

Zen & The Art of Legal Networking

INSIGHTS & COMMENTARY ON RELATIONSHIP BUILDING WITHIN THE INTERNATIONAL LAWYERS NETWORK

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Potential Investment Opportunities in Vietnam – Electricity



The second half of Alex Larkin's presentation addressed the opportunities for foreign and domestic investors in the electricity generation sector. He began by saying that the government needs to make some good decisions to facilitate this, specifically when it comes to electrical pricing. Electricity is just too cheap at this point to attract foreign investors to come in and build power plants. They won't make any money if they're forced to sell at 5 cents per kilowatt hour.

For 2010, the anticipated demand for power was about 20,000 megawatts - by the time we get to 2025, this is estimated to quadruple to 80,000 megawatts. Alex said this information was provided by the MoIT, the Ministry of Industry and Trade, who might be a bit overly optimistic. These projections are based on the idea that electricity will remain very inexpensive, but if it does, they won't be able to meet demand because power plants won't be built.

So there's no doubt that the demand for electricity in Vietnam will increase dramatically over the coming years. The demand has doubled in the last five or six years - it was 10,000 megawatts in 2005.

Current Electricity Capacity

The current electricity capacity by the type of power plant is:

- Gas - 39%
- Hydro - 35%
- Coal - 16%
- Imported - 4%
- Oil - 3%
- Others - 3%

Alex noted that this breakdown will change dramatically in the future, because Vietnam is moving heavily towards more coal-fired plants and a little bit of nuclear power in the distant future. They no longer want to rely heavily on hydro power. They will continue to keep whatever dams that they currently have in operation, and they may build a few more, but because they are downstream of other countries, they would rather not depend on what those countries are doing upstream.

There is also a very strong need to maintain the use of the rivers for irrigation for farming, and this starts to become very complex. So Vietnam wisely does not want to become any more dependent on hydro power.

Peter Altieri of Epstein Becker & Green said that in the Vietnamese news that morning, he had read that the government is raising the price of coal. He asked Alex whether they would be similarly affected by what the government decides to do with the price of coal if someone is looking at investing in power plants.

Alex clarified that this was only government supplied coal, and said that there are other ways to get coal from foreign suppliers. But he agreed that it would have an affect, saying that it's part of the reasons that electricity prices have to go up dramatically, because at the current pricing, it's not profitable to bring in the coal whether its domestic or imported.

He added that the price of coal is going up worldwide because demand is increasing worldwide, so the whole world will be chasing the same coal. This all goes to one major point - the government is going to have to dramatically increase or allow the dramatic increase in the price of electricity. Or they will have to remove their controls all together and let the market work.

Current Electricity Generation by Ownership

Alex then showed a chart of the current electricity generation by ownership:

- Electricity of Vietnam (EVN) - 54%
- Domestic investors - 16%
- PetroVietnam (PVN) - 11%
- Foreign investors - 11%

- Imported - 4%
- Vinacomin (TKV) - 3%
- Other - 1%

EVN, PVN and TKV are all state-owned enterprises, comprising 68% of all power generation. Alex said that this is something that the government is also committed to changing, because they don't want to own such a large portion of the electricity generating sector. There has been some legislation in the works to transition from essentially state control of the power sector to non-state control.

How will the Future Demand be Met?

Foreign investment in power plants is key to meeting Vietnam's future demand for electricity - they can't get there or even begin to think about meeting the demand unless they're bringing in substantial foreign investment.

According to the draft of Master Plan VII on the electricity sector, which has not officially been released yet by the MoIT, they're estimating that \$5-7 billion US dollars will be needed per year for the foreseeable future in investment, whether foreign or domestic in order to meet the demand. Fuel for power plants will increasingly depend on imports, mostly imported coal, but also imported LNG and eventually, nuclear fuel.

Coal-fired thermal power plants are also a key focus. As Alex said earlier in his presentation, Vietnam does not want heavy reliance on hydro power. To this end, coal's contribution is expected to increase from 16% of the total electricity today to 47% in 2020 and 56% in 2030 (based on the draft of Master Plan VII).

Alex commented that he's not sure where that coal will come from, but he said there is an effort underway to increase the retail price of electricity. Currently, it's at about 1,000 Vietnamese Dong or slightly more than 5 US cents per kilowatt hour. This rate is mandated by the government, and the government, to some degree, subsidizes electricity. This is compared with some neighboring countries, like Indonesia, who have a rate of about 6.1 cents and Thailand at 9.4 cents.

Recently, the Vietnam Energy Association requested a 50% increase, to 7-8 cents. In February 2011, the government authorized a 15% increase. This was effectively a 5% increase because of the recent devaluation of the Dong (there was a 9.3% devaluation in February 2011). So the pricing went from about 5 cents per kilowatt hour to 5 1/4 cents per kilowatt hour, a fairly meaningless increase. Effectively, the government just compensated for the devaluation of the Dong, which doesn't attract foreign investment.

The bankability of power plant investment projects depends on the increases in the retail price of electricity. Foreign investors currently entering into power plant projects are likely relying on anticipated future increases of electricity prices. Alex said that his firm, LEADCO, has some good clients who are investing right now in coal-fired plants, and must be anticipating increases or being allowed to charge higher prices for electricity in the future.

Electricity Market Development

In 2006, a decision came from the Prime Minister's office, known as Decision 26, which called for the formation and development of an electricity market. The overall objectives of the decision are to:

- Create a competitive electricity market as part of the government reducing its control of the market
- Eliminate or at least reduce subsidies
- Improve efficiency of electricity production
- Ensure stable and reliable supply of electricity
- Attract domestic and foreign investment into the electricity sector
- Reduce state investment in the electricity center.

Decision 26 has Vietnam's electricity market being developed in three stages:

1. Stage One (2005-2014) - this stage calls for the creation of a competitive electricity generation market. This stage is intended to replace the state monopoly on electricity generation with a competitive market.
2. Stage Two (2015-2022) - this stage calls for the creation of a competitive electricity wholesale market - moving downstream from power plants to the wholesale market, which will include electricity distribution companies owned by EVN being converted to IPPs (Independent Power Producers). These IPPs will buy electricity directly from power plants, and power plants will compete to sell electricity.
3. Stage Three (2022 onward) - this stage calls for the creation of a competitive electricity retail market. Alex said he can't imagine how this would work, and Barbara Migallos from Migallos & Luna commented that this is the stage they're currently at in the Philippines. Alan Griffiths said that the US allows this and it works very well - the transmission is fixed and everyone has access, but as an individual you can decide to buy from different suppliers.

BOT Contracts as an Investment Vehicle

Alex then went into a discussion of Build-Operate-Transfer (BOT) contracts as an investment vehicle. A BOT contract for the development of a power plant is typically a contract between the MoIT and a BOT company, which is owned by one or more foreign investors - this can be much more complex, but that's the general idea. The investor may also be a joint venture with a Vietnamese party.

The BOT context is desirable because, since the government is a party to the contract, they have a vested interest in ensuring the success of the project. This can be helpful for obtaining licenses, investment certificates, land-use rights, etc. Because Vietnam is so bureaucratic, if you don't have the government on your side to get things done, it may take a very long time and never get done. So a BOT contract with the government as your investment vehicle is desirable.

Other agreements and documents to consider in the BOT context:

- Power Purchase Agreement (PPA): This is the big one, and the one that's delaying the investment for their current clients. You need to have an agreement to sell your electricity into the grid or to the government. It's difficult to do that right now because the government is going to move out of the business of being the monopoly on purchasing and supplying electricity.

So you don't know who's going to be buying the electricity you produce five or ten years from now, and coming up with a PPA is very tricky. As part of that move towards a free market for electricity, they are in the process of creating a single buyer for electricity so that all power producers will sell to a single provider and then that provider will sell electricity to wholesalers.

There's a specific exception in that legislation creating a single buyer for BOT investors - they don't have to sell to the single buyer, so that's another benefit.

Alan asked whether the government has used any other models besides BOT contracts. Phan Nguyen Toan said that the government has successfully signed off on three BOT agreements with three different foreign investors. During that process, with the technical assistance of the ILN, LEADCO helped them to set up the standardized set of documents for those transactions.

Ian Clarke of Gadens Lawyers said that he's seen this issues in other places where the government wants to have an equity stake, but there is a real conflict of interest. The state can't work out whether they're a shareholder or a regulator. So if Vietnam is trying to sell down their exposure and bring in investors, why would they keep a stake?

Alex said that the government generally doesn't put capital in, but the reason that the BOT contract is so attractive to the investor is because you'll have the government doing things like negotiating land use rights where your plant will be, making sure you have the local infrastructure and whatever you need for your power plant. Ian had asked whether petty corruption was also an issue, and Alex said that you would see more of that if you didn't have the government on your side.

He said that if Vietnam were more developed and advanced, he would agree that it's better for the government not to be involved, but in the current state, it's much better to have the government on your side, partly as a guarantor that your project proceeds smoothly.

Phan said that under the common law on BOT for infrastructure, the recent development of regulation of PPP (Public Private Partnership) for those investors investing in infrastructure like power plants, they will get some incentives from the government. These incentives include flexible concession time, allocation of the land to the investor free of charge, and the provision of a clean land site and the materials needed.

Ian asked whether there is a minimum equity that the government wants, and Phan said that for

the first three BOT projects, they were 100% foreign-owned. Alex added that once the concession period is over, then the government will have 100% ownership of the plant.

- Land-Lease Agreement (LLA)
- Coal (or other fuel) Supply Agreement (CSA) - it's also important to understand who's going to go after the same coal, since some countries are willing to bring in their military to get it.
- Joint Venture Agreement among investors - Capital Contribution Agreement
- Investment certificate
- Other contracts related to local infrastructure to support the power plant
- Government Guarantees and Undertakings (GGU)

Tony Nicholson from Burton & Co asked whether there was precedent for the government coming back and taking the land use rights back? He asked whether there was sufficient certainty in the market, the extent of your right as a contractual owner, that the government won't step in and take it back?

Alex said that there wasn't a precedent for that yet, but none of the BOT contracts had been around long enough to know for sure. If the government did that, it would be a breach of contract.

- MoIT Acknowledgement and Consent (MoIT A&C)
- Taxation regime and foreign currency regime
- Security agreement for lender financing

Alex said that LEADCO is advising investors for two plants, the Hai Duong Coal-Fired Thermal Power Plant, a 1,200 megawatt plant with a domestic coal supply that's expected to be complete in 2015, and the Duyen Hai 2 Coal-Fired Thermal Power Plant in the Tra Vinh Province, which is a 1,300 megawatt plant with imported coal coming from Indonesia.

Phan said that for the first project, in addition to the investment license for the power plant, the government ran a second license for the investor for coal mining. Next to the plant is a big coal mine, and as an additional incentive for the investor, the government gave them the ability to get the rights to coal mining.

Major Considerations in Planning a BOT Power Plant Project

Alex raised some considerations to keep in mind when planning a BOT power plant project:

Coal Supply (or other fuel source supply)

- Guarantee of supply for 25 years
- Source(s) of supply - if imported, consider the stability of the country supplying the coal
- Quality of the coal (efficiency in burning)
- Price of coal over 25-year period

Power Purchase Agreement (PPA) with EVN, with new single buyer of electricity

- What happens in the future, during the 25-year period, when there is a free market for the sale of electricity into the grid?

Force Majeure

- A typical contractual force majeure clause will not suffice.
- The government is a party to the contract, so think carefully about force majeure clauses that include governmental actions as justifications for excusing contractual performance
- Distinguish between governmental and non-governmental events

Choice of Law and Venue for Dispute Resolution

- Vietnamese law is in an early stage of development and is likely to change substantially during the period of the BOT contract
- Choose a well-established, long-standing predictable law (English common law) and a
- Neutral location for dispute resolution such as Singapore or Hong Kong

Changes in the Law

- This is a tricky one, so you want to build in some cushion or anticipation of what will happen
- Foreign law will apply for the purposes of dispute resolution, but domestic law will apply to all aspects of construction and operation of the power plant
- Considering construction and operation up to the date of transfer to the Vietnamese government, the investor's involvement will last about 30 years
- What will happen to domestic tax law, land-use law, labor law, environmental law, etc. during the next thirty years?

- Typically, if a change in the law is economically *favorable*, then both parties will share the benefit (ratio of 50/50)
- If a change in the law is economically *unfavorable*, the government (MoIT) must compensate the investor accordingly - this is tricky in practice because how do you prove how much it really costs?

Ian asked whether the state was liable to be sued for breach of contract, or if they had sovereign immunity. Alex said that in the context of a BOT contract, you would have to make it clear in the contract that the state is waiving any claim that it otherwise would have to sovereign immunity, otherwise, you have no protection at all.

Ian asked whether an arbitration award issued in Singapore is enforceable in Vietnam. Alex said yes, and the assembled group agreed that this was by the New York Convention.

Additional considerations include taxes, labor issues, and government guarantees and undertakings - this is one of the most important things about the contract because it identifies what the government is committing to.

Plant performance is another consideration - what is expected from the performance of the plant at startup? When it is transferred to the government in 25 years? Does it still have to be a 2,500 megawatt reactor, or is there some allowable deterioration?

Other items to consider include assignability, warranty of plant performance after the transfer, and foreign exchange.

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