who own or manage infrastructure facilities in developing countries increase the price of rates charged from the end users in their attempt to recover investments and earn profits, the host governments are likely to feel the public backlash. The situation becomes even more complicated in countries where the "culture of payment" for services is still immature

462 *M.C. Mehta v. Kamal Natha* (1977) ISCC 388.
463 33 ILM 173 (1994)

or where the system for regulating rate increases is unstable or incapable of withstanding political pressures during an economic crisis.

One of the best methods of minimising the risk of public opposition would be to educate the public of the advantages of allowing private sector and foreign investor participation in development of infrastructure. Whilst educating the public of the advance technology and efficient management the private sector and foreign investors would bring into provision of infrastructure facilities, the public also need to be educated of the certain sacrifices that have to be made, for example, increased pricing or acquisition of private land by the government for development needs. The public will have to be persuaded that these sacrifices are worth making in the larger interest of the nation. As noted by the preparatory committee for the World Summit on Sustainable Development, education at all levels is a key to sustainable development. Educating people for sustainable development does not mean the mere addition of environmental protection to a school curriculum; it involves the promotion of a balance among economic goals, social needs and ecological responsibility.[464]

Steps will also have to be taken to wipe out corrupt practices in the procurement process of development projects. Steps also need to be taken to maintain transparency throughout the life cycle of development projects. As the end user or the ultimate beneficiary of every infrastructure project will be the public, the governments will need to ensure that no projects are promoted and given the green light to proceed at the expense of national interest.

Governments should thus take specific actions in the future to defend their infrastructure development policies when faced with opposition. One method that could be adopted is to ensure

464 Commission on Sustainable Development (acting as the preparatory committee for the World Summit on Sustainable Development), Implementing Agenda 21, Second preparatory session (28 January - 8 February 2002), E/CN.17/2002/PC.2/.

that specially appointed teams comprising of members of all political groups representing the country's legislature screens development projects. This will indeed minimize the room for criticism of development projects by political parties who are not in control of the county's legislative and executive bodies purely in order to gain political mileage.

The conflict of interest between public concerns and development needs of countries is an important issue the host countries, investors and other participants in project financing will need to address. Winning over public opinion will not be difficult if the parties involved in a project to which public criticism has been expressed, act in a transparent manner and without any corrupt practices.

It may not be possible for the developing countries to implement above initiatives by them selves. Thus the investors as well as the international development agencies may have to support the social reform initiatives taken by developing countries. As noted by Hewko (2003):

> *"If legislative and institutional reform is a goal to attract FDI, considerably more attention needs to be paid by the international development community to the precise concerns of foreign investors and their advisers. Foreign investors place their own resources at risk and spend considerable funds on lawyers and accountants to identify the specific dangers and problems relating to their investments. As a result, foreign investors and their advisers, much more so than a development guru flying in for a weekend of diagnostic analysis, are best suited for identifying exactly the changes needed in the legislative framework to address foreign investors' concerns and thus to facilitate FDI".*[465]

5.4.2. Judicial Reforms

A legal and judicial system that includes consistent and modern legislation, effective and efficient courts, and regulatory institutions that interpret and enforce the laws in a fair and transparent manner is a desirable and laudable goal and, all things being equal, a country with such an ideal system will attract more FDI than one that does not.[466]

465 See supra note 415.

466 Id.

There is a substantive body of empirical evidence that demonstrates the importance of legal and judicial reform in achieving a high rate of economic growth.[467] The argument is that weak or nonexistent laws and judicial institutions not only create a bias against new firms that have no means by which to persuade clients of their reliability, but also a bias in favour of simple over more complex transactions, since it is unlikely that legal remedies can be invoked in cases of non-fulfilment of contracts.[468]

As far as infrastructure development projects are concerned, foreign investors will generally prefer a country in which the legal system is developed, fair, open, and transparent to one in which the rule of law is absent. On the other hand an impartial judicial system is also necessary to advance equality and allow a voice for the poor, thereby making a fair and functioning legal system an element of a comprehensive developmental framework.

However, the existence of such a pristine system or the degree to which it is absent is often not the decisive factor in attracting foreign investment. The most important factor in attracting FDI remains the existence of actual business opportunities. Nevertheless, it is an accepted fact that a legal environment that is conducive to foreign investment helps developing countries to attract more investors.

In the circumstances, host governments in developing countries should take initiatives to establish an investment friendly legal environment in their jurisdictions. This should not be done by compromising the rights of their nationals or at the cost of violating the national laws and or

467 Barro, R.J., *"Economic Growth in a Cross Section of Countries"*, Quarterly Journal of Economics 106:407 (1991), p.43; Havrylyshyn, O. and Ron van Rooden, "Institutions Matter in Transition, But So Do Policies", Working Paper 00/70 (Washington, D.C: International Monetary Fund, 2000); Campos, N.F. "Context Is Everything: Measuring Institutional Change in Transition Economies", Policy Research Working Paper 2269, Washington, D.C.: The World Bank, 2000)

468 Posner, R.A., *"Creating a Legal Framework for Economic Development"*, Research Observer 13(1):1–11 (Washington, D.C.: The World Bank, 1998).

policy regimes, but rather, by identifying the national development goals and thereafter by providing a legal environment in which those goals could be pursued.

In the circumstances, the developing country governments should take two key initiatives: 1) the establishment of an investment friendly legal regime;[469] and 2) the education of the local law makers and judges on the importance of investment initiatives to the development of the nation and the sensitiveness of such projects being put on hold by bad court orders.

However, this does not in any way mean that the power of courts to interfere in the in the larger interest of the public and the nation should be curtailed if sufficient evidence of imminent danger to the environment or public life is available. What needs to be done is on the one hand while maintaining transparency on all investment projects so that room for misinformation is minimised, on the other hand to introduce a judicial mechanism that can be swiftly put into motion by the public or other interest groups who wants to question any initiatives or effects involving an investment project. Identifying and or creating special courts that can swiftly deal with such issues may be a good solution, as this will allow a competent court to deal with disputes in relation to an investment project promptly, without being burdened by the heavy work load of other existing disputes.

469 Some countries like Philippines and Vietnam have already introduced specific investment laws to deal with most aspects of infrastructure investment.

Chapter 6 - Infrastructure Development and Protecting the Rights of Indigenous People

6.1. Nature of the Problem

Investment decisions in developing countries are too often made with scant regard for their potential effect on human rights. While environmental and social impact assessments are now an entrenched and necessary reality, foreign investors are often not required by developing country governments to study a project's potential effect on human rights in the host communities. Consequently, human rights violations resulting from foreign direct investment are often addressed only after they have occurred and after the damage is done. As a result, many development projects in developing countries have been abandoned or cancelled. Thus, for future progress of infrastructure development with FDI, it is important that the parties concerned give careful consideration to issues relating to human rights violations resulting from development activities. Understanding these issues would enable host countries as well as investors to promote sustainable development whilst ensuring that the interests of the local communities are not compromised.

In recent times, most acute violations resulting from development activities in developing countries had been of the rights of indigenous communities. As socioeconomic development takes place many development initiatives are extending farther into geographically remote areas often considered the traditional homelands of indigenous peoples; these areas offer resources such as forests, minerals, and hydropower potential. Roads, dams, power transmission lines, and other infrastructure development projects similarly are extending into the traditional areas of

indigenous peoples.[470] In parallel with physical and economic development, dominant and mainstream populations and cultures also are extending into the traditional areas of indigenous peoples.

Protection of indigenous peoples from development or maintenance of a status quo for indigenous peoples should not be a development objective. At the same time, it is not uncommon that interests of indigenous peoples differ from those of the mainstream and that development policies and approaches addressing the interests of dominant and mainstream communities' conflict with the interests of indigenous peoples.[471] What may be in the broad national interest may not be in the specific interests of indigenous peoples, and thus, development emerging from dominant and mainstream community-oriented initiatives may arrive in forms not consistent with indigenous peoples' interests or concerns.[472]

Development, as it most often is pursued is intended to meet national goals and the interests of dominant and mainstream societies. Reducing poverty and improving the quality of life of people in general most often are the primary objectives of development.[473] However, it is not always the case that poverty reduction and improvement in the quality of life realised from development extend equally to all segments of society or that, improvement reaches each segment of society. Moreover, in mainstream-oriented economic development policies, indigenous peoples' communities may bear a disproportionate burden of the negative social, economic, and environmental effects that such development projects may bring, without realising commensurate benefits.[474]

470 Asian Development Bank, The Bank's Policy on Indigenous Peoples, April 1998.

471 Id.

472 Id.

473 World Bank, "Entering the 21st Century", World Development Report 1999/2000.

474 See supra note 468.

Development viewed from the mainstream often is measured in terms of economic advancement or gain and improvement in quality of life, and most often places emphasis on economic growth.[475] From the development perspective of indigenous peoples, in addition to economic advancement, there may also be concern for social, cultural, environmental, and community aspects of development.[476] Indigenous peoples sometimes view the principles and efforts of mainstream development as inappropriate or unsustainable, and as an intrusion into traditional ways of life.[477] The physical intrusions of development interventions into the traditional domains of indigenous peoples and social intrusions into indigenous cultures can be viewed by indigenous peoples as a violation of rights to land and rights associated with the maintenance of culture.

As discussed in the previous chapters, developing countries rely on FDI for their ever-growing development needs. Most infrastructure development projects, be it a development of a highway, a water resource or power generation, would involve the granting of long term concessions on land and/or other natural resources of the host country to the parties investing in the project. Initiating development projects and granting of concessions to investors will often require the acquisition of lands and other natural resources held by individuals or groups by the state.

Most developing countries have introduced fair mechanisms for acquisition of private land for development projects. Usually, a reasonable compensation package and an offer of relocation satisfy most individuals or corporate entities who are required to give up their land and other resources to the state for development projects. However, acquisition of land and other resources owned or occupied by indigenous peoples is not as easy. Monitory compensation or

475 Id.

476World Bank, Revised Draft Operational Policy/Bank Procedures (op/bp 4.10), Indigenous Peoples (14 April 2005).

477 See supra note 468.

relocation might not always be adequate compensation for taking over traditional homelands of indigenous peoples where they and before them their forefathers have lived and enjoyed right of life from time immemorial.

The protests by indigenous peoples and legal actions that may be filed seeking redress and protection of their rights over land might cause long delays to infrastructure projects, causing grave and irreparable damage to the host governments as well as investors. What governments and investors fear most concerning indigenous people as far as infrastructure development projects are concerned is the risk facing legal actions seeking injunctive relief to prevent the development of projects. Usually, there are two principles relating to the granting of injunctive relief to restrain development projects when allegations are made that native titles of indigenous people are being compromised.[478] The first is whether there is a serious issue to be tried. This would require the indigenous people alleging the violation of their rights to put forward some satisfactory evidence as to the existence of their native customary title to the lands in issue. The second is the "balance of convenience" issue where the indigenous people should show that the balance of convenience favour the granting of an injunction to prevent a development project from proceeding with its work.

In considering the said issues, the courts would weigh the alleged prejudice to the native title claimants if a project is developed as against the prejudice to the government[479] and or the investor if the project is suspended. The difference can best be illustrated by contrasting a "grass roots" exploration program with an established mining operation. It is conceivable that the implementation of a grass roots exploration program on ground which may have native title and

478 This is in addition to other pre-conditions such as whether injunction is necessary or futile, whether an alternative remedy available, whether damages alone serves as an appropriate remedy, requirement of actionable wrong or prima facie case, which the courts in most common law jurisdictions as well as civil law jurisdictions consider before granting injunctive relief.

479 In some jurisdictions injunctive relief against the government is barred by statute. For example, see Section 24 of the Interpretation Ordinance (Chapter 2) of Sri Lanka. In such situation, the only remedy available to the complainants may be compensation for their losses.

which has not yet been disturbed would be stayed by courts. The courts would most likely take the view that the prejudice to the indigenous people from having the ground disturbed is greater than the prejudice to the project company if the ground remains undisturbed for the present. However, in contrast, an injunction may not be issued to restrain mining operations once a mining project has been constructed with substantial amounts of capital invested in it, on the basis that native title exists over the land used for the project. The courts may consider that the ground would already be so disturbed that any additional disturbance could not be said to prejudice the indigenous communities, but there would be great prejudice to the project company if the project operations are stayed.

Given the above background, the aim of this chapter is to show how the indigenous rights come into conflict with the development activities. Case studies from the Philippines, Malaysia and Indonesia will be used emphasis how the rights of the indigenous people are affected and how the ensuing legal battles with the governments and the investors result in delays and inconveniences to the project proponents. Proposals will be made on various approaches that could be taken by developing countries, investors and also by international organizations to ensure that development activities could be carried out without compromising the rights of indigenous peoples.

6.2. Indigenous People

There is no universal and unambiguous definition of the concept of 'indigenous peoples', but there are a number of criteria by which indigenous peoples can be identified and characterised. The most widespread approaches are those proposed in the International Labour Organization (ILO) Convention No.169[480] and in the 1986 Martinéz Cobo Report to the UN Sub-Commission on the Prevention of Discrimination of Minorities.[481]

The ILO Convention No. 169 states that a people are considered indigenous either because they are descendants of those who lived in the area before colonisation; or because they have maintained their own social, economic, cultural and political institutions since colonisation and the establishment of new states.[482] Furthermore, the ILO Convention states that, self-identification is crucial for indigenous peoples. This criterion has for example been applied in a land-claims agreement between the Canadian Government and the Inuit of the Northwest Territories.[483]

According to the Martinéz Cobo Report to the UN Sub-Commission on the Prevention of Discrimination of Minorities, indigenous peoples may be identified as follows:

> *"Indigenous communities, peoples and nations are those which, having a historical continuity with pre-invasion and pre-colonial societies that developed on their territories, consider themselves distinct from other sectors of the societies now prevailing in those territories, or parts of them. They form at present non-dominant sectors of society and are determined to preserve, develop and transmit to future generations their ancestral territories, and their ethnic identity, as the basis of their*

480 ILO, Convention (No. 169) concerning Indigenous and Tribal Peoples in Independent Countries. Adopted on 27 June 1989 by the General Conference of the International Labour Organization at its seventy-sixth session. Entry into force on 5 September 1991.

481 See the 'Study of the Problem of Discrimination against Indigenous Populations' submitted to the UN Sub-Commission on the Prevention of Discrimination and the Protection of Minorities by Special Rapporteur, Mr. Martinez Cobo, UN Doc. E/CN.4/Sub.2/1986/7 (1986).

482 Supra note 480.

483 Id.

continued existence as peoples, in accordance with their own cultural patterns, social institutions and legal systems."

"This historical continuity may consist of the continuation, for an extended period reaching into the present, of one or more of the following factors:

- *Occupation of ancestral lands, or at least of part of them;*
- *Common ancestry with the original occupants of these lands;*
- *Culture in general, or in specific manifestations (such as religion, living under a tribal system, membership of an indigenous community, dress, means of livelihood, lifestyle, etc.);*
- *Language (whether used as the only language, as mother-tongue, as the habitual means of communication at home or in the family, or as the main, preferred, habitual, general or normal language);*
- *Residence in certain parts of the country, or in certain regions of the world."*[484] [485]

Thus, Indigenous people in any country are the off springs and heirs of the peoples who have first inhabited and cared for the land long before any central government was established. At least 350 million people worldwide are considered to be indigenous. Most of them live in remote areas in the world.[486] Indigenous peoples are divided into at least 5000 peoples ranging from the forest peoples of the Amazon to the tribal peoples of India and from the Inuit of the Arctic to the Aborigines in Australia. Very often they inhabit lands that are rich in minerals and natural resources.[487]

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484 Supra note 481.

485 Before 1969 the problems of indigenous populations have not been on the agenda of the Commission on Human Rights or of the Sub-Commission on Prevention of Discrimination and Protection of Minorities, although a number of studies undertaken by Special Rapporteurs of the Sub-Commission on various discrimination issues indirectly benefited indigenous peoples. In 1969 the Sub-Commission had before it a report of the Special Rapporteur on the Study on Racial Discrimination in the Political, Economic, Social and Cultural Spheres. It included a chapter on measures taken in connection with the protection of indigenous peoples. This started a process of discussion in the Sub-Commission and in the Commission on Human Rights. In 1970 the Sub-Commission recommended that a comprehensive study be made of the problem of discrimination against indigenous populations. The recommendation passed the Commission and was finally taken up by the Economic and Social Council. The Council adopted resolution 1589 (L) of 21 May, 1971, in which it authorized the preparation of such a study. in 1971 Mr. Jose Martinez Cobo was appointed Special Rapporteur for the study on the problem of discrimination against indigenous populations. The study which was finally completed between 1981 and 1984, starts with a working definition of "indigenous populations" and covers a wide range of issues, such as indigenous identity, culture and legal systems, health and medical care, housing, education, language etc. (see supra note 481).

486 For a Map on the spread of indigenous people in the globe, see the following website: http://www.ifg.org/programs/indig/IFGmap.pdf

487 Source: International Work Group for Indigenous Affairs. Online:http://www.iwgia.org/sw155.asp

There has been a dynamic evolution of nation-states during the last four hundred years. This process has produced over 190 States in the global community.[488] This emergence of nation-states as a dominant political reality has pushed aside empires, kingdoms and indigenous tribes to set new rules for the organisation of human political, economic and social affairs. Where there were empires, nation-states have been formed. Where there were kingdoms, nation-states have been established. Where indigenous tribes had lived for thousands of years, nation-states have been created.[489]

While empires collapsed and kingdoms either assumed the character of nation-states or dissolved, thousands of indigenous tribal groups have been absorbed into nation-states, often against their will or without their knowledge. This has resulted in indigenous groups in many countries having to go along with the policies of the State that has assumed control over them without their consent. This brings to light the interesting issue concerning the status whole populations of indigenous peoples who had neither chosen to join a nation-state nor to lose their separate and distinct political identity.[490]

Until recently, in most countries, the indigenous groups were neglected. Their political, economic and cultural rights were under the control of nation-states. They were suppressed and exploited to the benefit of the nation-state or in the larger interest of the majority. Legal or

488 As of November 2005 there are 191 member countries of the United Nations. The figure is likely to be increased by one if in the near future Serbia and Montenegro decide to end their current partner-state existence and claim recognition as separate States.

489 See generally, Ryser, R. C., Concept Paper: Finding a Place for Indigenous Peoples in the family of Nations (Olympia: Center for World Indigenous Studies, 1980).

490 Many indigenous tribal groups have assumed the character of nation-states (particularly in Asia, Africa and the Middle East) by having political control over the nation-state. However, there are many other indigenous tribal groups who are surrounded by nation-states, but yet have no influence or control in the national government. The indigenous communities such as the Veddhas in Sri Lanka and the Bedouins in the Arab states are good examples.

political recourse were hardly offered to the indigenous tribal group to determine their own future or govern themselves except at the whim of the controlling nation-state.[491]

6.3. Rights of the Indigenous People

All peoples in the world are said to possess, without qualification, the right to self-determination.[492] They are inherently free to act and decide as a matter of principle on questions concerning their civil and human rights. In short, any grouping of people may choose a form of government and one day, in time; choose to associate with any other government.[493] They may also choose to remain independent. The principle of self-determination is specified in the Charter of the United Nations and it is given further expression in the Universal Declaration of Human Rights (1948).[494] Also supportive of this notion is the International Covenant on Economic, Social and Cultural Rights (1966).[495] Self-determination is also expressed in the International Covenant on Civil and Political Rights (1966).[496] The Universal Declaration provides a common standard for the human rights of all peoples and all nations, and proclaims the importance of traditional, political, and civil rights, as well as basic economic social and cultural rights. The

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491 There are some exceptions however, to this general practice of non-reorganization of the rights of self determination of indigenous groups. For example, in the island territories of Palau, Yap, Truk, Ponape, Kosrae and Marshal (North Pacific Ocean), the tribal populations have successfully negotiated a status of free association with the United States. By virtue of a bi-lateral compact with the U.S. Government, the indigenous peoples of these islands are guaranteed internal self-government and the full right to carry out their own relations with other peoples without U.S. interference. The compact (for five years) places the military defense of the islands under the authority of the United States. The free associate status permits the indigenous peoples to express their political will within the global community without interference from the state with which they have associated. Another example is the Basque peoples of Northern Spain who have achieved home-rule in three provinces.

492 A corollary to this principle of political self-determination can be found in the Declaration on the Granting of Independence to Colonial Countries and Peoples (United Nations General Assembly resolution 1514), which provides that peoples (can) "freely determine their political status." This assertion also appears in the International Covenant on Human Rights and in the Declaration on Principles of International Law Concerning Friendly Relations and Cooperation Among States in Accordance with the Charter of the United Nations (United Nations General Assembly resolution 2625).

493 Gray, A., The Indigenous Movement in Asia, Indigenous Peoples of Asia, (Michigan: Ann Arbor Association for Asian Studies, 1995) pp. 35-42.

494 Adopted and proclaimed by the United Nations General Assembly resolution 217 A (III) of 10 December 1948. Online: http://www.un.org/Overview/rights.html

495 Adopted and opened for signature, ratification and accession by the United Nations, General Assembly resolution 2200A (XXI) of 16 December 1966. Entry into force 3 January 1976,. Available online: http://www.unhchr.ch/html/menu3/b/a_cescr.htm.

496 Adopted and opened for signature, ratification and accession by General Assembly resolution 2200A (XXI) of 16 December 1966. Entry into force 23 March 1976, in accordance with Article 49 . Available online: http://www.ohchr.org/english/law/ccpr.htm.

Covenant spells out civil and political rights and guiding principles based on the Universal Declaration.

The 1957 International Labour Organization (ILO) Convention No. 107 was one of the first international instruments in specific support of indigenous peoples.[497] It addressed the right of indigenous peoples to pursue material well being and spiritual development. ILO Convention No. 107 was followed in 1989 by ILO Convention 169.[498] This Convention presented the fundamental concept that the way of life of indigenous and tribal peoples should and will survive, as well as the view that indigenous and tribal peoples and their traditional organisations should be closely involved in the planning and implementation of development projects that affect them. As the most comprehensive and most current international legal instrument to address issues vital to indigenous and tribal peoples, Convention No. 169 includes articles that deal with consultation and participation, social security and health, human development, and the environment.[499]

The indigenous peoples rights to participate meaningfully in natural resource management that affects their rights is also recognised in several international declarations and conventions including the Rio Declaration on Environment and Development,[500] the International Convention on the Elimination of All Forms of Racial Discrimination,[501] the ILO Convention 169, Agenda 21,[502] the OAS Declaration on the Rights of Indigenous Peoples,[503] the UN Draft

497 Convention on Protection and Integration of Indigenous and Other Tribal and Semi-Tribal Populations in Independent Countries (1957).

498 Convention Concerning Indigenous and Tribal Peoples in Independent Countries (1989).

499 To date, Convention No. 169 has been ratified by only a few countries, and significantly so far by none of the developing countries in the Asian and Pacific Region.

500 Agenda 21, the Rio Declaration on Environment and Development, and the Statement of principles for the Sustainable Management of Forests were adopted by more than 178 Governments at the United Nations Conference on Environment and Development (UNCED) held in Rio de Janeiro, Brazil, 3 to 14 June 1992.

501 Adopted and opened for signature and ratification by General Assembly resolution 2106 (XX) of 21 December 1965. Came into force on 4 January 1969.

502 Adopted on 27 June 1989 by the General Conference of the International Labour Organization at its seventy-sixth session. Came into force on 5 September 1991.

503 OEA/Ser/L/V/II.95 Doc. 6, Feb. 26, 1997.

Declaration on the Rights of Indigenous Peoples,[504] and the UN Convention on Biological Diversity.[505]

Included in these various conventions and declarations are the recognition of indigenous land rights, traditional resource management, equal rights to participate in public affairs, the need to protect indigenous lands from environmental threats, and the need to achieve prior informed consent of indigenous peoples before making decisions affecting their rights and interests.

Agenda 21 adopted by the United Nations Conference on Environment and Development (UNCED) in 1992, recognizes the actual and potential contribution of indigenous and tribal peoples to sustainable development.[506] The 1992 Convention on Biodiversity calls on contracting parties to respect traditional indigenous knowledge with regard to the preservation of biodiversity and its sustainable use.[507] The Vienna Declaration and Programme of Action emerging from the 1993 World Conference on Human Rights recognizes the dignity and unique cultural contributions of indigenous peoples, and strongly reaffirms the commitment of the international community to the economic, social, and cultural well-being of indigenous peoples and their enjoyment of the fruits of sustainable development.[508]

In addition, the Working Group on Indigenous Populations (WGIP) established by the UN in 1982 completed its work on a "Draft Declaration on the Rights of Indigenous Peoples" in

504 U.N. Doc. E/CN.4/Sub.2/1994/2/Add.1 (1994).

505 The Convention on Biological Diversity was negotiated under the auspices of the United Nations Environment Programme (UNEP). It was opened for signature at the June 1992 UN Conference on Environment and Development (UNCED) and entered into force on 29 December 1993. Signed by 150 governments, the Convention is dedicated to promoting sustainable development. The Convention is available online: http://www.biodiv.org/doc/legal/cbd-en.pdf

506 Agenda 21 is a comprehensive plan of action to be taken globally, nationally and locally by organizations of the United Nations System, Governments, and Major Groups in every area in which human impacts on the environment. Agenda 21, the Rio Declaration on Environment and Development, and the Statement of principles for the Sustainable Management of Forests were adopted by more than 178 Governments at the United Nations Conference on Environment and Development (UNCED) held in Rio de Janerio, Brazil, 3 - 14 June, 1992.
Available online: http://www.un.org/esa/sustdev/documents/agenda21/english/agenda21toc.htm

507 See supra note 505.

508 UNHCR, Fact Sheet No.9 (Rev.1), The Rights of Indigenous Peoples. Online: http://www.unhchr.ch/html/menu6/2/fs9.htm

1993.[509] This Draft Declaration, developed with the direct participation of indigenous people is currently under consideration within the United Nations. It addresses issues such as the right to participation, the right of indigenous peoples to direct their own development, the right of indigenous peoples to determine and develop priorities and strategies for the development or use of ancestral territories and resources, and the right to self-determination.[510] It represents one of the most important developments in the promotion and protection of the basic rights and fundamental freedoms of indigenous peoples. It consists of 19 preamble paragraphs and 45 articles that covers rights and freedoms including the preservation and development of ethnic and cultural characteristics and distinct identities; protection against genocide and ethnocide; rights related ownership, possession or use of indigenous lands and natural resources; maintenance of traditional economic structures and ways of life, including hunting, fishing, herding, gathering, timber-sawing and cultivation; environmental protection; participation in the political, economic and social life of the countries concerned, in particular in matters which may affect indigenous peoples' lives and destinies; self-determination; self-government or autonomy in matters relating to indigenous peoples' internal and local affairs; and the honouring of treaties and agreements concluded with indigenous peoples.[511]

In 1995, the Commission on Human Rights established its own working group to examine the draft declaration.[512] Since its establishment, the working group on the draft declaration has held two sessions. At its first session, in November-December 1995, the group considered the draft declaration adopted by the Sub-Commission and held a general debate on the text section by section in order to identify where there was general consensus and which articles

509 E/CN.4/Sub.2/1994/56, (28 October, 1994)

510 The emerging concern for indigenous peoples prompted the United Nations to declare 1993 as the International Year of the World's Indigenous Peoples and the decade from December 1994 as the Indigenous Peoples Decade.

511 See Supra note 507.

512 See supra note 508.

would require greater deliberation.[513] At the second session, in October-November 1996, articles dealing with similar themes or having some other relationship with each other were re-clustered for the purposes of discussion and in order to hear proposals.[514] No changes have yet been made to the draft declaration adopted by the Sub-Commission, which remains the basis for the work of the inter-sessional working group. When the Commission on Human Rights completes its work, the Draft Declaration is expected to be submitted to the UN General Assembly for final adoption.

As of March 1997, 15 organisations of indigenous peoples have consultative status with the United Nations Economic and Social Council (ECOSOC). Consultative status entitles them to attend and contribute to a wide range of international and intergovernmental conferences.[515] It is likely that these organisations will put significant amount of pressure on the ECOSOC for recognition and up-liftment of indigenous rights.

In addition to the aforesaid initiatives taken by the international community to recognise and promote indigenous rights, the indigenous movement also got a boost in the mid 1970's from the foundation of international indigenous organisations such as the International Indian Treaty Council (IITC)[516] and the World Council of Indigenous People (WCIP).[517] These organisations have been effective in bringing the indigenous affairs to the international agenda.

513 See E/CN.4/1996/84.

514 See E/CN.4/1997/102.

515 These organisations are: Aboriginal and Torres Strait Islander Commission, Asociación Kunas Unidos por Nabguana, Four Directions Council, Grand Council of the Crees (of Quebec), Indian Council of South America, Indian Law Resource Centre, Indigenous World Association, International Indian Treaty Council, International Organization of Indigenous Resource Development, Inuit Circumpolar Conference, National Aboriginal and Islander Legal Services Secretariat, National Indian Youth Council, Saami Council, Sejekto Cultural Association of Costa Rica, and World Council of Indigenous Peoples (Source: Fact Sheet No.9 (Rev.1), The Rights of Indigenous Peoples, Office of the High Commissioner for Human Rights).

516 The IITC was founded in 1974 at a gathering by the American Indian Movement in Standing Rock, South Dakota attended by more than 5000 representatives of 98 Indigenous Nations. In 1977, the IITC became the first organization of Indigenous Peoples to be reorganized as a Non-Governmental Organisation (NGO) with Consultative Status to the United Nations Economic and Social Council.

517 WCIP is a non-governmental organization created in 1975. Its goal is to promote the pacific co-existence between indigenous or autochthonous people, the national governments and other members of society by developing and supporting different projects.

The people of the Philippine Cordillera, the first Asians to take part in the international indigenous movement, were the first indigenous group to carry out a successful campaign against a development project that affected their rights, namely the building of the Chico River Dam in 1981-1982. [518] [519] Since then, there have been growing concerns for indigenous rights in the international arena. Increased publicity focused on the continuing disrespect for indigenous human rights and the destruction of the indigenous peoples' environment, together with the national governments' inability to deal with the situation has largely contributed towards this growing world focus on indigenous people and their rights.[520] However, despite the international recognition of equality of people and their right to self determination, various indigenous groups in the world continue to face an uphill task in preserving their identity and enjoying their rights.

6.4. Risks to Development Projects Resulting from Violation of Indigenous Peoples Rights

As a result of the growing global concerns for human rights and protecting indigenous communities which were discussed in the previous section, there has been an increased formalisation of the legal rights of indigenous peoples during the last two decades. New and revised indigenous laws have been passed, legal challenges raised and, new, yet weak institutions formed to protect indigenous rights.[521] This movement has been complimented by several international organizations who, having realised the necessity of applying policies, programs and

518 The Chico River is the longest and most elaborate river system in the Cordillcra mountain ranges in Northern Luzon. The indigenous people who occupy neighbouring lands belong to the Kalinga and Bontoc tribal groups. The lands in question are the ancestral properties of these communities and are considered sacred. In 1981 the tribal people fiercely resisted military led engineers who tried to construct the Chico River dam in the northern Philippines. They were able to prevent the acquisition of their lands after a guerrilla war that cost hundreds of lives.

519 See generally, Ghee, L.T., and Valancia, M., Conflict over Natural Resources in South-East Asia and the Pacific, (Tokyo: United Nations University Press 1990), Chapter 6.

520 See generally, Kastrup, J.P., *"The Internationalization of Indigenous Rights from the Environmental and Human Rights Perspective"*, 32 Texas International Law Journal (1997) p. 97 at 102 .

521 See generally, Anaya, S. J., Indigenous Peoples in International Law, (Oxford: University Press, 2000).

specific rules concerning indigenous peoples and their protection in some countries, have taken the initiative put such policy frameworks in place.

As noted in the previous section of this thesis, since in 1957, the ILO adopted the Convention No. 107 of 1957 concerning Indigenous and Tribal Populations to be applied to indigenous and tribal populations in independent countries and aimed at protecting these peoples against abuses[522] several other key international organizations have adopted policies on protecting the indigenous communities from being sidelined or their rights being compromised as a result of development initiatives taken by the States in which they live.[523] The World Bank, for example, first adopted a policy on indigenous peoples in the early 1990's as a result of the dismal experience of projects in Latin America. The World Bank now seeks to apply its current policy on indigenous peoples to all investment projects in which it participates.[524] In 1998 the EU adopted the 'Council Resolution on Indigenous Peoples within the Framework of the Development Cooperation of the Community and Members States', which provides the main guidelines for support to indigenous peoples.[525] ADB adopted its policy on indigenous people in 1998. The ADB's Operations Manual of 2004 describes the bank's policy and procedures in addressing indigenous peoples' issues in ADB funded projects.[526] It provides *inter alia* that:

> *"Reducing poverty and improving the quality of life of all people in Asia is ADB's overarching objective. Poverty is defined by ADB as "a deprivation of essential assets and opportunities to which every human is entitled". The poor may be denied access to assets because they belong to an ethnic minority or a community considered socially inferior. Therefore, poverty reduction and improvement in the quality of life realized from development must be extended equitably and reach each segment of society, including indigenous peoples."*[527]

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522 See supra note 497.

523 In 1989, a revised Convention - Convention No. 169 on Indigenous Peoples was adopted by the ILO in the light of changes in the position of indigenous and tribal populations and of greater understanding of their position by governments, employers and workers.

524 On May 10, 2005, the World Bank Executive Directors approved a revised policy on Indigenous Peoples. The updated policy, as reflected in the OP/BP 4.10, Indigenous Peoples, replaces the earlier policy (Operational Directive 4.20, Indigenous Peoples, dated September 1991). OP/BP 4.10 applies to all investment projects for which a Project Concept Review takes place on or after July 1, 2005.

525 The resolution is available online: http://ec.europa.eu/comm/external_relations/human_rights/ip/

526Available online: http://www.adb.org/Documents/Policies/Indigenous_Peoples/default.asp

527 Paragraph 5 of the Operations Manual issued on 13 May 2004. Available online: http://www.adb.org/Documents/Manuals/Operations/OMF03_13may04.pdf

The other international organizations that have adopted similar policies on protecting the indigenous people in the light of development activities which may result in them being sidelined or their rights being compromised include, the Inter-American Development Bank (IADB) which's policy on indigenous peoples is entitled 'Strategy for Indigenous Development'[528]; the United Nations Development Program (UNDP), which's policy on indigenous peoples is entitled "UNDP and Indigenous Peoples: A Practice Note on Engagement"[529]; the United Nations Educational, Scientific and Cultural Organization (UNESCO), which's Universal Declaration on Cultural Diversity adopted in 2001 is of relevance to indigenous peoples.[530] In addition, there is the World Conservation Union's (IUCN) policy agenda for indigenous peoples and conservation which is very broad and is guided by the resolutions of the World Conservation Congress (WCC) and by specific international agreements, Inter governmental organisations and UN agencies. In particular, the Unit's work in these areas is guided by the Convention on Biological Diversity (CBD), the World Intellectual Property Organization (WIPO), the World Trade Organization (WTO), and the United Nations Framework Convention on Climate Change (UNFCCC).[531]

In addition to the aforementioned policy frameworks put in place by international organizations, several development agencies linked with developed countries that provide substantial development aid to developing countries too have adopted policies to ensure the protection of indigenous communities. Examples of such agencies include the Norwegian Agency for Development Cooperation (NORAD) which's policy on indigenous peoples is entitled 'Guidelines for Norway's Efforts to Strengthen Support for Indigenous Peoples in

528 Available on line: http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=691275

529 Available online: www.undp.org/cso/policies/doc/IPPolicyEnglish

530 Available online: http://unesdoc.unesco.org/images/0012/001271/127160m.pdf

531 For further information see: http://www.iucn.org/themes/pbia/themes/indigenous/whatwedo.htm

Development Cooperation'[532] and the Danish International Development Assistance (DANIDA), which in 2004 developed its 'Strategy for Danish Support to Indigenous People'.[533]

As a result of the continuing development of the movement towards recognising indigenous peoples rights noted above, in the years to come, most developing countries are likely to pass new legislations or amend existing legislations in order to cater to the demand of recognition of the rights of indigenous people. However, in countries where efficient and effective mechanism have not been put in place to ensure that the rights of indigenous people are not unfairly compromised in favour of infrastructure development needs, there bound to be conflicts between the indigenous groups on one hand and the governments and investors on the other. Some of these conflicts may lead to prolonged legal battles between the parties causing severe economic losses to host countries as well as investors. Sometimes, the conflicts could continue to consume local and national resources long after the investment projects have been stopped and the foreign investors have left. A good example is the conflict concerning the uranium mining in Navajo, where the damages done in the 1940's were drawn out for over fifty years until in 1990 statutory provision was made to provide compensation for the native Indians who were victims of severe respiratory and other illnesses due to exposure to uranium.[534]

In the circumstances, it could be argued that the risks of infrastructure projects being disrupted, delayed or even cancelled due to conflicting interests of indigenous people is matter that needs serious consideration by developing country governments as well as other key project participants. The following case studies emphasize the key issues discussed above and look at

532 Available online: http://www.norad.no/default.asp?V_ITEM_ID=1632

533 Available online:http://www.um.dk/Publikationer/Danida/English/DanishDevelopmentCooperation/StrategyforDanishSupport/strategyforDanishSupport.pdf

534 In 1990 a law was passed known as the Radiation Exposure Compensation Act of 1990 (RECA). The law required $100,000 in "compassion payments" to uranium miners diagnosed with cancer or other respiratory ailments. To qualify for compensation, a miner had to prove that s/he had worked in the mines and was now suffering from one of the diseases on the compensation list. For more details, please see http://www.umich.edu/~snre492/sdancy.html

several development projects from the perspectives of affected groups as well as host countries and foreign investors.

6.4.1. Case Studies

a. The Case of the Indigenous Peoples of the Philippines

I. The Affected People

The Indigenous Peoples Rights Act of the Philippines[535] defines indigenous people and indigenous communities as a group of people or homogeneous societies identified by self-ascription and ascription by others, who have continuously lived as organised community on communally bounded and defined territory and, who have, under claims of ownership since time immemorial, occupied, possessed and, utilised such territories, sharing common bonds of language, customs, traditions and, other distinctive cultural traits or, who have through resistance to political, social and cultural inroads of colonisation, non-indigenous religions and cultures, became historically differentiated from the majority of Filipinos.[536]

The indigenous peoples in the Philippines today number about 7.5 million. This is about 16% of the total population of the country.[537] Historically, these peoples resisted colonisation by the Spaniards for three centuries from the 16th to the 18th century and were able to maintain their indigenous lifestyles and cultural practices. Indigenous peoples in the Philippines share distinctive traits that set them apart from the Filipino mainstream. They are non-Christians.[538] They live in less accessible, marginal, mostly upland areas. They have a system of self-

535 Indigenous Peoples Rights Act of 1997.

536 Section 3(h).

537 Source: Cordillera Peoples' Alliance (CPA). Praymer Maipanggep iti Nainsigudan nga Umili wenno Indigenous Peoples.

538 Id.

government not dependent upon the laws of the central administration of the Republic of the Philippines. They follow ways of life and customs that are perceived as different from those of the rest of the population.[539] The Philippines' indigenous cultural communities can be classified into seven major groupings. These are the Igorots of the Cordillera, the tribes of Caraballo and Cagayan Valley, the Negritos or Agta, the Mangyan, the people of Palawan, the Lumad of Mindanao and the Moro people. Within each major group are smaller but distinct sub- groupings of indigenous people.[540]

II. Customary Land Rights of the Indigenous Peoples of the Philippines

Ancient Filipinos settled in communities situated near water systems. Their life revolved around fishing and farming. The property regime then was community based, with usufruct regulating and determining land and resource use. Land was the central element of the existence of indigenous peoples' in the Philippines. This is a trait that can be seen even today among the Filipino indigenous communities.[541] There is no traditional concept of permanent, individual, land ownership. For example, as noted by the Supreme Court of the Philippines in the case of *Isagani Cruz and Cesar Europa v. Sec. of Environment and Natural Resources, et al.* among the tribal people of Igorots, ownership of land more accurately applies to the tribal right to use the land or to territorial control.[542] The people are the secondary owners or stewards of the land and that if a member of the tribe ceases to work, he loses his claim of ownership, and the land reverts to the beings of the spirit world who are its true and primary owners.[543] Under the concept of

539 MacDonald, C., 'Indigenous Peoples of the Philippines: Between Segregation and Integration, Indigenous Peoples of Asia', in Gray, A., The Indigenous Movement in Asia, Indigenous Peoples of Asia (Michigan: Ann Arbor Association for Asian Studies, 1995) p. 345.

540 Carino, Jacqueline K., Dams, Indigenous People and Vulnerable Ethic Minorities: A Case Study on the Ibaloy People and the Agno River Basin, Province of Benguet, Philippines, Contributing Paper Prepared for Thematic Review I.2: Dams, Indigenous People and Vulnerable Ethnic Minorities, World Commission on Dams (December 1999).

541 Id.

542 Decided on 6 December 2000. the judgment is available online: http://www.elaw.org/resources/text.asp?id=236

543 Gatmaytan, D. B., *"Ancestral Domain Recognition in the Philippines: Trends in Jurisprudence and Legislation"*, 5 Phil. Nat. Res. L.J. No. 1 (1992), pp. 47-48.

"trusteeship," the right to possess the land does not only belong to the present generation but the future ones as well.[544]

Customary law on land rests on the traditional belief that no one owns the land except the gods and spirits, and that those who work the land are its mere stewards.[545] Customary law has a strong preference for communal ownership, which could either be ownership by a group of individuals or families who are related by blood or by marriage, or ownership by residents of the same locality who may not be related by blood or marriage.[546] Thus, it is correct to say that land titles do not exist in the indigenous peoples' economic and social system. The concept of individual land ownership under the civil law is alien to them.

Spanish colonialism in the 16th century, imposed the Regalian Doctrine, enunciated under the Laws of the Indies when Ferdinand Magellan first colonised Philippines in 1521 and declared that all land in the Philippine archipelago belonged to the King of Spain. This was the beginning of the rule by Regalian Doctrine in Philippines that declared all public lands as property of the State, represented by the King of Spain. Accordingly, the Barangay (village) based ownership of land and natural resources were supplanted with *jura regalia*, placing the entire Philippine archipelago under the Spanish Crown.[547]

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544 Id.

545 Bennagen, Ponciano L., "Indigenous Attitudes Toward Land and Natural Resources of Tribal Filipinos", 31 National Council of Churches in the Philippines Newsletter (October – December 1991), pp. 4 - 9.

546 Gatmaytan, supra note 543 at p. 99.

547 The "Regalian Doctrine" or jura regalia is a Western legal concept that was first introduced by the Spaniards into the country through the Laws of the Indies and the Royal Cedulas. The Laws of the Indies, i.e., more specifically, Law 14, Title 12, Book 4 of the Novisima Recopilacion de Leyes de las Indias, set the policy of the Spanish Crown with respect to the Philippine Islands.

The 1893 Mortgage Law (*Ley Hipotecaria*) and the 1894 Maura Law reinforced Regalianism.[548] With the latter, the Spanish Crown claimed all untitled lands, thus declaring nearly two–thirds of the Philippine land area as public forestlands.[549] The Regalian Doctrine was formalised with a passage of the Maura Law in the year 1894, which required that all lands owned privately be registered with the Government and that titles would serve as the proof of private ownership of land in order to be excluded from the public domain.[550] However, since the forefathers of present day indigenous people of the Philippines were not subjugated and were at that time outside the control of Spanish colonial rule, they did not bother to apply for titles. Their lands were thus considered by the State as public lands and open for use by the State despite having been occupied and used by these people continuously for many years.

In 1896-97, a group of Filipinos led by Emilio Aguinaldo fought a war for independence, which ended in a truce.[551] In early 1898 the armed struggle resumed, and soon the Filipinos controlled most Spanish centres. In June 1898 Aguinaldo proclaimed the Republic of the Philippines and in December 1898, the U.S. and Spain signed a treaty and Spain sold Guam, Puerto Rico and the Philippines.[552]

The victory of the Philippine war of independence was however, aborted when Regalianism passed from the Spanish to the Americans under the 1898 Treaty of Paris when Spain ceded to the US Government "all rights, interests, and claims over the national territory of

548 The Mortgage Law sought to register and tax lands pursuant to the Royal Decree of 1880. The Royal Decree of 1894, or the "Maura Law," was partly an amendment of the Mortgage Law as well as the Laws of the Indies, as already amended by previous orders and decrees. This was the last Spanish land law promulgated in the Philippines. It required the "adjustment" or registration of all agricultural lands, otherwise the lands shall revert to the state.

549 The Spanish Mortgage Law provided for the systematic registration of titles and deeds as well as possessory claims. The law sought to register and tax lands pursuant to the Royal Decree of 1880. The Royal Decree of 1894, or the "Maura Law," was partly an amendment of the Mortgage Law as well as the Laws of the Indies, as already amended by previous orders and decrees. This was the last Spanish land law promulgated in the Philippines. It required the "adjustment" or registration of all agricultural lands, otherwise the lands shall revert to the state. See generally, Carino, Jacqueline K, supra note 540.

550 Carino, supra note 540.

551 Ileto, R. C., *"Philippine Wars and the Politics of Memory"*, POSITIONS: East Asia Cultures Critique (Spring 2005), pp. 215-235.

552 Id.

the Philippine islands".[553] Under the American rule, the idea that all land belonged to the State except for those with Torrens titles[554] was affirmed through the passage of the First Public Land Act of 1902.[555]

The continuation of the Regalian Doctrine was seen even after the independence of the Philippines. The Regalian doctrine was enshrined in the 1935 Constitution.[556] One of the fixed and dominating objectives of the 1935 Constitutional Convention was the nationalisation and conservation of the natural resources of the country. State ownership of natural resources was seen as a necessary starting point to secure recognition of the State's power to control their disposition, exploitation, development, or utilisation.[557]

The 1935 Constitution, in Section 1 of Article XIII on "Conservation and Utilisation of Natural Resources," provided as follows:

> *"All agricultural, timber, and mineral lands of the public domain, waters, minerals, coal, petroleum, and other mineral oils, all forces of potential energy, and other natural resources of the Philippines belong to the State, and their disposition, exploitation, development, or utilisation shall be limited to citizens of the Philippines, or to corporations or associations at least sixty per centum of the capital of which is owned by such citizens, subject to any existing right, grant, lease, or concession at the time of the inauguration of the Government established under this Constitution. Natural resources, with the exception of public agricultural land, shall not be alienated, and no license, concession, or lease for the exploitation, development, or utilisation of any of the natural resources shall be granted for a period exceeding twenty-five years, except as to water rights for irrigation,*

553 Commissioners from the United States and Spain met in Paris on October 1, 1898 to produce a treaty that would bring an end to the war after six months of hostilities. The American peace commission consisted of William R. Day, Senator Cushman K. Davis, Senator William P. Frye, Senator George Gray, and the Honourable Whitelaw Reid. The Spanish commission was headed by Don Eugenio Montero Rios, the President of the Senate. Jules Cambon, a French diplomat, also negotiated on Spain's behalf. U.S. ultimately paid Spain 20 million dollars for possession of the Philippines. The treaty was signed on December 10, 1898.

554 The principles and procedure of the Torrens system of registration was formulated by Sir Robert Torrens, who patterned it after the Merchant Shipping Acts in South Australia. The Torrens system requires that the Government Issue an official certificate of title attesting to the fact that the person named is the owner of the property described therein, subject to such liens and encumbrances as thereon noted or the law warrants or reserves.

555 In 1903, the United States colonial government, through the Philippine Commission, passed Act No. 926, the first Public Land Act. Act No. 926 was superseded in 1919 by Act 2874, the second Public Land Act. It was more comprehensive in scope but limited the exploitation of agricultural lands to Filipinos and Americans and citizens of other countries which gave Filipinos the same privileges. Act 2874 was amended in 1936 by Commonwealth Act No. 141. The Commonwealth Act No. 141 remains the present Public Land Law and it is essentially the same as Act 2874. The main difference between the two relates to the transitory provisions on the rights of American citizens and corporations during the Commonwealth period at par with Filipino citizens and corporations.

556 Aruego, J. (1937), The Framing of the Philippine Constitution (Manila University 1936), p. 592

557 Id. at pp. 600-601.

water supply, fisheries, or industrial uses other than the development of water power, in which cases beneficial use may be the measure and the limit of the grant."

The 1973 Constitution reiterated the Regalian doctrine in Section 8, Article XIV on the "National Economy and the Patrimony of the Nation," and provided that:

"All lands of the public domain, waters, minerals, coal, petroleum and other mineral oils, all forces of potential energy, fisheries, wildlife, and other natural resources of the Philippines belong to the State. With the exception of agricultural, industrial or commercial, residential, and resettlement lands of the public domain, natural resources shall not be alienated, and no license, concession, or lease for the exploration, development, exploitation, or utilisation of any of the natural resources shall be granted for a period exceeding twenty-five years, renewable for not more than twenty-five years, except as to water rights for irrigation, water supply, fisheries, or industrial uses other than the development of water power, in which cases beneficial use may be the measure and the limit of the grant."

The 1987 Constitution reaffirmed the Regalian doctrine in Section 2 of Article XII on "National Economy and Patrimony," and provided that:

"All lands of the public domain, waters, minerals, coal, petroleum, and other mineral oils, all forces of potential energy, fisheries, forests or timber, wildlife, flora and fauna, and other natural resources are owned by the State. With the exception of agricultural lands, all other natural resources shall not be alienated. The exploration, development and utilisation of natural resources shall be under the full control and supervision of the State. The State may directly undertake such activities or it may enter into co-production, joint venture, or production-sharing agreements with Filipino citizens, or corporations or associations at least sixty per centum of whose capital is owned by such citizens. Such agreements may be for a period not exceeding twenty-five years, renewable for not more than twenty-five years, and under such terms and conditions as may be provided by law. In cases of water rights for irrigation, water supply, fisheries, or industrial uses other than the development of water power, beneficial use may be the measure and limit of the grant."

To simply state, the above constitutional provisions provided that all lands of the public domain as well as all natural resources enumerated therein, whether on public or private land, belong to the State, thus effectively undermining the rights of the indigenous peoples.

III. State Recognition of the Land Rights of the Indigenous People

The 1987 Philippine Constitution formally recognised the existence of indigenous cultural communities and indigenous peoples for the first time and declared as a State policy the promotion of their rights within the framework of national unity and development.[558]

In 1997, in order to address the centuries-old neglect of the Philippine indigenous peoples, the Tenth Congress of the Philippines, passed and approved R.A. No. 8371, the Indigenous Peoples Rights Act (IPRA) of 1997.[559] The IPRA amalgamated the Philippine category of indigenous cultural communities (ICCs) with the international category of indigenous peoples (IPs)[560] and was heavily influenced by both the International Labour Organization (ILO) Convention 169[561] and the United Nations (UN) Draft Declaration on the Rights of Indigenous Peoples.[562] The IPRA introduced radical concepts into the Philippine legal system that appeared to collide with settled constitutional and jural precepts on State ownership of land and other natural resources. It is likely that the IPRA was enacted by Congress not only to fulfil the constitutional mandate of protecting the indigenous cultural communities' right to their ancestral land but, more importantly, to correct a grave historical injustice to our indigenous people.

The IPRA grants the ICCs/IPs several rights over their ancestral domains and ancestral lands. Section 7 (a) defines the ICCs/IPs the right of ownership over their ancestral domains which covers (a) lands, (b) bodies of water traditionally and actually occupied by the ICCs/IPs,

558 Section 22, Article II, 1987 Constitution.

559 The law was a consolidation of two Bills - Senate Bill No. 1728 and House Bill No. 9125. Senate Bill No. 1728 was a consolidation of four proposed measures referred to the Committees on Cultural Communities, Environment and Natural Resources, Ways and Means, as well as Finance. It sought to recognize the right of indigenous people to own and possess their ancestral land. The House Bill No. 9125 was based on the policy of preservation as mandated in the Constitution and emphasized that the rights vested in indigenous people to their land prior to the establishment of the Spanish and American regimes.

560 Interpellation of Senator Flavier on S.B. No. 1728, Deliberation on Second Reading, November 20, 1996, p. 20.

561 Convention Concerning Indigenous and Tribal Peoples in Independent Countries, adopted on June 27, 1989. The Convention is based on the Universal Declaration of Human Rights, the International Covenant on Economic, Social and Cultural Rights, the International Covenant on Civil and Political Rights, and many other international instruments on the prevention of discrimination. ILO Convention No. 169 revised the "Convention Concerning the Protection and Integration of Indigenous and Other Tribal and Semi-Tribal Populations in Independent Countries" (ILO No. 107) passed on June 26, 1957.

562 International Labour Organization, Guide to R.A. 8371, Coalition for IPs Rights and Ancestral Domains (Geneva: ILO, 1999), p. 3.

(c) sacred places, (d) traditional hunting and fishing grounds, and (e) all improvements made by them at any time within the domains. The right of ownership includes the following rights: (1) the right to develop lands and natural resources; (b) the right to stay in the territories; (c) the right to resettlement in case of displacement; (d) the right to regulate the entry of migrants; (e) the right to safe and clean air and water; (f) the right to claim parts of the ancestral domains as reservations; and (g) the right to resolve conflict in accordance with customary laws.

Section 8 governs their rights to ancestral lands. Unlike ownership over the ancestral domains, it gives the ICCs/IPs also the right to transfer the land or property rights to members of the same ICCs/IPs or non-members thereof. This is in keeping with the option given to ICCs/IPs to secure a Torrens title over the ancestral lands, but not to domains.

Although the aforesaid sections of the IPRA appear at least prima facie to recognize the rights of the ICCs/IPs to ancestral lands and ancestral domains, the Act also provide in Section 3 that "ancestral domains" are all areas generally belonging to ICCs/IPs comprising lands, inland waters, coastal areas, and natural resources therein, held under a claim of ownership, occupied or possessed by ICCs/IPs by themselves or through their ancestors, communally or individually since time immemorial, continuously to the present except when interrupted as a consequence of government projects or any other voluntary dealings entered into by government and private individuals/corporations, and which are necessary to ensure their economic, social and cultural welfare.[563] Further, it provides that "ancestral lands" are those occupied, possessed and utilised by individuals, families and clans who are members of the ICCs/IPs since time immemorial, by themselves or through their predecessors-in-interest, under claims of individual or traditional group ownership, continuously, to the present except when interrupted as a consequence of

563 Sec. 3 (a) of the IPRA.

government projects and other voluntary dealings entered into by government and private individuals/corporations.[564]

Furthermore, Section 56 of the IPRA which deals with existing property right regimes provide that the property rights within the ancestral domains already existing and/or vested upon effectively by the Act shall be recognised and respected. Thus, the right of indigenous peoples to their ancestral domains and lands and natural resources found therein is in fact limited by section 56 of IPRA. In the circumstances, exploitation of ancestral lands of the indigenous people continues even at present. For example, the mining companies licensed by the Government under the 1995 Mining Act continue to operate in these domains despite opposition by indigenous communities and organisations.[565]

Thus, the IPRA recognizes the possibility of the discontinuation of the rights of the ICCs/IPs on their ancestral lands and domains as a consequence government projects and other voluntary dealings entered into by government and private individuals/corporations. Section 7 of the IPRA however, provides some comfort to the ICCs/IPs concerning such discontinuation of their rights over ancestral domains by providing that the ICCs/IPs have a right to an informed and intelligent participation in the formulation and implementation of any project, government or private, that will affect or impact upon the ancestral domains and to receive just and fair compensation for any damages which they may sustain as a result of the project; and the right to effective measures by the Government to prevent any interference with, alienation and encroachment upon these rights.[566] No such provision is made in Section 8 concerning ancestral lands.

564 Sec. 3 (b) of the IPRA.

565 See generally, United Nations Commission on Human Rights (UNHCHR), Report of the Special Rapporteur on the Situation of Human Rights and Fundamental Freedoms of Indigenous People, E/CN.4/2003/90/Add.3 (GENVA: UNHCHR , March 5, 2003).

566 Sec. 7(b) of the IPRA.

Thus, it is clear that the right of ICCs/IPs over their ancestral domains and their right to develop lands and natural resources within the ancestral domains as guaranteed by the IPRA does not necessarily deprive the State of ownership over the natural resources and control and supervision in their development and exploitation. Thus, the IPRA does not undermine the Regalian doctrine on the ownership, management and utilisation of natural resources as declared in Section 2, Article XII of the 1987 Constitution of the Philippines.

Although, it was Section 3 of the IPRA that first statutorily recognised the concept of native title to land of the indigenous communities, this concept came to limelight in the case of *Cariño v. Insular Government* in 1909.[567] The case established that the concept of private land title enjoyed by the indigenous communities survived irrespective of any royal grant from the State giving legal title to land. The facts of the case are discussed below.

IV. Cariño v. Insular Government

In 1903, Don Mateo Cariño, an Ibaloi tribe member, sought to register with the Land Registration Court, 146 hectares of land in Baguio Municipality in the Benguet Province. He alleged that this land had been possessed and occupied by his ancestors since time immemorial and that he inherited the land in accordance with Igorot custom. He tried to have the land adjusted under the Spanish land laws. However, he had no document issued by the Spanish Crown, as it was the policy of the Spanish colonial rulers not to issue title of land to any tribal members.

567 41 Phil. 935 (1909), 212 U.S. 449, 53 L.Ed. 594

In 1901, Cariño obtained a possessory title to the land under the Spanish Mortgage Law.[568] The North American Colonial Government, however, ignored his possessory title and built a public road on the land prompting him to seek a Torrens title to his property in the Land Registration Court. While his petition was pending, a U.S. military reservation was proclaimed over his land and shortly thereafter, a military detachment was detailed on the property with orders to keep cattle and trespassers, including Cariño, off the land.

In 1904, the Land Registration Court granted Cariño's application for absolute ownership to the land. Both the Government of the Philippines and the U.S. Government appealed to the C.F.I. of Benguet and was able to obtain a reversal of the decision of the land registration court and a dismissal of Cariño's application. Later, the Philippine Supreme Court affirmed the decision of the C.F.I.[569] Cariño, and then took the case to the U.S. Supreme Court.

In a unanimous decision written by Justice Oliver Wendell Holmes, the U.S. Supreme Court held *inter alia* that:

"It is true that Spain, in its earlier decrees, embodied the universal feudal theory that all lands were held from the Crown, and perhaps the general attitude of conquering nations toward people not recognised as entitled to the treatment accorded to those in the same zone of civilisation with themselves. It is true, also, that in legal theory, sovereignty is absolute, and that, as against foreign nations, the United States may assert, as Spain asserted, absolute power. But it does not follow that, as against the inhabitants of the Philippines, the United States asserts that Spain had such power. When theory is left on one side, sovereignty is a question of strength, and may vary in degree. How far a new sovereign shall insist upon the theoretical relation of the subjects to the head in the past, and how far it shall recognize actual facts, are matters for it to decide."[570]

"The acquisition of the Philippines was not like the settlement of the white race in the United States. Whatever consideration may have been shown to the North American Indians, the dominant purpose of the whites in America was to occupy land. It is obvious that, however stated, the reason for our taking over the Philippines was different. No one, we suppose, would deny that, so far as consistent with paramount necessities, our first

568 Maura Law or the Royal Decree of Feb. 13, 1894.

569 7 Phil. 132 [1906].

570 Cariño v. Insular Government, supra note 567, at p. 939.

object in the internal administration of the islands is to do justice to the natives, not to exploit their country for private gain. By the Organic Act of July 1, 1902, chapter 1369, section 12 (32 Statutes at Large, 691), all the property and rights acquired there by the United States are to be administered 'for the benefit of the inhabitants thereof.' It is reasonable to suppose that the attitude thus assumed by the United States with regard to what was unquestionably its own is also its attitude in deciding what it will claim for its own. The same statute made a bill of rights, embodying the safeguards of the Constitution, and, like the Constitution, extends those safeguards to all. It provides that 'no law shall be enacted in said islands which shall deprive any person of life, liberty, or property without due process of law, or deny to any person therein the equal protection of the laws.' In the light of the declaration that we have quoted from section 12, it is hard to believe that the United States was ready to declare in the next breath that "any person" did not embrace the inhabitants of Benguet, or that it meant by "property" only that which had become such by ceremonies of which presumably a large part of the inhabitants never had heard, and that it proposed to treat as public land what they, by native custom and by long association,-- of the profoundest factors in human thought, regarded as their own."[571]

The Court held further that:

"[E]very presumption is and ought to be against the government in a case like the present. It might, perhaps, be proper and sufficient to say that when, as far back as testimony or memory goes, the land has been held by individuals under a claim of private ownership, it will be presumed to have been held in the same way from before the Spanish conquest, and never to have been public land. Certainly in a case like this, if there is doubt or ambiguity in the Spanish law, we ought to give the applicant the benefit of the doubt."[572]

The court thus laid down the presumption of a certain title held (1) as far back as testimony or memory went and, (2) under a claim of private ownership. Land held by this title is presumed to "never have been public land." Thus, the court ruled in favour of Cariño and ordered the registration of the 148 hectares in Baguio Municipality in his name.[573]

As recognised by the IPRA and in the case of <u>Cariño v. Insular Government</u>, The right of ownership and possession of the ICCs/IPs to their ancestral domains is held under the indigenous concept of ownership. This concept maintains the view that ancestral domains are the ICCs/IPs private but community property. It is private simply because it is not part of the public domain.

571 Id. at p. 940.

572 Id. at p. 941.

573 Certificate of Title No. 2 covering the 148 hectares of Baguio Municipality was issued not in the name of Cariño who died on June 6, 1908, but to his lawyers John Hausserman and Charles Cohn and his attorney-in-fact Metcalf Clarke. Hausserman, Cohn and Clarke sold the land to the U.S. Government in a Deed of Quitclaim-Richel B. Langit, Igorot Descendants Claim Rights to Camp John Hay, Manila Times, 12th January 1998 at 1.

But its private character ends there. The ancestral domain is owned in common by the ICCs/IPs and not by one particular person.[574]

Thus, the communal rights to the land are held not only by the present possessors of the land but extend to all generations of the ICCs/IPs, past, present and future, to the domain. This is the reason why the ancestral domain must be kept within the ICCs/IPs them selves. The domain cannot be transferred, sold or conveyed to other persons. It belongs to the ICCs/IPs as a community. However, it should be noted that, despite the above referenced victory in the Supreme Court of America, the Carino family of the Ibaloy tribe in Baguio-Benguet (Luzon) is still awaiting the restitution of its ancestral domain claim almost after hundred years since the conclusion of the legal action.[575]

V. The Continuing Violation of Indigenous Rights

The issue is whether the provisions of the IPRA provides necessary protection over ancestral property to the indigenous community in the Philippines given that, the provisions in the IPRA are necessarily undermined by the primary statutory law of the islands, i.e. the constitution. Despite the judicial and later statutory recognition of the rights of indigenous people to their community lands, the various lacunas in the law which were discussed above have provided ample room for the continuation of the violation of rights of the indigenous people.

For example, in Cordillera, the homeland of the Igorots, large dams have been constructed along the Agno river, namely the Ambuklao dam built from 1952-56 and the Binga Dam in 1956-60, the two dams submerging in total an area of 650 hectares of precious farmlands

574 Sec. 55, IPRA provides: "Subject to Section 56 hereof, areas within the ancestral domains, whether delineated or not, shall be presumed to be communally held: provided, that communal rights under this Act shall not be construed as co-ownership as provided in Republic Act No. 386, otherwise known as the New Civil Code."

575 See supra note 565.

and displacing approximately 300 Ibaloi families. [576] To date, the victims of dam construction are not yet fully compensated from the destruction of their land and properties.[577] Ambuklao dam is now un-operational due to siltation problem of 18 kilometres long, but the dam continues to submerge more rice fields and croplands in Bokod, Benguet.[578] Binga is likewise heavily silted, and its partial operation is dependent on the continuing dredging work of the reservoir.[579]

VI. San Roque Dam Project

The latest threat to the land and livelihoods of the Ibaloi people comes from Southeast Asia's largest private hydropower project, namely the San Roque Dam Project, which is being built by US independent power producer Sithe Energies and the Japanese Marubeni Corporation. The US$ 1.19 billion, 345 MW San Roque Project is being celebrated by the hydropower industry as a major success story in private sector financing.[580] No other private hydro project of its size has been able to secure the necessary financing, particularly in high-risk, economically embattled Southeast Asia.

If and when completed, San Roque would be the tallest dam at 200 meters in Asia and will provide power to the burgeoning mining, agribusiness, export industry and tourism centres planned for North-western Luzon.[581] The Government also claims that the project will irrigate 87,000 hectares of farmland, reduce the perennial flooding of at least 16 downstream towns

576 Carling, J., Chairperson, Cordillera Peoples Alliance-Philippines, 'Indigenous Peoples, the Environment and Human Rights in the Philippines: the Cordillera Experience' (October 2001). Online: http://www.asiasource.org/asip/carling.cfm/#peoples

577 Id.

578 Carling, J., Indigenous Peoples, the Environment and Human Rights in the Philippines: the Cordillera Experience, Asia Social Issues Program (October 2001). Online: http://www.asiasource.org/asip/carling.cfm

579 Id.

580 San Roque is one of 22 large dams planned for the Cordillera region, and is the first one to be built in the region as part of a wide-ranging development plan of former President Fidel Ramos. The dam site is located on the Agno River in Pangasinan Province, but reservoir inundation will occur in Itogon Province, home of the Ibaloi people.

581 International Rivers Network, World Rivers Review (April 1999).

during the rainy season and provide clean water for communities in Northern Luzon.[582] Yet, for the Ibaloi some of whom have already been displaced once before by upstream hydropower projects there is little to rejoice about.

In 1997 the National Power Corporation (NPC) of Philippines gave the San Roque Power Corporation (SRPC) the rights to build, operate and maintain the project as a BOT concession for a period of 25 years. The SRPC is owned by a Japanese trading company, Marubeni (41%); Sithe Philippines Holdings, Ltd, a subsidiary of US energy company Sithe Energies, Inc. (51%); and a Japanese utility company, Kansai Electric (7.5%). In April 1998, US construction company Raytheon won a US$ 700 million sub-contract to design and build the facility. Preparation of the site began in 1998, and construction is slated for completion in 2004.[583]

According to the project authorities' say 49% of the total cost of US$ 1.9 billion will go to the power component of the project, 9.7% to the water quality and maintenance system; and 1% to flood control.[584] In October 1998, the Export-Import Bank of Japan (JEXIM) approved a US$ 302 million loan to the private sector developers to finance the power component of the project. Funding for the non-power components was financed by a US$ 400 million loan the Government of the Philippines negotiated with JEXIM. Other financing is expected to come from a consortium of Japanese commercial banks and equity provided by the project sponsors.[585]

The project is being challenged by the affected indigenous people and several other groups supporting their cause on several grounds. The main ground being that, approximately 700

582 Id.

583 Id.

584 Id.

585 Id.

families are required to relocate before the project is completed.[586] It is also said that the San Roque Dam will adversely affect the livelihood sources of around 20,000 people of Itogon, Benguet. Further, it is estimated that about 100 hectares of productive rice fields will be submerged by the reservoir.[587]

An independent report claim that, homes, terraced rice fields, orchards, pasture lands, gardens and burial grounds of the Ibalois close to the Agno River would eventually be inundated by the rising waters.[588] The Government claims however, that only three households will be affected in this area, yet independent studies show that at least 343 households will be impacted by the reservoir.[589] Furthermore, while the Government claims that the project will control the occurrence of floods on the Agno River, the project's Environmental Impact Assessment (EIA) admits, "the reservoir is vulnerable to mismanagement with respect to flood routing." The EIA states that this may result in "catastrophic flooding" in some downstream areas.[590]

Going by the aforesaid report, this project that is being funded by the Japan Bank for International Cooperation (JBIC) under an onerous Power Purchase Agreement (PPA) is bound to cause environmental disasters such as massive flooding in the upstream and lower stream of the project site. Further, according to the said report, the project is likely to create a big reservoir containing toxic mine waste that would result in water pollution and possible destruction of the dam itself should a sufficiently strong earthquake occur.[591]

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586 Id.

587 Id.

588 Shen, D., *"Three Gorges Dam Swamped by Problems"*, World Rivers Review (April 1999), p. 5.

589 Id.

590 Id.

591 Id.

The project is also be criticised on the ground of its high cost. The Power Purchase Agreement (PPA) requires that the developer San Roque Power Corporation (SRPC) is granted a payment of US$ 400 million during the construction period in addition to guaranteeing purchase of all electricity produced.[592] Further, it requires the Government to guarantees "Capacity Fee" and "Operating Fee" payments, even if electricity is not generated for lack of water, at a minimum value in the first 12 years equivalent to US$ 10 million per month.[593] Thus, it is clear that the cost of power from San Roque is hugely inflated and that the SRPC stands to gain massive profits from the project, whether or not it successfully produces power. A review, conducted by Dr. Wayne White of Foresight Associates in the USA, supports the above criticism.[594] It shows that the National Power Corporation (NPC) will be paying SRPC between 13 to 21 pesos (US$ 0.32 to 0.51) per kilowatt hour of electricity purchased and that NPC has agreed to pay over 400 million pesos (US$ 10 million) per month to the SRPC regardless of whether there is sufficient water available to generate power.[595]

The San Roque project, although a type of BOT arrangement, does not meet the typical description of project financing, and therefore is not subject to market forces which would attest to its economic viability. The developer is not taking the financial risk for the project. Under the PPA, a substantial amount of risk is borne by the Government, not the developer. Thus, the non-recourse or limited recourse nature of the project financing is not present. The advance payment by the Government to the SRPC of US$ 400 million directly pays for a large portion of the construction cost. Earnings are not exclusively from fees earned from project performance, but rather from the funding for San Roque which include the contribution by the Government of

592 Imhof, A., *"San Roque Dam Power Purchase Agreement a Bad Deal"*, World Rivers Review (June 2000).

593 Id.

594 Dr. White, W. C., A Review of the Power Purchase Agreement Between the Republic of the Philippines National Power Corporation and a Consortium Constituting the San Roque Power Corporation Concerning the Construction and Operation of the San Roque Multipurpose Project (Foresight Associates, 2000) The review is available online: http://www.irn.org/programs/sanroque/000504.report.html.

595 Id.

US$ 400 million, as well as electrical tariffs and capital recovery payments in amounts set in the contract.[596]

Further, despite private sector participation, the project is a public subsidised construction contract that will also further compensate the developer during project life even in the event of low generation and/or absence of a market for the produced power. Not only does the private sector participation not demonstrate economic viability, the reliance on subsidy and the non-market based rates suggest that the project is not economically feasible in its own right.[597]

In addition to the San Roque Dam, it is said that in the Cordillera region, at least two more large dams will start construction upon the investment of foreign companies. These are the Agbulu Dam (365 megawatts) in Kabugao, Apayao and, the Matuno Dam (250 megawatts) in the border of Asipulo, Ifugao and Ambaguio, Nueva Vizcaya. A feasibility study of the National Power Corporation (NPC) has shown a potential generation of 4,259 MW from the damming of the said Cordillera Rivers. If no measures are taken to address the effects such development might have on the indigenous communities, it is likely that these developments too will adversely affect the indigenous people in the Philippines.

In his report submitted to the Commission on Human Rights in March 2003, Mr. Rodolfo Stavenhagen, the Special Rapporteur on the situation of human rights and fundamental freedoms of indigenous people, sites several more cases involving violation of or attempted violation of the

596 Id.

597 Article 8.5 of the agreement provides that "NPC will be required to pay the full amount of the capacity fees....whether or not any energy is dispatched" if the reason for the downtime is "insufficiency of water." Appendix B of this review calculates the fees due per month even if no power is generated, under the terms and formulas given in the Eight Schedule of the PPA. The result is a payment equivalent to US$10 million, over $ 400 million Pesos, per month.

rights of indigenous people in the Philippines in the light of various development projects.[598] Some of these cases are as follows:

i. The rejection by the Kankaney people in Bakun Benguet (Luzon) of a proposed mini-hydro project involving the construction of a tunnel passing under their territory, to which they did not give their prior consent and which they believe will adversely affect them by diverting river water needed for their traditional agricultural activities.

ii. The eviction in early 1990s around 67 T'Boli families of Sitio Datal Bonlangan in Mindanao from their ancestral domain by a private company, which took over their land under a Government-approved contract to fell trees in the forest and turn it into a coffee plantation. While eventually some of the evicted families returned to their village, the community is still claiming access to its land and resolution of the long-standing conflict.

iii. In the Baguio City area an area known as Happy Hollow, a part of the old John Hay American military camp is being designed to become a tourist destination. Nine Ibaloy clans demand that 250 hectares of their ancestral domain be segregated from the location of the proposed tourist destination as they wish to keep full control of their traditional land rather than accept a Government plan to subdivide it into individual home lots.

iv. For over 10 years 256 Tagbanua families on Calauit Island (Palawan, Visayas) have been reclaiming their ancestral lands, which by presidential decree were turned into a sanctuary of African animals. The families had to suffer relocation under stress and duress. In 1995, they even appealed to the United Nations

598 See supra note 565 at pp. 14 – 15.

Centre for Human Rights. Except for a letter of acknowledgement, the complainants have not received any relief.

v. The Subanon tribe of Zamboanga peninsula (Mindanao) have been forced over several decades to migrate into the mountains and forests, pushed by an increasing number of settlers from other areas and Government approved development projects, including commercial tree plantations on the Subanon's ancient lands, the conversion of forests into pastures, and mining. The resistance of the Subanon led to serious conflict, violence and human rights violations of the indigenous communities involving the Philippine Army, which led to attempts at negotiating the differences between the parties. At the present time, the Subanon people demand the full recognition of their ancestral land rights that will allow them to contribute to the process of defining a development that is people-centred.

vi. There have also been reports of displacement of indigenous peoples in San Luis, Bukidnon. The Manobo people, ancestral owners of tracts of land in San Luis, have reported that their land has been forcibly converted into large-scale agribusiness ventures, whose ownership was ultimately transferred to non-indigenous lowlanders. They have been reclaiming their traditional land through legal means since the 1980s, but to no avail.

vii. In Surigao del Norte, one of the provinces of the Caraga region, numerous families have been displaced from their homes and fields, and their agricultural lands were destroyed as a result of open-pit mining operations in Taganito and Tinabigan. Thirty families of the Mamanwa tribe are still living under a concrete bridge, exposed to the harsh climate and the pollution. Despite their appeal to NCIP, their demands were not met.

According to the Philippine's National Power Corporation's power development program, the Philippines Government is planning to implement several hydro power dam projects in the coming years. The projects planned to commence during 2004-2005 are listed in the following table.[599] Most of these dam sites are located within indigenous peoples' territories. Thus, it is likely that the indigenous community will protest and may even initiate legal action to prevent the projects from proceeding forward if the projects are likely to affect their native lands. In the premises it is clear that in the Philippines, the battle between indigenous rights and the development needs will continue for sometime.

Table 6.1 Hydro Power Projects Planned for 2004-2005 in the Philippines

Project	Capacity	Year	Location
Pasil B/C	42 MW	2004-2005 Apayao	Batong Buhay, Kalinga-
Amburayan	93 MW	2004	Kapangan, Benguet
San Roque	390 MW	2005	San Manuel, Pangasinan
Kalayaan 3/4	300 MW	2005	Bay, Laguna
Kanan B1	112 MW	2005	Infanta, Quezon
Villasiga	29 MW	2005	Panay, Antique
Bulanog Batang	150 MW	2004	Talakag, Bukidnon
Pulangi	300 MW	2005	P. Roxas, North Cotabato
Pugo D/B/A	44 MW	2005	Jabonga, Agusan

599 National Power Corporation, Power Development Program 1993-2003, (Quezon City, Philippines: NPC)

b. The Case of the Indigenous Peoples of Sarawak, Malaysia

I. The Affected People

In Malaysia, there are numerous groups of indigenous peoples. They form approximately 2.1 million or 10.2% of the total population.[600] They are not a homogenous group. There are at least 95 subgroups, each with their own distinct language and culture.[601] However, they are all marginalised socio-economically and culturally. Sarawak region in Malaysia is the home for majority of these indigenous peoples. Several groups, namely, the Kayan, Kenyah, Kajang, Ukit and Penan ethnic groups are living in this region.[602]

II. The rights of the Indigenous People of Sarawak

There are three laws governing the indigenous people's rights to their land, namely, the Land Code,[603] the Forest Ordinance[604] and, the native customary rights (NCR Law).[605] Under the Sarawak Land Code, lands are classified as follows:

i. Mixed Zone Land (8%) - is the most valuable land and may be purchased, sold or owned by any race in Sarawak;

ii. Natives Area Land (7%) - land formerly held by the natives under Customary Right to which titles have been granted to claimants;

iii. Native Customary Land (22%);

600 United Nations Development Programme, "Malaysia Achieving the country Development Goals" (2005). Available online: http://www.epu.jpm.my/New%20Folder/publication/UNDP1.pdf)

601 Id.

602 In Sarawak there are 26 different ethnic groups making up 70% of the state's 1.7 million inhabitants (Source: Sarawak State Government Website - http://www.sarawak.gov.my/contents/population/population.shtml). The total land area of Sarawak is 12.3m hectares which is roughly 2.3 times the size of Holland.

603 Sarawak Land Code of 1958.

405 Sarawak Forest Policy and Forests Ordinance of 1953.

605 For more details on the native customary rights please see, The European Commission - United Nations Development Program, 'Small Grants Programme for Operations to Promote Tropical Forests (EC UNDP SGP PTF), Country Guideline Paper 2004-2007- Malaysia. Available online: http://www.sgpptf.org/docs/CGPMalaysia.pdf

iv. Reserved Land (16%); and

v. Interior Area Land (47%).

Under the Sarawak Land Code, the land in which native customary rights (NCR) had lawfully been created prior to 1st January 1958 is termed Native Customary Land (NCL), thus, recognising the concept of customary title to lands occupied by the indigenous groups. However, Section 5(3) of the Land Code states that "any native customary rights may be extinguished by direction issued by the Minister" for "public purposes" or to facilitate alienation of land that under Section 15A must be for the purpose of any undertaking that would, in the opinion of the Minister, be for the benefit of the State. In the premises, in effect, as of 1958, NCL became a part of State land, and native customary title became something that is easily disposable. In other words, the indigenous people lost bona fide control over their land.

III. The Bakum Hydroelectric (Dam) Project

The Government of Malaysia implemented a hydroelectric project for the building of a dam in the Sarawak region, namely, the Bakum Dam Project, which comprises of the construction of a 2,400 MW hydroelectric dam, the transmission of its electricity and, the building of related infrastructure including, access roads.[606] The dam is being built on the Balui River, some 37 kilometres upstream of Belaga in Sarawak.[607]

Although the Government has claimed that the dam is needed to meet the growing demand for electricity in Malaysia, the critics argue that most of the growth in demand for electricity is not in the region of Sarawak in east Malaysia where the dam is being built, but in the

606 Friends of the Earth Organization, supra note 369.

607 Id.

peninsular, and thus, the land rights of the indigenous communities of Sarawak should not be compromised.[608]

The project is strongly opposed by the indigenous communities of Sarawak. In addition, the opposition Democratic Action Party (DAP), the Coalition of Concerned NGOs on Bakun (Gabungan), a coalition of over 40 Malaysian NGOs, the World Wildlife Fund (WWF) and the Environmental Protection Society of Malaysia (EPSM) are key organisations which oppose the project.[609]

The opposition to the project is based on several grounds. The basis for the strongest challenge is the expected forced relocation of approximately 10,000 indigenous people, mainly of the Kayan, Kenyah, Kajang, Ukit and Penan ethnic groups. Some of the other key criticisms have been already discussed in Chapter five of this thesis.[610]

IV. Kajing Tubek & Others v. Ekran Bhd & Four Others

The various allegations levelled against the Bakun Dam Project led to the famous legal action against the project, namely, the case of *Kajing Tubek & Others v. Ekran Bhd & Four Others* [611] (popularly known as the Bakun Dam case). In this case, hearing an application made by the party opposed to the project, the High Court of Malaysia found that the Malaysian Government, together with Ekran and the Sarawak State Government had subverted the rights of the indigenous peoples by denying them the opportunity to comment on the environmental impact assessment (EIA) of the project before granting approval. However, this ruling was dismissed by

608 See Allison, T., supra note 372. Also see, Chapter 5.2.1 of this Thesis for further details on the project.

609 Friends of the Earth Organization, supra note 369.

610 See Chapter 5.2.1.

611 *Kajing Tubek & Ors v. Ekran Bhd & 4 Ors* [1996] 2 AMR 2441

the authorities as 'technical'. The Court of Appeal in Malaysia later revised the High Court decision in 1997.[612] The facts of the case are as follows:

The plaintiffs (natives affected by this project), who were residents of longhouses in the Belaga district in Sarawak applied for a declaration that the project developer, Ekran Bhd must comply with Section 34A of the Environmental Quality Act (EQA)[613] and the guidelines made there under before carrying out any construction work.

The project developer was required under the EQA and the Natural Resources and Environment (Amendment) Ordinance of Sarawak[614] to submit EIA reports detailing the possible impacts and the mitigating measures. The Natural Resources and Environment Board (NREB) of Sarawak and the Department of Environment, Ministry of Science, Technology and Environment, were the responsible authorities for approving the EIA reports and in ensuring that the project promoter complied with any mitigation measures as stipulated in the EIA reports under the Natural Resources and Environment (Amendment) Ordinance. The plaintiffs alleged that, although the EIA was published, not only did it specifically exclude assessment of the impact on the communities, but the assessment of the project generally was full of omissions, mistakes and questionable assumptions.

The plaintiffs argued further that, in matters relating to land development, the attention should be focused on Section 34A of the EQA, under which the Environmental Quality (Prescribed Activities) (EIA) Order 1987 was made. It was argued that the Act required any person intending to carry out any "prescribed activity" must submit an environmental impact assessment (EIA) report to the Director General of Environmental Quality (DGEQ) and that the

612 *Ketua Pengarah Jabatan Alam Sekitar & Anor v Kajing Tubek & 2 others*. [1997] 3 AMR 2521.

613 Environmental Quality Act of 1974.

614 Natural Resources and Environment (Amendment) Ordinance, 1993.

report must be in accordance with the guidelines prescribed by the DGEQ and shall contain "an assessment of the impact" such activity will have on the environment and the "proposed measures" to be taken to prevent, reduce, or control any adverse impact.[615] The DGEQ had the power either to approve the report with or without conditions or, to reject it. No prescribed activity could be carried out until the EIA report had been approved. Any person who contravenes this section was guilty of an offence punishable by fine and/or imprisonment.[616]

The plaintiffs' applied for declarations that the Environmental Quality (Prescribed Activities) (Environmental Impact Assessment) (Amendment) Order 1995 ("Amendment Order"), a delegated legislation made under the EQA which sought to exclude dams from this federal law was invalid as it was done retrospectively. They argued that they were entitled to a copy of the environment impact assessment ("EIA") report on the project and, for this reason, they had been deprived of an opportunity to make representations in respect of the impact which the project would have upon the environment before the decision to implement the project was made. The plaintiffs' contended that the project would adversely affect their longhouses; destroy their ancestral sites as well as the lands and forests from which they obtained shelter, livelihood, food and, medicine.[617]

Granting the declaration, the High Court Judge, James Foong J, held that *"the guidelines become a subsidiary piece of legislation when published by the Director-General"*. The learned Judge held that public participation in the form of obtaining a copy of the EIA report, commenting thereto and making representation is *"explicitly provided and in fact*

615 Section 34(2), Environmental Quality Act 1974.

616 Id.

617 The Federal EIA laws applied throughout Malaysia until 1 September 1994. Effective that date, they do not so apply in Sarawak State for a range of activities now governed by the Sarawak EIA Order 1994, to which the Federal Government concurred by gazetting the EIA Amendment Order 1995 which with retrospective effect "disprescribed" from the ambit of the section 34A of the EQA those activities governed by the Sarawak EIA Order 1994. Under the Sarawak provisions public participation is not mandatory and is only a privilege accorded by the project proponents and that too, only at the Detailed EIA stage.

encouraged".[618] Further, it was held that this procedure must be complied with before the Review Panel makes its recommendations to the DGEQ, who in turn must take into consideration these recommendations before arriving at a decision. The Judge added that the compliance with the procedure "is mandatory" and any decision of the DGEQ made contrary to this procedure "should be rejected".[619]

However, on appeal, the Court of Appeal overturned the decision on the grounds that respondents had no *locus standi* to move the court for the declaratory relief. The Court of Appeal also held that constitutionally, as the development involved land and river within the State of Sarawak, the expression 'environment' by reason of item 2(a) of List II and item 13 of List IIIA of Schedule 9 to the Federal Constitution would lie wholly within the legislative and constitutional province of the State of Sarawak. Therefore, it was held that the State of Sarawak possessed exclusive jurisdiction to exclude the operation of the federal law, that is, the Amendment Order. The court also ruled that, even though the complaints advanced by the respondents amounted to deprivation of their lives under Article 5(1) of the Federal Constitution, such deprivation was in accordance with the law, that is, the Land Code (Sarawak Cap 81) and therefore, they had suffered no injury and there was thus, no necessity for a remedy.[620]

The court also held that the 1987 Order,[621] for constitutional reasons, did not apply to Sarawak. The relevant statute regulating the use of the environment relative to the Bakun project is the Natural Resources Ordinance of Sarawak. As the EQA does not apply to the Bakun project, the Court of Appeal held that the respondents' (the plaintiffs at the High Court) did not have any vested interest under the Act and therefore no ability to bring any suit under the Act. In the

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618 *Kajing Tubek & Ors v. Ekran Bhd & 4 Ors* [1996] 2 AMR 2441.

619 Id.

620 Id.

621 Environmental Quality (Prescribed Activities) (EIA) Order 1987.

circumstances, the Court of Appeal also held that there was no requirement under the law for the respondents to be supplied with a copy of the EIA report. The Court said that the right to the report on payment of the cost of the report is a conditional right which must be exercised by the person concerned, which was not done in this case.[622]

Interestingly, in a latter case, Gopal Sri Ram JCA stated that *"it is now settled beyond argument in our jurisdiction that deprivation of livelihood may amount to deprivation of life itself and that state action which produces such a consequence may be impugned on well-established grounds"*.[623] Going by this decision, the respondents in the Bakun Dam Case could not have been denied the legal standing to sue if their fundamental rights under Article 5(1) have been infringed. However, the court held that the main reason for denying the respondents *locus standi* in Bakun Dam case was because a substantial number of persons whose rights were also affected by the Bakun project were not before the court.

Surprisingly, the decision in the Bakun Dam case and the above decision of Gopal Sri Ram JCA seem to contradict an earlier decision in *Jok Jau Evong & Ors v Marabong Lumber Sdn Bhd & Or.,* where it was held that three members of the Kayang community were entitled to initiate a representative action despite half of the Kayan community disagreeing with the filing of the suit.[624] This in effect means that the legal principles relating to some members of an ethnic or an indigenous community initiating legal action to protect their rights in the absence of consensus among the entire affected group is not well established. Further, it shows that many can either wilfully or through apathy stultify the action taken by the more vigilant or alert members of the community.[625]

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622 Id.

623 *Kerajaan Negeri Johor & Anor v Adong bin Kuwau & Ors* [1998] 2 MLJ 158, 164.

624 *Jok Jau Evong & Ors v Marabong Lumber Sdn Bhd & Ors* [1990] 3 MLJ 427.

625 Nijar, G.S., *"The Bakun Dam Case: A Critique"*, 3 MLJ (1997), ccxix.

V. Continuing Violation of the Rights of the People of Sarawak

From what is set out above and what was discussed earlier in Chapter 5.2.1, it is clear that the Bakun project faced public and political criticism on several grounds and that, serious questions had been raised concerning the viability of the Project from economic, ecological, technical, social and, cultural perspectives. Despite these objections to the project, the Government of Malaysia has given the green light for the project to continue. Further, in order to ensure that future objections to the project will be minimal, feasibility studies and reports commissioned by the Government on the Bakun project have been classified under the Official Secrets Act, meaning that it is now a criminal offence for anyone to even have, let alone use, the information contained therein.[626]

The indigenous communities affected by the Bakun project have failed to receive any meaningful redress from the courts as is evident from the Bakun Dam case. Given the various human, environmental, as well as economic concerns, it is highly doubtful that the Bakun Dam project could be classified as project contributing to sustainable development. There are allegations that as a result of the project, the rights of the indigenous communities continue to be violated. This might result in future conflicts and more legal actions. Thus, it is important that the State as well as the investors give serious consideration to the pleas of the affected people. Unfortunately, such action does not seem to be forthcoming. The following are some examples of continuing violation of the rights of indigenous peoples in Sarawak:

i. <u>Acquisition of Land for Bakun Dam</u>: According to the Bakun Region People's Committee (BRPC) three main issues arising from the Bakun Hydro-Electric Project have so far not been fully resolved. In relation to resettlement matters,

626 See supra note 388.

they are unhappy with the size of the land and the area of the resettlement area as it will not be able to support their means of survival. It appears that the offer may be as low as 3 acres per family, lower than the earlier offer of 7 acres and significantly lower than the demanded size of 30 acres per family. The terms and demands that the indigenous peoples have submitted to the Government through the Bakun Development Committee have not yet elicited any response. Full resettlement details have not been disclosed resulting in worry over the uncertainties of the future.[627]

ii. Encroachment of land by loggers and the abuse of police power in Ulu Baram: Indigenous peoples from Ulu Baram allege that indiscriminate logging by Government authorized developers since 1987 in their native lands is destroying their livelihood.[628]

iii. Encroachment of land for oil palm plantation at Bukit Limau: Around 35 families with an estimated population of 300 people involving 500 hectares of land are affected by the oil palm plantation scheme managed by Bukit Limau Estate. Like their neighbours at Sungai Nat, the villagers have been there since the rule of Rajah Brooke when their NCR land was first recognised. Their land has been encroached upon for some years, first by the Land Custody and Development Authority (LCDA), without their knowledge, and secondly since 1992 through land clearance for plantations.[629]

iv. Opening of Rumah Umping land for an oil palm plantation: The residents of Rumah Umping are still demanding recognition of their NCR Land. They have been resisting efforts by the LCDA to open their customary land for an oil palm

627 Sources: Sahabat Alam Malaysia Press Releases, 3 July 2001, A Letter from Bakun Region People's Committee to the Deputy Prime Minister; The World Rainforest Movement. Online: http://www.wrm.org; and International Rivers Network (www.irn.org)

628 Source: Aliran Kesedaran Negara (“ALIRAN”.) (National Consciousness Movement). Online: http://www.aliran.com. ALIRAN is a reform movement dedicated to Justice, Freedom, and Solidarity and is listed on the roster of the Economic and Social Council of the United Nations.

629 Id.

plantation scheme since 1992. They have been alleging that their land was being taken by the LCDA without their permission.[630]

c. The Case of the Indigenous Amungme People of Irian Jaya

I. Historical Aspects

Indonesia, the fifth largest country in the world was discovered by the Dutch at the end of the sixteenth century. Starting early 1600s Indonesia was dominated by the Dutch East Indies Company, a private concern, for nearly 200 years. In 1798, authority over Indonesia was transferred to the Netherlands. The Dutch retained dominion over the country until 1941, at which time the Japanese moved in during the course of World War II. By 1945 Japan was defeated in Indonesia and Achmed Sukarno and Mohammad Hatta rose to become the President and the Vice President of the newly independent Indonesia. However, within a month of the Sukarno/Hatta proclamation of independence, British army units began landing in Jakarta to help Dutch restore its colonial rule. After four years of fighting, in 1949, the Dutch officially ceded sovereignty back to Indonesia with the exception of one key area, namely, Irian Jaya (Dutch New Guinea, or West Irian,[631] as the Indonesians previously called it).[632] Unlike rest of Indonesia which achieved independence in 1949, West Irian remained a Dutch colony until 1962.

In 1962, the United Nations (UN) voted to cede West Irian fully to Indonesia with the provision that, by 1969, the people of West Irian should be granted an opportunity to vote whether to remain with or secede from Indonesia.[633] Under the international agreement between

630 Id.

631 Sometimes also referred to as West Papua.

632 Source: Free Papua Movement (Organisasi Papua Merdeka). Online: http://www.globalsecurity.org/military/world/para/papua.htm

633 United Nations, The United Nations in West Papua – An Unprecedented Story , UN pamphlet, (New York: United Nations Press, 1963); United Nations, 'Report of the Secretary-General regarding the act of self-determination in West Irian tabled at the UN General Assembly dated 6 November 1969' (Ref: A-7723).

the Netherlands and Indonesia brokered by the UN and the US in 1962 (the New York Agreement), the UN was under an obligation to 'advise, assist and participate' in an 'act of self-determination in accordance with international practice.[634]

In 1968, a UN team arrived in West Irian to help Indonesia prepare for the promised act of self determination.[635] However, in January 1969, the Indonesian Government declaring that a referendum was impractical because the people were too 'primitive', selected 1,026 West Irians to act as representatives of the population for special vote on self-determination.[636] Rather than protest, the UN chose to co-operate. Unsurprisingly, given the level of intimidation, the West Irian representatives unanimously declared their love for Indonesia and their desire to join the Republic.[637] In November 1969, the UN General Assembly, with opposition from a small number of African countries, voted to 'take note' of a UN report of the West Irian declaration of loyalty, and with that, recognising the legitimacy of Indonesian control over the West Irian people.[638]

II. The Affected People and their Opposition to Indonesian Control

Irian Jaya as the Indonesian Government has re-named it is the territory on the western half of the island of New Guinea. Irian Jaya is mainly populated by native tribes such as the Danis and the Amungme. The indigenous people of Irian Jaya are different both, racially and ethnically from the majority of Indonesians. They are Melanesian and share cultural similarities with Papua New Guinea and other Melanesian areas while most Indonesians are Malay.

634 Id.

635 Id.

636 PJ Kuyper, P.J., and Kapteyn, P.J.G., "A Colonial Power as Champion of Self-Determination: Netherlands State Practice in the period 1945-1975", in International Law in the Netherlands Van Panhys, H. F. et al. (ed.), (Sydney: Oceania Publications Inc., 1980), Vol III Ch 3; Poulgrain, G., 'Outside Indonesia - An international perspective on the 1962 New York Agreement and the Indonesian Claim to Netherlands New Guinea' (Brisbane: Queensland University of Technology, 2000).

637 Id.

638 See supra note 633.

Opposition to Indonesian control has existed in Irian Jaya since 1963.[639] This opposition takes two forms: those in favour of a federation with Papua New Guinea, and those who prefer independence as West Papua or "West Melanesia".[640] The indigenous community accuses the Indonesian Government of implementing a policy of "transmigration" which translates as colonisation and planned re-settlement of Indonesian migrants in Irian Jaya.[641] Other infringements blamed on the Government include wide array of human rights abuses.

III. Violation of Rights of the Indigenous Peoples of Irian Jaya

The issues concerning violation of the rights of indigenous people of Irian Jaya involve indigenous land, human rights and environmental protection. According to the allegations, the responsibility lies primarily with Government of Indonesia, Freeport McMoran Copper and Gold (Freeport); a New Orleans based trans-national mining conglomerate and, the United States Government.[642] The root cause is foreign direct investment in production and export of copper and gold.

Freeport first entered Indonesia in 1959 following a meeting between Freeport Director and top engineer Forbes Wilson and Jan Van Gruisen, the then Managing Director of the East Borneo Company, a mining concern. Gruisen had by then just stumbled upon a report first made in 1936 regarding a mountain called the "Ertsberg" ("Copper Mountain") in Dutch New Guinea, by Jean Jacques Dozy.[643] Dozy reported a mountain heavy with copper ore. Following Wilson informing Freeport's New York headquarters of the information contained in the report concerning the copper mountain and asking for permission and money to make a joint exploration

639 Free Papua Movement, Statement concerning the right of self-determination of the West Papuan people to the Working Group on Indigenous Populations, Fifth Session (Geneva, August 1987)

640 Id.

641 Id.

642 Klare, M. T., Resource Wars, The New Landscape of Global Conflict, (Metropolitan/Owl Books 2001), p.195.

643 Pease, L., JFK, Indonesia, CIA & Freeport Sulphur, Probe, Vol. 3, No. 3 (March-April, 1996) and Vol. 3, No. 4 (May-June, 1996).

effort with the East Borneo Company, a contract was signed on February 1, 1960.[644] This was followed by Freeport, subsequently signing a contract with the Indonesian Government in 1967 to mine for copper in 10,000 hectares of land belonging to the indigenous Amungme people. It is alleged that over time Freeport's control has extended over three times as much land.[645]

In West Papua near the town of Timika, Freeport now operates the world's largest gold mine and the third largest copper mine. With the construction of a new city for its employees Freeport had taken over an additional 25,000 hectares of land from the Amungme people.[646] Further, Freeport recently opened a new mine at Grasberg just two kilometres from the Timika site. Resting on 2.6 million hectares of land acquired from Indonesia in 1991, "the new mine will increase output to 900 million pounds of copper and 1.1 million ounces of gold, making it the world's single biggest mining operation".[647]

As the new York based journalist Eyal Press says *“Freeport is simply following the standard Third World development model “developing a glamorous satellite city with complete facilities and a five-star Sheraton Hotel that will only widen the gap between the local people, who have nothing, and the Freeport staff, who have access to resources and facilities. Only 15 percent of the roughly 14,000 people Freeport employs in the area are locals, and most of them occupy the lowest-level jobs.*"[648]

PT Freeport Indonesia, the subsidiary that operates the Grasberg copper and gold mine, has been accused of environmental abuse, especially the dumping of 130,000 tons of waste rock

644 Id.

645 Id.

646 Id.

647 Id.

648 The Nation, July 31 / August 7 (1995), p. 125.

(known as tailings) a day into local rivers as a means of disposal.[649] Grasberg has also become notorious for the human rights abuses committed by the thousands of soldiers on the site who are allegedly there to protect the mine from disgruntled locals, whose home the company has dug up or on which it dumps the tailings.[650]

It is alleged that at 13,500 feet in the Jayawijaya Range of New Guinea, the Grasberg copper and gold mine is from an engineering standpoint, in a notoriously difficult place to mine.[651] Further, it is alleged that, already the company has hewn 400 feet off this structure, a sacred mountain to the Amungme people, and when it leaves in 40 years' time, it is expected to have created a 1,500-foot crater.[652]

The indigenous people and environmental groups accuse Freeport's mines of uprooting natives and washing pollutants into rivers.[653] Freeport is also accused by many for not having any policy of commitment or royalty distribution to the local community.[654] Apart from the problems faced by the Amungme, it is alleged that the downstream community, a tribe known as the Komoro, has a lot to complain about, with the death of a substantial tract of rainforest in the lowlands below the mine where the tailings have been dumped.[655] It is alleged that the company had admitted that 30 square kilometres of forest is currently dead and over the life of the mine, it expects the destruction to spread to at least 130 square kilometres.[656]

649 Kennedy, D., *"Mining, Murder and Mayhem: The impact of the mining industry in the South"*, Third World Resurgence No. 93 (May 1998).

650 Id.

651 Id.

652 Id.

653 Amnesty International, Indonesia and East Timor: Power and Impunity; Human rights Under the New Order, (New York: Amnesty International Publications, 1994).

654 Id.

655 Id.

656 Id.

Another allegation levelled against Freeport is that, for decades the indigenous people of Irian Jaya have been suffering blatant human rights abuses (imprisonment, torture, extrajudicial executions and "disappearances") at the hands of the Indonesian military aided by Freeport.[657] A 1995 study published by the Australian Council for Overseas Aid (AC F OA) describes a six-month reign of terror around Freeport's operations in which 37 Irianese civilians had been killed by Indonesian military personnel operating in the area of the mine.[658] Far Eastern Economic Review, reported in December 1997 that Freeport McMoRan Copper & Gold is known "as the most maverick American multinational in the world today".[659]

The main question that could be asked in connection with the Freeport's involvement in Irian Jaya is that, what are the rights for locals when a trans-national mining company enters an area of disputed nationality and over a number a decades extracts billions of dollars worth of copper and gold while re-investing almost nothing in the local economy. Although Freeport has continuously denied any involvement with the alleged violations of human rights of the indigenous peoples in Irian Jaya, one aspect that raises concerns regarding the company's activities in Indonesia is the fact that currently the company has no political risk insurance against risks such as nationalisation, having lost policies with the Multilateral Investment Guarantee Agency (MIGA) and the US Government's Overseas Private Investment Corporation (OPIC) during the period 1996 -1998.[660] Freeport McMoRan Copper & Gold's version is that it no longer requires insurance "against political risks such as civil wars or nationalisation". The unofficial

657 See supra note 648.

658 Chatterjee, P., *"The Mining Menace of Freeport-McMoRan"*, The Multinational Monitor (April 1996).

659 McBeth, J., *"Bull's Eye"*, Far Eastern Economic Review, (December 4, 1997).

660 In response to the US Federal Government Overseas Private Investment Corporation's cancellation in October 1995 of PT Freeport's political risk insurance on environmental grounds, the parent company, Freeport McMoRan, launched an expensive lobbying and legal campaign against OPIC's decision. It enlisted former US Secretary of State, Henry Kissinger (a director of Freeport McMoRan), and former CIA director, James Woolsey, as formidable apologists. Kissinger and others sought to intimidate other OPIC customers, threatened to lobby the US Congress to cut OPIC funding, and even tried (unsuccessfully) to pressure the US government to cut its funding to the environmental organization, WALHI, which had been the first Indonesian NGO to raise public concern about the environmental impact of the mine. Louisiana politicians, Democrat Senator John Breaux and Republican Representative Billy Tauzin - who had each received major campaign contributions from Freeport McMoRan - were amongst the most vocal critics of OPIC. With the cost to OPIC of the dispute estimated at between $100,000 and $200,000 a month in legal fees, the agency subsequently reinstated the insurance for a limited period of six months, in exchange for a commitment by the company to set up a $100-million trust fund to remediate the site when the mine is closed (see supra note 649).

version however, is that the insurance was cancelled to avert the scrutiny and conditions that the Bank and US Government had required in return for their guarantee. It is also alleged that the company terminated its contract with MIGA on the eve of an investigation into the mine by MIGA.[661] This goes to show the extent to which the company has gone to cover it tracks and avoid issues regarding the conduct of its affairs being raised by the US Government and MIGA.

In the Indonesian context, laws established by the Government guarantee the investors safety in their activities and make operating companies privy to a number of special rights which are designed to facilitate profitable outcomes (Mining Law No. 11 of 1967 and its regulations, supported by the Foreign Investment Law No. 1 of 1967 and Domestic Investment Law No. 6 of 1968 and its implementing regulations).[662] These special rights, combined with the full support of the State and its security apparatus means that the potential for human rights violations perpetrated by the company or State is high in relation to the communities living around their operations.[663]

Tensions with indigenous people in Irian Jaya concerning the Freeport McMoRan mining concession near Timila, has led to the crackdown by Government security forces on several occasions, resulting in the deaths of civilians and other violent human rights abuses. In 1977, the Amungme people filed a claim for compensation for their lost land which the Indonesian Government promptly rejected. A spokesman for the Free Papua Movement (OPM) summarises the situation as follows: *"since Freeport signed contracts in 1967, it has regarded this land as not*

661 Kennedy, D., with Chatterjee, P., and Moody, R., Risky Business, The Grasberg Gold Mine, Berkeley, USA: Project Underground (1998). Online: http://www.moles.org.

662 Ballard, Dr. C., Human Rights and the Mining Industry in Indonesia: A Baseline Study, (Canberra: International Institute for Environment and Development, 2001).

663 The 1967 Foreign Capital Investment Law opened the door to foreign investment in minerals and in 1967, Freeport Sulphur signed the first Contract of Work (COW) with the Indonesian government to mine copper in West Irian. Indonesia's mining Contracts of Work essentially designate foreign firms as contractors working for the government and paying corporate income tax on profits in addition to royalties and other taxes. A second 'generation' of COWs, signed on slightly less generous terms than the Freeport contract saw fifteen foreign mining enterprises initiate exploration in Indonesia between 1968 and 1971, including INCO, which developed a nickel mine at Soroako in Sulawesi. During seven different COW generations, 268 contracts had been issued, of which only 12 have achieved production status.

belonging to our people... the Indonesian constitution considers it state land and any complaints made by the Amungme people (are seen by the company) as terrorist action."[664]

Freeport's parent company, Freeport McMoRan Copper & Gold (hereinafter Freeport McMoRan) is facing two major lawsuits in Louisiana State and the Federal Court about the human rights issues surrounding the Grasberg Mine.[665] Freeport has been cited by the U.S. Environmental Protection Agency "for emitting the largest amount of toxic chemicals of any company." Further, allegations have been made that over hundreds of people have been extra-judicially executed by the Indonesian military over the past 15 years with the knowledge and aid of Freeport. There are also allegations of torture and murder of members of the indigenous community living near Freeport's mines.[666]

IV. Legal Action against the Grasberg Copper and Gold Mine Project

A member of the indigenous community of Irian Jaya, Tom Beanal, instituted legal action in 1996 challenging the continuing violations of indigenous human rights and environmental pollution by Freeport in Irian Jaya.[667] Beanal, a resident of Tamika, was the leader of the Amungme Tribal Council of Lambaga Adat Suki Amungme. The action was filed in the Federal District Court in the Eastern District of Louisiana for alleged violations of international law.[668]

664 Statement of the Hon. Eni F. H. Faleomavaega at the United States House of Representatives, September 30, 1999.
Online: http://www.house.gov/apps/list/speech/as00_faleomavaega/stmteasttimor.html

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665 State of Louisiana, *Yosefa Alomang v. Freeport McMoRan Inc, and Freeport McMoRan Copper & Gold, Inc*., Case No. 2002-C – 0864.

666 Id.

667 *Tom Beanal Et. Al. vs. Freeport –McMoran, Inc. & Freeport –McMoran Copper and Gold, Inc*.

668 Beanal invoked jurisdiction under (1) 28 U.S.C. § 1332, (2) the Alien Tort Statute, 28 U.S.C. § 1350, and (3) the Torture Victim Protection Act of 1991, sec. 1, et seq. , 28 U.S.C. § 1350 note.

In his first amended complaint, Beanal alleged *inter alia* that Freeport is engaged in environmental abuses, human rights violations, and cultural genocide by destroying the Amungme's habitat and religious symbols, thus, forcing the Amungme to relocate. He asserted specifically that Freeport's private security forces acted in concert with the Republic to violate international human rights. Freeport moved to dismiss Beanal's claims under Federal Rules Civil Procedure 12(b) (6). The District Court in April 1997 issued a thorough forty-nine page Opinion and Ordered dismissing Beanal's claims without prejudice and with leave to amend.[669] In the said order, pursuant to Rule 12(e) of the Federal Civil Procedure, the District Court instructed Beanal to amend his complaint to state more specifically his claims of genocide and individual human rights violations.

In August 1997, the District Court granted Freeport's motion to strike Beanal's second amended complaint on the basis that Beanal inappropriately attempted to add third parties. At the motion to strike hearing, the court again instructed Beanal to plead facts sufficient to support his allegations of genocide and individual human rights violations. In March 1998, the District Court granted Freeport's motion to strike Beanal's third amended complaint and dismissed his claims with prejudice.[670]

Beanal appealed from the District Court's rulings. The Court of Appeal affirmed the District Court ruling after review of each of the arguments made by Beanal alleging violation of international law by the defendants.[671] The Court of Appeals findings on each of the arguments are summarised below:

669 See *Beanal v. Freeport-McMoran* , 969 F.Supp. 362 (E.D.La. 1997).

670 The District Court dismissed Beanal's claims pursuant to Fed.R.Civ.Proc. 12(b)(6).

671 United States Court of Appeal, 5th Circuit Case No. 98-30235. The full text of the judgment is available at : http://laws.findlaw.com/5th/9830235cv0.html

Beanal claimed that Freeport engaged in conduct that violated the Alien Tort Statute.[672] He argued that under §1350, the District Courts have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States.[673] However, Beanal did not claim that Freeport violated a United States Treaty. Thus, the issue before the court was whether Beanal had pleaded claims upon which relief can be granted for violations under international law. The Court concluded that it is only required to determine whether the pleadings on their face state a claim upon which relief can be granted and that Beanal's allegations under the ATS can be divided into three categories:(1) individual human rights violations; (2) environmental torts; and (3) genocide and cultural genocide. The court addressed each issue as follows:

(I) Individual Human Rights Violations

Beanal had claimed that Freeport was engaged in the following conduct; (1) surveillance; (2) mental torture; (3) death threats; and (4) house arrest, thereby violating the rights of the indigenous people of Irian Jaya. Freeport argued that Beanal's allegations fail to give adequate notice under the federal pleading requirements. Also, Freeport claimed that Beanal had failed to plead the requisite state action to support his claims under the ATS. The District Court found that Beanal merely made nominal changes to his third amended complaint in an attempt to comply with its order to provide a more definite statement of what had happened to him individually.

After reviewing Beanal's pleadings de novo, the Court of Appeal agreed with the District Court's ruling that Beanal's complaint merely makes conclusiory allegations and that Beanal's claims are devoid of names, dates, locations, times or any facts that would put Freeport on notice

672 The "ATS" or "§1350".

673 §1350 confers subject matter jurisdiction when the following conditions are met; (1) an alien sues, (2) for a tort, (3) that was committed in violation of the "law of nations" or a treaty of the United States. See *Kadic v. Karadzic* , 70 F.3d 232, 238 (2d Cir. 1995).

as to what conduct supports the nature of his claims. Furthermore, after comparing Beanal's third amended complaint with his second, the court agreed with the District Court's observation that, Beanal had made a superficial effort to personalise his complaint in order to comply with the court's order.

Although Beanal argued that the District Court inappropriately subjected his complaint to a heightened pleading standard, the Court of Appeal held that, nonetheless, the notice requirements under Rule 8 require more than bare bone allegations that a wrong has occurred. The Court of Appeal also affirmed the District Court's dismissal of Beanal's claims of individual human rights violations under the ATS on the ground that his complaint failed to provide adequate factual specificity as to what had happened to him individually the ATS.[674]

(II) Environmental Torts and Abuses

Beanal argued that Freeport through its mining activities engaged in environmental abuses, which violated international law. Specifically, Beanal alleged in his third amended complaint that Freeport', in connection with its Grasberg operations, deposits approximately 100,000 tons of tailings per day in the Aghwagaon, Otomona and Akjwa Rivers and that the said tailings divert the natural flow of the rivers and have rendered the natural waterways of the plaintiff unusable for traditional uses including bathing and drinking.

Further, it was alleged that Freeport, in connection with its Grasberg operations had diverted the aforesaid rivers greatly increasing the likelihood of future flooding in Timika. It was also alleged that the Grasberg mining operations had caused or will cause through the course of its operations, 3 billion tons of "overburden" to be dumped into the upper Wanagon and Carstensz

674 See supra note 667.

creating the likely risk of massive landslides directly injurious to the plaintiff. It was alleged that the said "overburden" creates acid rock damage resulting in “acid streams” and rendering the Lake Wanagon an "acid lake", extremely high in copper concentrations. Beanal and the amicus referred the court to several sources of international environmental law to show that the alleged environmental abuses caused by Freeport's mining activities are cognizable under international law. Chiefly among these were the Principles of International Environmental Law I: Frameworks, Standards and Implementation 183-18[675] and the Rio Declaration on Environment and Development, June 13, 1992.[676]

Freeport argued that Beanal's allegations of environmental torts were not cognizable under the "law of nations" because Beanal failed to show that Freeport's mining activities violate any universally accepted environmental standards or norms. Furthermore, Freeport argued that it would be improper for a United States tribunal to evaluate another county's environmental practices and policies.

The Court of Appeal held that *"[i]t is only where the nations of the world have demonstrated that the wrong is of mutual and not merely several, concern, by means of express international accords, that a wrong generally recognised becomes an international law violation in the meaning of the [ATS]."*[677]. Thus, the ATS *"applies only to shockingly egregious violations of universally recognised principles of international law."*[678] The Court further held that, Beanal failed to show that these treaties and agreements enjoy universal acceptance in the international community. “Although the United States has articulable standards embodied in federal statutory

675 See generally, Sands, P.(ed.), Principles of International Environmental Law I: Frameworks, Standards and Implementation, (Cambridge: University Press, 1995) pp. 183-18.

676 United Nations, ‘Rio Declaration’ (1992), U..N. Doc. A/CONF. 151/5 rev.1.

677 Referring to *Kadic v. Karadzic* , 70 F.3d 232, 238 (2d Cir. 1995).

678 Referring to *Zapata v. Quinn* , 707 F.2d 691, 692 (2d Cir. 1983)(per curiam)..

law to address environmental violations domestically,[679] nonetheless, federal courts should exercise extreme caution when adjudicating environmental claims under international law to ensure that environmental policies of the United States do not displace environmental policies of other governments. Furthermore, the Court noted that the argument to abstain from interfering in a sovereign's environmental practices carries persuasive force especially when the alleged environmental torts and abuses occur within the sovereign's borders and do not affect neighbouring countries." Accordingly, the Court of Appeal held that the District Court did not err when it concluded that Beanal failed to show in his pleadings that Freeport's mining activities constitute environmental torts or abuses under international law.[680]

(III) Genocide and Cultural Genocide

Beanal claimed that Freeport engaged in acts of genocide and cultural genocide. In particular, in his first amended complaint, Beanal alleged that Freeport's mining operations caused the Amungme people to be displaced and relocated to other areas of the country. He also alleged that Freeport's mining activities destroyed the Amungme's habitat. As such, Beanal asserted that Freeport purposely engaged in activity to destroy the Amungme's cultural and social framework.

Freeport attacked Beanal's allegations claiming that cultural genocide is not recognised as a discrete violation of international law. The District Court relying chiefly on the express language of Article II of the Convention on the Prevention and Punishment of the Crime of Genocide, 78 U.N.T.S. 277 (the "Convention on Genocide"), concluded that cultural genocide was not recognised by the international community as a violation of international law. The

679 See, The National Environmental Policy Act (42 U.S.C. § 4321 et seq.) and The Endangered Species Act (16 U.S.C. § 1532)

680 See supra note 667.

District Court then instructed Beanal to amend his complaint to allege genocide. Specifically, the Court instructed Beanal to allege facts that would demonstrate that "he [was] the victim of acts committed with the intent to destroy the people of the Amungme tribe . . . ." Consequently, the District Court found that Beanal's third Amended Complaint failed to comply with its express instructions.

The Court of Appeal observed that Beanal's third amended complaint revealed that his claim of genocide suffered from the same pleading defects that plagued his other claims of individual human rights violations. The Court concluded that Beanal's complaint is saturated with conclusory allegations devoid of any underlying facts to support his claim of genocide.

Further, the Court held that, although Benal had alleged cultural genocide, the claim failed to identify and establish conduct on the part of Freeport that would constitute an act of cultural genocide, and as such it would be problematic to apply these vague and declaratory international documents to Beanal's claim because they are devoid of discernable means to define or identify conduct that constitutes a violation of international law. The Court also held that, Beanal had not demonstrated that cultural genocide has achieved universal acceptance as a discrete violation of international law and thus it would be imprudent for a United States tribunal to declare an amorphous cause of action under international law that has failed to garner universal acceptance.[681]

V. The Legal Action filed by Walhi against Freeport

The environmental group, WALHI's (Friends of the Earth-Indonesia) case against Freeport was launched in 2000, after a rockslide in May 2000 at the Wanagon Dam where,

681 Id.

Freeport disposes overburden and waste rock from its Grasberg mine in Irian Jaya. The collapse triggered a tide of water, sludge and overburden to cascade into Wanagon Valley and caused flooding in Banti village several kilometres downstream from the dam. As a result, four construction workers were swept away and killed.[682] A Freeport's press releases blamed the incident on high rainfall. The company claimed that the accident did not pose any risk to human health or have an impact on the environment. However, Indonesia's environmental protection agency, Bapedal, reported that the company had used the lake to dump and neutralise acid slag and that, at the time of the incident, the sediment in the lake contained toxic and dangerous material.[683]

On August 28th 2001, the South Jakarta District Court declared Freeport guilty of violating Indonesian Environmental Law (No. 23, 1997). The company was ordered to reform its waste management systems. The Court held that Freeport had deliberately concealed information and had given false and inaccurate explanations, thereby misleading the public. The Court therefore ordered Freeport to minimise the risk of more rockslides at Wanagon. It also ordered the company to reduce its production of toxic waste so that it fulfils water quality standards.[684]

WALHI demanded that the company be penalised by issuing public apologies through the national and international media, but this was rejected by the Court. At present appeals filed by both WALAHI (against the order dismissing the application for an order against the company, requiring the company to issue a public apology) and by Freeport (challenging the judgement declaring the company guilty of violating Indonesian environmental law) are pending before the Indonesian Supreme Court.[685]

682 Down to Earth, *"Court orders Freeport to clean up its act"*, Vol. 51 (November 2001). Online: www.gn.apc.org/dte/51Frp.htm

683 Id.

684 Source: WALHI Press Release 11/Oct/03; see also WALHI website: www.walhi.or.id

685 Source : Jakarta Post, Thursday, August 30, 2001; Down To earth, No. 51, November 2001.

VI. The Current Situation in Irian Jaya

Although, the aforementioned legal action by Walhi produced an encouraging result for the indigenous people in Irian Jaya, as far as the environment in which they live is concerned, according some experts, the worst is yet to come.[686] It has been pointed out that through a chemical weathering process by which sulphites in the tailings are exposed to air and water, the so-called Ajkwa Deposition Area (the area surrounded by the massive corporate-made levees resulting from the Freeport operations) could become a perpetual pollution machine, slowly leaching sulphuric acid into the ecosystem. Acid mine drainage has already been recorded within the main waste-rock dump, and is likely to accelerate.[687] It is alleged that the potential effects of acid mine drainage are devastating and capable of destroying the ecology of entire river systems, both by raising acidity to dangerous levels and by releasing dissolved heavy metals into the river system.[688] Thus, if no preventive measures are taken, it is likely that the indigenous community living in Irian Jaya will continue to suffer due to the mining activities carried out by Freeport with the blessings of the Government of Indonesia.

As far as human rights violations affecting the indigenous community are concerned, the available evidence shows that there has been no improvement despite various representations made by the affected groups of people and even the international community. For example, according to the report of Maurice Glélé-Ahanhanzo, Special Rapporteur to the Commission on Human Rights on contemporary forms of racism, racial discrimination, xenophobia and related intolerance, the situation of the indigenous people of Irian Jaya had not improved even by the late

686 See Kennedy, D., supra note 661.

687 Id.

688 Id.

1990s.[689] His report in 1997 confirms of widespread abuses ongoing within the context of an oppressive military presence and that there is continuing environmental damage and the cultural subordination of indigenous people in the face of the massive exploitation of resources by powerful multinational corporations including Freeport.[690] Further, the report points out that multinationals carrying out mining operations are being given the local people's land and that as a result, all aspects of the locals' lives have been altered and they are forcibly resettled. It also makes the point that the politics, culture, economy, education and work opportunities are Indonesian, imposed from Jakarta; and, the Freeport Mines Company controls the economy of Irian Jaya.[691] However, these allegations are vehemently denied by the Government of Indonesia. For example, in its reply to the Commission on Human Rights, the Government stated that the allegations of human rights violations in Irian Jaya were half truths and uncorroborated and therefore the allegation that the people in Irian Jaya are tortured, arbitrarily detained and extra judicially executed is totally unacceptable.[692]

6.4.2. Measures for Protecting Indigenous Rights whilst Promoting Infrastructure Development

As noted in the previous sections of this chapter, protecting the rights of indigenous people can be a hard task for developing country governments, given the need to balance the increasing development needs with the interests of the indigenous communities. Even though in democratic societies, governments have to undertake development projects for the benefit of the

689 United Nations Commission on Human Rights, Report by Mr. Maurice Glélé-Ahanhanzo, Special Rapporteur on contemporary forms of racism, racial discrimination, xenophobia and related intolerance, submitted pursuant to Commission on Human Rights resolution 1996/21 on 16 January 1997 (E/CN.4/1997/71) .

690 Id.

691 Id.

692 Id. (Referring to the Reply from the Government of Indonesia by letter dated 20 October 1996).

majority, making certain sacrifices in the larger interest of the nation, development projects can no longer be undertaken neglecting the rights of indigenous communities.

In the circumstances, both governments and investors should take precautions to ensure that their project development activities do not unduly undermine the rights of the indigenous people. Doing this would be of mutual benefit to both the host governments and the investors as it could help avoid the risk of their development projects being challenged by indigenous communities which can sometimes result in long drawn out legal battles. The international community too could help this process by taking measures to help ensure that development initiatives do not compromise the rights of indigenous peoples.

a. Initiatives that could be taken by Developing Countries

As noted earlier in this Chapter, most common cause for objection by indigenous peoples to development projects is the acquisition of their traditional homelands for development purposes. In every jurisdiction, it is likely that some form of legislative mechanism exists for the acquisition of land in the name of development.

It is a well-established principle of law, both internationally and nationally in most countries that rights must entail remedies, especially where property rights are concerned. For example under Article 1, Protocol 1 of the European Conventions for the Protection of Human Rights and Fundamental Freedoms, the government taking of property must be accompanied by some payment of compensation.[693] Similarly, Article 21 (2) of the American Convention on

693 European Conventions for the Protection of Human Rights and Fundamental Freedoms, Rome, 4.XI.1950.

Human Rights, it is provided that "[n]o one shall be deprived of his property except upon payment of just compensation, for reasons of public utility or social interest".[694]

However, a key issue concerning the lands of indigenous peoples is that, in many countries there is no legal recognition of their title to traditional homelands. For example, as was held in the famous Australian case of Mabo,[695] which paved the way for the enactment of the Australian Native Titles Act of 1993 (NTA), the source of native title to land is common law. In common law, no recognition of native title by legislation is sometimes required and its source lies in connection with the land and this connection must accord with traditional laws and customs. Native title usually does not amount to ownership of the land, but the natives are entitled to possession, occupation, use and enjoyment of the land "as against the whole world" subject only to the power of Parliament to extinguish that title.

In the circumstances, it is important that developing country governments amend their existing laws or pass new laws to ensure that compensation for acquisition of land does not cover only title but, also possession, at least when it concerns indigenous peoples. As far as such national legislation that provides for award of compensation to indigenous peoples is concerned, The NTA of Australia is a good example. The NTA enables natives to seek compensation not only for property takeovers initiated by the government after the coming into operation of the Act, but also for property takeovers before the Act came into operation.[696]

Dr Whipple, the Foundation Professor in Valuation and Land Economy at Curtin University, Australia, who has written a number of articles on compensation for take over of

694 The American Convention on Human Rights was signed at the Inter-American Specialized Conference on Human Rights, San Josi, Costa Rica, 22 November 1969.

695 *Mabo v Queensland* (1992) 175 CLR 1.

696 See Sections 20 – 23, Native Titles Act of 1994.

indigenous lands, draws a distinction between the 'material' aspects of native title and the 'spiritual' aspects of native title.[697] He says that the material aspects include things like fishing and hunting rights and other incidents of native title which can be equated to incidents of ordinary land tenure. Such material aspects can be valued in the same way that similar interests existing in a Western land tenure system are valued.

However, putting a value on spiritual rights to native lands is not so easy, although it could be argues that "something more" should be added to the compensation package to cover spiritual rights when native lands are acquired for development purposes. The "something more" argument relates to the 'spiritual' aspects of native title. Dr. Whipple recognizes that the spiritual attachment which indigenous people may have to land cannot be measured by traditional methods. He argues that the courts must therefore develop methods of valuing the spiritual aspects of native title.[698] The value of the spiritual aspects of native title can then be added to the value of the material aspects of native title and the total can be the measure of compensation for native title.[699] However, Dr. Whipple makes no suggestions on how the spiritual aspects of native title should be valued. However, the important thing to note is that he, at least, suggests an important factor to be considered when adequate compensation for acquired lands of indigenous communities is being considered.

Considering risks that pop up in connection with infrastructure development projects when the rights of indigenous communities are affected, the following legislative, judicial, policy and administrative measures can be suggested as further measures that could be taken by developing countries to avoid such risks:

697 Whipple, R., *"Assessing compensation under the provisions of the Native Title Act 1993 - part 2"*, Native Title News, vol. 3 no. 4 (1997), pp. 49-52
698 Id.
699 Id.

i. Adopt or continue to apply, in concert with indigenous people, constitutional, administrative, legislative and judicial measures to promote, protect and ensure the enjoyment of their human rights and fundamental freedoms on the basis of equality, non-discrimination and full and free participation in all areas of society, in particular in matters affecting their interests.
ii. Honour, respect and observe the treaties and agreements concerning indigenous peoples.
iii. Give full and appropriate consideration to the recommendations produced by indigenous peoples in their own forums.
iv. Make regular assessments of the progress achieved in overcoming discrimination and prejudice.
v. Consult the indigenous communities in the process of decision-making concerning policies and measures that directly affect them.
vi. When implementing investment projects, cooperation with indigenous peoples to stimulate their access to economic activities and increase their level of employment, through the establishment, acquisition or expansion by indigenous peoples of enterprises, and the implementation of measures such as training, the provision of technical assistance and credit facilities.
vii. Carry out special projects through appropriate channels and in collaboration with indigenous peoples to support their initiatives at the community level and to facilitate the exchange of information and technical know-how between indigenous peoples and experts in these areas.
viii. Enhance policies and measures to reduce income and wealth inequalities and to take appropriate steps to promote and protect economic, social and cultural rights on a non-discriminatory basis.
ix. Promotion of understanding among society at large of the importance of special measures to overcome disadvantages faced by indigenous peoples.

x. Promote better knowledge of, and respect for, indigenous cultures and heritage among the majority communities.

xi. Keep the international organizations and foreign investors who finance development projects informed of the indigenous peoples, their customary rights and cultures and heritage if any development project is to be located in areas occupied by the indigenous communities.

Some of the above measures that could be taken by countries have already been recognised by various international forums as necessary measures to ensure the protection of the rights of indigenous peoples and for striking a balance between protecting such rights and promoting economic development through foreign direct investment.[700]

b. Measures that could be taken by Investors

In modern day FDI, as noted in Chapter 2 of this thesis, most investors are large MNCs.[701] The UN Sub-Commission on the Prevention of Discrimination and Protection of Minorities noted that, "*While it is clear that transnational corporate activity has the potential to aid economic development in developing states, the activities and working methods of TNCs are oriented towards maximizing profit rather than promoting equality and improving human well-being"*.[702] The sub-commission noted that foreign direct investment by MNCs can negatively interfere with a number of human rights, including: *"the right of peoples to self-determination and to permanent sovereignty over their natural wealth and resources; the right to development;*

700 For example see: Draft of the Inter-American Declaration on the Rights of Indigenous Peoples, 19 September 1995,Draft Declaration on the Rights of Indigenous Peoples, Commission on Human Rights (E/CN.4/Sub.2/1994/2/Add.1 (1994));Proposed American Declaration on The Rights of indigenous Peoples (Approved by the Inter-American Commission on Human Rights on February 26,1997, at its 133rd session, 95th regular session);The International Cancun Declaration of Indigenous Peoples (5th WTO Ministerial Conference - Cancun, Quintana Roo, Mexico, 12 September 2003).

701 Sometimes also referred to in this thesis as TNCs (Transnational Corporations).

702 ECOSOC, The Realization of Economic, Social and Cultural Rights: The Relationship between the Enjoyment of Human Rights, in particular, International Labour and Trade Union rights, and the Working Methods and Activities of Transnational Corporations, UN Doc. E/CN.4/Sub.2/1995/11 (1995), Para 91.

the right of everyone to a standard of living adequate for the health and well-being of himself and his family and the continuous improvement of living conditions…"[703]

Under international human rights law, states have an obligation to respect and ensure the respect for human rights within their territorial jurisdiction. However, the same cannot be said of MNCs as in the past the popular perception has been that they are under no legal obligation, saving any corporate ethics they may have, to respect human rights. In a study that explores the governance gap with respect to the accountability for human rights abuses of corporations operating trans-nationally in conflict zones, Gagnon, Macklin and Simons conclude that neither international human rights law nor general international law clearly impose "direct obligations on MNCs to respect and ensure respect for human rights within their sphere of influence.[704] Nor is there an "international legal duty on home states to ensure that their corporate nationals are not complicit in, or perpetrators of, violations of international human rights and humanitarian law in host state jurisdictions."[705]

During the last decade however, a growing consensus among individuals and organisations seem to have developed that MNCs too should be accountable for violations of international human rights related to their business activities.[706] Academics, NGOs and international organizations have begun to address the question of whether MNCs have obligations under international or domestic law to respect and ensure respect for human rights in their

703 Id. Para 89.

704 See for example, Gagnon, G., Macklin, A., and Simons, P., Deconstructing Engagement; (Social Science and Humanities Research Council and Law Commission of Canada, 2003); at pp. 54-55; and McCorquodale, R., "Human Rights and Global Business", in Bottomley, S. and Kinley, D., (ed.) Commercial Law and Human Rights, (Burlington: Aldershot, 2001) 89 at pp. 92-97.

705 Id. at pp. 55-58; Also note that under the Draft Articles on State Responsibility of the International Law Commission, there is no apparent obligation incumbent on a home state to take steps to prevent the effects of the extraterritorial activities of corporate nationals. See Crawford, J., The International Law Commission's Articles on State Responsibility: Introduction, Text and Commentaries, (Cambridge: University Press, 2002) at pp. 91-121.

706 Muchlinski, P.T., "Human Rights and Multinationals: Is There a Problem?", 77 International Affairs (2001) p.31 at pp. 31-32; see also, Ratner, S.R., *"Corporations and Human Rights: A Theory of Legal Responsibility"*, 111 Yale L. J. (2001), p.443 at pp. 446-448.

extraterritorial activities.[707] In particular, there appears to be an emerging consensus that MNCs are bound by fundamental norms of international law that prohibit, among other things, abuses such as forced labour, slavery, genocide, torture and crimes against humanity,[708] and that investors that transgress these principles might be criminally prosecuted in any State under the principle of universal jurisdiction and officers and employees of corporations may be subject to prosecution as individuals in the International Criminal Court (ICC).[709]

However, it is important to note that the ICC does not currently have jurisdiction to prosecute corporations, and to date no companies have been criminally prosecuted in domestic courts for such abuses. In the circumstances, it is clear that, unlike in the case of governments, there is no clear obligation on the part of the investors to respect the rights of indigenous communities and to ensure that investment activities do not violate the rights of indigenous communities.

The UN Sub-Commission on the Promotion and Protection of Human Rights has recently adopted the "Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights."[710] These norms are the product of a four-year drafting and multi-stakeholder consultation exercise by the Sub-Commission Working Group on Transnational Corporations. They provide a comprehensive set of principles that address, among other things, the human rights and labour rights concerns related to MNC activities. The

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707 Ramasastry, A., *"Corporate Complicity: From Nuremberg to Rangoon, An Examination of Forced Labour Cases and Their Impact on the Liability of Multinational Corporations"*, 20 Berkeley J. Int'l L. (2002), p. 91; Clapham, A., and Jerbi, S., *"Categories of Corporate Complicity in Human Rights Abuses"*, 24 Hastings Int'l & Comp. L. Rev (2001), p. 339; Kamminga, M.T., and Zia-Zarifi, S., "Liability of Multinational Corporations under International Law: An Introduction", in Kamminga, M. T. and Zia-Zarifi, S., (ed.), Liability of Multinational Corporations under International Law, (The Hague: Kluwer Law International) at pp. 1-15.

708 See Kamminga and Zia-Zarifi, supra note 707at p. 8.

709 See Ramasastry, supra note 707 at pp. 153-156.

710 U.N. Doc. E/CN.4/Sub.2/2003/12/Rev.2 (2003), Approved on August 13, 2003, by U.N. Sub-Commission on the Promotion and Protection of Human Rights resolution 2003/16, U.N. Doc. E/CN.4/Sub.2/2003/L.11 at 52 (2003).

principles are drawn from a variety of binding international treaties and drafted in mandatory language, and a separate document provides interpretive commentary.

The said norms recognize that the primary responsibility to respect and ensure respect for human rights lies with States.[711] However, they also state that MNCs have an "obligation to promote, secure the fulfilment of, respect, ensure respect of, and protect human rights recognized in international as well as national law, including the rights and interests of indigenous peoples and other vulnerable groups" within their sphere of activity and influence.[712] These principles include: a prohibition on the commission of, complicity in, or benefiting from, violations of international humanitarian law and fundamental human rights;[713] provisions on the hiring and conduct of public and private security forces; [714] the obligation to respect both "economic, social and cultural rights as well as civil and political rights and contribute to their realization" and to "refrain from actions which obstruct or impede the realization of those rights.[715] They require MNCs "to respect the principle of free, prior, and informed consent of the indigenous peoples and communities," and prohibit both forced displacement of such communities and the deprivation of their means of subsistence.[716] In addition, the norms recommend that States establish "the necessary legal and administrative framework for ensuring that norms and other relevant national and international laws are implemented" by MNCs.[717]

It is important that the developing country governments ensure that the investors, who wished to participate in development activities in their countries, undertake to adopt, respect and

711 ECOSOC, 'Commentary on the Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights' (2003), UN Doc. E/CN.4/Sub.2/2003/38/Rev.2 (2003), Article 1.

712 Id.

713 Ibid. Article 3.

714 Ibid. Article 4.

715 Ibid. Article 12.

716 Ibid. Article 10, Para. c

717 Ibid. Article 17.

follow the above norms and responsibilities. This can be done by the developing country governments introducing them to their investment policies and ensuring that adequate measures are built into the contract documents to ensure that the investors follow them.

Thus, from the investor perspective, it is important that they play no role in violating indigenous rights. In addition to financial losses that may be caused due to long delays in project completions or due to overall project failures that may result from legal actions and protests by indigenous communities, bad reputation gained by violating the rights of indigenous communities may result in lack of access to investment opportunities in some developing countries. This may be caused by developing countries and or international funding agencies blacklisting investors.[718] Thus, steps should be taken to ensure that project viability studies look beyond economic viability and examine also areas such as the rights of indigenous communities and environmental impact.

One of the main allegations against foreign investors in connection with infrastructure development projects in developing countries is that they give minimal consideration to the best interest of the host country, its environment, and the various groups of people in the host country that may be adversely affected, due to the project. Although many investors and multinational funding agencies disagree with this criticism and sometimes boast of their impressive environmental policies and business ethics to ensure fair play, there is plenty of evidence to show that such policies exists only on paper and are not put into practice.

718 For example, the World Bank in July 2004 blacklisted its first multinational with the debarring of Canadian engineering firm Acres International from new contracts for three years. The blacklisting came as a response to the company being found guilty by the High Court of Lesotho, for having engaged in corrupt activities to influence the Lesotho Highlands development authority, which was responsible for the multibillion-dollar Lesotho Highlands water project. Source: The Hindu 24 July 2004.

A good example is the attitude of JEXIM towards the San Roque dam Project in the Philippines.[719] JEXIM's environmental guidelines state that people resettled by projects it funds must have given their consent. On this basis, it is alleged that at the beginning JEXIM reportedly held off any loan disbursements until it was satisfied that the project would conform to its environmental and indigenous peoples' criteria. However, given that the project started construction in May 1998, despite heavy protests by the indigenous community in the Philippines, who alleged that they are being displaced due to the project and no proper compensation package has been offered to them, and that the project is scheduled for commercial operation by the end of the year 2004, it appears that JEXIM's support for the project violates its own guidelines.[720]

The investors should realise that, in the long run, for infrastructure development projects to provide a win-win stage for all participants, including the investors, the projects have to contribute to the sustainable development of countries. Investment white elephants or failed projects would be dangerous for the reputation of the investors and might result on many investment opportunities being shut to them. In the circumstances, investors too should take the initiative to follow guidelines such as those adopted by the UN Sub-Commission on the Promotion and Protection of Human Rights.

Even in instances, where, certain developing country governments may wish to give various concessions undermining the rights of indigenous communities to induce investors to invest in what appear to be profitable projects, the investors should insist on co-operation with local communities, keeping in mind the distinctive needs of different communities as well as their

719 San Roque is one of 22 large dams planned for the Cordillera region, and is the first one to be built in the region as part of a wide-ranging development plan of former President Fidel Ramos. The dam site is located on the Agno River in Pangasinan Province, but reservoir inundation will occur in Itogon Province, home of the Ibaloi people.

720 World Rivers Review, April 1999.

cultural diversity. Further, they should refrain from seeking or accepting exemptions from host country regulatory requirements in areas such as human rights, environment and labour.

c. What the International Community can do

As already noted in this Chapter, since the 1960's the voice of the indigenous peoples in the world have been gaining momentum. Since the beginning of the 1960's International organizations such as the WB, ADB, HRC, and the ILO have been active, passing various declarations and promoting certain internationally acceptable norms to protect the rights of indigenous people in order to ensure that their rights are not compromised in the face of development. NGO's too have played a very active role in promoting the indigenous peoples rights and in pressurising governments and investors to adopt various measures to ensure that the indigenous peoples are protected. So far, these initiatives have been considerably successful.

Key international lending and development financing organizations such as the WB and the ADB have adopted policies on indigenous peoples and have started applying these policies to all investment projects in which they participate, thus putting pressure on developing country governments as well as investors to taking note of the importance of protecting the rights of indigenous communities. For example, the ADB in its Operation Manual on Indigenous People[721] provides *inter alia* that:

> *Since ADB recognizes the potential vulnerability of indigenous peoples in development processes, development interventions that will affect indigenous peoples should ensure that they have opportunities to participate in and benefit equally from the interventions.*[722]

721 ADB, Operation Manual on Indigenous People, (Manila: ADB, 21 September 2000), Section 53.

722 Id. Para 6.

It provides further that:

> *ADB's interventions affecting indigenous peoples should (i) be consistent with the needs and aspirations of affected indigenous peoples; (ii) be compatible in substance and structure with affected indigenous peoples' cultures and social and economic institutions; (iii) be conceived, planned, and implemented with the informed participation of affected communities; (iv) be equitable in terms of development efforts and impact; and (v) not impose the negative effects of development on indigenous peoples without appropriate and acceptable compensation.*[723]

The ILO Convention 169 Concerning Indigenous and Tribal Peoples in Independent Countries[724] expressly states that governments have the "responsibility for developing, with the participation of the peoples concerned, co-ordinated and systematic action to protect the rights of these peoples and to guarantee respect for their integrity." These measures include ensuring that indigenous peoples benefit from the rights and opportunities of national laws, promoting the full realisation of social, economic and cultural rights with respect to their social and cultural identity; and assisting indigenous peoples to eliminate socio-economic gaps in a manner compatible with their aspirations and ways of life. Indigenous peoples shall enjoy, without discrimination, the full measure of human rights and fundamental freedoms.

Other international conventions also reference the responsibility of governments. For example the UN Convention on Biological Diversity (CBD)[725] expressly recognizes the rights of indigenous peoples to customary uses of their lands, and to the traditional knowledge associated with those uses. Similarly, the UN's International Convention on the Elimination of All Forms of

723 Ibid. Para 7.

724 Adopted on 27 June 1989 by the General Conference of the International Labour Organization at its seventy-sixth session. Date of entry into force: 5 September 1991.

725 The CBD was negotiated under the auspices of the United Nations Environment Programme (UNEP). It was opened for signature at the June 1992 UN conference on Environment and Development and entered into force on 29 December 1993. More than 170 countries have become parties to the CBD since it was opened for signature.

Racial Discrimination (CERD) [726] also refers to the responsibilities of governments to condemn and eliminate racial discrimination.

As noted in Chapter 1, Modern day infrastructure development projects are so vast that developing country governments or foreign investors cannot most of the time finance them on their own or even in partnership. Thus, in addition to developing countries giving concessions and some times limited capital, and investors putting substantial capital, most investment projects are financed with heavy debt and less equity. Thus, international financing agencies such as the WB and the ADB have a tremendous opportunity to put pressure on developing country governments and investors to ensure that development projects do not under mine and compromise the rights of indigenous people. If they strictly apply their policies and ensure that projects which are purely profit driven, and not leading towards sustainable development are not financed by them that would help control the violation of the rights of indigenous people under the pretext of development to some extent.

Thus, the international entities such as the World Bank and the Asian Development Bank should take the initiative to further strengthen their policies concerning development activities in regions occupied by indigenous communities. The NGOs and other pressure groups should continue their good work by identifying problem areas and drawing the international attention towards protecting the indigenous communities and need for sustainable development in lieu of profit driven ill planed development activities.

United Nations Secretary-General Kofi Annan's recent appointment of Professor John Ruggie as Special Representative on the issue of human rights and transnational corporations and

726 Adopted and opened for signature and ratification by General Assembly resolution 2106 (XX) of 21 December 1965, and entered into force on 4 January 1969. As of 2 November 2003, 148 countries have become signatories.

other business enterprises can be viewed as a key step taken towards suggesting mechanisms for future control of abuse of human rights including the rights of indigenous communities by the large MNCs who invest in developing countries. The mandate includes identifying and clarifying standards of corporate responsibility and accountability with regard to human rights. An interim report presenting views and recommendations for consideration by the Commission on Human Rights is due at its sixty-second session in 2006 and a final report in 2007. The creation of this mandate was requested by the United Nations Commission for Human Rights in its resolution 2005/69 and approved by the Economic and Social Council on 25 July 2005.[727]

727 UN Press Release No. SG/A/934 of 28.7.2005.

Chapter 7 - Conclusions and Recommendations

7.1. Summary of Findings

As already noted in this thesis, project financing has entered the mainstream of investment in developing countries as the preferred mode of FDI for development. It has gained new impetus in the dynamic environment created by increasing globalisation and sophistication in the financial markets on the one hand and, by political and regulatory reforms in countries which have opened infrastructure sectors to the private sector, on the other.

During the last decade, the volume of investment flows related to project financing has expanded dramatically, although there has been an overall reduction of investment flows to developing countries due to the financial crisis and various risks associated with them, including, political instability, war, and terrorism. For example, the financial crisis that started in East Asia in 1997 and then gradually spread to other areas in the globe brought about a significant pause in the upward movement of FDI until the early part of 2000. The crisis dampened the investment opportunities in several countries causing the investors, host governments and project sponsors to rethink financial and economic viability of project proposals, and the need to re-evaluate risks involved. However, these problems created by the financial crisis can be regarded as a blessing in disguise to some extent as they have made all project participants rethink the pros and cons of project financing. One significant lesson from the crisis has been the

understanding of the need for exercising grater care in structuring projects and assessing their risks.

The growth in project financing has been ably supported by increased competitiveness in the financial markets with financiers reducing funding costs and providing more innovative and long term financial options. During the last five years or so, the financial markets have become more relaxed towards entertaining long term and limited or non-recourse financing. Bonds, syndicated loans and private placements have offered new hope for finding necessary finances for the development needs of countries. The growing use of securitization techniques also has increased the liquidity and attractiveness of lending for projects to a wider range of investors. The regulatory and policy reforms undertaken by developing countries have boosted investor confidence in pumping finances to non traditional sectors such as infrastructure development which were less than two decades ago, thought to be the primary duty of the public sector. The ever growing interest in risk minimization and innovative methods of risk mitigation, discussed in Chapters three and four of this thesis have helped boost the confidence of project participants giving reliable hope of project success.

However, despite these initiatives, in some developing countries, projects continue to be developed without proper risk assessment, mitigation, and allocation. As analyzed in the several case studies dealt with in this thesis[728] it is clear that such projects are sometimes developed intentionally ignoring the risk implications they might have on the environment and society. More often than not, ulterior motives of profit driven project developers and/or corrupt practices of politicians and policy makers are behind such decisions. There is no doubt that such projects, although they might bring short term financial gains, would not contribute towards sustainable

728 See Chapters 5 and 6.

development of countries.[729] With the consumers of utilities provided by such projects, environmentalists, human rights activists and the affected members of the public (including indigenous communities who are often at the receiving end of badly planned development projects) learning to fight back and challenge the governments and project developers who in their view are engaged in development projects that do not or are unlikely to contribute to sustainable development, it is likely that the future will witness developing countries as well as project developers being more cautious in their approach to developing infrastructure projects.

Despite the various problems and issues identified with FDI for infrastructure development, more particularly with project financing techniques, development of infrastructure projects is likely to continue to attract foreign investment in the years to come. This is because, given the precarious finances of the developing countries and their inability to keep up with the growing demand for modernized and increased infrastructure facilities and, the growing interest among investors to explore new and hitherto inaccessible markets, project financing seems to be the most acceptable mode of FDI for both developing countries and investors. Further, despite the various flaws that have been noted during its short existence, no better alternative to project financing for developing infrastructure projects in developing countries have yet been found.

What is important from the developing country perspective is to ensure that project financing contributes to sustainable development. This is important from the investor perspective too as their contribution to sustainable development would open doors for more long-term business opportunities in countries in which they have already invested as well as in new countries which would want to attract investors who have been successful with development projects, elsewhere. From the perspective of international financing agencies, it is important that FDI mechanisms such as project financing contributes to sustainable development as active

729 See Chapter 1.4.3 of this thesis for an explanation concerning the use of the term "sustainable development" in the context of this thesis.

private sector participation in sustainable development would reduce their burden and the level of participation in physical infrastructure development activities. This would in turn allow them to focus their attention and more active financial support on the social infrastructure development in developing countries. Further, at bilateral and regional level too, there could be benefits to countries from sustainable development of neighbouring countries. For example, a landlocked developing country may benefit from the development of an advance road network or a regional hub port in its neighbour.

In the circumstances, project financing for development of infrastructure can be a win-win option for developing countries, investors, lenders, other project participants and also, for the neighbouring countries. However, in order to ensure that the future of project financing would be bright and it would help developing countries to achieve sustainable development, certain initiatives will have to be taken by developing countries, both at country level and at bilateral and regional levels. In addition, certain initiatives will have to be taken by the investors and the lenders, especially the international financing agencies.

7.2. Initiatives that could be taken by Developing Countries

Investors would be more comfortable in investing in developing countries in which project financing techniques have been successfully employed and in which, the economic and policy environment is transparent. Further, they would prefer investment destinations where the legality of contracts is being honoured. In the circumstances, a sound policy framework with regard to foreign investments, sound infrastructure of support services such as banking, licensing, transport, customs clearance, investor exemptions and also a sound dispute settlement mechanism with a hierarchy of judicial authority and a system of law that recognises basic international norms on investments and trade are basic necessities for attracting FDI for infrastructure

development. Developing countries hoping to gain maximum advantage of project financing techniques will have to thus, ensure that these basic necessities are visibly present in their jurisdictions.

The success of project financing largely depends on good and efficient risk management. For projects in which the risks have been identified, clarified, and appropriately mitigated up front, private financiers are frequently willing to provide significant funds and to bare project specific commercial risks. Thus, proper project evaluation is necessary for investor confidence. However, a point to remember is that not all aspects of risk can be managed contractually. The most important thing for potential participants to bear in mind is that they need to fully understand what they are getting into. All projects involve some element of risks, and the best way to minimize them is to do extensive research beforehand.

The current trend in most developing countries is to take a rather lethargic approach towards promoting foreign investments by merely identifying sectors for investment promotions. This alone will not attract investors into countries, as the developing countries cannot expect the investors or project promoters to identify projects, carryout substantive feasibility studies covering all aspects including financial viability, environmental risks, social and political risks and then make representations to the developing country governments to initiate development projects. Thus, the developing countries will have to take the initial initiative in project identification and doing the preliminary feasibility studies before marketing project for investment. This would enable developing countries to identify appropriate projects that could in fact contribute to their national development. Thus, the so called one-stop investor facility centres found in most developing countries (for example, the Board of Investments in India and the Board of Investment in Sri Lanka) will have to play a more significant role in the future with regard to attracting investors. They will have to collaborate with the relevant line ministries or

other public entities in connection with national development plans to ensure to the greatest extent possible, projects that are marketed to attract foreign investment have been properly assessed for risks and the likelihood of any unexpected risks such as for example, social or political objections to projects occurring, the prevention of which is mostly under the control of the host countries, is remote.

In the past project financing has been used mainly to attract international financing for infrastructure development projects. However, with the growing popularity of project financing, and the understanding of the need to hedge currency rate fluctuation risks, as most projects generate income in vulnerable local currency to pay up debt in foreign currency, domestic financial markets will have to play an effective role in future project financing. Local funding can help mitigate the significant interest rate and foreign currency risk that most projects face. However, in order for this to happen, local financial markets will have to have some depth. The insurance funds, provident funds and other such funds that hold public funds on long term basis may have to be encouraged to invest in infrastructure projects. At present, in most developing countries, the managers of such funds are rather lethargic when it comes to investing in non-traditional sectors. Developed countries like England, USA and Singapore to name a few have good schemes where public pension and provident funds are invested in long-term commercial projects. Developing countries should learn from them. In addition, it is also necessary to develop internal bond and equity markets in developing countries so that project developers will have more local options in raising necessary finances for projects. Developing country governments will have to help meet these prerequisites by encouraging the broadening and expanding of local financial markets and liberalizing the control and management of funds held by the public sector.

Ensuring the participation of local investors in infrastructure development projects is important for another reason. After the Asian financial crisis, foreign investors were hesitant to

fund development projects in developing countries and as a result the developing countries found it difficult to place total reliance on foreign funding for development projects. In order to have a natural hedge against any currency crisis, parties to developing infrastructure projects are likely to seek more domestic financing. Thus, developing countries needing investments for infrastructure development will have to promote the local players to come up with substantial local equity and credit for necessary project developments. In the premises it could be predicted that in future, the local currency component in the usual 70:30 or 60:40 debt: equity ratios of project financing transactions might increase substantially.

It is also important that the developing countries take initiatives to ensure that steps taken to attract foreign investors for development activities would not result in local investors being marginalized. This is important, as foreign investors who invest in infrastructure projects in developing countries are unlikely to stay beyond their concessions. Their motive is usually to develop the project, recover costs, make profits and get out. As most infrastructure projects involve long term operational or concession periods (for example 20 to 30 years), developing country governments should have suitable successors to fill in the vacuums created by outgoing foreign investors. As, in most developing countries, project financing mechanisms go hand in hand with deregulation initiatives of governments, after 20-30 year concession periods, developing countries are unlikely to have technologically and market qualified successors in the public sector to takeover infrastructure projects developed by foreign investors. Thus, the most suitable candidates could be found among the local investors. In the circumstances, it is important that developing countries introduce mechanisms to facilitate local investor participation in infrastructure development projects from the outset or, if not, at least develop a system by which shares in the projects gradually transfer to local investors before the concession period given to foreign investors run out. This would enable smooth transition of operational and management responsibilities.

A further initiative that should be taken by developing countries is the introduction and implementation of necessary reforms to improve the institutional framework that supports investment, finance and risk-taking. They need to generate a reduction in overall risks associated with development projects in their respective jurisdictions by making markets more efficient and complete. This will promote investment, productivity and growth. While the political and regulatory risks can not be altogether eliminated, there is a need to minimize them in the interest of sustainable development. As suggested in Chapters 5 and 6, ensuring the collective participation of the various political and social groups in developing countries in a forum that would decide development policies and approve development projects is one initiative that could be taken. For example, in order to ensure that political opposition to development projects is mitigated, it is prudent to have advisory bodies in place with representatives from the government, members from the opposition parties in Parliament, NGOs, religious and indigenous groups, representatives of industrial sectors and the members of the general public. Such bodies could then be instrumental in the recommendation of new investment policies or suggesting necessary improvements to investment policies already in place to the developing country governments and, in addition, vet the viability of investment projects before they are initiated by the government. Such initiatives however, should not be misunderstood with the legislative decision making in the Parliament where the majority vote would determine the final adoption of policies.

There is no doubt that globalization has resulted in large increase in FDI. Greater inflow of FDI has, in turn, bolstered deeper integration of world economies. Though there

are some serious potential drawbacks of FDI, developing countries are not in a position to turn back from FDI. This is a reality. But, what they can and should do is to try to minimize its negative effects. They should look at ways to make FDI more meaningful. One option might be to encourage investment in certain specific sectors. For example, developing countries such as Sri Lanka, where certain public utility services such as water and power supply have always been provided by the State at subsidized rates, and where the people are stringently opposed to any form of privatization or foreign investor participation in such sectors, could concentrate more on using FDI for less controversial sectors such as highways, ports, airports and, export processing zones. This does not mean that development of infrastructure services such as water and power should not be opened for FDI. To the contrary, what is suggested is that the political and public opponents to such development are gradually educated and informed of the benefits of such development before making drastic decisions to transfer public utilities to the private sector.

7.3. Initiatives for International Organizations

In some quarters, an opinion has been expressed that international organizations such as the World Bank should expand their role in project financing to become saviours at distress rather than being mere financial participants.[730] The basis of this argument is that, traditionally entities such as the World Bank have been interested in economic development of developing countries without concentrating too much on the profitability to such institutions. This trend however, has changed over the years with the increasing interest of the institutions to finance private sector led

730 See generally, Martin B., In the Public Interest? Privatisation and Public Sector Reform, (London: Zed Books, 1993); Richardson R. and Haralz, J., Moving to the Market: the World Bank in Transition, Overseas Development Council. Policy Essay No. 17., (Washington D.C.: ODC, 1994)

development. Thus, in the near future it may not be too surprising to see international financial organizations taking a step backwards and re-identifying their role. If such reformation takes place, in future, while continuing to support private sector led development activities, the international financial organizations may also be in a position to provide comfort to project participants in crisis situations such as the Asian financial crisis.

International organizations should also re-consider their current policies towards developing countries as over the years some agencies seem to have lost focus on their real purpose. For example, the IFC's mission statement is *"to promote private sector investment in developing countries, which will reduce poverty and improve peoples' lives"*. Without doubt, the IFC certainly has done much to achieve the first part of its mission statement. However, it would be interesting to find out whether it has in fact substantially achieved the second part of its mission. The IFC, in fact, often appears to be driven by a deal-making mentality similar to that of private sector banks.[731] The Corporation's annual report and other publications use the IFC's profit (net income) as the main yardstick of success, with other information about its achievements presented in a vague, somewhat haphazard way.[732] How the IFC decides that the projects it backs could not have been undertaken on a purely private basis is unclear and often dubious.

Further, despite various strategy and policy restatements over the years, the IFC still appears to operate without any clear methodology for estimating or evaluating development impacts. Moreover, the IFC has no mechanism in its project cycle to articulate the intended

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731 Friends of the Earth Organisation, 'Dubious Development: How the World Bank's Private Arm Fails the Poor and the Environment' (September 2000). Online: http://www.foe.org.

732 Id.

development impact of a given project.[733] Without such a mechanism, the IFC is unable to factor development effectiveness into either project design or implementation.[734] Thus, on the evidence available outside the institution it is hard to conclude that it has a clear approach to selecting projects that will maximize benefits for poor people and the environment.

Investors, in addition to doing their own due diligence concerning investment prospects in developing countries, often rely on information disseminated by the international financial institutions, including in the context of their routine surveillance of countries and during policy discussions pertaining to economic programs supported by the IMF and the World Bank. A number of investors, especially those engaged in the infrastructure and utilities sectors, work closely with the World Bank Group, including the IFC, Foreign Investment Advisory Services (FIAS), and the Multilateral Investment Guarantee Agency (MIGA), in securing financing for various projects in developing countries. In the circumstances, it is important that these international agencies which may have better access to policy makers and information in developing countries take the initiative to undertake periodic risk assessment in developing countries and have a scheme to grade or classify countries according to the risks involved.

Further, given their experience in directly investing and actively participating in development activities in developing countries, the investors would appreciate the role of international organizations such as the IMF and the World Bank in surveillance and program support for country policies. In particular, the IMF's lead role in assisting countries in near-crisis and crisis situations provides a degree of comfort to investors in maintaining and continuing a presence in developing countries. Thus, agencies such as the IMF and the World Bank should

733 Id.

734 Mavrotas G., Multilateral Development Banks and Private Sector Financing The Case of IFC, Discussion Paper No. 2002/118 (United Nations University, World Institute for Development Economics Research, December 2002).

make even greater efforts to discuss with investors, risks and vulnerabilities associated with doing business in developing countries and provide opportunities to gain a greater understanding of their policies, for example, IMF stabilization and reform policies, in developing countries.[735]

Further, a more regular and in-depth assessments of the investment climate in developing countries, including in the context of the IMF's Article IV consultation discussions[736] and the World Bank's economic and sectoral work, could be useful in enabling investors make informed judgments about investment opportunities and associated risks. Furthermore, focusing the policy dialogues with member countries on issues relating to the investment regimes including the legal and regulatory frameworks, business environment, and tax systems would help the policy makers in developing countries to appreciate the role of equity capital in promoting sustainable growth and facilitate the prioritization of necessary structural reforms. Further, regular assessment of investment climate issues would promote FDI in developing countries and help reduce vulnerabilities by facilitating better risk management by investors.

The world has already witnessed the failed attempt by the OECD to negotiate a Multilateral Investment Agreement (MAI). The attempt to negotiate an international instrument dealing with investment related measures at the WTO too failed although it was included in the agenda of the Fifth Ministerial Conference of the WTO in Cancun, Mexico, due to opposition

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735 The fundamental difference is this: the Bank is primarily a development institution; the IMF is a cooperative institution that seeks to maintain an orderly system of payments and receipts between nations. Each has a different purpose, a distinct structure, receives its funding from different sources, assists different categories of members, and strives to achieve distinct goals through methods peculiar to itself. For further information regarding the different functions of the two organs, please see: Driscoll, David D., The IMF and the World Bank How Do They Differ? (International Monetary Fund August 9, 1996). Available online: http://www.imf.org/external/pubs/ft/exrp/differ/differ.htm

736 Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the economy, collects economic and financial information, and discusses with officials economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the authorities.

from the developing countries. At Cancun a new bloc of developing countries emerged, called the G20 group, led by a number of large nations across a range of regions - Brazil, India, China, Argentina, South Africa, Nigeria and Indonesia.[737] They opposed any decisions being made on the so-called Singapore issues, namely, investment, competition, trade facilitation and transparency in government procurement.[738] The G20 group were opposed to having any international investment related instruments in place which would reduce the development options of developing countries and require them to give equal treatment to both foreign investment and local investment and restrict the rights of developing country governments to limit foreign investment in particular industries, or to require foreign investors to transfer skills and technology, use local products or develop relationships with local firms or place any of these conditions in government purchasing contracts. The meeting eventually came to a dramatic end without any agreement on 14 September 2003, leaving negotiations in a deadlock.[739] In the circumstances, the international organizations should take the initiative to encourage the member countries that push for such international agreements to ensure that, in future, special consideration is given to the needs and interests of the developing countries.

There is a capacity deficiency in some developing countries to professionally package, aggressively market and successfully negotiate investment opportunities. This is another area in which the international organizations such as the World Bank, ADB and, other development agencies could come to the assistance of developing countries. They

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737 It also includes Bolivia, Chile, Cuba, Egypt, Mexico, Pakistan, Paraguay, the Philippines, Thailand, Venezuela, Tanzania and Zimbabwe. The group also had the support of over 70 other developing countries.

738 Even prior to the commencement of the Cancun meeting, Delegates from 16 developing nations Led by then Malaysian Trade Minister Rafidah Aziz, held a press conference to announce an agreement reached between them in advance to the meeting. They announced their opposition to any decision to launch negotiations on the Singapore issues at Cancun insisting that the Singapore issues should be referred back to the WTO in Geneva for further discussion and clarification before any decision could be taken to launch negotiations on the issues. They stressed on the lack of clarity about how new investment rules might impact upon domestic policies. Source: World Development Movement, Online: http://www.wdm.org.uk.

739 Source: Australian Fair Trade and Investment Network (AFTINET), 'The Cancun WTO Meeting' (March 2004). Online: http://www.aftinet.org.au

can act as specialist advisors on developing investment ideas, marketing them and successfully negotiating investment contracts avoiding any arbitrary deals. In addition, they could also facilitate project administration and management training so that developing countries could develop skills and expertise for future use in relation to development of infrastructure projects.

7.4. Bilateral and Regional Initiatives

It was noted in Chapter two that with the growing interest among developing countries for regional integration, the future might witness many cross-border and regional infrastructure projects being developed. Already, steps in this direction have been taken in some regions. For example, the European Commission has actively coordinated a strategy to develop a Regional Electricity Market in South-East Europe. A Memorandum of Understanding on creating a Regional Electricity Market in South East Europe and its integration into the Internal Electricity Market by 2005 was signed at a ministerial meeting in Athens on 15th November 2002. Further, A Strategy Paper listing all measures to be taken in that regard was approved at this occasion.[740]

A similar initiative has been suggested by the ADB for South Asia when it proposed a model of cross-border (multinational) projects for India, Bangladesh, Nepal and Bhutan.[741] The bank has mooted that the four countries could strengthen the economic cooperation among them by emulating the infrastructure funding model employed by the Greater Mekong

740 Office for South East Europe European Commission/World Bank , 'Developing Regional Infrastructure Strategic Approach and Implementation of Projects' (2003), Note Prepared by the Secretariat of the Infrastructure Steering Group, May 24, 2003.

741 The Financial Express, August 6, 2005.

sub-region, comprising Cambodia, Laos, China and Vietnam. The ADB has identified surface transport, tourism, environment and energy as the four sectors to be covered under the South Asian Sub-regional Economic Cooperation (SASEC) funding pattern. It has also set up task forces to explore the project/funding possibilities.[742]

The key reasons behind the need and desire to develop regional and cross-border infrastructure projects is the realization by most developing countries that such projects are mutually beneficial. For example, a power project in one country may be able to supply its excess power to a neighbouring country at a very competitive rate. Further, a landlocked small developing country may benefit from an advance transport network developed in partnership with a more affluent neighbour.

One constraint to foreign investment in some of the least developed countries is the size of their market. Regional and bi-lateral economic cooperation and integration can help overcome the problem of market size, attracting private sector investment in infrastructure. Thus, lesser known and least developed countries in regions could benefit from the spill-over effects of investment when regional infrastructure development projects are undertaken. Thus, understanding the regional and bi-lateral benefits of FDI is important for future development of infrastructure projects in developing countries.

To make regional and bi-lateral initiatives for infrastructure development more sustainable, it is critical that the policy makers and investment planners build the national capacity for managing regional public goods and sharing of experiences. A look across the

742 Id.

world reveals that some regional blocks have several countries in their regions that do not have the same level of development as others. A number of sub-regional blocks in Africa and the Asia Pacific regions still have huge disparities between the nations with respect to development. Further, some regional blocks do not have transmission infrastructure that directly connect the nations to one another nor cross-border connectivity for the nations that share common borders. Thus, developing countries in such regions should take the initiative to address these issues in order to facilitate regional infrastructure development. Mechanisms should be established to enable regulatory bodies in different countries to share resources, facilities and experiences as these bodies could the help to articulate regional positions; encourage adoption of uniform technical and quality standards; promote harmonization of policies within the region; and facilitate regional/cross border connectivity and infrastructure development.

7.5. Areas recommended for further Research

This thesis is one of a handful that has researched the changing nature of risks associated with FDI given the increasing practice among developing countries to employ mechanisms such as project financing techniques to develop infrastructure projects. There is need for more investigation to analyze how the developing countries could achieve sustainable development through the use of project financing techniques and how such techniques could be put into use for the benefit all project participants whilst at the same time, protecting the rights and freedom of people. The following key issues therefore could be recommended for further research:

1. What “best practices” could be developed to deal with the risk of conflict between central governments and local governments when the demands for political decentralization clashes with consumer and foreign investor preference to deal exclusively with central governments.

2. How investment rules and policies could articulate broad common principles applicable to regional and bi-lateral infrastructure development while allowing for policy diversity and institutional innovation at the national level.

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