
THE LEGACY OF FAILED GLOBAL PROJECTS: A Review and Reconceptualization of the Legal Paradigm

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EXECUTIVE SUMMARY

The General Counsels Roundtable was held on January 21-22, 2005 at Stanford University, hosted by the Stanford University Collaboratory for Research on Global Projects (CRGP). The Roundtable was co-chaired by Professor Thomas C. Heller of the Stanford Law School and Barry Metzger, a senior partner of the Coudert Brothers international law firm. Participating in the Roundtable discussions were senior lawyers and business executives from a cross-section of project sponsors, investment funds, engineering firms, multilateral financial institutions, export credit agencies and private law firms and academics from law, engineering, sociology and environmental science disciplines; a list of the participants is set forth in Annex A.

The stated purpose of the Roundtable was to address the legal issues raised by experience with failed and distressed private infrastructure projects in the emerging markets over the past decade, to identify areas of further research into such experience to foster our understanding of the reasons for such failures, and to draw lessons from such experience to inform future public policy and project design. The Roundtable is part of a broader examination by CRGP of the managerial and institutional reasons for project failure. The Roundtable also benefited substantially from the work of the Program on Energy and Sustainable Development (PESD) at Stanford's Institute for International Studies and, in particular, PESD's study, "The Experience of Independent Power Producers in Developing Countries – Interim Report."

Background papers were presented detailing the explosive growth of private infrastructure projects in the emerging markets during the 1990s, the small number of such projects cancelled prior to completion or otherwise deemed to have failed, and the much larger number of distressed projects, which required renegotiation of their substantive economic terms. While it is common to attribute such failures to the systemic economic shocks of the Asian financial crisis (1997) and the financial crises in Russia (1998) and Argentina (2002), a significant number of failed and renegotiated projects are to be found in countries largely unaffected by such crises. While considerable research and analysis has been undertaken and continues into such failed and distressed projects from a public policy perspective, little attention has been focused on the legal paradigm used in structuring such projects. The identification of the component risks in each private infrastructure project and the allocation of such risks among the parties to such project are at the heart of the structuring and negotiation of such projects. Once risks are identified, they are allocated among the various project parties, some risks being allocated in accordance with the requirements of the host country legal and regulatory structure for private infrastructure and other risks being allocated on the basis of project design and negotiation among the parties. Some risks allocated to a party may then be reallocated by that party obtaining coverage of such risks from a third party, for example, by political risk insurance or foreign exchange and interest rate swaps. The global project legal paradigm applicable to such projects generally involved (i) establishment of an appropriate legal framework for private infrastructure in the host country, (ii) the creation of detailed contracts among the project participants, setting out the obligations to be performed by each party and addressing a broad range of contingencies which may affect the project, (iii) the use of the law of a well-established, developed country

jurisdiction to the maximum extent possible, rather than the laws of the host country, to govern the project and its financing, and (iv) dispute resolution in a foreign court or arbitral tribunal, with the expectation that a court judgment or arbitral award would then be enforced in the host country, if not complied with voluntarily.

If evaluated in terms of the enforcement of the parties' original economic bargain, the global legal paradigm has not performed well. Probably 40% of all emerging markets private infrastructure projects undertaken during the 1990s (excluding projects in the telecommunications sector) have been or are currently being renegotiated. In PESD's analysis of independent power projects (IPPs) in nine emerging market economies, substantial renegotiations of projects took place in seven of the countries. Yet in five of the countries, project sponsors expressed satisfaction with the renegotiated terms of such projects. Further work is required to understand the process of project renegotiation and the outcomes. Case studies undertaken to date have not documented the renegotiation experience in adequate detail and, in particular, have not yet made it possible to compare project outcomes in terms of renegotiated tariffs or other prices for the infrastructure services provided, in terms of the extent of the impairment of the shareholders' equity in the project companies, or in terms of the extent of the lenders' losses. A number of Roundtable participants observed that lenders' losses have not been substantial and that, in many projects, "failures" resulted instead in the loss or substantial impairment of the project sponsors' equity in the projects. Until it is possible to compare project outcomes with more refinement than simple categorizations as "failed" or "renegotiated," our understanding of how various factors – including elements of the global project legal paradigm – contributed to project success or failure will be incomplete. The Roundtable solicited the cooperation of its participants in making available, subject to appropriate confidentiality undertakings, project information to permit further studies of project renegotiations and the development of more refined measures of project outcomes.

In discussions among the Roundtable participants about the causes of project failure, more than 40 specific projects were discussed in which Roundtable participants and their companies have been involved. Thirteen factors were identified by participants as contributing to project failure. These factors were:

- An "irrational exuberance" for foreign investment in emerging markets in the 1990s as many such countries adopted more market-oriented economic policies
- Industry-wide assumptions as to the adaptability of private infrastructure models to emerging markets based on successful initial experience in a number of developed economies (particularly the United Kingdom and the United States)
- Poor assessments of the demand for incremental infrastructure and resulting overbuilding, exacerbated by falling demand as a result of economic crises in some countries
- Public expectations that infrastructure services (particularly for power and water) would continue to be provided at low costs, below the prices necessary to attract new capital to the sector
- Inadequate appreciation by project sponsors and lenders of the strength of the opposition to projects among civil society and interest groups

- Incomplete or ineffective consensus within host governments as to the desirability of private infrastructure investment or the appropriateness of specific projects, despite the passage of laws authorizing such investments and government approvals for specific projects
- Changes in government in the host country and the politicization of projects, often because of their size, visibility and the public interest in basic infrastructure services
- Corruption and the damaging effects of allegations of corruption, even when unproved
- Unreasonably high or guaranteed returns to the project sponsors or projects with high levels of project-related risks allocated to the host government and its agencies
- The mismatch in many projects between local currency project revenues and foreign currency-denominated debt financing of the project company, and the difficulty of hedging such currency exposure
- Systemic financial crises, creating multiple project claims concurrently on the host country government and, in the case of the Asian crisis, subjecting project sponsors and project lenders to the suspension of normal project operations/payments concurrently in multiple countries
- Aggressive use by the host government of the local courts to defeat the jurisdiction of foreign courts and arbitral tribunals and the local enforcement of foreign court judgments and arbitral awards
- A general misalignment of project incentives among the various project stakeholders, including the host government

Despite the sophistication of the risk analysis and risk allocation in such projects, the bargained-for allocation of such risks proved unsustainable commercially, politically and legally. Considerable experience with such risk allocation in private infrastructure projects had been gained in other (mostly developed) countries and, in many cases, there had been considerable experience in the specific emerging markets host countries in risk allocation and project financing of other types of projects (principally export-oriented resource projects). Yet certain of the risks inherent in private infrastructure projects proved particularly difficult to effectively allocate and enforce in an emerging markets context. “Price risks” in most cases were allocated to the host government, its public sector utilities as purchasers of the private infrastructure project’s output, or consumers (through tariff adjustment mechanisms by governmental entities intended to ensure the project sponsors full cost recovery for the services provided). The public, political and bureaucratic sensitivity of price rises based upon such risk allocations was seriously underestimated, particularly in those countries with infrastructure services provided at low costs on a highly subsidized basis or priced at levels not reflecting the replacement cost of capital. It proved impossible or impractical in such circumstances to enforce the terms of the project contracts in accordance with the global project legal paradigm. While risk identification and allocation did take place, there was inadequate appreciation by the foreign sponsors and foreign lenders that some risks were “radioactive” in their sensitivity, effectively defying effective legal enforcement. The enforcement of obligations against host country governments has never been easy, but has proven particularly difficult in the context of private infrastructure.

Reservations were expressed at the Roundtable as to experience with international arbitration as a means of resolving infrastructure disputes. By the time matters reached

arbitration, the working relationships between the parties and government had broken down to a point at which negotiated resolutions were not possible. Arbitration proved slow and expensive, and in many cases was thwarted by the government taking action in the local courts to enjoin the proceedings, even where such proceedings were technically beyond their jurisdiction.

A greater understanding is necessary of those situations in which the project sponsors structured transactions to cover government default risks through political risk guarantees or insurance from agencies such as the World Bank, OPIC and MIGA. The presence of political risk guarantees from the World Bank did not prevent challenges to the Hub River Power Project in Pakistan or its renegotiation. OPIC coverage of CalEnergy's investments in its Indonesian IPPs resulted in recovery of the sponsor's investment, but the outcomes from the perspective of the other project stakeholders are not known.

Some of the Roundtable participants described this experience as the inevitable result of the fundamental unpredictability of social and political risks and the competing and incompatible systems of logic which divide foreign investors and governments. Foreign investors are interested in profit, driven by competitive industrial norms of efficiency, and measure success in terms of return on investment. Politicians and bureaucrats are driven by governmental norms of accountability and, in the case of politicians, popular support and re-election.

The discussions then turned to the question of what could be done differently in private infrastructure projects in the future and how the global projects legal paradigm might be changed. Despite the decline in private infrastructure investment in emerging markets in recent years, the projected demand for infrastructure investment in such countries remains very large. Private infrastructure investment is expected to continue in most markets, though the relative balance between publicly financed infrastructure and private infrastructure is unclear. The role of foreign investment in the sector was questioned, particularly in those markets or in respect of those projects in which the foreign investor does not have a clear advantage in terms of technology, managerial efficiency or the cost of capital. At the moment, local and regional project sponsors are particularly active in acquiring distressed private infrastructure projects in their home markets and with the greenfield private infrastructure projects now being undertaken.

Participants spoke of a change in investment parameters by some project sponsors on the basis of experience with failed and distressed projects. Some investors will no longer take completion risk and are only investing in projects, which have begun operations. Others have altered the list of countries in which they will invest. Consideration is being given to mechanisms for enforcing foreign court judgments and arbitral awards against government and partner assets located outside the host country, as a means of enhancing the enforceability of project contracts (and incentivizing such parties to honor such contracts in lieu of default).

Particular attention at the Roundtable focused on the question of whether it is possible to create "more flexible project contracts" which would better accommodate the need for changes in the project economics (or other aspects of the project over time), recognizing the

recent history of renegotiations of the detailed contractual documents which have to date governed private infrastructure projects and recognizing the very long-term nature of most private infrastructure projects (often 25 to 30 years). The participants discussed a more dynamic “governance model” for private infrastructure, which might be contrasted to the more static “contractual model” currently prevailing. The “contractual model” that has been dominant in the past, emphasized the initial division of risks and rewards among the parties involved. Relatively less attention was paid towards ensuring that the parties had sufficient ability to adhere to the terms of the agreement over the long term. Little attention was paid to the possibility that the initial division of risks and rewards might have to be readjusted during the project term. The lack of concern with the “robustness” of the deal often meant that, when commercial or political exigencies arose, the successful completion of the project was jeopardized.

Under a “governance model” greater attention would be devoted to establishing rules for decision-making over time between the project sponsors and government and, possibly, other interested parties. One would draw on experience, including legal learning, from the long history of joint ventures and partnership arrangements between foreign investors and local parties, including governments. Not only would procedures for decision-making be addressed in the legislative or contractual arrangements between the parties, but such decision-making might be constrained within defined parameters, for example, to ensure that the economic interests of the foreign investor were not subject to expropriation. The objective would be a broader alignment of incentives for the project sponsors and government, typically with the government being a participant in the project with a direct and material economic interest in the project’s returns to the sponsors. Equally important, such a “governance model” would seek to foster trust between the private sector sponsors and government through their continuous participation in decision-making in respect of the project. In essence, this model would acknowledge the possibility – if not the probability -- of conditions changing in the future, and would allow for the renegotiation of some project terms and conditions under certain circumstances.

The question arose as to whether such a “governance model” is already embodied in so-called “public private partnerships” or “PPP projects” now prevalent in Europe and Japan and increasingly popular in certain emerging markets. Such projects have been particularly common in the transportation sector. A positive assessment was made of experience to date with such public-private partnerships, though a recent World Bank study (Estache and Serebrisky, “Where Do We Stand on Transport Infrastructure Deregulation and Public-Private Partnership”, World Bank, July 2004) emphasizes that experience to date has been limited to developed countries and a small number of emerging markets countries which have demonstrated a strong commitment to reform of the transport sector (including addressing tariff structure and quality of service issues). Experience with partnerships between foreign investors and governments in the oil sector, in the form of production-sharing agreements, has not been favorable, though that experience may be influenced by the distinctive political economy of the oil and gas industry. Questions were raised as to whether “public-private partnerships” are capable of dealing with “radioactive” pricing risks, for example, in the power sector or the water sector. Further research and analysis was called for, to further articulate how “governance models” for private investment in infrastructure might be

developed and for evaluation of the experience with PPP projects. Does such experience with PPP projects demonstrate more favorable outcomes to project stakeholders than has been experienced with projects embodying a stricter contractual model? It was noted that, separate from the use of a PPP model, it may be significant whether the project is financed on a limited recourse basis. Lenders may require an allocation of risks for limited recourse financing purposes which re-introduces many of the features of the strict contractual model. Financing on a general recourse basis to the project sponsors or to a project company with a broader range of assets than a single project may produce more favorable results. Consideration needs to be given to the impact of such alternative structures on the investors' returns and on the costs of service provision.

An alternative to the "governance model" is amendment to the currently prevailing structures of private infrastructure projects, adding "components" which are patches or new structural elements intended to address specific problems encountered to date with failed and distressed projects and in application of the global projects legal paradigm. Many of these components are currently under consideration by project sponsors and financiers and have been incorporated into some contracts. The components referred to in the Roundtable discussions included the following:

- Local currency borrowing, which is increasingly available from the multilateral development banks and from local financial institutions, to address currency mismatches
- Greater use of partnerships with local or regional private sector sponsors, in an effort to mitigate opposition to foreign investment
- Greater use of other hedging techniques to address currency mismatches
- Competitive bidding of projects rather than negotiated mandates, as part of greater transparency in the government's decision-making processes on project approvals
- Enhanced political risk insurance for both investors and lenders, such as denial of justice coverage currently being developed by multilateral and bilateral investment insurers
- Greater use of balance sheet financing
- Recognition in project design of the need (through, for example, liquidity facilities) of financing to bridge gaps during periods of delayed tariff adjustment or other disputes between project sponsors and government
- Creation of a new multilateral arbitration or mediation program specifically dedicated to resolving infrastructure-related disputes between project sponsors and governments
- Establishment of a firmer link between governmental defaults and continuing eligibility for multilateral and bilateral borrowing programs, at least in those instances in which multilateral or bilateral political risk coverage has been provided to projects
- New approaches to particular contract clauses, for example, limitations on lost profit damages where breach arises under force majeure-like circumstances
- Creation of effective recourse to governmental assets offshore, to facilitate contract enforcement
- Creation, generally, of other project incentives aligning the economic interests of the project sponsors and government

In respect of each component, consideration needs to be given to the impact on project costs. For example, local currency borrowing and political risk coverage increase project costs and/or diminish investors' and financiers' returns. The "components" approach still contemplates a thick set of contractual arrangements between the project parties, rather than utilizing a more governance-oriented model which leaves many matters to future decision-making between the parties, in accordance with (contractually) established procedures and, often, within pre-established parameters.

Finally, Roundtable participants identified important areas for further research and analysis, with the expectation that the results of such research and analysis would be presented to future meetings of the Roundtable for consideration:

- Detailed examination of the enforcement and renegotiation experience of successful as well as failed and distressed private infrastructure projects, particularly in the context of the existing country and project studies of PESD's IPP study, to understand the enforcement and renegotiation strategies pursued and the outcomes achieved
- Contrasting the experience documented in the PESD's interim report on its IPP study with private infrastructure experience in one or more other infrastructure sectors, such as transportation
- Articulation and analysis of the "governance model" as an alternative to the prevailing "contract model" for private infrastructure, including assessment of the experience to date with public-private partnership projects
- Examination and analysis of the work now being done on "components" to complement existing private infrastructure project design and the global projects legal paradigm, including an assessment of the likely performance of such components in addressing factors contributing to project failure

The CRGP will be reverting to Roundtable participants with a more detailed research program based on the Roundtable discussions, with a request for access to participants' project experience for such research, and for material support of such research program through CRGP.

INTRODUCTION

“If the only tool you have is a hammer, then every problem looks like a nail. If you only have an economic, or legal, or engineering perspective, then guess what your problem looks like?”

- Participant in the General Counsels’ Roundtable

Problems on large-scale, complex, global infrastructure projects—motorways, dams, power plants, ports, pipelines, and the like—do not end at the contrived boundaries between academic disciplines and industrial professions. To fully understand these problems, an interdisciplinary approach is necessary. The General Counsels’ Roundtable (GCR) was assembled to unite leading academics and practitioners—from industry, law, political science, economics, sociology, finance and engineering—to reflect upon, identify, and inspect the shortcomings and failures of the legal paradigm supporting capital-intensive, high-stakes projects. This document summarizes the GCR deliberations, notes possible new directions for the global projects legal paradigm of the future, and recommends an agenda of future activity.

Under ground rules established at the commencement of the GCR discussions it was agreed that, to encourage open and candid discussions, records of those discussions including this Summary would address the substantive content of the discussions without attribution to particular participants and without identification of specific projects, except where the project-related information was already a matter of public record.

A History of Fifteen Years of Private Infrastructure Investment

The Rise. During the 1990s, developing governments successfully attracted large sums of capital from both public and private sources to build new infrastructure projects worldwide. According to statistics prepared by the World Bank (PPI Database, 2001), investment commitments for private sector infrastructure projects in the emerging markets grew dramatically during the 1990s, from \$18bn in 1990 to a record \$128bn in 1997. This surge was driven mainly by privatization of government infrastructure assets in Latin America and greenfield power plants and mobile telecommunications projects in Asia, though 132 developing countries adopted policies during this period to attract private infrastructure

investment for infrastructure projects. The number of new projects with private participation grew from only 65 projects in 1990 to a peak of 361 in 1997. In 1990-2001 developing countries transferred to the private sector the operating risk for almost 2,500 infrastructure projects, involving investment commitments of more than \$750bn. Such projects were implemented under schemes ranging from management contracts to divestitures to greenfield facilities under build-operate-own contracts, build-operate-transfer contracts, and so-called ‘merchant facilities’.

The Fall. Then followed a tremendous collapse, with the Asian financial crisis and subsequent collapses in Russia and Argentina, and a general retreat of investors from emerging markets. New investments in such projects fell to \$58bn in 2001, and the number of new projects fell by half. This decline in investment commitments was driven mainly by a reduction in privatizations and investments in concessions to provide infrastructure services; investments in privatizations fell by almost 80% between 1997 and 2001. Investments directed to new projects dropped by around 40%.

The Costs. It is difficult to quantify the costs to stakeholders of distressed and failed private infrastructure projects. One World Bank Study, which analyzed 46 cancelled projects, identified investment commitments to those projects of \$21bn . This figure does not include the vastly larger number of renegotiation situations where investors and lenders took significant “haircuts”. Nor does it begin to address the broader costs to the citizens, communities and businesses in the countries affected, such as the time and money costs of failed services—water, power, sewer, telecom, etc.—interrupted services, and misallocated resources when project sponsors and host governments clash and projects are delayed or cancelled..

The Global Projects Legal Paradigm

The Paradigm. From a lawyer’s perspective, the essence of private infrastructure projects is risk identification, risk allocation, and embedding responsibilities for these risks in a legal framework and an intricate network of contractual relationships. While there has been a great deal of activity looking at lessons to be learned from failed and distressed projects (e.g. Harris, 2003), there has been very little attention to the underpinning and supporting “legal infrastructure,” which consists of several core elements: the country legal framework for

private infrastructure investment; detailed contractual agreements between the various participants; the use of third-country governing law; and dispute resolution by international arbitration (Metzger, 2004). This collection of elements, the so-called *global projects legal paradigm*, underpinned many of the private infrastructure projects in developing countries funded during the 1990s.

Its Failures. In spite of this rational global projects legal paradigm for managing risk, as already noted, there were large numbers of severe failures. Why? Was something missed? Were the people in the early 1990s who put the deals together overly simplistic in their analysis of risks, or irrationally exuberant? Did they fail to incorporate the lessons of history? Did they simply build a house of cards? Have lawyers contributed to this, by constantly re-inventing the “bullet-proof” contract, all the while saying to themselves, “Aha, I’ve got it right this time. That guy before me, he was really dumb.” However, there were no dummies playing in this game, the strategies were quite complex, and, at the time, thought to be well-reasoned. So, the interesting questions are, how and why were those strategies belied by the flow of the actual experience which followed? Addressing these questions is particularly timely, since we have seen in 2004 the first signs of significant interest reviving in private infrastructure investment in the emerging markets, marked most notably by the sale of a significant number of (renegotiated) power projects and planning for a modestly increasing number of new private infrastructure projects. Have lessons been learned or are early errors being repeated?

RESEARCH QUESTIONS & OBJECTIVES

“What is the role of the law in trying to manage the risks associated with large-scale, privately-funded infrastructure projects? And what has been the problem—and what are the lessons to be learned—with private infrastructure investment into foreign markets?”

- Participant in the General Counsels’ Roundtable

Research Questions

In two groundsetting GCR issue papers, and during the course of the two-day GCR discussion, a host of complex, often interrelated, questions were raised, addressed, and

debated. To capture the breadth and depth of this dialogue, it is helpful to set out the questions raised:

- ❖ What can be learned about what happened to the legal paradigm on which these projects were built?
- ❖ What happened to these projects when they were stress tested by economic crisis?
- ❖ Why did many projects come under attack even where no external macro-economic crisis triggered problems?
- ❖ Were the contractual provisions used as vehicles for allowing re-negotiation effective (Miller & Lessard, 2000)?
- ❖ To what extent was recourse to the courts or arbitration actually used to resolve the problems facing such projects, and to what extent was the ultimate project outcome a direct result of such proceedings?
- ❖ What role did other approaches to the resolution of such problems play—such as domestic lobbying or the use of diplomatic channels by foreign investors or financiers—and which proved to be the most effective in contributing to resolution?
- ❖ In comparing different projects in the same country and projects in different countries, is it possible to identify the factors which most contributed to a satisfactory resolution of disputes arising either from a systemic crisis or project-specific issues?
- ❖ Was the experience different where projects were jointly owned by foreign investors and the host government and its agencies?
- ❖ Were projects jointly owned by foreign and local investors more prone to disputes or was the presence of a local partner an effective avenue for the avoidance or resolution of disputes with the host government?
- ❖ To what extent did the structure of the financing for failed or distressed projects contribute to the outcome?
- ❖ Did the state of development of the local legal profession or the ability of foreign lawyers to practice locally have an impact on the effectiveness of foreign investors' and financiers' legal remedies in respect of failed and distressed projects?
- ❖ To what extent did other features of the host country's legal system—its judiciary, its court procedures, the availability of interim remedies (such as injunctions), its procedures for enforcement of judgments, the availability of bankruptcy proceedings,

and the speed with which cases proceeded through the courts—contribute to the legal outcome of such failed and distressed projects and to the level of the resulting losses?

- ❖ Were the outcomes different in emerging markets which are democracies and those with other political systems?
- ❖ Why was the political consensus on the desirability of private investment in infrastructure so imperfect, even in countries where legislation to authorize such projects had been enacted by democratically elected legislatures and implemented by democratically elected governments?

Questions to elicit “thick narratives”

In the moderators’ introductory remarks, GCR participants were encouraged to put aside their hindsight clarity, to reflect back on the mood of the early 1990s, and to offer “thick narratives”—a term from cultural anthropology describing anecdotes or stories that are sensitive to the flow of events and rich with contextual details. To stimulate “thick narratives”, six specific questions were posed by the moderators:

1. ***What were you thinking about the world?*** In the early 1990s, what was driving the models? In the U.S. and other developed nations? What were you thinking about the demand for services on the commercial side? And about the regulatory and legal world? And if you want to go further, into the cognitive-cultural, or normative world, what were we thinking about how these projects were framed?
2. ***What did you come up with as a response strategy?*** Including the global-legal paradigm, what was your response to survive in this world that we thought was upon us?
3. ***What went wrong?*** Did projects go wrong? What does failure mean? If things went wrong, there must have been a mismatch between events and strategies and expectations. What were the mismatches?
4. ***When there was legal failure—default or renegotiation—what happened next?*** In the workout of the mismatch of expectations, strategies and events, what happened and why?
5. ***What kind of a world do you think about now?*** We are in a world of hybrid institutions—it is not a competitive market, nor a heavy administrative command-and-control structure like it was in the ‘80s in many of these sectors. In what direction is the world going?

6. *What should be done to live, survive and hopefully make money, in that world; assuming that there are such strategies?* What are such strategies for foreign direct investment? What comes next?

Objectives

Eight major objectives of the General Counsels' Roundtable were articulated:

- ❖ To “thicken the narratives” in order to capture the subtlety, and nuance, of the conflicts, judgments, emotions and interactions of the 1990s.
- ❖ To discuss interpretations of these narratives across sectors, regions, and sponsors, to tease out a sense of how uniform were these experiences.
- ❖ To test the ideas in the ongoing PESD and CRGP research against the GCR group's narratives and interpretations.
- ❖ To develop, beyond the meeting, a network of people willing to stay in contact, to continue to fill in the details of the narratives, and to enhance understanding of how the global projects legal paradigm can be improved.
- ❖ To turn the PESD working paper into a monograph— that goes beyond aggregation and oversimplification, but which reflects the rich narratives of the GCR meeting—to advance the literature, so that future activity is illuminated.
- ❖ To develop policy proposals and sectoral analyses that are not naïve. Too often policy proposals are overly simplistic. (One common proposal is that countries should strengthen their rule of law. That is not a proposal, as far as we are concerned.) Policy should reflect actual experience and a relatively sophisticated view of political economy, accounting for what is likely to change and what is not likely to change in the sectoral and national context.
- ❖ To engage in a discussion of which direction to take further activity.
- ❖ To look at new tools and techniques to manage project risks, including using the creative frameworks in the Engineering School through the collaboration with CRGP.

BACKGROUND STUDIES

“I am unhappy with the level of aggregation in a great many studies...that put together investment in Argentina with China... distribution with generation... road building with power. That leaves me very unhappy.”

- Participant in the General Counsels’ Roundtable

GCR Preparatory Papers

Four papers (Metzger, 2004; Mahalingam et. al., 2005; Woodhouse, 2005; Harris, 2003) were circulated to GCR attendees in advance of the event in order to stimulate thinking and reflection. Metzger’s Issue Paper #1, drawing on World Bank data, summarized many of the challenges associated with large-scale private infrastructure projects in emerging markets throughout the 1990s, and concluded with several clusters of questions regarding the global projects legal paradigm. Mahalingam’s Issue Paper #2 reviewed prior literature on the types of risks—e.g. social, political, technical, financial—that plague large complex projects. Woodhouse’s interim report summarized an ongoing PESD study of independent power projects in 10 developing countries. The focus of the PESD study was on explaining the variance of two types of performance:

- ❖ *Country performance.* The success or failure of a country in attracting private investment in power projects.
- ❖ *Project Performance.* The success or failure of a project to meet the reasonable expectations of key stakeholders. The study voiced primarily the investor viewpoint.

The study found, somewhat unexpectedly, that investors in eight of ten countries reported legal failures, but despite these legal failures, in five of these countries they reported successful project outcomes, indicating that their deals had been satisfactorily restructured, or renegotiated. This finding implies that a large majority of contract agreements are doomed to failure, and that the renegotiation process is at least as important, if not more so, than initial project planning and structuring. Finally, Harris’s article, a World Bank working paper, reflects many of the current ideas circulating in the World Bank with respect to the legacy of failed and distressed projects and what should be done. One shortcoming of the interim report, noted by a GCR participant, is that the data are at a high level of aggregation and the legal component of the study is relatively small.

Ongoing CRGP and PESD Research

Much of the ongoing work at Stanford, within the CRGP and PESD centers, addresses the challenges of large-scale global projects. Both centers follow in the traditions of social science: to focus on detail, and also to discover trends and generalizable findings.

CRGP. CRGP serves as Stanford University's primary forum for research on the organization and management of global projects — infrastructure, industrial, commercial, telecommunication, IT and other projects involving sponsors, financiers and developers from multiple countries. CRGP is a collaborative undertaking between Stanford University, partner universities, industry and government affiliates, to advance the science and practice of planning and implementing global projects.

A major focus of CRGP's work is on organizational and institutional processes affecting the outcomes of global projects. Much of the recent CRGP work, guided by prominent institutional scholars in sociology and economics, focuses on how differences in institutions—beliefs, values, norms, rules and laws—between formal and informal project participants cause so-called 'institutional exceptions'—misjudgments, misunderstandings and conflicts—that create a host of unforeseen costs and consequences—reputation damage, relationship damage, extortion, opportunity forgone, delay, and sanctions—for both formal and informal participants in global projects (Orr & Scott, forthcoming). The long-term goal is to develop computational models to predict these costs, and to identify coping mechanisms operating at various levels—including leader behaviors, inter-team adjustments, corporate strategies, and activities of other actors—that project personnel utilize to interpret and deal with institutional conflicts.

PESD. PESD Serves as an interdisciplinary program that draws on the fields of political science, law and economics to investigate how the production and consumption of energy affect sustainable development. It sponsors research on the political, legal and economic aspects of the world's energy system and is catalyzing the creation of a funded, worldwide network of researchers working on these issues.

A current study is investigating why developing countries—aspirants of fast growth such as China, India, South Africa, Brazil and Mexico—were attracted to Western models of power sector reform, and how their experience of reform unfolded (which was seldom as expected) from 1990 to present. Other current studies focus on the provision of energy services to rural areas; global climate change and life after Kyoto; the worldwide shift to natural gas, and how countries that lead this push are not necessarily the ones with a rich resource base, but usually the ones with transparent and competitive institutions and the experience of independent power projects in ten major developing countries (Woodhouse, 2005).

Other Relevant Research

The most intensive research effort related to the failures of privately-funded infrastructure projects has been within the multilateral institutions themselves and their related research arms. For example, the Harris (2003) paper identifies policy lessons that can be drawn from the 1990s, to ensure that the provision of infrastructure services does not become a blockage to growth in developing countries.

There are also the efforts of individual scholars to look at problems of privately-funded infrastructure (e.g. Hall & Bayliss, 2000; Irwin et. al., 1997; Wells, 1999). Often these take the form of case studies of individual projects (e.g. Mehta, 2001; Nickson & Vargas, 2002; Linaweaver, 2003; Stern, 2004).

Also, pending, and slated for release in the near future, is the result of a year long collaborative effort between the Asian Development Bank (ADB), Japan Bank of International Cooperation (JBIC) and the World Bank, titled “Infrastructure in East Asia.” The focus is on the public and private supply of infrastructure, lessons to be learned from the past 15 years’ experience, and recommendations as to policy alternatives for countries and multilaterals. The study in part addresses the question, “What role does private infrastructure have to play?” Interim reports indicate that the study will conclude that private investment in infrastructure will be significant into the future as public financing is limited. Such reports identify “inadequate rule of law” and “ineffective regulative systems” in many of the countries as unsolved obstacles to further infrastructure investment, but without intensive analysis of the reasons for the persistence of such problems.

Gaps in Extant Literature

In preparation for the GCR, we were left somewhat ill-at-ease by much of the research and accounts that we find in extant literature. Much of the so-called analytic literature is overly facile, highly subjective, highly aggregated across regions and sectors, quite “bare bones”, and does not get down into the details where lawyers tend to live and flourish. Thus, to address this gap, the GCR forum was designed, as already noted, to focus on “thick narratives” and to inform policy and practice from insights which can be drawn from such research.

THE 1990s: LEGAL FAILURE & RENEGOTIATION

“The examination thus far supports the notion that contracts are going to fail, despite all of the manifold, ironclad guarantees. That leads to the question, why not design a contract for instability? And that leads to the question, what would such a contract look like?”

- Participant in the General Counsels’ Roundtable

The findings presented here integrate the large number of comments, insights and experiences that emerged during the GCR dialogue. More than 40 specific projects were discussed, both failures and successes, across a variety of countries and sectors. For several projects, more than one GCR participant had been involved—as a debt holder, investor, insurer, lawyer, engineering firm or arbitrator—and made possible an integrated project narrative. Across the many vignettes and cases, much of the discussion focused in three thematic areas: the factors leading to distressed or failed projects (summarized in Table 1), the treatment of “uncertainty” and “risk” in the global project legal paradigm, and the inevitability of renegotiations.

Table 1 – Summary of factors contributing to distressed or failed projects

Factors Contributing to Distressed & Failed Projects

1. Irrational exuberance in the 1990s. What were investors thinking in the early 1990s? The era was characterized by a mood of irrational exuberance after the collapse of the Soviet Union, the failure of the Marxist/Leninist model, and the consequent lack of an alternative model to capitalism as a basis of economic organization. Suddenly, there were many lucrative opportunities in Eastern Europe, and in many other countries, and foreign investors “threw caution to the winds”. Of the tremendous increase in foreign direct investment (FDI) in the 1990s, including in infrastructure, most of those investments were without investment insurance. The assumption was that expropriation was not a material concern because everyone had or was moving towards a capitalist model. So, while common knowledge recognized that the legal system was not as fully developed in some of these countries, the prevailing attitude was that these systems would improve with time. Investors put too much faith in their ability to discern how the domestic and international political system was going to evolve. They entered countries that had under-developed legal systems, often with excessive enthusiasm, believing that things had changed or would change after the fall of communism. Often those changes did not materialize as expected, even where new laws and regulations signaled an invitation and, seemingly, a strong commitment to private infrastructure.

2. Industry-wide illusions during the 1990s. What were the assumptions that led the global push into developing countries? First, irrational exuberance, as noted above. Second, in the investment community, there were a great many references to the successes of deregulation in the United States and of privatizations in the U.K., and to the power of market forces. There were false assumptions as to the relevance of these models to developing countries, based on an incomplete understanding of the reasons for the successes in the U.S. and the U.K. and a failure fully to analyze how developing country infrastructure markets were different. Third, there was a breakdown in some disciplines. Can you really assess political risk? This has indeed been difficult. While some analysts have been able to offer better insights than others, risk assessments in the past have too often offered a false sense of accuracy and comfort to investors. Data on infrastructure demand in these countries (for example, power demand or traffic forecasts) were often unreliable and failed fully to assess the impact of government policies which opened the sector to multiple private infrastructure projects at the same time or of competition from alternative publicly- owned infrastructure.

Insufficient attention has been paid to content validity, measurement validity and predictive validity of many of the political risk assessment methodologies that have been utilized.

3. *Increased mobilization of civil society and interest groups.* Since the 1990s, the number of informal stakeholders *activated* and *mobilized* in opposition to privatization and private participation infrastructure has skyrocketed. Its not that there are more stakeholders—the stakeholders were there earlier—but with the spread of democratic values and a steady growth in disposable income, these people came to feel more empowered than before, to express interests and opposition in socially and politically sensitive areas. Democracy and wealth bring changes in citizens' and individuals' self-conception, notions about their rights, and new kinds of action possibilities. This redefinition in identities and broader cultural frames has empowered a transnational, socially-active, politically-entitled, middle-class that fights for environmental and social equity issues; a stance that tends to counterbalance the interests of investors, financiers and governments. People have gone from relatively passive actors, to being actively involved in expressing themselves.

Social protests and opposition, at best, create unforeseen costs and delays in the project approval and implementation process, and at worst, lead to outright project failure. Consider how much money Exxon Mobil spent in preparing for the Chad-Cameroon pipeline through stakeholder consultation. From a risk management perspective, it is difficult to anticipate who the informal stakeholders will be—in one community they may be very different from the informal stakeholders in another community. Also it is not only locals who are involved; international NGOs and networks of activists enabled by new IT technologies can form strong coalitions, raise funding and lobby politically.

For example, India introduced a new constitution when it became independent. It has been a very successful constitution, but it has given standing to every Tom, Dick and Harry to pose a constitutional challenge. The cost to pose such a challenge is very low, because of the way the system is structured. So, for many of the major infrastructure projects in India, Tom will initiate proceedings, and when Tom fails, then Dick will have a go, and so on, down the list, endlessly. The stakeholders in India increasingly are using these constitutional challenges and other administrative and judicial procedures to pursue what they feel are their rights, including challenges to private infrastructure projects which they oppose.

Another example of legal changes empowering citizen challenges is the Administrative Litigation Law in China, though it does not yet seem to have been used to challenge government approvals for private structure projects.

It may be that the legal paradigm, with a more traditional view of who the stakeholders are, has not yet evolved to account for this newly-minted set of stakeholders, which is increasing both in number and in perceived entitlement to participate in the project decisions. Likewise, the contract structures, which are more historically based, may be built on assumptions that are no longer correct about who the stakeholders will be.

4. Public expectation for “below-cost” prices. Problems arise when government officials, and the public at large, hold deep-seated beliefs that price-levels for water, power, and other public goods should follow historical precedents, which are often far below actual costs of provision. Where did these expectations of below-cost prices come from? Historically, in the emerging markets, the state sector has been the dominant actor in building water and power infrastructure, often funded with concessionary finance from state development banks, with low costs of capital, often with no amortization. The state, using other people’s money, got to overbuilding. Nobody cared about giving signals to a private market. The price of electricity did not reflect the costs of invested capital. Then in the 1990s, everyone turned to private investors. But the private investors needed more than the retail prices that were being charged. This created conflict. Governments made commitments to full cost-recovery pricing for private infrastructure providers which in many cases they were unable to sustain, either in the face of political or civil society opposition or when confronted by the implications of such commitments in the context of systemic economic crises.

5. Conflicting views of “project success”. The metrics of project success can be different for every party involved. Lenders want security, equity investors want capital appreciation, builders want a profitable project, policy makers want to meet policy objectives, members of the public demand certain levels of service and pricing, and informal stakeholders have environmental and social impact reduction targets. Indeed, all have different notions and assumptions as to what constitutes a successful project outcome. Across countries and regions, taken-for-granted, culturally-supported logics of success can vary tremendously. Different tacit expectations lead to conflict, and conflict causes distressed and failed projects. If a universal definition of success is non-existent, how is it possible to align interests?

Herbert Simon tried to answer this question in 1954. He said, if you have a set of goals, and I have a set of goals, and we need to cooperate together, then your goals are my side-payments, and my side-payments are your goals. So there can be alignment, but the goals really do vary. Such goal alignment must take place, however, in the context of the recognition that private investors and financiers will invest in infrastructure projects only if they have a reasonable expectation of realizing a return on their investments which is attractive in comparison with the alternative investment opportunities available to them.

6. *Incentive misalignment between stakeholders.* Following from different definitions of success, investors and their legal advisers face the seemingly impossible challenge of designing project structures and incentive systems to distribute costs and benefits in a manner that is perceived to be equitable by all parties. One participant told of a toll-road project in Eastern Europe, that had been the “Deal of the Year” in 1995, but by the early 2000s was a failed investment, much because of misaligned incentives. A contractual and risk allocation structure devised by the lawyers had failed to account for a number of factors critical to the success of the project. First, a national engineering institute felt unacceptably ignored in government negotiations with the foreign investor. They battled to be more involved. Second, the host government had designed a tolling structure that seemed good on paper, but really did not reflect public expectations. Eventually, there was a public outcry, and the constitutionality of the tolling mechanism was challenged. Citizens who had to pay the tolls didn’t understand the whole scheme. They were used to a communist system, used to having TVs, washing machines, cars, and similar “necessities” subsidized. Roads had always been free. As the GCR participant recalled, “I remember seeing 19 year old kids standing beside the park singing all the communist songs to bring back the government who gave them everything for free. Nobody had explained to them that they would have to pay for the road.” Lastly, because this new motorway connected to other parts of Europe, the value to users was saving time and the primary beneficiary was the truckers, but nobody accounted for how this would increase waiting time at the border. In the end, a group of prostitutes saw this as an opportunity, and set up business at the border, causing yet a further set of issues. The lawyer who told this story speculated that many of these issues might have been avoided had the contractual-legal structure provided a better alignment of incentives to the various parties.

7. *Poor understanding of risk factors across sectors.* Cement plants, telecom, ports, railways, container ports, they all have different risk factors. In general, water projects are more risky than power, and power projects more risky than telecommunications. This is partly explained by the average build-out time-frame for different types of projects. As the build-out time-frame increases, there is greater risk that the political climate, or the demand structure, will change. The regulatory framework varies across sectors as well as the basics of sector economics. As noted, highly subsidized services, such as water and power, present particular challenges when private investment enters the sector.

8. *Public expectations of government conduct.* The European motorway project, noted above, ran into problems when the citizens became aware that they would have to pay for the services. Indeed, there was a national expectation—a shared mindset shaped by decades of communism—that roads should be provided free of charge. Of course, this expectation was unimaginable to the foreign investors, who were accustomed to Western logics where toll roads are a part of everyday life. Toll roads work in Britain because there is a society that is prepared to accept (a la Margaret Thatcher), that it is not a government’s job to supply roads, if and when private investors can pay for them and operate them more efficiently. Likewise in the U.S., Canada, and other industrialized nations.

If the general public has deeply-embedded beliefs about the types of services they expect their government to provide, problems can and do arise when a foreign investor tries to implement a contrary scheme. Water is another common example. In many locales, the public believes that the government should be providing water for free. But when foreign investors are invited to provide water systems, they expect to be paid, and either the government has to subsidize this payment, or the public must pay directly.

Another example discussed was a power project in Latin America that was undergoing privatization of distribution. While the government had controlled distribution, power was only available intermittently, 4 – 6 hours a day. Under the private investor’s management, power was now available 20 hours per day. But the private investor, in the participant’s own words, “had the audacity that it expected to be paid.” Under the old government-supplied system the government had pretended to supply power, the citizens had pretended to pay (and by and large they didn’t pay), the government hadn’t been very good at collecting, the default rate was very high on collection, and many of the lines had been tapped. When the new

foreign firm came in, they installed meters, and they cut off all the tapped lines, and if citizens didn't pay, they would cut them off, too. This created a public outcry, and much popular opposition to the whole scheme, which became very problematic for the well-intentioned foreign investor and for the government, which solicited, negotiated and supported such investment – only to subsequently oppose it.

9. *Incomplete consensus within host governments.* Probably the greatest miscalculation of private infrastructure project sponsors was in the conclusions they drew from their dealings with government in obtaining project approvals. Private infrastructure was possible in most countries as a product of recent laws and regulations authorizing infrastructure privatization and/or private infrastructure projects. Parameters were established by such legislation or regulations for the negotiation and approval of specific projects. Yet projects approved in accordance with such laws and regulations were often the subject of partisan political debate and civic opposition. This was often compounded by resistance if not outright opposition by government agencies with important rules to play in project implementation. In a number of cases, one government agency went to court to challenge a private infrastructure project that had been approved by other government agencies. Court proceedings exacerbated public opposition, with different interest groups rallying behind the opposing arms of government. Such problems, ironically, appear to have been more severe in those countries with pluralistic democratic regimes than in places more autocratic.

10. *No true need for new infrastructure.* Is there a public need for what is being provided? While this has little to do with the legal structure, it has everything to do with the success of a project. If demand does not materialize, neither will revenues, and the project will fail, no matter what the legal structure.

While the unmet needs for additional infrastructure in the emerging markets have been extensively documented by the World Bank and others, specific projects – and often multiple projects approved by governments in a short period – failed adequately to assess demand and created excess capacity.

The Dabhol mega-failure—one of the largest in recent history—might have been avoided had more attention been paid to the economics of supply and demand. Indeed, long before the Dabhol project was approved, there was a World Bank report that advised against building a base-load plant given the levels of regional demand for power. But the host government went

ahead and authorized a base-load plant, in collaboration with a U.S. firm who was overly eager to enter the market, relying on the principle of “too big to fail”. The lawyer’s role in this project was to build a great structure of risk allocation with the risks of inadequate demand being allocated to the state electricity board as power purchaser through the minimum payments due under the contracts. But all talk of allocating risks is an exercise in futility if the economics cannot be sustained, either commercially or politically. The view was expressed that an unviable project cannot be made viable with contracts.

One further example, in the participants own words, “Turkey may be the next energy disaster. There are 9 to 11 plants producing power with take-or-pay obligations from the government at 7 to 10 cents per KW-hour. You can produce power today at 3 cents. And the Turkish government will never dishonor an agreement. So there are all kinds of arbitrations. The governmental judgment at the time to privatize was short-sighted and cut against the basic social and political needs of the country. In Turkey, they had massive amounts of hydro and coal. Was there really a true need for new power, or was it just fabricated government hype or profit-driven by the private sponsors in reliance on the demand risk having been allocated to government ? Were the economics strong enough to support these projects?”

11. Mismatch of dollars and local currency. Many projects failed because the local distributor was going to be paid—in so far as it was going to get paid by its customers—in rupees, or yen, or some other local currency, and the payment to the investors had to be in U.S. dollars. This risk allocation, which was executed to make the investors safe—their receipts were to be received in U.S. dollars—meant that the host government was to bear the risk of currency exchange risk. In many of the cases, before a project was constructed, devaluations in local currency meant that the local distributor was never going to be able to collect enough local currency to pay the obligation. Despite contractual provisions, legislation or regulations providing for adjustments in prices to cover such costs, such adjustments often were not made. In some cases there was a public outcry of plunder by the foreign investors. In other cases the local currency devaluation was so severe that a rise in price to the end user was not a tenable political option.

12. Lack of host government credible commitment. There is a fundamental problem with the credibility and reliability of host government promises. This may be the basic, deepest underlying problem with private infrastructure investment in developing countries. Many

governments cannot make credible commitments to foreign investors. Their promises—about tariffs, demand, subsidies, and the like—are just not reliable. And investors are justifiably gun shy, because they see governments breaking their commitments that usually were given fully, honestly and in great detail at the time of the signing. Sovereign governments can and do break their promises, and they have done so very frequently—in China, Indonesia, India, Pakistan, Thailand, and the Philippines.

Moreover, private investors making investment decisions need to appropriately identify where the economic benefit for a project will lie. This can be another problem. If the local government cannot be trusted, and they manufacture numbers to justify a project on the basis of secondary political interests, how is an investor to know what the true demand for the project will be? And how is an investor to obtain an independently prepared economic value analysis?

Finally, governments change frequently. The period of investment for an infrastructure project ranges from 10 to 30 years, which means the contractual agreement will be reviewed by anywhere from 3 to 8 different host governments. And with each new government, decisions are made that are politically advantageous in the short-run. As one participant remembered, “The initial contract was signed just before the state government of the day fell. And, it was plain as day that there was strong political opposition to this project from the incoming government. And in society there were strong nationalistic feelings. So there was every indication that this project was going to fall on its face. And it did.”

13. *Misuse of home courts by host governments.* Another facet of political risk is the “home court” advantage enjoyed by host governments “when they decide that they don’t like what they signed up for.” Several GCR participants noted experiences in Asia where the local court interjected itself into an arbitration proceeding.

A participant gave the following example of a project that had become embroiled in the politics of the country: “When arbitration was commenced, the government went to its own Supreme Court to get an injunction to restrain the arbitration proceedings. And it’s very important to note the rationale which underwrote the application—it was that there were essential issues to the state, allegations of corruption and such, that could have caused significant economic impact on the state. These factors required that the resolution of issues not be undertaken by three arbitrators, but by the state’s court. This injunction threatened

every protection that was inserted in the contract agreements, to ensure that there would be an impartial resolution of any dispute arising under the contract.”

“Perhaps as an indication of how these things work, the argument in the Supreme Court went quite well for the consortium on the first day. On the second day five generals showed up in full military dress uniforms and sat in the front spectators’ seats. And the next day there was a 3 to 2 award against the consortium. It goes to illustrate the difficulty of enforcement, of the contractual provisions designed to protect investors.”

“What are lawyers to do, and what are business people to do, when they undertake the most elaborate exercise in risk identification, and management, and contractual risk allocation which is then defeated by the courts themselves?”

“At the end of the day, if you are contracting with a foreign state entity, you are going to be at risk. But let me remind you, for the benefit of lawyers, to review or revisit any arbitration cases where the public policy of the United States was threatened. The point I make is that while we are subject to criticizing the Asian courts, we do the same things in our own country.”

“So, if you can’t trust the local government, what do you do? There is the issue of keeping the state honest. If you’re lucky enough to get an award, how are you going to enforce it?”

14. *Thievery by corrupt political officials.* Much more political corruption occurs than ever is reported. On one project recently completed in Asia, a participant told of a \$20M dollar budget item for community education, which reprehensively was divided up among the politicians themselves. On another project in Asia, a participant explained, “there the situation appeared to be that the husband of the then prime minister was supposed to have taken 15 to 20% by way of an educational expense. That impaired the economic value, and the project became embroiled in the politics of the country.” In another example provided by a participant, “There is currently an arbitration that is not confidential, because at least one party is broadcasting everything that happens in the local papers in Kenya. It is a claim of a company from the Emirates against the Republic of Kenya. [The] claimant said, in his own case, that to get the contract for the duty free shops in the towns of Mombassa and Nairobi, he went to visit the then president, Mr. Moi, with a suitcase of \$2M, and left with a suitcase filled with sawdust. And everything went splendidly until two very large men came and said the president needed some more money. The issue here is exceedingly troublesome. The

claimant argued that this is not really a case of bribery, of which the State of Kenya was unaware, because the president was the Republic of Kenya. So, really, it was impossible to divorce the payment to President Moi, from the knowledge of the President of Kenya which was embodied in the person of the President. The case...really throws into sharp relief, for a person educated in Western law or political systems, a difficult question. Is this is not a case of bribery? And, yet, that is the claimant's argument, on which the state is supposed to rule."

15. *The "deal was too rich"*. In several of the cases, the deal was simply too unbalanced in favor of the foreign equity investors. As one GCR participant explained, "As a general rule, never bring home too good a deal for your client, because then you're going to have trouble. Certainly, if the other side is giving you everything you want, then you have to say, 'we're going to have to work with these people, and one morning they are going to wake up and say, hey, I really got screwed on this.' And then they're going to be looking for ways to give you trouble. And particularly in the developing world, with all the issues that go around exploitation. So, if you see a real misallocation of risk, even it favors you, you better sit down and look at it. Clearly there has to be an alignment of interests, it can't be all one way, or all the other way, or it will never work."

16. *Concurrent multi-region financial collapse*. One of the ways in which foreign investors and lenders deal with risk is through multi-country, and regional, diversification. The Asian financial crisis was a "contagion"—a crisis giving rise to significant problems simultaneously in a number of jurisdictions. Many foreign investors and lenders—and organizations like Standard & Poors' and Moody's—did not contemplate problems arising in multiple jurisdictions at the same time. Thus, when the bottom fell-out, many firms—and countries—were under immense pressure as to how they were going to survive; this created a panic situation, with host countries failing to honor contracts as one of their many survival tactics. Moreover, this chaos was exacerbated, as one participant noted, by "some multilateral institutions, international aid agencies, and the development advisory groups, who were creating substantial misunderstandings, by telling host governments to suspend projects, and that the investors would renegotiate and not do something more drastic."

Risk and Uncertainty

There is a large body of literature that talks about different risks—commercial, systemic, macro-economic, exchange, financial, and construction risks. Then there is the whole world of political, regulatory, social, and legal system risks. There is a litany of different risk categories. And every firm has its own risk-return calculus.

And yet firms report, in a great many cases, that *ex-ante* attempts to identify and mitigate risks failed to prevent project-threatening unforeseen costs and delays. Why is this so? As one participant explained about the mood during the early 1990s, “On the side of risk management, there was a lot of glossing over just how much uncertainty there was of how things might evolve. There was this broadly accepted language of assessing risks—such as political risk—that may not even be assessable ... creating a false sense of confidence for investors.” When we think about where this “language” came from, undoubtedly it has been promulgated by overly-rational tools and techniques for risk analysis taught in business schools, promoted by management consultants, and marketed by risk-management software providers. Many uncertainties in this world cannot be accurately predicted *a priori*. Social and political risks are difficult to predict and can only be loosely approximated even by adopting models that attempt to capture the probabilistic nature of social and political reality.

That certain risks may be difficult to predict accurately does not prevent unpredicted risks from being allocated by contract between the parties, though such residual risks—if material—are particularly prone to efforts at avoidance and default.

Government default on its obligations in respect of private infrastructure projects has been identified as a particular problem. Further research is warranted, focusing on those projects in which government default risk was covered by a World Bank, MIGA or OPIC guarantee covering political and/or commercial risks. Was the outcome of such projects different from comparable projects in which risks of government default were uncovered?

Re-negotiations and Contract Failure.

Legal contractual failure. The general mood among the GCR participants was that the legal contractual structures used during the 1990s, for the most part, were inadequate and that there have been a large number of failures and renegotiations. As one participant shared, “The only thing that is predictable, is that over a 20 year life, the situation in these countries is going to change. Is it a reasonable expectation that over this long life, the contract will be

enforced as written? No, I don't think so. Contracts did not hold up in the last round. Is it fair to expect that they will in the next round?"

Arbitration is a wearisome process. Several GCR participants expressed frustration with the arbitration process. As one equity investor explained, "Every contract I've ever written has an arbitration clause in it. Arbitration is fine, and sometimes you win. It takes a long time to get something to an arbitral tribunal. Once the arbitration tribunal hands down an award, you have to enforce it through the local court. And there you have the real problems. I think I've been through five arbitrations, and I don't think it has done a damn bit of good."

Court judgments are hit and miss. Participants also expressed frustration with the quality of courts' judgments. As a participant remarked, "In the majority of judgments, they were an absolute disgrace and really the authors should be ashamed of themselves. There wasn't one authority cited. It just went into a statement. And friends, if there's a solution to this, I can't think of it."

Arbitrations and court proceedings are a zero-sum game. "It is really a parasitic exercise in a sense because nobody is really going to get anything for that expenditure," said one attorney, "Sure you can renegotiate, and do all sorts of things to get the [project] back on its feet, but in the meantime its going to cost somebody money." For the private equity investors at the table, they agreed that once a project entered arbitration or the courts, it was in most cases a lost investment because of the breakdown in the fundamental working relationship between the parties. In some settings, such as engineering and construction contracts, arbitrations are recognized as a mechanism to resolve disputes which can be expected to arise in the normal course of the working relationship between the parties. In such a context, arbitration of disputes takes place without a fundamental break in the working relationship between the parties; work on the project often continues as the arbitration proceeds. With private infrastructure projects, the nature of the disputes brought to arbitration or to the courts are such that it is project termination and compensation which are most often at issue. The question was raised as to whether mediation could be used in an effort to resolve matters before the relationship between the parties (typically, the project sponsors and government) had become irretrievable.

Renegotiation climate is important. Current world and national events can have a large impact on renegotiation outcomes. As one equity investor remarked, "Some of [the

renegotiation outcome] has to do with the amount of pressure the government is under, and that is hard to quantify. From time to time, there is local pressure—elections, broader political or economic problems, what have you—and things begin to change, not always for the better. Governments do not behave rationally. Not our government, nor any government I know. The only people that behave rationally are those who want to make money. Governments are subject to all kinds of interests and forces. When governments change and congressional inquiries come, rationality goes out the window.”

THE CRUX OF THE PROBLEM : OPPOSING LOGICS OF RATIONALITY

“When the private and the public work together to provide infrastructure, no matter what the arrangement, what you have is two totally irrational systems, trying to cooperate.”

- Participant in the General Counsels’ Roundtable

Opposing logics of rationality. There has long been, and may always be, an entrenched clash between government agencies and private firms: they have opposing interests, institutions, and measures of success, arising from differing logics of rationality. Foreign investors are interested in profit, driven by competitive industrial norms of efficiency, and measure success in terms of short-term return on investment. Politicians are interested in public image and status, driven by government norms of accountability and rule-following, and measure success in terms of popular support and re-election. These logics are remarkably different and often lead to conflict. For example, from the logic of a private infrastructure investor, the government is an unpredictable and irrational partner. And looking the other way, the political elite admonishes the corporate firm for being overly-greedy and lacking sensitivity to social and environmental concerns. Titans of industry are frequently surprised, confused and dismayed by the decisions and actions of the political elite, and vice versa. And yet, both sides would claim rational behavior. Is one logic any more rational or irrational than the other?

Origins of opposing logics. Where do these different logics come from? Many taken-for-granted human interests are innate—the desire for power, achievement or wealth. Institutions—beliefs, values, norms, rules and laws—are socially constructed, and define how

rational social, economic and political behavior should appear. Measures of success are benchmarked against complex sets of interests and institutional forces in combination. Differences in the value systems within which contracting parties operate need to be understood by all parties to a project in order to minimize conflict.

The basic problem. So a basic problem with private infrastructure, then, is the inherent conflict in logics between the public and private sectors. That conflict, though, is a reality of daily life in both capitalist and mixed economies. Government, as either a regulator or as an owner and operator of economic assets, interacts with the private sector as regulator, competitor or partner. The nature of the conflicting interests – the differing perspectives on what constitutes for each ‘rational’ conduct in such conflicts – is the reason why the alignment of incentives in a transaction is so important. Private infrastructure projects allocated risks rather than aligned incentives. Is this a fundamental cause of the large number of projects which became distressed or failed?

In the words of a sociologist at the table, “When the private and the public work together to provide infrastructure, no matter what the arrangement, what you have is two totally irrational systems, trying to cooperate. You have this somewhat differently organized governmental system on the one hand, with great variation around the world. And then you have a set of more homogenous Western and multilateral financial institutions forcing one type of general economic model. And these really are misaligned. And the cost of this is just enormous, huge transaction costs—the result of all the elaborate contractual arrangements with bells-and-whistles that gets heavier and heavier with time.”

PRIVATE INVESTMENT IN FOREIGN INFRASTRUCTURE: IS THERE A FUTURE?

“If you go to China, and look across the range of projects, most have been renegotiated. Equity has been squeezed out. But the plants are still operating. They are not closed down. Power is being produced. The renegotiated price is fair compared to other Chinese plants. What is the game? Will they need more money from the outside? Will there be another round of investors? Will the memory be there? Will there be new guys, with new bonuses for signing deals? A new group of politicians predicting high demand, because they want to justify their policies? Are we

basically talking about a game, that we have seen a couple of rounds of now? Or, can we fix this in some way?

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Participant in the General Counsels' Roundtable

Short Run

With world population growth projected at 1 billion new persons by 2015, and continued world population growth well into the middle of the 21st century, common sense tells us that there will be continued demand for newly constructed—and refurbished—infrastructure in emerging markets. How will that infrastructure be financed? There are only three ownership options: private, public, or private-public co-ownership. And until emerging countries, such as China, start to generate their own surplus indigenous capital, these countries will lack the internal capital fully to meet their own infrastructure investment programs. Thus, the consensus of the GCR is that private money will be necessary to initiate and sustain infrastructure growth in many emerging markets for at least some time to come.

Longer Run

Why is there ever foreign direct investment, either in infrastructure or other sectors? The answer that economists usually give, is because foreigners are able to capitalize on some sort of short-run monopoly opportunity—by providing scarce capital, new technologies, or superior knowledge—which generates a comparative advantage. But, this comparative advantage must be large enough that it also outweighs the “liability of foreignness” faced by outsiders. Indeed, locals are always going to have an advantage, from an organizational standpoint, in running successful relationships and strategies, because they have trust, bargaining power and local knowledge—of local rules, customs, norms, and beliefs; of the local natural environment; of local actors including individuals, firms, regulators, and ties and network structures between actors; of local technologies, from office supplies to heavy equipment; and of local history, market trends, and business cycles. A foreigner who faces a “liability of foreignness” will always enact sub-optimal strategies and resource allocations relative to those of local competitors, and thus if they are to compete with locals they must have a comparative advantage that exceeds these costs.

So, in the long run, as more local financing comes available in emerging markets, it is unlikely that the shorter-run comparative advantage created by a surplus of Western capital can be sustained.

It must be recognized, though, that even when foreign investment does not have a comparative advantage, foreign investment – whether foreign direct investment or foreign portfolio investment (that is, investment in stocks, bonds and other financial instruments) – can continue at high levels. This is driven less by any comparative advantage that foreign investment may have and simply reflects the desire of foreign investors to participate in investments with attractive economic returns, which are either higher than those available in their domestic markets or – even if not providing higher returns – provides desired diversification to their businesses or investment portfolios. This is most evident in respect of foreign investment into developed economies (for example, foreign investment into the United States has been a long-running phenomenon), but can also be seen in emerging markets.

THE FUTURE OF THE GLOBAL PROJECTS LEGAL PARADIGM: TWO PROSPECTS

Is the 1990s model broken?

Evidence of failure. In the 1990s, in a general sense, the foreign investment community allocated a majority of the risks of foreign infrastructure investments to host governments—usually they were the party most suited to bear these risks. Such a risk allocation was also, however, a reflection of the underlying problems arising from such governments’ historic infrastructure policies. For example, government undercapitalization of its state electricity enterprises meant that the commercial risk of default (inability to pay) by such enterprises had to be guaranteed by the governments; private infrastructure projects dealing with such state electricity enterprises as power purchasers or fuel suppliers allocated such commercial risks to the government. But then mismatched currencies, broken government promises, the Asian financial crisis, and a host of other factors (noted in the discussion above) caused a large majority of these contractual arrangements to fail, at least in the power sector (Woodhouse,

2005). While some of the contracts were renegotiated to successful outcomes, in other cases the investors were best served to “cut and run”. So, how has the global projects legal paradigm fared? As one participant observed, “the model is broken, we all know that.”

Were the risks misallocated? As the GCR moderators summarized, “That gets to be very hard. You might make what seems to be the right risk allocation, economically. Saying the foreign exchange risks ought to lie here, because they are the cheapest currency exchangers, and the demand risks ought to lie there, because they are controlling the policy environment that will ultimately set the demand for the available power. But what everyone has said, is that even if... the economic allocation [is correct], we shouldn’t do it. We ought to have the less efficient risk bearer take the risk—which by the way, will presumably raise prices—[because] the way the risks were allocated during the 1990s was a recipe to have [things] come apart, because of social and political unrest.”

Can the model be fixed? In a foreign environment, with great institutional instability and uncertainty—that is not likely to end within the discounted net present value horizon of most large infrastructure projects—and with all the shortcomings of risk analysis, how do you practice law or manage risk? Is it inevitable that the original terms of a binding contract will be defeated by the actions of a host government? Can you have enforceable contractual arrangements over the duration of major infrastructure projects? The answer provided by one participant was, “Not entirely, our attempt to assuage and accommodate risks by creating a contractual arrangement is not going to work in each and every case. You’re going to have these risks, whether you have a foreigner running them, or whether you have a large local financial contribution. Nothing in the contract is going to save you from these difficulties. [They are] endemic in all major infrastructure projects.”

Two Roads Diverge...

The global projects legal paradigm is broken. Improvement is necessary before the next round of investment. Two foreseeable paths of continued evolution are: revision of the legal paradigm by altering or adding components (the “components alternative”) and a “governance model” for private infrastructure.

The components alternative recognizes that the reason for the relatively consistent contractual breakdowns of the 1990s is that there were a series of choices made about the

structure of risk allocation that can be re-defined and fixed by unbundling and reallocating the risks, treating them one at a time with “patches” or new legal and financial engineering “tools”.

The governance model offers a radical departure, with more flexible contracts to provide a framework for periodic renegotiation, as well as private and public co-ownership arrangements and co-governance structures.

Components Alternative

One participant set the framework for the “components alternative” in the following terms, “Many governments cannot make credible commitments to foreign investors. Their promises are just not believable. Sovereign governments can and do break their promises, and they’ve done so very frequently. So what are investors supposed to do? Well, if we had a descendent of Grotius here, he’d probably say something like, “We need a system to protect international property rights, and we need a global investment agreement.” But, I hate to tell all the lawyers around the table, what we have is an unplanned, undesigned—and I hate to even use the word—system. We’ve got some components lying out there. What have we got? Well, we’ve got access to international arbitration, we’ve got some regional economic agreements, we’ve got some rules for conducting international arbitrations, the forms for the arbitration, we’ve got the New York Convention to help us enforce the awards, we’ve got international political risk investment insurance—more than 24 of them available now, some multilateral ones like MIGA, some international development banks with guarantee programs, and a private political risk insurance market and we also have what you call home government support. In the 19th Century this was sending the Marines into Haiti, a kind of protection of international property rights. The lawyers at the table know about the Hickenlooper amendments. Then we have the somewhat amorphous multilateral development bank “halo effect” or, if you want to be militaristic, a deterrent effect, that might protect some investors if they have a multilateral institution... or export credit agency [behind them]. So then the question becomes, are these components adequate to protect us and answer our concerns about the credibility of a host government’s promises, and can we put these components together in a fashion that addresses our needs? Or, are we missing some key components? Do we need the equivalent of a multilateral arbitration, mediation or amicable conciliation

program? Should the World Bank or ADB have a formal program in trying to work with investors in the infrastructure area who are trying to work through disputes with host governments?”

“Extending” the global projects legal paradigm. The components alternative offers patches, add-ons and substitutions that contradict—and augment—the existing global projects legal paradigm. As summarized by one of the moderators, “The components contradict the global projects legal paradigm strategy, because the paradigm would say, let’s move to contracts, and let’s load into the contracts the commercial, regulatory, foreign exchange and all manner of other risks. And let’s allocate these to the host governments. Basically, that hasn’t worked. It hasn’t held. So, we want to move beyond that. Let’s unpack those things that we did in the 1990s, which was to bundle everything together and handle it as legal risk. Instead, let’s deal with them one at a time, as component elements.” While the essence of such an exercise involves risk identification and risk allocation, the components alternative gives much greater attention to risk mitigation in project design, including the possibility that some risks cannot effectively be allocated (that is, one party taking responsibility for the consequences of such risk) but can only be mitigated (steps taken to minimize the likelihood of the risk materializing). The components alternative also focuses attention on effective enforcement: attempting to ensure that, if a risk does materialize, the party to whom such risk has been allocated (assuming it is among the risks specifically allocated to a party) will honor the obligation or the obligation can be effectively enforced against such party. Too much of the experience of the 1990s has been about allocated risks which have not been honored and which provided incapable of effective enforcement.

The components. A list of components suggested by GCR participants is as follows:

- ❖ Flexible contracts to remove the “brittleness”
- ❖ Local currency borrowing, which is increasingly available from multilateral banks, to deal with mismatched currency risks and, to the extent of foreign currency financing, more effective hedging mechanisms
- ❖ Competitive bidding, as opposed to negotiated contracts, to minimize allegations of corruption
- ❖ Balance-sheet financing as an alternative to limited recourse project financing

- ❖ New multilateral arbitration or mediation program specifically to resolve infrastructure-related disputes between private investors and host governments
- ❖ New forms of political risk insurance to deal with government defaults, such as denial of justice insurance, to guarantee collection of an award against the government made by an arbitral panel
- ❖ Mechanisms to better align private and government interests and to create mutually rewarding incentives for contract compliance
- ❖ New enforcement mechanisms for levying on offshore assets
- ❖ A direct linkage between government default and the loss of access by the government to multilateral and bilateral aid, at least in respect of transactions guaranteed by such multilateral and bilateral agencies, or such a government default giving rise to cross-defaults on other loans from such agencies
- ❖ Liquidity facilities as a part of project structures, to ensure project survival during periods of conflict with government and renegotiations

GCR participants also spoke of measures already being taken in response to experience with failed and distressed projects. These include (i) avoiding approval and construction risks by investing in projects only after completion, once they are operational. (ii) investing in or financing projects undertaken with substantial local capital on the basis that local partners are better able to deal with political risks and the seemingly unavoidable prospect of renegotiation at some time during a project's life, and (iii) greater selectivity in the countries in which investments will be made, avoiding countries previously thought to involve acceptable political risks but now considered to be too risky.

These components are a mixture of “carrot” and “stick”. Some, such as local currency financing, are intended to mitigate rather than allocate risk. Others are intended to improve enforcement, encouraging the honoring of contracts by making clear and certain the “pain” which default will bring.

In respect of all components, however, and in respect of other attempted solutions to the problems of private infrastructure in the emerging markets, the importance of sectoral reform must be given high priority. During the 1990s private infrastructure was undertaken with the belief that risk identification and risk allocation could insulate a project and its private sector investors and financiers from broader problems of an unreformed and economically

unsustainable public infrastructure in the sector. IPPs, for example, were thought to insulate a power plant from the problems of tariffs for electricity in a country which were economically unsustainable (for example, by not factoring in the cost of capital) or in which state electricity agencies were effectively insolvent. The process of insulation involved transferring the risks of pricing and of such agencies' insolvency onto the host governments. Ultimately, the contractual and financial burden on governments of such obligations proved politically unacceptable (creating partisan political opposition or public and civil society opposition) and/or such obligations proved financially unsustainable when the risks crystallized into payment obligations which the governments were unable or unwilling to meet. Will any system of private infrastructure succeed when the broader public infrastructure sector remains unreformed and economically unsustainable and, as a result, prone to instability?

Political risk insurance. One general counsel indicated that projects with political risk insurance were able to weather the Asian financial crisis better than those projects that did not have this coverage. He noted that, "if they had political risk insurance backing them, arbitration was more likely." When political risk insurance is purchased, there are two reasons, explained one lawyer, "From one perspective, it was project sponsors trying to protect themselves from expropriation risk. At another level, you can say that sponsors were trying to *create an incentive* for the host government not to expropriate for fear of compromising their relationship with the United States government (OPIC) or MIGA who provided the coverage—and who bang these countries over the head and threaten to revoke future loans when they get out of line."

Problems with political risk insurance. Four primary problems were discussed. First, the added cost to the investment may make it prohibitive. It is very difficult to pass along the cost of political risk insurance in the tariffs. That's why some equity investors no longer enter certain countries, because, if they add on the cost of the political risk insurance from MIGA or OPIC, "the IRR goes down too far."

Second, where projects do have political risk insurance, the policies are often written in a way that parties are forced to go through an arbitration process, and its only once an award is issued that the political risk insurance will pay out. Thus, claiming on political risk insurance creates a great deals of distraction, cost, and management time, which is difficult to value, but very expensive to the parties involved.

Next, there are, as one lawyer explained, “complex dynamics and gamesmanship problems. The guy on the other side is more likely to be tough if he knows it’s a different pocket that it is coming from. There are the problems of subrogation and whether or not you can bring the home government to pressure the host government. What is the result of this? You are running up the costs of the system.”

Fourth, it creates complex government to government negotiations, shrouded in secrecy. As one participant described, “Now, all those kinds of dynamics, they are not written up anywhere. There is almost a conspiracy of silence, as I’ve called it, about them. Because it’s in everybody’s interests to hush them up. The investor doesn’t want it to be known that it reached into its back pocket and pulled out a bludgeon and helped induce a host country not do what it was thinking about doing, by bringing in an OPIC or a MIGA. The investment insurer isn’t going to go around bragging about what it did. And the host country isn’t going to go around admitting that it backed down, because of a threat of the sky falling on it and all sorts of “disruptions”. So everything is quiet. But I can tell you, because it was made public at OPIC, for every claim that OPIC has actually paid, there were four that came knocking on the door saying, “We think something terrible is going to happen to us, of an expropriatory nature”. Well, what happened to the other three? Some just naturally went away. Some got cured through amicable discussions between parties. And some got “induced—I just better leave it at that”—to come to a settlement. But you don’t see those things written up, and that is a very hard topic to research. Most people buy MIGA and OPIC insurance, not to cover themselves to get compensation in the event of a loss, but to deter that kind of a loss from occurring.”

What is surprising is that a larger number of the private infrastructure projects undertaken in the emerging markets during the 1990s were not covered by political risk/investment insurance or guarantees. Further study is warranted to compare how projects with such coverage fared by comparison to projects lacking such coverage and to better understand the reasons investors and financiers did not avail themselves of coverage.

Out-of-country collateral assets. Two insightful comments were offered by participants with respect to the increasing importance of this strategy. First, “with increased globalization of the world economy, there are a lot of assets outside of the host countries, and you can get to them. And that is going on more and more. It was always there, but I think you are going to

see more of it. In response to some of these cases—say where the U.S. makes a bad law—courts in other jurisdictions will be relatively flexible in letting assets get reached.” Second, “Someone alluded to the fact that there are often assets outside a home country, so once you do get an arbitration award, it may take some years, but if you can identify assets outside the home country you can enforce the award.”

Governance Model

The inspiration. An alternative model to cope with the problems of government default and misaligned incentives was alluded to by a participant investor. He explained that, “You’ve got to strive for partnership of government and private firms, in order to work together, and to have some common good. We brought them into these things, and made the government a partner. But when it is driven purely by greed, it fails. But the problem is that the equity guys want to make money.”

Stimulated by this remark, an academic participant at the table reinforced this set of ideas, “I think along the lines of what is being explained, another solution is to try and craft and cobble together arrangements that allow for more of a partnership model, as opposed to purely private ownership, that begins to work not just on individual case-by-case project contracts, but on longer term relational understandings that allow for some trust and allow for some alignment of interests. This requires co-ownership, co-alignment and co-direction, with a shared understanding that, ‘we are in this for the long run together, we are going to win sometimes, and lose sometimes.’ The contract becomes a [living document], something to revisit every so-often because the world is going to change. And I want to emphasize that this is the collision of multiple, irrational institutional forms. An many of those irrational institutional forms—what we call our “rational” economic incentive structures—are for many purposes and projects completely dysfunctional and irrational...”, though without a reasonable assurance of a profitable outcome, neither private investors nor lenders will “play”.

A general counsel at the table validated these theoretical arguments, as follows, “What the professor just said, reminds me of an important analogy from the world of EPCs—Engineering, Procurement & Construction contracts. When they work well, you have exactly that approach in the relationship between the project owner and the EPC contractor. You

have contracts, and they're big projects. But you cannot have one of those contracts work well if you take each class of interests all the way through the dispute resolution process, it doesn't work, it doesn't pay. It's a zero sum game. And when you're lined up with your client, you don't have to do that. A good contractor steps up to the plate and takes responsibility. There is recognition, if you do very large projects for a living, that you have to create such a working relationship if you are going to survive."

“Re-inventing” the global projects legal paradigm. The governance model posits that contracts need not be “brittle documents”: they can be designed for periodic renegotiation and readjustment and can contain built-in “shock absorbers” to deal with destabilizing events. This is a radical deviation from the global projects legal paradigm of the 1990s, which assumed fixed contractual arrangements to be enforced over the life of a project. It is a governance model rather than a contractual-legal model. It draws heavily on concepts of corporate governance and on extensive experience, in the international arena, with joint ventures and consortia.

A way to think about this shift is along the hierarchies versus markets continuum. Market-based governance -- wherein functions are widely distributed and controlled by market forces -- requires relations with external parties, contracts, and many kinds of bargaining and negotiations. Hierarchical governance -- wherein all functions might be housed within a single entity -- requires shared goals and incentives. The complexity of the present arrangements suggests that too much reliance has been placed on the external bargaining model, of which the components alternative will add another set of potentially burdensome contractual safeguards. So another alternative is to try to develop a more elaborate, richer, set of governance relationships to align interests. Not a lot of research work has been done in this area, although the United Nations Public-Private Partnership Alliance does have some studies available.

Public-Private Partnerships. A number of participants addressed the question as to whether so-called “public-private partnerships” for private sector infrastructure effectively embody the governance model. Projects embodying the approach have been particularly popular in recent years in Europe and particularly in the transport sector, influenced by the English government’s Private Finance Initiative (PFI).

In partnerships that have worked in Europe, there is an alignment of interests, and the government usually shares some of the profits. This is different from a classic BOT project. As one lawyer with experience setting up deals in Europe explained, “In a classic BOT, the government grants a concession, or land rights, but no monetary compensation. Whereas in a public-private partnership, the partnership is much stronger, with some contingent obligation provided by the government. It is usually designed as a special purpose corporation, and some of the ownership of that corporation goes to the government, so, it has a much greater level of trust because there is greater involvement. It is not just cursory reporting. The government is involved, and can be involved, in major decisions. There is a greater awareness, and the government is bound more into the responsibility of what is taking place. The government does not actively manage, but they can have a seat [on the board], super-majority rights in the organizational documents and structure, and revenue or profit sharing incentives. All of this is designed to create greater accountability on the government side, with greater information flow, and greater levels of trust. A key difference from a non-partnership arrangement, in that the financial structure is non-recourse to the private sector side, but again, the government may have some contingent obligation.” Another participant explained that where he had seen public-private partnerships work well in Estonia and China, there had been 30% to 40% government ownership, provided not as cash, but through the contribution of assets, such as rights of way and track when a government de-nationalized a railway.

Advantages of public-private partnership. Several hypotheses were offered for why an entity that is 70% foreign owned, versus 100% foreign owned, is a more effective mode of organization. First, the government has a publicly perceived duty to manage high-profile infrastructure assets, such as the tube (subway) line in London. As one participant explained, “They just can’t turn it over to the private sector. There is a government responsibility. Many people ride the tube lines every day. By doing a partnership, they are satisfying their obligations to the populace by staying involved. They can’t just tell the public that they’ve turned the subway over to a private group.” Whether or not it is the case, the public may perceive that the government can best exercise its duty from the inside, as a partner, rather than as a regulator. Thus, in the move towards privatization, it may be better for reasons of

social perception about the public being able to exercise its responsibilities, to adopt a public-private partnership model.

Second, the partnership arrangement actually improves the economics, by changing the probabilities that the underlying problems are going to be solved—through tariff rises or whatever is necessary—because the government is now a partner in this arrangement. As one lawyer remarked, “If you buy a company, that’s making widgets and you run out of money, you have to get new financing. If you do a partnership in a road, or water, and it runs into trouble, I think there is a significant positive economic benefit of having the government involved.”

Lastly, there is greater information availability, sharing and flow, and trust relationships evolve, leading to more faith that the government entity will not be “ripping private investors off.” The public-private partnership model encourages early conversation, negotiation, and shared vision between the two “irrational logics” at the bargaining table, about all the different issues that could come up, which leads to earlier resolution of issues in the shaping phase, before commitments are made. As one of the academic participants observed, “In many situations with more of a partnership model, you have a lot of reduced restrictions on advanced information, and being able to tune in to what other peoples’ concerns are, in a way that you would not have in a more adversarial or regulatory kind of arrangement, arm’s length, what’s going on? So it’s partly a matter of interests and alignment. But it’s also a matter of more shared, common understanding, about what’s happening on your side, and on our side, and can we anticipate and make some changes here before the whole thing goes in the wrong direction. Those are the kinds of advantages in partnerships that work well. There are more information-rich possibilities for aligning, and correcting and anticipating difficulties.”

Disadvantages of public-private partnership. There were also disadvantages of the governance model that were discussed. First, a political scientist noted, “I’m not convinced that some of these benefits—information sharing, greater co-awareness, trust—don’t exist with other models.”

Second, the viewpoint of an investor and the viewpoint of a lender are extremely different. As an investor described, “The lender is likely to say ‘yes’, I feel more secure to having governmental participation (even if it may be unreal). The equity investor may be less

sanguine about it. The reason is that governments tend in the process of decision-making to look on themselves as having a golden share (that is, a veto right). That can raise serious problems in governance. You may have partners, but it doesn't mean the partners will agree." Another equity investor concurred, "When you have a public partner, the decision making within that partner can be influenced by concerns that the government may have. It may taint the process, instead of assist the process."

Third, in the oil industry public-private partnerships have been standard operation for many years. A 57% state partner will team with a 43% foreign operator. But this has not worked. A participant explained, "The wisdom in the oil industry is that it is a disaster, and they are trying to break away from it. What has occurred almost everywhere is, over time, confidence is lost in the public sector. The perception from the public is that the government officials are in cahoots with the multinational investors, and taking money."

Fourth, one of the principal problems is financing. When lenders finance on a limited recourse basis they want higher levels of certainty, and the partnership model may increase uncertainty by raising the prospect of deadlocks in the project company.

Fifth, a lawyer who has seen partnership models in action noted, "In my own experience, in both Thailand and Manila, the partnership has not been sustained. Local participation has not been, in my own view, a very successful concept."

Sixth, there is still the practical problem of how to deal with changes in government. As one investor complained, "We had a railroad in Brazil. The new government came in, and in turn the board members changed, and we had to start from square one. And this created problems. Are there other things you can do—added bells and whistles with partnering—to protect against the risk of government change? I don't know."

Seventh, a problem with institutionalizing some sort of flexibility into contracts, is that an investor is immediately forced to negotiate with a government that decides, for whatever reason, they want to expropriate. As one transaction lawyer speculated, "if you're going to change to a more flexible contract, the debt and equity levels are going to need to change dramatically, otherwise the investors will not invest."

Lastly, whether a government is thinking about squeezing the windfall profits out of a 70% owner, or a 100% owner, it may not make a lot of difference from a straight economics standpoint. Either way, the government stands to gain from a refusal to pay.

Reference was also made to a recent World Bank study (Estache and Serebrisky, 2004) evaluating recent experience with public-private partnerships in the transportation sector. The study linked the success of such partnerships to broader issues of sectoral reform, raising many of the same issues as noted above about the ability of the contractual-legal model to successfully address risk identification, risk allocation and risk mitigation in the absence of broader sectoral reform.

AGENDA FOR FUTURE RESEARCH

“There are three modes of future work: (1) elaboration and enrichment of the PESD power sector work to look at the renegotiations...(2) improvement of the private components model to look at add-ons and substitutions to augment the existing contractual allocation of risks...(3) development of the public-private partnership governance model and new ways to design flexible contracts.”

- Participant in the General Counsels’ Roundtable

Components model & partnership model. The participants of the General Counsels’ Roundtable have identified a fork in the road for the future of the global projects legal paradigm and private infrastructure investment, and further research is necessary:

- ❖ To study the factors that would be necessary to make the global projects legal paradigm work better by rethinking the allocation of risks in the 1990s with new mechanisms to support the allocations more sustainably.
- ❖ To study how projects can be designed for “instability” through the partnership model, and to identify more flexible contract frameworks, more flexible governance models, and more flexible project organization models.
- ❖ To develop a “proper tool for the proper job” approach, like the contingency theory of organizations, to guide project planners in their decision to select the best legal structure (contractual or partnership) and best component risk management elements to fit the attributes and aspects (sector, term of investment, past political track record, degree of government ownership, degree of subsidy, renegotiation clauses, etc.) of any given project.

Other research agendas. Further possible research directions, voiced by the participants of the GCR, are as follows:

- ❖ To study the link between the diminishing role of foreign private investors and the rising importance of local partners, and sources of financing. Do we see differential results in projects with higher levels of domestic sponsors and higher levels of domestic financing, as compared to the vast majority of projects where foreign investors and financial institutions dominate?
- ❖ To study the perspectives of each formal participant and informal stakeholder on a major infrastructure project—the lender, investor, builder, building inspector, permitting agency, government sponsor, NGO, community interest group, etc. The final result might take the form of a comparative chart, summarizing each party’s interests, objectives, definitions of success, and a checklist of go/no-go criteria.
- ❖ To study successful projects to provide a balance to those projects that went horribly wrong. Who ran it? And how was it organized legally-contractually?
- ❖ To study the successful project anomalies in a country where all the other projects in the sector failed.
- ❖ To study the project renegotiations, and understand what explains the success of renegotiations. How important is the negotiation climate? Do sponsors have a greater tolerance for renegotiation when there is an external macro-economic shock? How important is the negotiation process? Do some processes bring more favorable results?
- ❖ To study cultural-cognitive government logics and the perceived moral hazard of deviating from a contract in different cultures and countries. Is there a cultural aspect under the surface that makes some countries more, or less, likely to breach contracts?
- ❖ To explore the possibilities for resolving conflicts without going through the costs of arbitration.
- ❖ To have a mock “project design session” during the second General Counsels’ Roundtable where we take a real project, and as a group, do the financial engineering, legal engineering, and structure the deal, with the aim of generating new innovations.
- ❖ To study the incidence of payout to claims for political risk insurance and to study how projects with political risk insurance had different outcomes compared to projects

without political risk insurance, including the Hub River power project in Pakistan and the CalEnergy power projects in Indonesia.

- ❖ To study other alternatives to solve the mismatch of currency. Are there ways that the investor can take this risk? Or to involve more local currency financing?
- ❖ To expand the research scope to include the perspective of the government agencies. How does the government approach the renegotiation process? Can government representatives join future meetings of the General Counsels' Roundtable?

PESD study. Recommendations to enhance the ongoing PESD study, which investigates the experience of private power projects in developing countries, are as follows:

- ❖ To better understand the renegotiations that led to a varied range of experiences, and not uniform project failure. Does the varied experience allow a basis for future prediction? Detailed case studies of specific renegotiations are necessary.
- ❖ To extend the study to investigate the experience in another sector (possibly transportation), to see how that experience was similar or different.
- ❖ To go away from the abstract notion of political risk as an attribute or quality of a country that is an “amorphous concept that trickles down and affects every asset equally across a country,” and to adopt a more sophisticated approach to think about risk as it relates to “a specific asset, at a specific time, in a specific context.”
- ❖ To develop metrics for project success and failure rather than, as is presently the case, relying simply on whether contracts were terminated or renegotiated and on whether project sponsors have expressed general satisfaction with the renegotiation process. Such metrics could include the price-per-KWH at which electricity is sold by a project, the amount of write-offs recorded by project sponsors and project lenders, the resale price of specific projects, etc.
- ❖ To increase the number of variables in the analysis: to account for the fact that the likelihood of contractual-legal failure rises as contracts allocate increasingly large amounts of risk; to assess the effect of varying degrees of subsidy across projects; to control for the operation—foreign or local—of the plant; to account for the sophistication of bankruptcy laws in the host country legal systems.

- ❖ To strengthen the conceptual framework by recognizing the weaknesses of the country-unit of analysis—countries are very fragmented and permeated systems—and analyzing factors and forces both one level up and one level down. Going down, at the organizational field level, who are the actors—state actors, advisors, local partners, etc.—surrounding the project? Going up, at the transnational level, what transnational regimes—NGOs, IMF, World Bank, OPIC, etc.—were activated and mobilized to challenge or defend a particular project, or to threaten, or advise a host government one-way or the other? Can more of the variance across the cases—legal failure, or renegotiation failure—be explained with a stronger conceptual framework?

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