A Critical Review of Sovereign Guarantees and it's Adequacy as a Risk Mitigation Instrument in a Limited Recourse Context

Pakistan's Energy Sector Case Study

By

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Undertaking a PhD has been a great learning experience. I have come across various concepts, theoretical frameworks, and academic literature that I would not otherwise have explored. I was 17 when I met young scholars at the University of Cambridge. I was moved by their research, and their commitment to preserve knowledge by creating more. My decision to pursue a PhD was rather fortuitous, however an insightful learning experience.

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This thesis is not the end. The ideas that I have reviewed and reflected upon are all very broad, modestly, a thesis within their own right. I hope to expand on these ideas and continue to contribute within this area.

Declaration

I, **Ahmed Abdullah Khan**, hereby declare that this thesis is my original work, which to the best of my knowledge, information and belief does not infringe rights of any third parties. I also confirm that the chapters of this thesis have not been submitted either in part or in full before any other University for the award of any Degree or Diploma.

Abstract

This study provides a holistic outline of the investment security measures provided by host states, especially in developing countries normative to a limited recourse context. In order to provide a thorough, discursive analysis, this thesis refers to Pakistan's energy sector as a case study example. Rising electricity shortfall and continued rise of circular debt have inhibited Pakistan's continued efforts to address electricity challenges. These pose serious questions insofar as sovereign guarantee measures provided by the state. Moreover, in view of the acute shortage of capital for infrastructure development in developing economies, especially in the energy sector, there is an omnipresent question around the adequacy of these security measures. This thesis canvasses the use of sovereign guarantee measures normative to Pakistan's energy sector, adopting a three-tier approach. First, this thesis attempts to discuss the highly leveraged nature and structure of project finance transactions. These measures are explained as an area of immense importance, especially from an energy sector standpoint. This form of finance is especially important for infrastructure projects in volatile, risky jurisdictions. The second tier focuses on risk-mitigation strategies adopted by host states especially in an unregulated or poor investment regime. It examines sovereign guarantees offered by host states, with a specific focus on legal structures under a suretyship arrangement from a Common law perspective. Whilst undertaking a thorough, discursive analysis this thesis reviews the existing frameworks of the organisations engaged within Pakistan's energy cycle to determine the adequacy of any guarantees. In an interesting twist, this study adopts the structural and functional tests laid out in various cases to determine the adequacy of sovereign guarantee frameworks. Last, this thesis

reviews third-party risk-mitigation instruments with a specific focus on MIGA's risk insurance as a measure of either an additional or replacement form of security.

List of Abbreviations and Acronyms

ADB	Asian Development Bank
CPPAG	Central Power Purchasing Agency Guarantee Limited
CPEC	China Pakistan Economic Corridor
DISCO	Distribution Companies
Draft Articles	Draft Articles on the Responsibility of States for Internationally Wrongful Acts
Debt Limitation Act	Fiscal Responsibility and Debt Limitation Act 2005
EPC	Engineering, Procurement and Construction
EIU	Economic Intelligence Unit
EVP	Executive Vice President
ESRP	Energy Sector Restructuring Program
EBRD	European Bank for Reconstruction and Development
FC	Financial Close
FDI	Foreign Direct Investment
Financial Assistance Act	United Kingdom Infrastructure (Financial Assistance Act 2012)
GDP	Gross Domestic Product
GOP	Government of Pakistan
GBP	Great Britain Pound
Group	The World Bank Group
GB	Gilgit Baltistan
HUBCO	Hub Power Company Limited
IEA	International Energy Agency
ICSID	International Centre for Settlement of Investment Disputes
IPP	Independent Power Producer/Provider

IA	Implementation Agreement
ILC	International Law Commission
IMF	International Monetary Fund
IFC	International Finance Corporation
LDC	Less Developed Country
LOI	Letter of Intent
LOS	Letter of Support
MIGA	Multilateral Investment Guarantee Agency
MIGA Convention	Convention Establishing the Multilateral Investment Guarantee Agency
MAC	Material Adverse Change
NEPRA	National Electric Power Regulatory Authority
NTDC	National Transmission and Distribution Company
NNPC	Nigerian National Petroleum Company
NAFTA	North America Free Trade Agreement
OGDCL	Oil and Gas Development Company Limited
PPIB	Private Power Infrastructure Board
PPA	Power Purchase Agreement
PPP	Public-Private Partnership
PRI	Political Risk Insurance
PSO	Pakistan State Oil
SACE	Servizi Assicurativi Del Commercio
SPV	Special Purpose Vehicle
SOE	State Owned Entity
SWF	Sovereign Wealth Fund
T&D	Transmission and Distribution

Twh	Tera Watt Hours
Oxfam	Oxford Committee for Famine Relief
O&M	Operation and Maintenance
OPIC	Overseas Private Investment Corporation
USAID	United Stated Agency for International Development
US	United States of America
UNCTAD	United Nations Conference on Trade and Development
WRI	World Resource Institute
WAPDA	Water and Power Development Authority

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Dedication

I dedicate this thesis to my father… He is the real hero, and inspiration behind this thesis. If I become half the man he is, I will consider myself successful! I am also grateful to my family for their continued support and trust.

Chapter 1

Introduction

1.1 Pakistan's Chronic Energy Crisis: Fruitless Effort

The inception of this study dates back to my work seeking investment for a 50MW power project in Pakistan. This experience led to familiarity with the notions of project finance, sovereign guarantees, risk management in infrastructure development finance, and measures to mitigate risk. A corporate entity was incorporated, and through this commercial enterprise several private equity firms were approached to explore investment opportunities in Pakistan's energy sector. After several successful meetings with government officials to discuss price tariffs, and with EPC contractors and private equity firms to discuss financial close arrangements, the mosaic was being completed. The second round of meetings were succeeded by a third, in order to facilitate a final round of meetings to commence work. Unbeknownst to me then, this was only the beginning of an endless chain of meetings between government officials and various representatives from the EPC contractors. This experience raised several pertinent questions, for example, how does the government aim to pay the project company in view of rising circular debt? The accumulation of circular debt renders any security offered under a sovereign guarantee inadequate; why offer it in the first place? And last, what concessions and measures will the government adopt to address the state-owned entity issue? It was the lack of answers for these questions that inhibited, and later thwarted efforts to secure finance for an electricity project that could have contributed towards economic growth in Pakistan.

The outcome of this experience laid the foundation for undertaking this research project. The broader theme for this thesis rests upon illuminating various facets of sovereign guarantees and the implications of breach of contractual commitments by off-taking bodies in infrastructure development. It also illustrates how little investors and government officials know about 'sovereign guarantees', especially in project finance context. Failure to facilitate and establish an electricity power project was an end to one endeavour, but the beginning of another. In essence, this study is a journey to try and understand the sovereign guarantee framework as a means to not only assist investors to determine the adequacy of such guarantees, but also to provide government officials an outline of how they can improve their investment regime by understanding what a sovereign guarantee entails.

As we look around us; we see roads that our cars drive on, we see transmission lines through which electricity is transferred from the generation facilities to our households, water storage facilities, and a thick network of roads, amongst many other examples. Infrastructure in one form or another surrounds us. Infrastructure facilities play a key role in promoting and sustaining rapid economic growth, and attracting more investment in other sectors to stimulate growth. Infrastructure, designed properly, can also make growth more inclusive by sharing its benefits with poorer groups and communities, especially by connecting distant lands, remote areas and landlocked countries to major trade routes or business centres.[1] Moreover, it also creates a systemic effect wherein one infrastructure project

[1] See Biswa Nath Bhattacharyay, 'Estimating demand for infrastructure, 2010-2020', in Biswa Nath Bhattacharyay, Masahiro Kawai and Rajat M Nag, *Infrastructure for Asian Community,* (ADBI/ADB and Edward Elgar Publishing, 2012).

leads the way for another infrastructure project, for example investment in an electricity generation plant will attract investment for distribution centres.

Project finance has been used in sectors where large investment capital is required, investment vehicles have long-lived assets, and a longer period is required in order to amortise investment costs. A close correlation exists between the projected cash flows of the project and the required rates of return for the lenders and sponsors alike.[2] Whereas there is growing acceptance and recognition to improve infrastructure facilities and invest within the infrastructure alleviation in order to foster growth, it is argued that public coffers are cash strapped. There is a big gap in the ability of both developing and developed countries to finance all of their infrastructure needs.[3] In particular, infrastructure funds for developing countries like India, Pakistan, Nigeria and other Sub-Saharan Africa countries are scarce, and subject to competition. In order to meet these growing demands for infrastructure, and involve the private sector to share the risk of operations within these imperative infrastructure

[2] Antonio Estache and John Strong, 'The Rise the Fall, and…the Emerging Recovery of Project Finance in Transport', (July 2000) World Bank Policy Research Working Paper No. 2385 <https://ssrn.com/abstract=630757> Accessed 03 May 2017. Estache and Strong submit 'project finance has typically been used in those sectors that require large capital expenditures, that have long-lived assets and, that require long periods to amortize investment costs and generate required rates of returns for both creditors and equity holders. Historically, project finance has been used to describe financings in which the lenders look to the cash flows of an investment project for repayment, without recourse to either equity sponsors or the public sector to make up any shortfall.

[3] Kwok-Chii Fung, Alicia Garcia-Herrero and Francis Ng, 'Foreign Direct Investment in Financing Regional Infrastructure', in Biswa Nath Bhattacharyay, 'Estimating demand for infrastructure, 2010-2020', in Biswa Nath Bhattacharyay, Masahiro Kawai and Rajat M Nag, *Infrastructure for Asian Community,* (ADBI/ADB and Edward Elgar Publishing, 2012).

development projects, project finance is increasingly used to facilitate high-risk infrastructure development.[4]

From the outset, the international infrastructure regime is very competitive. As global economy growth expands, industrial production levels are soaring. As outlined by Bhattacharyay, in order to keep pace with the demands of rapid urbanisation and economic growth (currently at 4%), developing economies will need to increase spending from the current US$800bn-$900bn to about US$1.8 trillion-US$2.3 trillion per year by 2020, or from about 3% to 6-8% of GDP in infrastructure development.[5] These figures correspond with ADB's report regarding infrastructure development in Asia's context.[6] Growing demands and rapid expansion have created a chronic infrastructure deficit especially in the energy sectors of countries with emerging and developing market economies.[7] Lack of long-term planning and inadequate regulatory measures have culminated in a whole gamut of issues for the infrastructure industry in these jurisdictions. Inderst notes that good infrastructure is key to economic growth as well as social

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[4] It is also interesting to note that borrowers prefer project finance loans if the corporate governance system in a country is weak, economic health is poor, and political risk and bank influence is high. See Christa Hainz and Stefanie Kleimeier, 'Project Finance as a Risk-Management Tool in International Syndicated Lending', (December 2006). Governance and the Efficiency of Economic Systems (GESY), SFB/TR 15, Discussion Paper No. 183 < https://ssrn.com/abstract=567112> Accessed 21 April 2017; also see Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002). Yescombe argues that 'a high ratio of debt is the essence of project finance. Within prudent limits, therefore, sponsors wish to limit the amount of equity they invest in a project, to improve their own return, and thus to raise the maximum level of debt'; also see International Energy Agency, *World Energy Investment* (IEA, 2017).

[5] See Biswa Nath Bhattacharyay, 'Estimating demand for infrastructure 2010-2020', in Biswa Nath Bhattacharyay, Masahiro Kawai and Rajat M Nag (ed.), *Infrastructure for Asian Connectivity,* (ADBI/ADB and Edward Elgar, 2012) pp 19-79.

[6] Asian Development Bank, *Meeting Asia's Infrastructure Needs* (Philippines, ADB, 2017) < https://www.adb.org/publications/asia-infrastructure-needs> Accessed on 14 August 2017.

[7] India is a good example of industrial growth at a staggering pace. With a total of 300 million people still without access to electricity, it is believed that India's rapid economic growth and industrial expansion is further straining the existing energy deficit that exists. For an insight into India's energy sector and their current reliance and shift from traditional energy mix, please see Richard Martin, 'India's Energy Crisis' *MIT Technology Review* (7 October 2015) <https://www.technologyreview.com/s/542091/indias-energy-crisis> Accessed 10 January 2017.

and ecological development[8]. Public expenditure in both developed and developing countries is stretched to its limits; the growing population, expanding middle classes, rapid industrialisation, urbanisation, and depletion of resources are creating huge and visible pressures on existing infrastructure framework. As a result, infrastructure investment demand has grown immensely in developing countries.[9] Consequently, there has been an increasing reliance on the private sector or on public-private partnership model to promote infrastructure development.[10]

Pakistan's chronic energy crisis is no hidden fact. Not only is this crisis deeply rooted in the electricity production deficit, which in 2015 stood at 5000MW[11], it also relates to governance issues that are experienced through widespread inefficiencies, including transmission and distribution (hereinafter referred to as "T&D") losses of more than twenty percent.[12] Pakistan has thus been embroiled in an issue that threatens its economic presence in the global markets. As this study later discusses, the impact of the energy crisis on the textile industry, and agriculture is immense. Pakistan's installed electricity capacity stands at

[8] For a contrasting perspective on the impact of infrastructure investment on the environment, see Bruce Rich, *Mortgaging the Earth: The World Bank, environment impoverishment, and the crisis of development (*Island Press, 2013).

[9] See Biswa Nath Bhattacharyay, Masahiro Kawai and Rajat M Nag, *Infrastructure for Asian Community,* (ADBI/ADB and Edward Elgar Publishing, 2012).

[10] See Hugh G McCrory Jr, 'Infrastructure Projects in Developing Countries', (April 1995) American Society of International Law Vol.89, pp 19-36. McCrory argues 'by the end of the 1980s, many emerging nations had rejected models of development that stressed state ownership of industry and had embraced a new model of development based upon support for the private sector'.

[11] See Musadik Malik, 'Pakistan's energy crisis: Challenges, Principles, and Strategies', in Michael Kugelman (ed), *Pakistan's Interminable Energy Crisis: Is there any way out?* (Woodrow Wilson International Centre for Scholars, 2015). On average Pakistan experiences a shortfall of 4000MW of electricity.

[12] Michael Kugelman (ed), *Pakistan's Interminable Energy Crisis: Is there any way out?* (Woodrow Wilson International Centre for Scholars, 2015).

21,000MW.[13] However, this figure does not reflect Pakistan's electricity need; it indicates the total generation capacity. Pakistan is no different to Sub-Saharan Africa, or any other developing country for that matter. Developing countries emphasise on power generation whilst completely overlooking investment for power distribution networks. Consequently, electricity generation is centred on the existing consumers, and is supplied to an existing demographic without wide circulation. In the Sub-Saharan Africa, there are over 620 million people who lack access to electricity. That is over two-thirds of the region's population. A report published[14] by *Oxfam* outlines that even dramatically expanding such supply would leave many in energy poverty. The report relies on the International Energy Agency's (hereinafter referred to as "IEA") forecasting and submits that on-grid generation in Sub-Saharan Africa will increase 350% by 2040, from 440 to 1541 Tera watt hours (TWh). Despite this increase, 530 million people will still be without electricity.

The predominant reliance on imported fossil fuels and lack of energy mix is not providing any consolation for the current investment regime. As Khalid Mansoor highlights, 44% of Pakistan's energy supply is imported. With an estimated US$15bn spent on oil imports, it is hard to imagine how an already constrained

[13] This is an estimated figure. As per various sources it is argued that Pakistan's peak demand during 2014 along was 20,800MW. This figure is expected to rise to nearly 32,000 MW by 2019. Also see John R. Hammond, 'The role of the US Private sector in Meeting Pakistan's Energy requirements', in Robert M Hathaway, Bhumika Muchhala, Michael Kugelman, *Fuelling the Future: Meeting Pakistan's Energy Needs in the 21st century* (Woodrow Wilson International Centre for Scholars, March 2007). Hammond argues that Pakistan will require 143,310MW by 2030.

[14] Ryan Hogarth and Llmi Granoff, 'Speaking truth to power: Why energy distribution, more than generation, is Africa's poverty reduction challenge' (OPM/Oxfam, Working Paper 418, May 2015).

economy can sustain such high expenditure.[15] Moreover, the oil import bill is subject to fluctuation depending upon the market conditions, for example dollar exchange rate, and International oil prices.[16] To put this into perspective, Pakistan produces only 19.9% of the oil it consumes. This means that a major proportion of this fuel is imported, often paying heavy premiums due to fluctuating oil prices in the global markets. This economic constraint directly affects the liquidity position of distribution companies in Pakistan.

Rapid growth through industrialisation and urbanisation has placed considerable pressures on the existing infrastructure facilities in Pakistan. This also correlates with the general expansion and growth in Asia. The region's rapid growth by providing services to the developed economies through cheap labour, lack of adequate regulatory framework to protect employees, and their drive to attract foreign capital has meant that Asia has been predominantly a scapegoat for large, multinational corporations based in the United States, United Kingdom and Europe to produce high-quality products at cheaper, competitive prices.[17] Growth at an unanticipated pace and lack of availability of capital have inhibited these states to manage the allocation of resources and provision of services, further constraining the existing framework. Whereas, India, China, and even Bangladesh have kept up-to-date with investment reform and adequate

[15] Khalid Mansoor, 'How coal can help address Pakistan's energy crisis' In Michael Kugelman (ed), *Pakistan's Interminable Energy Crisis: Is there any way out?* (Woodrow Wilson International Centre for Scholars, 2015).
[16] See Robert M Hathway, Bhumika Muchhala, Michael Kugelman, *Fuelling the Future: Meeting Pakistan's Energy Needs in the 21st century* (Woodrow Wilson International Centre for Scholars, March 2007).
[17] See Biswa Nath Bhattacharyay, Masahiro Kawai, and Rajat M Nag, *Infrastructure for Asian Community* (joint publication of the Asian Development Bank Institute and Asian Development Bank with Edward Elgar, 2012).

regulation[18], Pakistan's political and policy challenges have led to a decline in investment and increasing energy deficit.[19] Scarcity of public funds has meant that there has been no major undertaking insofar as investment in the energy sector in the last decade.[20]

1.2 Research Methodology

The notion of 'sovereign guarantees' is predicated upon the understanding that an organ of the state will guarantee the performance of an off-taking body to the project company. This statement is fraught with various implications for the entire project finance transaction. However, despite the growing use of sovereign guarantees in emerging, developing economies, they have not attracted a major academic undertaking that deal exclusively with the use of guarantees in investment regimes. As a result, this study focuses on the use of guarantees issued by sovereign states to investors in order to attract investment, and provide a robust mechanism for security. This thesis relies upon various primary and secondary sources to carry out a discursive analysis. However, it is often difficult to label or categorise a thesis, especially one involving a hybrid of research

[18] For a detailed discussion on India's energy sector reform please see Sheoli Pargal and Sudeshna Ghosh Banerjee, *More Power to India: The Challenge of Electricity Distribution* (The World Bank Group, 2014) <file://wimple/User53/l/lapnai/Desktop/PhD%20folder/India%20Energy%20Sector%20Report/ More%20Power%20to%20India,%20pargal%20and%20Banerjee.pdf> Accessed on 23 March 2017. The report lauds efforts undertaken by India to improve distribution networks and enhance efficiency. However, there is still room for improvement as the energy sector is inhibited by approximately US$77bn circular debt (as of 2011) which amounts to 5% of India's GDP.

[19] Pakistan's lack of an up-to-date policy framework is primarily due to the state's constant 'firefighting' strategy, rather than undertaking any meaningful policy. As a result, any incumbent government continues to address old policies that have either been challenged or dissolved, instead of implementing new policies.

[20] For a detailed discussion on the timing of infrastructure development please see Fan Zhai, 'Benefits of Infrastructure: An empirical study' in Biswa Nath Bhattacharyay, Masahiro Kawai and Rajat M Nag, *Infrastructure for Asian Community,* (ADBI/ADB and Edward Elgar Publishing, 2012).

methods.[21] The scope of this thesis encompasses qualitative research of a doctrinal nature, reviewing the underlying features of a guarantee transaction from a 'black letter law' perspective. Moreover, this project is predicated on using Pakistan as a case study model to discuss and highlight the logical connections or disjunctions between the uses of sovereign guarantees as a mode of investment security. This conjunction of doctrinal research and comparative study is highly relevant for the purposes of this project. Whereas, doctrinal research has been defined as 'a detailed and highly technical commentary upon, and systematic exposition of, the context of legal doctrine'[22], the law of guarantees is extensively a black letter law subject. It is argued that this study uses the doctrinal and black letter law approach to provide a context to the sovereign guarantee framework that is widely used by various developing countries. This section outlines the research methodology to help readers understand the sources that have been used to carry out and support the primary hypothesis; are sovereign guarantee instruments an adequate form of security?

1.2.1 Books, articles, cases and other academic literature

Despite their wide use, sovereign guarantees have not attracted a major academic undertaking. In order to understand the intricacies and the underlying features of a sovereign guarantee, this study has separated the two terminologies 'sovereign' and a 'guarantee' and tries to determine their significance in isolation. Whereas academic text and case law on guarantees is predominately from a private sphere of law, the underlying features within a guarantee transaction from a public,

[21] Michael Salter and Julie Mason, *Writing Law Dissertation: An Introduction and Guide to the Conduct of Legal Research* (Pearson, 2007) 31.
[22] Michael Salter and Julie Mason, *Writing Law Dissertation: An Introduction and Guide to the Conduct of Legal Research* (Pearson, 2007) 49.

meta-form are the same. Consequently, academic text from common law countries has been referred to, in order to understand the characteristics of a guarantee transaction. Primarily, there are three broad research questions that have been addressed as part of this academic undertaking:

1. Why is there a need for security measures in highly leveraged financial transactions?
2. What is being offered by the state under a sovereign guarantee framework, and what are the underlying features of this framework?
3. In the event that the sovereign guarantee framework proves inadequate, what measures can be adopted to strengthen the existing security framework?

Relying on various cases, academic literature on guarantees from private law sphere aligns the above-mentioned questions to the principal purpose of this project, which is to identify ambiguities in sovereign guarantee framework. Additionally, there is a vacuum in the determination whether an entity forms an integral part of the state's organic structure. This study seeks recourse to the Draft Articles, and judgements pronounced by ICSID tribunal on *Articles 4* and *5* to review the contention.

1.2.2 Academic Workshop

Academic engagement is a vital portion of any robust academic undertaking. Through funding from the Economic Social Research Council (ESRC), a workshop was organised at the Centre for Commercial Legal Studies (London) as part of this project, in order to discuss ideas, exchange views, and to engage with both practitioners and academics. The event focused on deliberating various contours that have been discussed in this study. The primary underlying issue

that was reviewed at the workshop was the role of political risk insurance. In light of the discussion undertaken throughout this study, it was pertinent to incorporate the views of the people at MIGA, policy advisors and practitioners. This workshop provided a great platform to engage with these practitioners and policy advisors in order to field ideas from this study as a method to influence policymaking, and to seek their advice. Since the workshop has been mentioned throughout this study as a source, it is worthy of being discussed separately as a 'method'. This workshop afforded a useful sphere to get an insight into the minds of government officials who negotiate these sovereign guarantee agreements with private investors, and decipher their views to understand what is really being offered under a sovereign guarantee framework. Organising a workshop was also a great opportunity to discuss some of the arguments presented in this thesis to gauge the opinion of practitioners and other eminent academics.

1.2.3 Fieldwork analysis and interviews

In the absence of a theoretical framework to support my contentions, it was vital that various facets of this project were discussed with members of government, key policymakers, and civil servants in the organisations that have been extensively discussed, especially in Chapter 4. The primary aim and objective for undertaking fieldwork focused on gathering and reviewing information from confidential agreements signed with PPIB and private investors. Whereas no commercially sensitive information has been used for the purposes of this project, various contingent liability terms, guarantee provisions, and general responsibilities of the parties have been perused and are subject to

confidentiality. Since the major focus of this study is predicated on Pakistan and its energy sector, this study endeavours to use the relevant information derived through interviews and fieldwork to establish the underlying relationship of sovereign guarantees with investment flow. As outlined in the study, *Whitman's* contention regarding state guarantees inviting 'political interference' and such assurances being construed as a form of 'favouritism' are some of the norms that required extensive understanding of how such transactions are undertaken.[23] Moreover, as explored in Chapter 2, the premise of risk is not entirely mitigated through careful structuring of a transaction by insulting one party from another's contractual risk. This is an interesting contention especially in view of breach of contractual provisions by SOEs.

As part of the fieldwork undertaken for this project, investor-government meetings were witnessed in order to understand the underlying framework. An understanding developed by undertaking fieldwork and attending government-investor meetings strengthens the contentions that such measures are necessary to attract investment, especially in a developing-country context. Moreover, another contention that facilities the proposal concerning the establishment of a revenue management plan is predicated upon the understanding that underdeveloped countries will have to follow ways and methods of development importantly different from those followed by the Western countries.[24]

1.3 Investment Security, Certainty and Promotion

[23] Marina Von Neumann Whitman, *Government Risk Sharing in Foreign Investment* (Princeton University Press, 1965) 123.
[24] Arghyrios A Fatouros, *Government Guarantees to Foreign Investors* (Columbia University Press, 1962) 102.

A theme that is constant throughout this study is predicated on the understanding that highly leveraged project finance transactions cannot mitigate risk through project finance alone. As a result, least-developed countries (hereinafter referred to as "LDCs") and even some developed economies adopt guarantees as a form of risk mitigating measure. Unlike a private party or a corporate entity, a sovereign cannot be bankrupt or liquidated.[25] In the event that an off-taker defaults on payment to the project company, the state, as the sovereign, will indemnify the project company against breach of contractual undertaking. As a result, sovereign guarantees have been used in infrastructure development sector to increase capital inflow, and to provide a robust form of security to investment vehicles, sponsors and lenders.

However, as discussed in Chapters 3, 4 and 5, the concept of security and secure investment options is often elusive. Security culminates into certainty, and consequently leads to promotion. The three notions may seem obscurely connected, however they have a very strong correlation. Certainty and security in an investment regime promotes the infrastructure development capacity of a jurisdiction. Consequently, infrastructure development leads to growth.[26]

Countries, especially volatile jurisdictions are prone to policy change due to economic conditions or regime change. This study discusses Riqo Diq as an example to illustrate this issue. Cases like Riqo Diq are a classic example of how regime change can lead to unfavourable results for investors. Such cases also

[25] For a detailed discussion on sovereign debt restructuring, see Rodrigo Olivares-Caminal, *Legal Aspects of Sovereign Debt Restructuring* (1st Edition, Sweet & Maxwell, 2009).
[26]See Daron Acemoglu and James Robinson, *The Role of Institutions in Growth and Development* (World Bank, Working Paper 10, 2008).

illustrate that the revocation of an agreement is not primarily targeting the investor per se, but trying to secure an otherwise undervalued deal. Sovereign guarantee agreements are a measure to provide security against such instances, especially in developing countries. Another aspect of sovereign guarantees is predicated upon the future revenue stream aspect of project finance. This is discussed later in detail.

It is fascinating to see how despite higher returns, favourable policies, and even concessions on tax and import duties, investors are increasingly content to wield more robust security measures for their project companies. This signifies the investor's interest in trying to protect their investment returns, and consequently lenders associating a lower risk premium. Therefore, within the ambit of investment and infrastructure development there is an increasing demand for sovereign guarantees from host states, as a measure of security to provide certainty within a highly-leveraged transaction. As outlined in Chapter 2, project finance transactions are predicated on high debt to equity ratios, especially in transactions involving the energy sector, wherein there are agreements signed between the off-taker and the project company. Project finance is viewed as an informal method to mitigate risk. Equity investment by sponsors is often associated with the lower risk that sponsors undertake. However, there is an increasing debate amongst practitioners and academics concerning the risk mitigation characteristic of project finance. Even though the sponsor's equity investment may form a smaller part of the larger proportion of the total financing secured for the project company, there is a lack of adequate due diligence measures to inspect the investment regime, and the practicalities of carrying out

an extensive study to understand the dynamics of the host country are almost impossible. Even if extensive studies were carried out, this would not only involve time, it would directly increase the total cost of capital. While the due diligence measures may be ipso facto correct, the dynamics of liquidity or fiscal inadequacy might mean that there can be a radical shift due to previous administration's poor policies or inadequate risk management.

This study aims to discuss the underlying notion and legal principles within a sovereign guarantee framework. Whereas there are several methods to mitigate risk and create an environment where investors are comfortable to invest, sovereign guarantees are a more formal method of risk mitigation. Academic discourse on bank guarantees, sureties in both private and international law, is illustrative of the variety of material available on the subject.[27] We have often come across the term guarantee used in an abstract manner, usually symbolic of an assurance towards a product, discharge of debt or even under land law.[28] As financial contractual relationships grow complex, we have come across the term in various contexts[29], often involving private parties and large financial

[27] For main academic texts on guarantees please see James O'Donovan and John Phillips, *The Modern Contract of Guarantee* (1st Edition, Sweet & Maxwell, 2010); Geraldine Andrews and Richard Millett, *Law of Guarantee* (6th Edition, Sweet & Maxwell, 2011); David Marks and Gabriel Moss, *Rowlatt on Principal and Surety* (6th Edition, Sweet & Maxwell, 2011); for a detailed discussion security in commercial transactions please see Hugh Beale, Michael Bridge, Louise Gullifer and Eva Lomnicka, *The Law of Personal Property Security* (1st Edition, Oxford, 2007).

[28] The registration of title or creating a charge is effectively a system wherein the State authoritatively establishes title by declaring, under a guarantee of indemnity, that it is vested in a named person or persons, subject to specified encumbrances and qualifications. See Ben McFarlane, Nicholas Hopkins, Sarah Nield, *Land Law: Text cases, and materials* (3rd edition, Oxford, 2015); Also see Law Commission, *Land Registration of the Twenty-First Century: A conveyancing Revolution* (Law Com No. 271, 2001).

[29] See *Royal Bank of Scotland v Chandra and Another* [2011] EWCA Civ 192; *Northshore Ventures Ltd v Anstead Holdings Inc and Others* [2011] EWCA Civ 230; Landlord-tenant perspective see *Hindcastle Ltd v Barbara Attenborough Associated Ltd* [1997] AC 70; banking business between a lender an ordinary borrower wherein the borrower provides a guarantee to the financial institution assuring them that the loan will be paid back. See *Royal Bank of Scotland v Etridge* (No.2) [2002] 2 A C 773; *Barclays Bank Plc v O'Brien* [1993] Q B 109; also see *CiBC*

institutions. However, guarantees from an infrastructure investment perspective are generally scarce, and even in instances where academic literature discusses guarantees from an international, sovereign perspective[30], it lacks a thorough, discursive analysis.[31] As discussed in Chapter 2, the principal rationale for using project finance as a method to provide financing for an infrastructure project relates to the management of risk. Highly leveraged project financings are predicated upon distribution of risk where a particular party is best able to manage it. Consequently, the risk of currency exchange or regulatory risk rests with the host state. Construction and other commercial risks are borne by the project company. There is an increasing competition for securing investment by LDCs and other developing countries. Subedi argues that investment contracts especially those relating to infrastructure projects, often provide for higher levels of protection to investors than typical commercial contracts, by insulating them from future changes in domestic law of the host state.[32]

Sovereign guarantees are one weapon in an arsenal used by host states to mitigate sponsor's risk. As a consequence of issuing these sovereign guarantees,

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Mortgages plc v Pitt [1994] 1 AC 200; simply within a structure where party A undertakes to guarantee the obligation of party B to party C.

[30] It is interesting to see the rationale adopted by the Court in *Rederiaktiebolaget Amphirite v The King* [1921] 3 K B 500. The scope of the case remains uncertain. The facts do demonstrate how an assurance can be mistaken for a guarantee. Rowlatt J submitted 'it is not competent for the Government to fetter its future executive action, which must necessarily be determined by the needs of the community when the question arises. It cannot by contract hamper its freedom of action in matters which concern the welfare of the State'. This principle was not endorsed in *Commissioner of Crown Lands v Page* [1960] 2 Q B 274 and in *Robertson v Minister of Pension* [1949] 1 K B 227.

[31] Sovereign guarantees have been mentioned briefly in the following texts: Surya P Subedi, *International Investment Law*: *Reconciling Policy and Principle* (2nd Edition, Hart Publishing, 2012); Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002); William M Stelwagon, 'Financing Private Energy Projects in the third world', 37 Cath Law 45 1996-1997; Philip R Wood, *International Loans, Bonds, Guarantees and Legal Opinions (*2nd Edition, Sweet & Maxwell, 2007*);* Ibrahim F Shihata, *'Towards a Greater Depoliticisation of Investment Disputes: The roles of ICSID and MIGA',* 1 ICSID Rev: Foreign Investment L J 1.

[32] Surya P Subedi, *International Investment Law: Reconciling Policy and Principle* (Second Edition, Hart Publishing, 2012)

not only do lenders feel comfortable lending to volatile jurisdictions, but such concessions are also reflected in the interest rates associated with the lending amount; lower risk involves lower premium and vice versa. Sovereign guarantees play a critical role in attracting and retaining investment especially in LDCs. Sovereign guarantees have so far not attracted any major academic undertaking within the literature that exists on foreign investment law.[33] The dearth of academic text on the subject undermines the role of sovereign guarantees as a pivotal plank in a bid for attracting foreign investment.[34] Since a major part of lending to developing countries has taken the form of publicly guaranteed debt or private debt finance, it is imperative that an academic discourse reviews the underlying framework of sovereign guarantees.[35] Foreign investment for infrastructure development in fragile, developing and underdeveloped economies like Pakistan, Nigeria and even India are contingent upon sovereign guarantees. Whereas sovereign guarantees can be adopted to mitigate various forms of risk, this study reviews the sovereign guarantee structure used by the government of the host state in order to guarantee the performance of the off-taking body. The

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[33] See Surya P Subedi, *International Investment Law: Reconciling Policy and Principle* (Second Edition, Hart Publishing, 2012); Philip R. Wood, *International Loans, Bonds, Guarantees and Legal Opinions* (2nd Edition, Sweet & Maxwell, 2007); a good academic text dedicated to government guarantees in foreign investment context is Arghyrios A Fatouros, *Government Guarantees to Foreign Investors* (1st Edition, Columbia University Press, 1962).

[34] See Jonathan Eaton, 'Public debt guarantees and private capital flight', The World Bank Economic Review, Vol 1, No 3 (May 1987), pp.377-395. Eaton expresses his understanding of sovereign guarantees and explains why they are necessary: first, that lenders may not be able to observe the parameters of particular loan projects directly and therefore rely on the local government to determine whether or not these are at financially sound levels. Requiring a loan guarantee makes accurate reporting of the relevant data incentive-compatible for the government. Secondly, that lenders may not have a direct method to enforce repayment. Even if funds are invested domestically, lenders must rely on the local government to pursue bankruptcy proceedings against a borrower who does not repay. For a contrasting picture regarding government guarantees see Marina Von Neumann Whitman, *Government Risk Sharing in Foreign Investment (*Princeton University Press, 1965). Marina argues 'businesses are generally extremely reluctant to seek a government guaranty for fear of thus inviting political interference, and governments are equally loath to grant them because such action might be construed favouritism or, at the very least, involve them undesirably in judging the merits of a given enterprise'.

[35] Jonathan Eaton, 'Public debt guarantees and private capital flight', The World Bank Economic Review, Vol 1, No 3 (May 1987), pp 377-395.

highly leveraged nature of the project transaction requires contractual packages from project sponsors confirming that the project company output, namely electricity, will be purchased at a proposed rate (x) for a period of (y) years.[36] In addition to a proposed letter of intent (hereinafter referred to as "LOI"), the lenders require a guarantee from the state in the form of a letter of support (hereinafter referred to as "LOS") confirming that the off-taker will buy this electricity as an agreed output; failure to do so will result in an indemnification by the host state. This indemnification is an additional form of security to the contractual warranties and indemnities contained in a power purchase agreement (hereinafter referred to as "PPA").[37]

However, as we extensively review this form of secure undertaking, there is an increasing narrative rebutting this presumption of an absolute undertaking under a sovereign guarantee framework. The increasing liquidity issues, or commonly known as 'circular debt', challenge the foundations of these security measures on the predication that the off-taking body does not have the economic means to satisfy project debts. As a consequence, there is a need to either strengthen the current framework or seek recourse to alternative, more robust measures.[38]

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[36] In many emerging markets, power purchase contracts for solar PV and wind are often set for 20-25 years as a way to reduce risks of revenues falling short of that required to recover the investment. This has been crucial for attracting private developers and raising debt finance in such markets. Please see International Energy Agency, *World Energy Investment* (IEA, 2017).

[37] It is however to be noted that even when no guarantee was provided, lenders have had governments accountable for the debts of private borrowers in default. Diaz Alejandro, 'Good-bye Financial Repression, Hello Financial Crash', Journal of Development Economics 19 (1985), 1-24 wherein an account of the bankruptcy of some Chilean Banks provides an example: even though the Chilean government explicitly did not guarantee foreign loans to these banks, creditors demanded and received payment from the government when private banks became insolvent. Also see M Breheny and J Beaven, 'Australian federal and state government guarantees—a legal overview', (1986) 4 J I B L 231.

[38] Sham Oirere, 'Dismay at proposal to scrap Kenyan guarantee', WindPower Monthly (Kenya, 01 May 2011); See Keith D Larson, 'New Incentives for Independent Power Projects in Nigeria',

The primary contention affecting any satisfactory results being derived from sovereign guarantee framework is predicated on the liquidity problems that originate within Pakistan's energy sector due to lack of or poor regulatory frameworks. These liquidity problems impede the off-taking entities from making timely payments to project companies. Consequently, the circular debt inhibits the state's ability to honour sovereign guarantees. The next section discusses the circular debt issue, and provides an outline of the presumption of why sovereign guarantee frameworks are inadequate, and why there is a need to understand their underlying features to improve them.

1.4 The Emergence and Risk of Circular Debt: A Threat to Investment?

Previous sections illustrate one point: risk. The risk of non-payment, risk of indirect expropriation, and risk of non-service of debt obligations have immense repercussions for the project company. The entire project is predicated on risk. However, the notion of risk is often ill defined and aspirational. The prognosis of an investment is predicated on risk. Historically in an investment context, risk has been defined as the threshold of an individual or an entity that reflects their ability to undertake or participate in a certain transaction wherein the returns are proportional to the risk undertaken. Risk determines the success of a transaction. In every business transaction, there is a certain degree of risk. A private vendor selling coffee opposite a large coffee shop knows that during busy hours the large coffee outlet will be unable to serve coffee to its anxious, impatient customers. He spots an opportunity. He believes in taking risk. A substantial

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05.01.2011. Lexology <www.lexology.com/library> Accessed 15 June 2015. Larson submits that in order to make sovereign guarantees more robust (i) a government backed letter of credit facility provided, (ii) capitalising a bulk trader with the proceeds of a government bond issue, (iii) through an LC facility backed by a partial risk guarantee issued by the World Bank.

risk! An independent clothes store next to a large retail outlet is taking a risk of not attracting enough customers. A bespoke tailoring company opening a store next to a large suiting outlet risks not attracting clients, and more importantly, an investor seeking to invest in a host state where political demographics are volatile is taking a risk. In essence, all transactions around us, no matter how small, are predicated on risk. As an SACE report outlines, the concept of risk is not easily quantifiable and the numerous steps compound the difficulty involved in its measurement.[39] The ability to summarise risk with a single denominator is unrealistic. However, while risks can be mapped out, they can hardly be quantified.[40]

Whereas the underlying features of a guarantee are common amongst most jurisdictions, this study will primarily review Pakistan's energy sector as a case study example. There are various challenges that inhibit Pakistan's ability to attract investment finance for developing a thriving electricity sector and foster growth. The biggest challenge facing Pakistan is the non-honouring of contractual commitments. An increase in fiscal and budgetary constraints has caused developing countries to reconsider investment options.[41] Developing countries are now increasingly seeking recourse to private sector led infrastructure development. However, with high T&D losses, the contractual

[39] See Raoul Ascari and Federica Pocek, 'Country risk from theory to practice', SACE (May 2012) <www.sace.it/docs/default/wp_sace_n15_countryrisk_en_pdf.pdf?> Ascari outlines that the difficulty in the measurement of risk is compounded by the steps involved i) the identification of the source of risk ii) the extrapolation of the risk-event unfolding process, iii) the estimate of the impact on a specific transaction/economic agent, iv) the means/actions undertaken to mitigate the impact before and after the event has occurred.

[40] See Raoul Ascari and Federica Pocek, 'Country risk from theory to practice', SACE (May 2012) <www.sace.it/docs/default/wp_sace_n15_countryrisk_en_pdf.pdf?>

[41] Pakistan for example faces an increasing budget deficit. Pakistan's budget deficit has increased to around 2.4% of the GDP during the first half of the fiscal year. See Mehtab Haider, 'Budget deficit swells to 2.4pc of GDP in first half of 2016-17' The News (Islamabad, 27 January 2017) <https://www.thenews.com.pk/print/182083-Budget-deficit-swells-to-24pc-of-GDP-in-first-half-of-2016-17> Accessed 27 January 2017.

commitments under which the private sector engages in infrastructure development can prove cumbersome for the off-taking bodies to honour their contractual agreements, and consequently for the state to provide any real security measure under the sovereign guarantee framework.[42] As outlined earlier, the competitive nature of investment regime provides very little space for error. Ostensibly, no one can argue that Argentina, and more recently Greece, defaulted on purpose. The implications of a host state's default under a PPA, or even expropriation, can have long-lasting adverse implications. Whereas all risk will not have the same implications for all host countries, in the context of Pakistan's energy sector it is argued that the prevailing economic stress, political crisis and an on-going war with extremist elements are the biggest deterrents for any investor.[43] Economic and political uncertainty is an investor's worst enemy. In addition to the political turmoil that has mired the country since its inception in 1947, the circular debt crisis has caused uproar in the energy sector. Investors have been sceptical concerning the investment regime because of delayed or ceased payments under the agreed tariff structures. Since project companies are primarily raising finance under newly incorporated special purpose vehicles (hereinafter referred to as "SPV"), the entire project financing is predicated on the future revenue stream of the project company. Delayed or no payment can cause disruption to the project company's debt servicing agreements, and have long-term repercussions for the host country. Consequently, circular debt is a

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[42] Akthar Ali, 'Alleviating the Energy Crisis: An Action Plan for the Gas and Electricity Sectors' in Michael Kugelman (ed.), *Pakistan's Interminable Energy Crisis: Is there any way out?* (Washington, Woodrow Wilson International Centre for Scholars, 2015). The report submits that Pakistan's T&D losses amount to approximately 23%. Even though these figures are lower than India (30%), they are still higher compared to other countries like Japan (4%), China (6%), South Africa (6%).

[43] See Asian Development Bank, *Circular Debt Impact on Power Sector Investment* (Supplementary Document 13, 2014) <www.adb.org/sites/default/files/linked_documents/47015-001-sd-04.pdf>. Accessed 01 April 2017.

severe inhibition for Pakistan in view of the increasing marketing of investment opportunities.

Circular debt, as outlined by a report commissioned by USAID, is the amount of cash shortfall within the Central Power Purchasing Agency (hereinafter referred to as "CPPA") that it cannot pay to power supply companies. This shortfall is due to two important factors. First, the difference between the actual costs of providing electricity in relation to revenues realised by the power distribution companies (hereinafter referred to as "DISCOs") from sales to customers plus subsidies and, secondly insufficient payments by the DISCOs to CPPA out of realised revenue as they give priority to their own cash flow needs.[44] In simple words, circular debt is one entity facing problems in its cash inflows, which results in that entity holding back payments to its suppliers and creditors. Thus, problems in cash flows of one entity transfer to other segments of the payment chain.[45] What this means is that cash flow problems of one entity cascade down to the other segments of the payment chain in such a manner that it affects both suppliers and creditors.

Circular debt in the energy sector has impaired investment prospects and created a differential between what the investors expect, and what protection they are really offered. In fact, the title to this thesis makes reference to the inadequacy of sovereign guarantees primarily because of the increasing threat that liquidity issues pose to investment regimes throughout developing countries. In light of

[44] Planning Commission of Pakistan and USAID, *The Causes and Impacts of Power Sector Circular Debt in Pakistan* (March 2013) <http://pdf.usaid.gov/pdf_docs/PA00KPHC.pdf> Accessed 22 March 2015.
[45] See Syed Sajid Ali and Sadia Babar, 'Dynamics of circular debt in Pakistan and its resolution', (2010) The Lahore Journal of Economics 15:SE, pp 61-74.

the circular debt problem, it is clear that the provision of a sovereign guarantee mitigates the risk that arises as a result of the occurrence of an event; they are not a guarantee that an event will not occur. It can also be argued that given its current form, circular debt can amount to an indirect expropriation measure, since it inhibits the project's ability to produce the desired results. Even though an investor is not being deprived or parted from the ownership of the project company, their ability to continue production and generation of the project company's core product is hampered due to the off-taking body's non-payment or delay in payment. Figure1.1 provides an overview of all the parties involved in Pakistan's energy sector, and helps to illustrate the dynamics of Pakistan's circular debt.

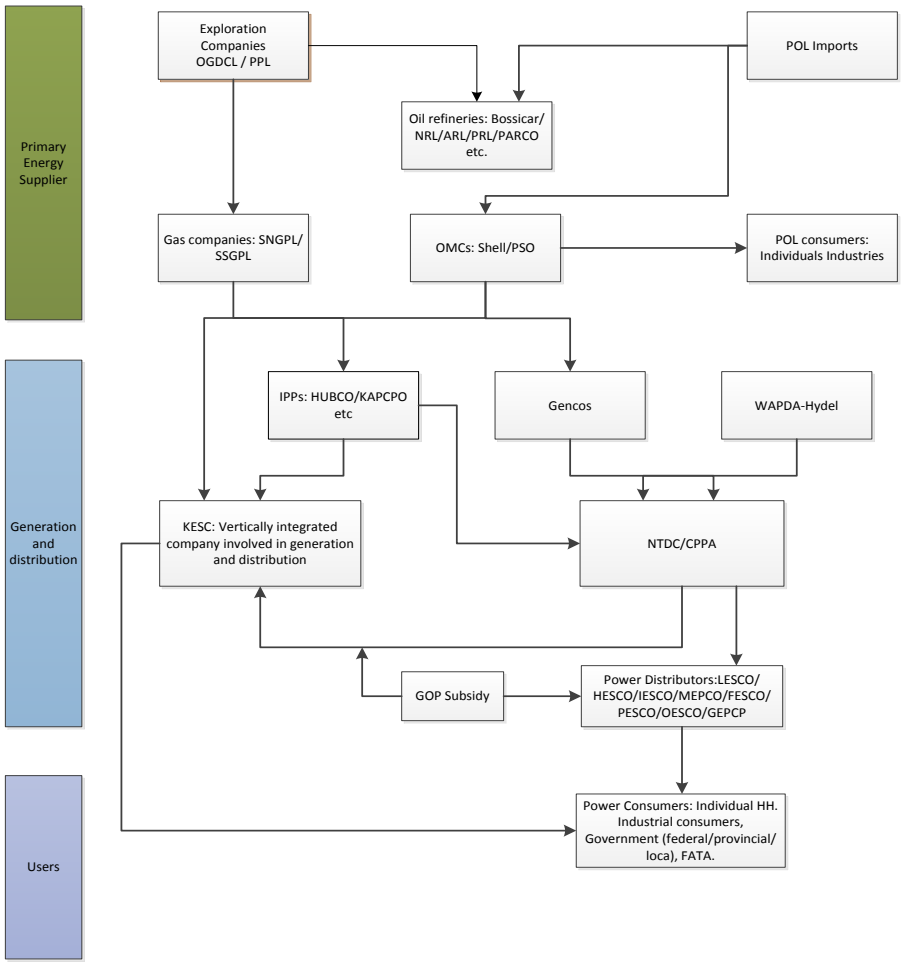

Figure 1.1: Key Players in Pakistan's Energy Sector[46]

Figure 1.1, key players in Pakistan's energy sector, provides an outline of the major parties involved. Moldova's energy sector post restructure can be compared with Pakistan, India and Nigeria. It is submitted that the underlying problem concerning liquidity issue relates to malfeasance, mismanagement and sometimes corruption, especially in the 'generation and distribution' section of the illustration. Improper regulatory frameworks and lack of adequate regulation insofar as the generation and distribution segment of the figure is a major contributor to the circular debt crisis. Not only are the main entities (ie DISCOs,

[46] Syed Sajid Ali and Sadia Babar, 'Dynamics of circular debt in Pakistan and its resolution', (2010) The Lahore Journal of Economics 15:SE, pp 61-74.

NTDC, CPPAG) ill-regulated, their cross-sectional relationship lacks any meaningful policy. For example, even though the distribution companies have mainly been restructured to form corporate entities, they are not operating independently from the state's influence. Their board is appointed by the Ministry of Water and Power through instructions from the Prime Minister. However, this lack of corporate governance is one of the issues in a mosaic of problems. Political influence is not only perpetrated in corporate governance matters but as a result of compromised management. This leads to inefficient application of laws preventing electricity theft, which are predominantly redundant because of political ramifications. Whereas there is an element of corruption prevalent within the issue concerning prevention and enforcement of electricity theft, political parties realise that enforcement and prosecution under the *Electricity Theft Act* (hereinafter referred to as the "*Theft Act*") can create consumer dissatisfaction from political circles, and a shift in voter preference.

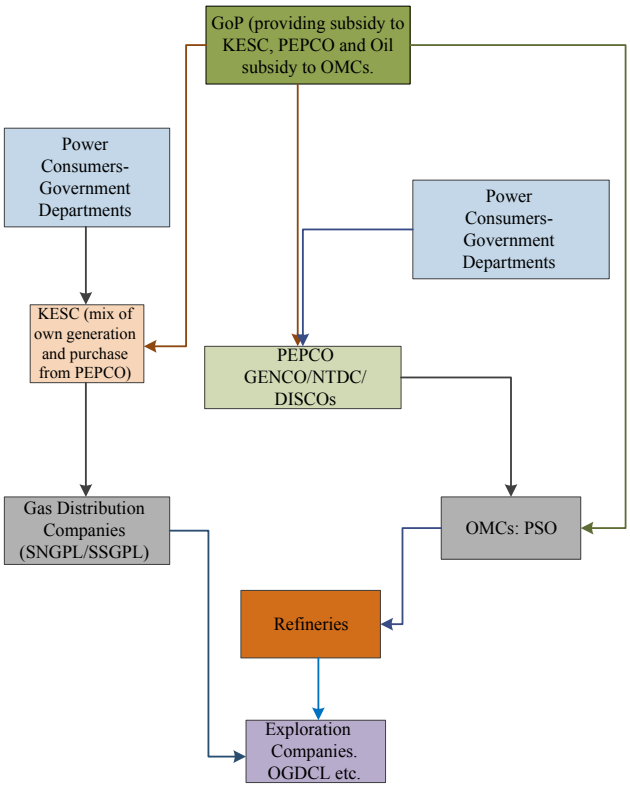

Figure 1.2: Payment Cycle in Pakistan's Energy Sector[47]

In comparison to Figure 1.1, Figure 1.2 illustrates the payment chain in Pakistan's energy sector. It also provides evidence to suggest the inception of the term 'circular debt'. The high T&D losses, especially in developing countries like India and Pakistan, are primarily because of consumers not paying their dues, or tampering with electricity meters in order to receive direct, free electricity from the grid. As illustrated in Figure 1.2, if consumers are not paying their electricity dues, the distribution companies are unable to pay the generation companies, thus creating a systemic liquidity crisis within the energy chain. As outlined earlier, no state intentionally defaults on their payments. However, despite several multilateral reports and studies identifying the fundamental issue with the energy sector's regulatory framework and no redressal of the

[47] Syed Sajid Ali and Sadia Babar, 'Dynamics of circular debt in Pakistan and its resolution', (2010) The Lahore Journal of Economics 15:SE, pp 61-74.

discrepancies, it can be concluded that the government, especially in Pakistan, is not intent on improving the situation.

Subsidies are another cumbersome factor, inhibiting the state's ability to make timely payments, and directly contributing to the accumulation of circular debt. In Pakistan, the state's inability to transfer the real cost of generation to the consumer has proved fatal for energy sector. In an existing constrained fiscal space, it is argued that subsidies are highly regressive.[48] As a result, end consumer tariffs are inadequate to recover the rising costs of power generation[49], and the government is unable to fully compensate CPPA against resulting losses.[50] Figure 1.3 illustrates the power tariff for consumers from November 2006 to January 2010.[51] This figure provides an illustration of how, the energy regulator NEPRA's recommendations are being ignored by demonstrating a price differential between what NEPRA recommends, and what is actually approved by the Ministry of Water and Power. It is submitted that an increasing burden on the economy will cause adverse impact on the long-term success of the infrastructure investment in the energy sector. Also, after drawing comparisons

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[48] See International Monetary Fund, *Pakistan: First review under the extended arrangement under the extended fund facility, request for waiver of nonobservance of a performance criterion and modification of performance criteria* (IMF Country Report No 14/1, January 2014) <https://www.imf.org/external/pubs/ft/scr/2014/cr1401.pdf> Accessed 08 March 2014. The report highlights the importance of either reducing subsidy or eliminating any subsidy arrangements altogether. The report appreciates the political ramifications of such policy shift. The report has also highlighted that due to political uncertainty Pakistan has been unable to shift its subsidy burden from the state exchequer to the consumer.

[49] Whereas Pakistan's policy has shifted over the years from diesel-powered IPPs to LNG powered energy projects, it is argued that when the diesel-powered energy projects were introduced there was an increasing number of objections from political circles to stop any investments in the IPP sector based on oil-based power generation. In respect of the declining price for oil products, it can be argued that had the administration continued to use the oil-based IPPs, the situation regarding energy production and generation would have been different.

[50] Syed Sajid Ali and Sadia Babar, 'Dynamics of Circular Debt in Pakistan and its resolution', (2010) The Lahore Journal of Economics 15: SE pp 61-74.

[51] Source: Syed Sajid Ali and Sadia Babar, 'Dynamics of Circular Debt in Pakistan and its resolution', (2010) The Lahore Journal of Economics 15: SE pp 61-74.

between Figure 1.3 and Figure 1.4, it is clear that the increasing price differential in the average power purchase price (Rs/Kw) and the price which consumers actually pay demonstrates the increasing economic burden of subsidies.[52] Without a complete overhaul in the energy sector, it seems unlikely that sovereign guarantees will have any meaningful impact in providing a robust form of security to the investors, or help attract new investment in Pakistan in order to sustain a long-term investment regime.[53]

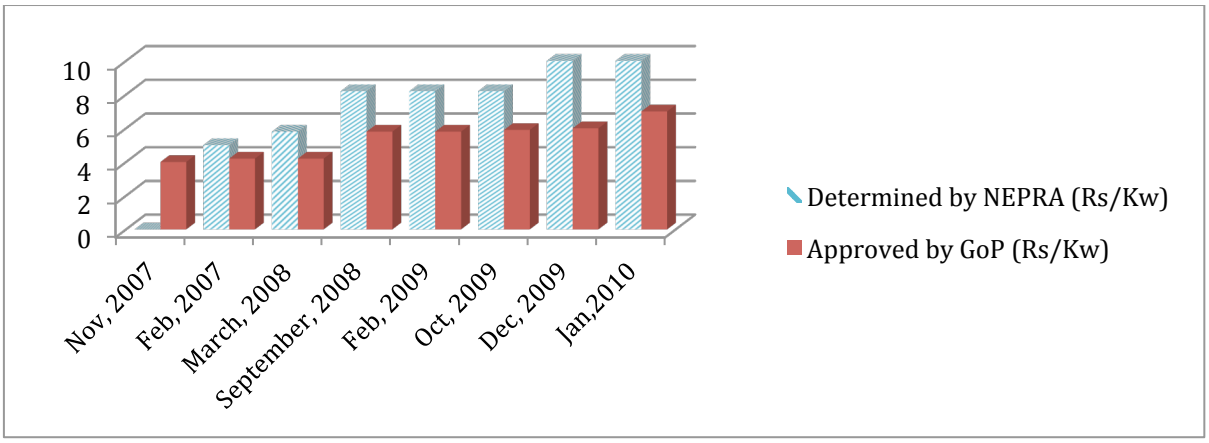

Figure 1.3: Price Differential Comparison

Moreover, the table below outlines the consumer tariff vis-à-vis the cost of power generation, reflecting on the point made earlier concerning the non-transfer policy of the cost of generation onto the consumer.[54]

[52] See *OGRA through its Secretary v M/S Midway II, CNG Station and others* (Civil Petition No. 455/2013). The Chief Justice noted that 'one of the reasons for reduced power generation was increase in the cost of generation whereas no tariff increase allowed between FY2003 to FY 2007, despite a steep increase in generation cost due to a surge in oil prices'.

[53] See International Monetary Fund, *Pakistan: First review under the extended arrangement under the extended fund facility, request for waiver of non-observance of a performance criterion and modification of performance criteria* (IMF Country Report No. 14/1, January 2014) <https://www.imf.org/external/pubs/ft/scr/2014/cr1401.pdf> Accessed 28 June 2016.

[54] The author is aware that these figures are outdated. However, their use is for illustrative purposes only.

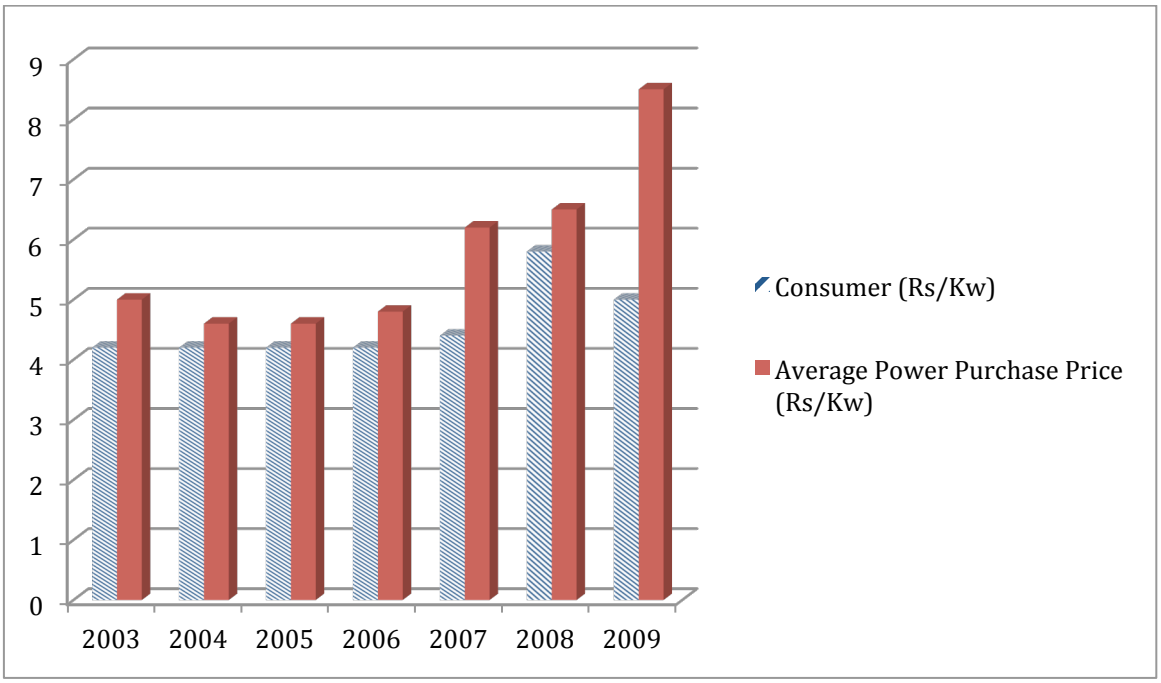

Figure 1.4: Cost of Generation v Consumer Tariff

As illustrated in Figure 1.5, the circular debt issues occurring in Pakistan's energy sector have constantly been accruing despite payments to the DISCOs and consequently, to the IPPs.[55]

[55] Gathered from various sources: Planning Commission of Pakistan and USAID, *The Causes and Impacts of Power Sector Circular Debt in Pakistan* (March 2013) <http://pdf.usaid.gov/pdf_docs/PA00KPHC.pdf> Accessed 14 October 2015; Wajeeha Riaz, 'Circular Debt: From where it all started', Prime Institute 21 May, 2014 <http://www.primeinstitute.org/blog/circular-debt-from-where-it-all-started> Accessed 06 December 2015; Asian Development Bank, *Circular Debt Impact on Power Sector Investment* (Supplementary Document 13, 2014) <www.adb.org/sites/default/files/linked_documents/47015-001-sd-04.pdf> Accessed 17 January 2017.

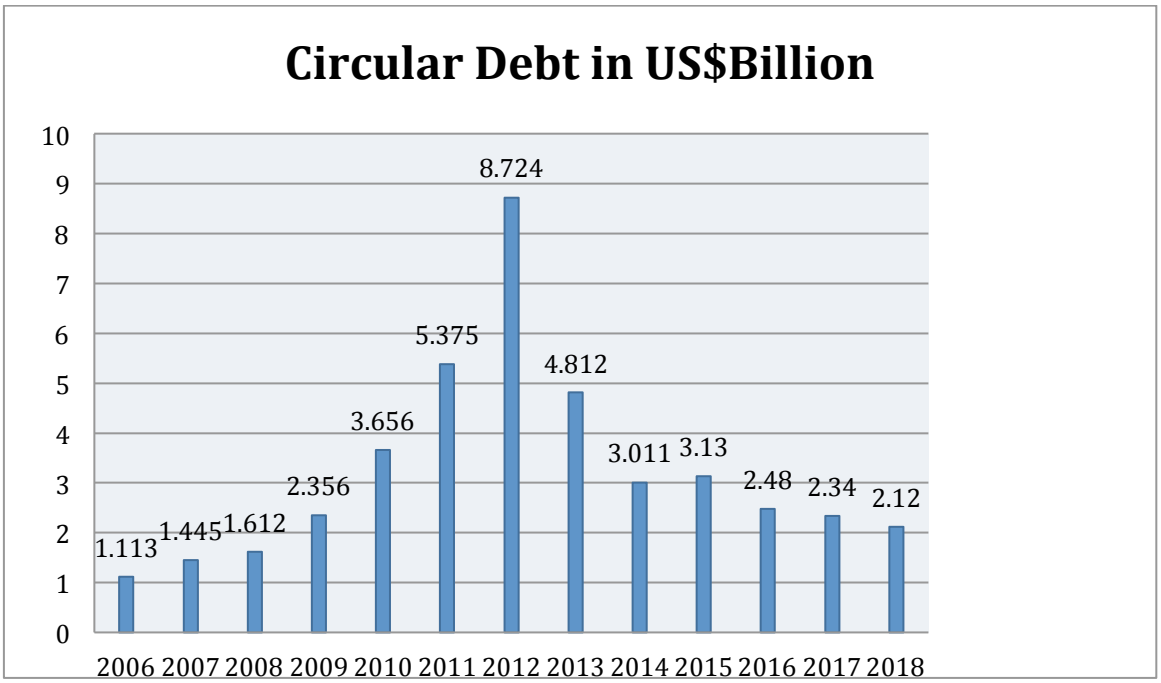

Figure 1.5: Circular Debt Figures (US$ Bn)

The accumulation of circular debt is not only predicated on the state's inability to meet or honour their contractual obligations, it also rests on poor policy making. The 1994 Energy Policy (hereinafter referred to as "1994 Policy") adopted the 'take or pay' provision in the energy agreements. Take-or-pay, send-or-pay, and ship-or-pay are commonly used provisions within the energy sector. This provision provides the buyer an option to both off-take electricity and pay, or in case they are unable to off-take electricity, to pay the project company regardless. These provisions are considered to form part of the fabric of energy industry risk allocation.[56] The inclusion of take-or-pay provisions in PPAs entered with IPPs during the operation of the 1994 Policy has directly inhibited the off-taking bodies' ability to pay. The off-taking body would pay the IPPs regardless of whether electricity has been purchased or not, if the IPP were ready

[56] Ben Holland, 'Enforceability of take-or-pay provisions in English law contracts-resolved', (2016) Journal of Energy & Natural Resources Law <http://dx.doi.org/10.1080/02646811.2016.1164554> Accessed 24 April 2017.

to supply such. However, the circular debt figures outlined in Figure 1.5 arose during 2006-07, when oil prices were all time high in the international market.[57] The government at the time endeavoured to approach the circular debt figures by injecting more cash, despite severe fiscal and economic stress on its own coffers. This standalone approach has since then been repeated once the incumbent government came to power after the 2013 general elections. Despite repeated instructions from the IMF as discussed earlier, Pakistan is yet to undertake an overhaul in their regulatory regime in order to curb the increasing discrepancy, rising circular debt, and the acute energy shortage.[58] From 2006 to 2012 there was a steep increase in the circular debt figures. The circular debt reached an all-time high during 2012 crossing the US$8 billion mark. Unlike the rural population, the urban cities like Islamabad, Lahore and Karachi faced the wrath of sweltering heat and electricity outages in excess of eight hours each day. In some parts of these major cities, it was even worse. According to articles published in various leading newspapers, some parts of Islamabad, Lahore were experiencing power outages of more than 16 hours on a daily basis.[59]

In the past, government guarantees were called by the IPPs due to non-performance by the power purchasers. This call of guarantees was not honoured, and consequently a group of IPPs took the case to the Supreme Court for

[57] Please note that during the year 2014-2016 oil has subsequently decreased from approximately US$160 per barrel to as low as US$32 per barrel.

[58] Also interesting to note is the observation recorded by the ADB regarding the weak governance structure and an overhaul in the regulatory measures prevailing at the time. ADB has submitted that the government's interest and role in the appointment of the Board of Directors of the DISCOs, and political and bureaucratic factors continue to limit the Board's independence and technical and management competency. At the corporate level, Board authority and efficiency in monitoring and enforcing the performance of DISCO management has been insufficient to improve performance. Asian Development Bank, *Circular Debt Impact on Power Sector Investment* (Supplementary Document 13, 2014) <www.adb.org/sites/default/files/linked_documents/47015-001-sd-04.pdf>.

[59] AFP, 'For Pakistan, every day is a blackout with no end in sight' *The Dawn* (Islamabad, 08 August 2012) <https://www.dawn.com/news/740705> Accessed 11 November 2014.

adjudication. The case was settled out of court.[60] Not only is circular debt creating uncertainty for payment of dues by the off-taking bodies, it also presents an overhanging risk, often deterring investment, and leading to an irreparable risk factor that causes higher premiums, and more stringent terms in the loan documentation.[61] When the incumbent government took office, special measures were undertaken to facilitate the Ministry of Finance to sanction funds in excess of US$4 billion to be paid to the IPPs. In 2013, payments were made and the circular debt (for the time being) was taken off the balance sheets. However, after several months the circular debt started to accumulate again and reached an amount in excess of US$1.6 billion. A pivotal role in the rise of circular debt is the price hike in the international oil market, and the devaluation of the Pakistani rupee against the dollar. It is submitted that from 2005 to 2011, the cost of furnace oil increased in real terms from US$236 to US$639 per tonne. In that period, the Pakistani rupee depreciated at an alarming rate wherein the cost per tonne went up from PKR21, 087 to over PKR70, 930. This meant that the cost of power generation had an astonishing increase of 236% in a period of six years.[62]

In view of the increasing circular debt, lack of adequate regulatory frameworks and a complete overhaul in the energy sector, it is questionable whether a sovereign guarantee offers any real protection to the investor. Chapter 3 discusses guarantees from a private sphere of the law. A sovereign guarantee is quintessentially a contract. A state's inability to make timely payments in the

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[60] Details of these cases are subject to confidentiality.

[61] Also see Asian Development Bank, *Circular Debt Impact on Power Sector Investment* (Supplementary Document 13, 2014) <www.adb.org/sites/default/files/linked_documents/47015-001-sd-04.pdf> Accessed 23 March 2017.

[62] Planning Commission of Pakistan and USAID, *The Causes and Impacts of Power Sector Circular Debt in Pakistan* (March 2013) <http://pdf.usaid.gov/pdf_docs/PA00KPHC.pdf> Accessed 06 September 2015.

absence of a well-regulated energy sector creates not only challenges for the investor, but also further constrains the already existing limited fiscal space.

One of the primary issues that emerges in this section indicates a stronger role being played by state-owned entities (hereinafter referred to as "SOEs") as a means to facilitate investment projects in a de-regulated industry. It is argued that SOEs play a pivotal role in enforcing PPAs, and ensuring that sovereign guarantees are honoured. As a result, SOEs both generally and from Pakistan's standpoint need to be discussed in order to carry out a discursive analysis.

1.5 SOEs and the Existential Paradox for the Sovereign Guarantee Framework

Corporate governance and regulation have been briefly referred to in the previous sections, and will be mentioned throughout the course of this thesis. The primary argument consistent throughout this project is predicated on the same foundations upon which these organisations in Pakistan's energy sector are structured. However, corporate governance and regulation will require a separate, serious undertaking. To understand the sovereign guarantee structure, it is pertinent to discuss those SOEs operating, in order to provide the basic frameworks upon which these contractual relationships are predicated.

Chapter 4 provides an interesting account of how these sovereign guarantee structures may be inadequate by referring to the basic principles of guarantees under common law. In pursuit of achieving the desired discourse, this study discusses SOEs and their role in the sovereign guarantee framework, and illustrates the absence of effective regulation in abstract, in order to provide a

discourse on the legal inadequacies in sovereign guarantee frameworks. There is no strict legal framework in international law that discusses the organic structure of the state in the aftermath of the state's heavy involvement through their SOEs. Consequently, this study refers to *Article 4* and *Article 5* of the ILC's Draft Articles on State Responsibility (hereinafter referred to as "Draft Articles") to discuss the notion of these SOEs being organs of the state. Any discussion to such account under relevant Company law rules will require a displacement of the long-standing principles of separate legal personality. However, this study reviews the sovereign guarantee framework from a guarantee law perspective, and makes recourse to Draft Articles in an effort to determine the adequacy of these guarantees in light of the decision in cases such as *Vossloh*[63] and *Thomas Lakeman.*[64]

SOEs play a pivotal role in infrastructure development.[65] SOEs were formally introduced in the capital markets due to the private sector's demand for deregulating various facets of the infrastructure industry and to mitigate sovereign risk. They were primarily aimed at providing one-window, specialised and efficient[66] bodies to facilitate investment options for the private sector. As a result, these institutions or corporatised bodies were created in order to reap the benefits of corporate machinery in the international capital markets. SOEs and

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[63] *Vossloh Aktiengesellschaft v Alpha Trains* (UK) Ltd [2010] EWHC 2443.
[64] *Thomas Lakeman v J P Mountstephen* (1874-75) L R 7 H L 17.
[65] See World Bank Group, *Corporate Governance of State-owned Enterprises: A toolkit* (Washington, International Bank for Reconstruction and Development/World Bank, 2014). The report submits that '…It is observed that despite the trend towards privatisation over the past 20 years, state-owned enterprises (SOEs) are still significant economic players. Globally, SOEs account for 20 percent of investment, 5 percent of employment, and up to 40 percent of output in some countries. They continue to deliver critical services in important economic sectors such as utilities, finance and the energy sector'.
[66] See Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment* (2nd Edition, Oxford, 2012). Also see Organisation for Economic Cooperation and Development (OECD), *Public Sector Modernisation: Changing Organisational Structures* (OECD Policy Brief, 2004).

their problematic nature in wake of breach of sovereign guarantees has been extensively discussed in Chapter 4 as part of this project's analysis to provide a critical review of the security offered under a sovereign guarantee. However, in the absence of adequate regulatory frameworks, increasing influence exercised by the government, and SOE's inability to exercise decision-making independent of the government, there is an increasing view that Pakistan's SOEs status as 'independent' is problematic. The SOEs discussed in Chapter 4 are not insulated from the state, nor operate under a clear concession agreement. A good illustration of the position of SOE in managing the affairs of the state is submitted by Jessel MR, who submits that 'if the financial activities were that of a government department, and assuming that the bank is right on international law, there would be no legal debts at all but only obligations of honour'.[67] This means that without SOEs engaged in international finance transactions, there would be uncertainty surrounding the corporate structure that is adopted by a government department.[68] However, with a variety of public policy goals in mind, the state's position insofar as arguing whether a SOE is in fact a 'separate legal entity' is subjective upon the nature of the case, and the cause of action arising therein.

In the 1990s, SOEs were seen as new method of Public-Private Partnerships (hereinafter referred to as "PPPs") wherein the state's primary purpose was to provide basic physical infrastructure by collaborating, and in essence, shifting

[67] See Jessel M R in *Twycross v Dreyfus*, 5 Ch D 605, 616.
[68] A stark reflection of this submission can be seen in various cases. An old but popular case of *Trendtex Trading Corporation v Central Bank of Nigeria* [1977] Q B 529 illustrates this 'cherry picking' nature of government, wherein they would claim that an institution is carrying out governmental functions in one instance and be a commercial enterprise in another.

risk to the private sector.[69] SOEs have also been used to reduce fiscal burden, fiscal risk, enhance transparency and accountability for the use of scarce public funds. Moreover, as governments face continued budget constraints, better-governed SOEs[70] are more easily able to raise finance for infrastructure and other critical services through the capital markets.[71] Public bodies were also corporatised in a bid to later privatise them, in order to raise capital and attract foreign investment in various basic facilities' projects globally. Moldova provides a good illustration of this submission. In the 1990s, Moldova's energy sector suffered from approximately 25% T&D losses. Circular debt accumulated, along with large commercial losses, primarily due to illegal connections and tampering of electricity meters, and electricity theft. Corporatisation, industry restructuring and privatisation led to a series of reforms within the energy sector to address these chronic issues. Whilst the principal reasoning underlying SOE reform is often viewed as a precursor to privatisation, Pakistan's energy sector has not implemented the requisite reforms as per the recommendations under the Energy Sector Restructuring Program (hereinafter referred to as "ESRP")[72] in 1998. The ESRP recommended a complete overhaul in Pakistan's energy sector including inter alia, privatisation of distribution companies and setting an independent regulator. Whereas a detailed regulatory reform is beyond the purview of this study, it is submitted that in order to continue using the current

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[69] See International Monetary Fund (IMF), *Public-Private Partnerships, Government Guarantees, and Fiscal Risk* (Washington, IMF 2006).

[70] In India, 41 centrally owned SOEs account for 20% of the market capitalisation of the Mumbai Stock Exchange.

[71] For a detailed discussion on SOEs, please see World Bank Group, *Corporate Governance of State-owned Enterprises: A toolkit* (Washington, International Bank for Reconstruction and Development/ World Bank, 2014).

[72] See Asian Development Bank, *Pakistan: Energy Sector Restructuring Program* (Performance Evaluation Report, Feb 2014) <www.adb.org/documents/pakistan-energy-restructuring-program-0> Accessed 22 April 2017.

sovereign guarantee structure, Pakistan needs to implement a complete transformation of its regulatory frameworks.[73]

SOEs play a pivotal role in facilitating the issuance of a sovereign guarantee. There are two methods through which SOEs can become involved in the process of sovereign guarantees. First, in a bid to balance a mosaic of stakeholder interests including multilateral agencies, states re-register previously publicly owned bodies as companies under the relevant Company Law rules. As a result, corporatisation transforms a previously publicly owned enterprise into a corporate entity managed by an appointed board and a managing director. This quasi-sovereign juristic fabric gives the impression that the entity is independent. This method is primarily used for off taking distribution companies. Second, sovereign guarantee structure involves a body that facilitates and issues a sovereign guarantee to the SPV. This form of entity is normally a statutory body, formed under the directions from the parliament, government or through legislative means to formulate, execute and contribute towards the inception of policies. Both these forms of entities are commonly used throughout the world in infrastructure sector in order to facilitate investment, and form the underlying feature of a sovereign guarantee.

Since the focus of this study is primarily reviewing the sovereign guarantee structure in Pakistan, Chapter 4 reviews the role of PPIB, NTDC and CPPAG. Sovereign guarantees have been discussed extensively throughout this study.

[73] From the data reviewed by the World Bank Group, the report submits that privatisation improved firm performance in competitive sectors and, when accompanied by proper policy and regulatory frameworks, in financial and infrastructure sector. See World Bank Group, *Corporate Governance of State-owned Enterprises: A toolkit* (Washington, International Bank for Reconstruction and Development/World Bank, 2014).

However, in the event that this study proposes that the sovereign guarantee framework is inadequate, what recourse can investors seek in order to strengthen their existing security package?

1.6 Redundancy Measure: Political Risk Insurance

Consistent with the theme throughout this study, this introductory chapter introduces the state's need to provide robust security measures in order to attract infrastructure investment funds. Contractual security measures such as sovereign guarantees form part of the fabric that provides a robust measure to mitigate risk. This thesis repeatedly makes reference to the highly-leveraged nature of project financings, especially in transactions involving a PPA. However, in light of the liquidity crisis discussed in the earlier part of this chapter, especially from Pakistan's standpoint, investors are increasingly seeking recourse to alternative contractual security measures. These additional or alternative security measures are increasingly being used in order to mitigate risk in infrastructure development. London's sewerage system upgrade project incorporates the payment at the start of construction method. Various other jurisdictions adopt an escrow account model as a means to mitigate risk. As discussed throughout Chapter 5, developing countries are increasingly competing against each other in order to secure infrastructure investment funds. Developing countries have adopted various measures to promote capital inflow inter alia publicising relevant investment opportunities, providing necessary infrastructure to support private investors, and to provide support in the form of equity investment and guarantees. However, wherein certain risks can be mitigated through non-conventional methods or ignored, liquidity issues in Pakistan's energy sector are

increasingly deterring investors from exploring new investment opportunities despite higher returns.

Moreover, in the absence of a robust framework to protect investment, and ensure timely debt servicing, it is not only the state that is driven by market-centric policies to provide protection. Investors too are seeking alternative ways to provide certainty and security in challenging, risky jurisdictions. Investors are persuaded by higher returns: however, they are content to transfer the risk of the project to other parties. Some of these parties have been discussed in Chapter 2. As a result, investors are seeking methods to mitigate risk. As outlined in Chapter 5, it is likely that sovereign guarantees or other favourable measures will be considered problematic by investors for two reasons; first, investors may feel that there is no real protection being offered under a sovereign guarantee or other non-conventional forms of security. Second, they may find that favourable treatment or concessions offered by the incumbent government may attract political criticism due to policy or regime change. As a result, this study refers to political risk insurance as a model to provide a substitute for sovereign guarantee framework, or as a measure of additional security. Since the focus of this study is to review Pakistan's energy sector, this study refers to the inclusion of risk insurance model offered by the World Bank's Multilateral Investment Guarantee Agency (hereinafter referred to as "MIGA") to either replace sovereign guarantee framework, or use as an additional form of security.

Chapter 5 discusses the notion of 'political risk' as not only the occurrence of some political event that will change the prospects of profitability of a project, but also as a material adverse change which either disrupts the operation of a

project or extinguishes its ability to provide the agreed services. Whereas the chapter provides an extensive outline of the risk endured by private investors, the main focus of the chapter relates to the use of risk insurance as an alternative means of promoting investment.

As extensively discussed above, the primary issue concerning the inadequacy of sovereign guarantees is the non-payment or delay in payment by the off-taking bodies. Consequently, the rise in circular debt figures relate to off-taking bodies' inability to honour contractual obligations. With inadequate fiscal space to entertain requests by investors to fulfil payment obligations, it is argued that the most relevant weapon in MIGA's arsenal of risk insurance instruments is to deal with contract repudiation. As illustrated in an earlier section, circular debt inhibits the ability of an off-taker to provide timely or no payment under the PPA. However, the chapter also reflects on some of the criticisms that may be involved in using a risk insurance model. Discussion of moral hazard has been undertaken because there is an increasing belief that the use of risk insurance model perpetuates irrational behavior by investors. Moreover, whereas risk insurance model can provide an adequate form of security primarily because multilateral bodies like the World Bank immediately indemnify the investor in cases where there has been a breach on an agreement, the host states are required to indemnify the insurer. As a result, there may be an incentive for an investor to use a risk insurance model, however from a host state's standpoint this will primarily entail a further constraint and possibly affect other projects since multilateral institutions can influence the reimbursement of finance in other projects.

1.7 Conclusion

Often the advantages associated with infrastructure development are intangible, at least immediately. Lack of supply of a commodity like electricity can create awareness of the benefits associated with generation of electricity amongst consumers. Consumers are generally very well aware of the benefits that are associated with development due to wide access to digital and print media. However, displacement of local population, smoke generated from coal-based power plants destroying crops, or more generally the idea of foreigners working in their area can lead to opposition for such projects. Infrastructure projects do not bring or associate themselves with immediate reform or results. China's US$4 billion recent investment in Kenya's railway sector will not only connect Uganda, Kenya and Rwanda, it will also provide cheaper goods alternative to the poorest segments within Kenya.[74] However, in order to achieve this development goal there will be land acquisition problems, terrain problems, and general dissent amongst the locals. Economic goods such as railway, electricity, and other infrastructure projects take several years before any real benefit can be derived from them. For example, some of the larger hydro-power dams take three to six years before they generate electricity. Whereas off-grid electricity generation takes less time to setup than a conventional power plant, it is targeted more towards smaller communities or individual consumers. Unlike the benefits of infrastructure, the risks inhibiting the progress of a project are often tangible. Its effects can severely disrupt the operation of a project.

[74] David Pilling and Emily Feng, 'Kenya's $4bn railway gains traction from Chinese policy ambition' *The Financial Times* (London, 4 April 2017) < https://www.ft.com/content/d0fd50ee-1549-11e7-80f4-13e067d5072c> Accessed 04 April 2017.

This study aims to provide a discursive analysis of the risk-mitigating measures that are used in highly leveraged finance transactions in order to understand the underlying features of a guarantee framework. Moreover, in the event that sovereign guarantees due to procedural issues prove to be inadequate, this study seeks an alternative measure to provide certainty in Pakistan's electricity investment regime. This study has been divided into six chapters. Whereas an outline has been provided in the previous sections of this introductory chapter, it is submitted that a brief detail of all the chapters is as follows.

Chapter 2 provides an introduction to project finance transactions. This chapter aims to provide the reader with an introduction to project finance, and assist in the terminologies used in the subsequent chapters. The high-risk nature of electricity generation in developing countries has led to an increase in project finance being used as a method to mitigate risk. This chapter provides an in-depth analysis of the principles underlying highly leveraged transactions within the electricity sector in general. A case study from Pakistan's energy sector has been included in the chapter as an example of project finance structure.

With an overview of the underlying financial transaction that predicates various energy projects, Chapter 3 begins to provide a historical account of the law of suretyship, the umbrella term that encompasses guarantees and indemnities. This chapter illustrates some of the fundamental principles of both guarantee and indemnity provisions within a project finance transaction. This chapter provides the bedrock of the subsequent chapter, Chapter 4. As the study progresses, sovereign guarantees are introduced as the most important facet within risk mitigation in Pakistan's electricity sector. Chapter 4 provides an outline of the

main parties to a sovereign guarantee transaction, and ascertains the adequacy of the relationship that exists between the SOEs and the government. The chapter refers to the possibility of these institutions being mere 'rubber stamp' organisations. Consequently, the chapter demonstrates how the sovereign 'guarantee' structure may be problematic from a procedural perspective by reviewing the current framework through the lens of the Draft Articles. This chapter provides a coherent indication that in the absence of a well-insulated SOE, there is a possibility that there is no meaningful security package being offered under the current sovereign guarantee framework from Pakistan's standpoint. In the event that there is no real protection being offered under the current sovereign guarantee framework, what recourse do investors have?

Chapter 5 illuminates instances wherein the state has failed to provide any robust form of contractual security to the project company or the lenders; what recourse do sponsors have as a means of protecting their investment? One of the primary reasons for using MIGA's political risk insurance product is because of their unique product offering 'non-honouring of sovereign contractual obligations'. In light of the discussion undertaken at the start of this chapter, it is submitted that in the presence of liquidity issues, it would be beneficial to scrap sovereign guarantee framework altogether and adopt the PRI model in order to mitigate risk.

The challenges discussed throughout this study are an illustration of the widespread issues prevalent within other developing countries. The lack of policy frameworks, marketing infrastructure investment opportunities without ancillary infrastructure facilities in place, and mismanagement of resources are

common instances in Asian and African countries. An example is where marketing investment opportunities fail due to the lack of distribution centers or infrastructure to off-take electricity from the project company. This has been a major challenge to countries like Nigeria, Kenya, Pakistan and even India. Whereas India is economically more stable than the other three listed countries, it is argued that without proper due diligence exercised on the part of the host state, investment opportunities should not be marketed at all. There have been reported instances where governments sign off-take or PPAs without realising that they do not have the infrastructure capacity to off-take such electricity.

As outlined in a recent report by the ADB, the increasing demand for infrastructure has led to a substantial increase in the cost associated with maintaining infrastructure development.[75] As a result, this study can be replicated to determine the adequacy of sovereign guarantee frameworks in other regimes and jurisdictions. In conclusion, it is submitted that the primary aim of this project is to provide an extensive analysis of guarantees offered in investment regimes. However, it also aims to achieve a larger purpose, much larger than the provision and availability of electricity. The lack of electricity in countries like Pakistan has directly affected the lives of millions. Hundreds of people die every day in countries like Pakistan, Nigeria, Namibia, and Ethiopia because of the lack of electricity that inhibits the functionality of basic health facilities. This study is an effort to provide an extensive discourse to help governments and investors better understand the security packages they are being

[75] Michael Peel and Tom Mitchell, 'Asia's $26tn infrastructure gap threatens growth, ADB warns' *The Financial Times* (Beijing, 28th February 2017) < https://www.ft.com/content/79d9e36e-fd0b-11e6-8d8e-a5e3738f9ae4> Accessed 28 February 2017.

offered, and to seek more robust measures in case there is uncertainty surrounding such measures.

Chapter 2

Project Finance as a Risk Mitigation Instrument—A Primer

2.1 Introduction

The underlying concept of project finance requires an understanding and explanation of all the relevant parties involved within a project finance transaction. This thesis refers to the highly-leveraged nature of project finance transactions, off-taking bodies, EPC contractors, and more importantly the host state. In order to assist and provide a valuable discussion on the area surrounding sovereign guarantee, it is important to understand how energy projects are structured. In addition to understanding the role of various parties involved in a project finance transaction, an attempt has been made to succinctly present an outline of how project finance is a tool to mitigate risk.

Furthermore, a brief outline of the differences between corporate finance and project finance transactions is reviewed. For the purposes of clarity, inherent differences are explicitly outlined to allow differentiation between an off- and on-balance sheet financing structure. This discussion highlights the nature of risk that is endured through project finance transactions, and illustrates how non-payment of dues/tariff, principally due to liquidity issues, can be problematic for the project company in particular and the host state's investment regime in general.

In order to provide a context for the discussion undertaken hereunder, Gulpur Power Project is illustrated as a typical project finance transaction. From a project finance standpoint, this transaction provides a good outline of the

relationship that exists between the parties, contractual frameworks, and a general understanding of how lenders can potentially mitigate their risk by contracting directly with the engineering, procurement and construction contractors (hereinafter referred to as "EPC"), and the operation and maintenance (hereinafter referred to as "O&M") contractors.

In view of this discussion, this chapter provides a bedrock for understanding the concepts that will be under discussion in the following chapters, and provides a basic framework for anyone trying to understand how risk of default canvasses for a project company from a financial perspective normative to sovereign guarantees.

2.1.1 Historical Outline

From a historical standpoint, it can be argued that infrastructure development has been predominately undertaken through private sources of finance. It was not until the end of the nineteenth century that public finance for large infrastructure projects[76] began to dominate private finance, and this trend continued throughout most of the twentieth century.[77] Whereas there are still remnants of public role within infrastructure development through sovereign wealth funds and other public sector entities, it is argued that the role of public finance has become limited. A report published by the World Resource Institute (hereinafter referred to as "WRI") makes a similar observation. WRI note that public divestment in

[76] See Biswa Nath Bhattacharyay, 'Estimating demand for infrastructure, 2010-2020', in Biswa Nath Bhattacharyay, Masahiro Kawai and Rajat M Nag, *Infrastructure for Asian Community,* (ADBI/ADB and Edward Elgar Publishing, 2012). The author highlights the key role of infrastructure development in promoting and sustaining growth, and as a result the uplift of poorer groups and communities.

[77] See Richard A Brealey, Ian A Cooper, and Michel A Habib, 'Using project finance to fund infrastructure investments', (1996) Journal of Applied Corporate Finance 9, 25-38.

the service sectors is necessary because governments can no longer afford to support loss-making enterprises due to budgetary and fiscal constraints.[78]

The early 1980s witnessed an increase in private sector financing of large infrastructure investments. Private investment in infrastructure development has now predominately taken the form of project finance.[79] Yescombe notes that:

> Private finance for public Infrastructure is not a new concept: The English road system was renewed in the 18th and early 19th centuries using private sector funding based on toll revenues; the railway, water, gas, electricity, and telephone industries were developed around the world in the 19th century mainly with private-sector investment. During the first half of the 20th century, however, the state took over such activities in many countries, and only over the last 20 years has this process been reversing.[80]

The International Energy Agency's (hereinafter referred to as "IEA") 2017 report highlights that more than 90% of energy investment is financed from the balance sheet of investors, suggesting the importance of sustainable industry earnings, which are based on energy markets and policies. However, the report submits

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[78] Navroz K Dubash and Sudhir Chella Rajan, *The Politics of Power Sector Reform in India* (The World Resources Institute, 2 April 2001). <**http://www.wri.org/sites/default/files/powerpolitics_india.pdf**> Accessed 21 April 2017.

[79] See Richard A Brealey, Ian A Cooper, and Michael A Habib, 'Using project finance to fund infrastructure investments', (1996) Journal of Applied Corporate Finance 9, 25-38. The growing popularity of project finance is primarily predicated on the fact that it reduces the need for government borrowing, shifts part of the risks presented by the project to the private sector, and aims to achieve more effective management of the project.

[80] Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002).

that project finance is a popular method for financing electricity projects in volatile economies.[81] The growing popularity of project finance is primarily predicated on a complex web of contractual structures[82] between various parties involved in a typical project finance transaction.[83] As Nevitt and Fabozzi submit:

> [T]he key to a successful project financing is structuring the financing of the project with as little recourse as possible to the sponsor while at the same time providing sufficient credit support through guarantees or undertakings of a sponsor (government), or third party, so that lenders will be satisfied with the credit risk.[84]

These contractual structures are designed to allocate risk within a transaction to parties who can best appraise and manage those risks.[85] Despite an

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[81] International Energy Agency, *World Energy Investment* (IEA, 2017).

[82] The presence of various contractual structures reduces risk as various methods of sub-contracting leads to transfer of risk within a project, from one party to another. See Francesco Corielli, Stefano Gatti, Alessandro Steffanoni, 'Risk Shifting through non-financial contracts: Effects on loan spreads and capital structure of project finance deals', (October 2010) Journal of Money, Credit and Banking, Vol 42, No 7, pp 1295-1320.

[83] In 2014, 12% of project finance transactions were financed through equity, 9% by bonds, and 79% by loans. See Georg Inderst, *Infrastructure Investment, Private Finance and Institutional Investors: Asia from a Global Perspective* (ADBI Working Paper 555, January 2016). <http.ssrn.com/abstract=2721577> Accessed 23 March 2016; also see Biswa Nath Bhattacharyay, 'Estimating Demand for Infrastructure 2010-2020', in Biswa Nath Bhattacharyay, Masahiro Kawai and Rajat M Nag, *Infrastructure for Asian Community,* (ADBI/ADB and Edward Elgar Publishing, 2012).

[84] Peter K Nevitt and Frank Fabozzi, *Project Financing* (7th Edition, EuroMoney, 2004). Nevitt and Fabozzi also submit that in project financing, the project, its assets, its contracts, its inherent economics and its cash flows are segregated from its promoters or sponsors, in order to permit a credit appraisal and loan to the project, independent of the sponsors. While in the final analysis, lending to a project requires strong credit support from some source, frequently this support can be accomplished in an indirect or contingent manner which may have little or no impact upon the sponsor's debt capacity when compared to a direct borrowing. In some circumstances the credit of third parties unrelated to the sponsor can be used to support the credit standing of the project.

[85] Richard A Brealey, Ian A Cooper, and Michel A Habib, 'Using project finance to fund infrastructure investments' (1996) Journal of Applied Corporate Finance 9, 25-38. Another interesting contention in view of the submission made above is that risk should be borne by parties who are best able to manage them. Brealey, Cooper and Habib have argued that 'the statement that capital is cheaper for governments than to the private investors is misleading.

overwhelming volume of academic text available on project finance, there is no strict definition of the term available.[86] Ostensibly, project finance can be defined to mean a project being financed. The word 'project finance' is a nebulous term with no precise meaning. It can be used in a variety of different instances, each with its own set of specifications to be taken into account. Project finance can be used to define the availability of funds raised through active participation of several parties. These funds are raised based upon direct or indirect credit support provided by the sponsor.[87] The Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards (Basel II) provides an apt definition of the term. This study refers to the Basel Committee's definition primarily because of its reference to the lender being paid solely or exclusively out of the money generated by the contract for the facility's output.[88] This definition captures the real issue concerning non-

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Governments do not have to provide a return to shareholders, however this does not imply that the total cost of capital is lower to governments than it is to the private sector. The lower interest rate simply reflects the guarantee provided by the taxpayers to lenders; also see Cynthia A Williams, 'Regulating the Impacts of International Project Financing: The Equator Principles', (April 2013) Proceedings of the Annual Meeting (American Society of International Law), Vol 107, pp 303-308.

[86] Some of the eminent texts available on project are as follows; these have been referred to throughout this study for the purposes of explaining the contours of project finance: Richard A Brealey, Ian A Cooper, and Michel A Habib, 'Using project finance to fund infrastructure investments', (1996) Journal of Applied Corporate Finance 9, 25-38; Peter K Nevitt and Frank Fabozzi, *Project Financing* (7th Edition, EuroMoney, 2004); Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002); Benjamin C Esty, 'Returns on Project Financed Investment: Evolution and Managerial Implications' (2002) 15 Journal of Applied Corporate Finance; Emanuele Rossi and Rok Stepic, *Infrastructure Project Finance and Project Bonds in Europe* (Palgrave Macmillan, 2015); Francesco Corielli, Stefano Gatti, Alessandro Steffanoni, 'Risk Shifting through non-financial contracts: Effects on loan spreads and capital structure of project finance deals', (October 2010) Journal of Money, Credit and Banking, Vol 42, No 7; Stefanie Kleimeier and William L Megginson, 'An empirical analysis of limited recourse project finance' (July 2001) University of Oklahoma, Michel F Price College of Business Working Paper Series <http//ssrn.com/abstract=283969> Accessed 21 September 2016.

[87] Peter K Nevitt and Frank J Fabozzi, *Project Financing* (7th Edition, Euromoney, 2004). The necessity of an equity investment by the sponsor in the project entity is a function of the collateral and the nature of credit support.

[88] Ellis Ferran and Look Chan Ho, *Principles of Corporate Finance Law (*2nd Edition, Oxford, 2013). An interesting submission by Ferran and Chan Ho reviews the significance of limited liability corporate structures and discusses the pre-eminent position this structure enjoys, due to limited financial risks and the ability to raise large amounts of finance; also see *Barclays Pharmaceuticals Ltd v Waypharm LP* [2012] EWHC 306 (Comm) as per Gloster J wherein she

payment of dues or liquidity issues within the energy cycle. As highlighted by the Committee, a project's reliance on the future revenue stream provides the debt-servicing component of the project. In the absence of certainty to that account, no project finance transaction is sustainable. The Committee defines project finance thus:

> Project finance may take the form of financing of the construction of a new capital installation, or refinancing of an existing installation, with or without improvements. In such transactions, the lender is usually paid solely or almost exclusively out of the money generated by the contracts for the facility's output, such as the electricity sold by a power plant. The borrower is usually an SPE (Special Purpose Entity) that is not permitted to perform any function other than developing, owning, and operating the installation. The consequence is that repayment depends primarily on the project's cash flow and on the collateral value of the project's assets.

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noted that the corporate form is a structure that facilitates the raising of necessary capital for business and that, for this reason, only in exceptional circumstances does the law allow the creditor for business and that, for this reason, only in exceptional circumstances does the law allow the creditor of a company to pierce the veil of incorporation.

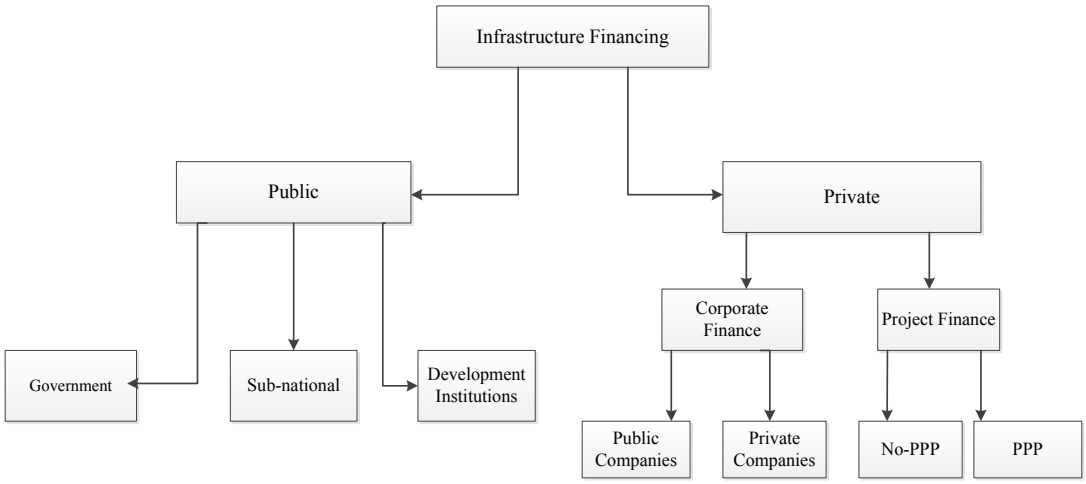

Figure 2.1: Infrastructure Finance Model[89]

Sovereign guarantees and risk insurance instruments are two of the many facets of risk mitigation that are being used by developing countries to attract investment. Similarly, project finance is a financial tool or a body of various contractual frameworks aiming to regulate the project company in view of the project's limitation insofar as generating revenue. From a risk management standpoint, project finance is a risk mitigation instrument. The leverage that such financial arrangements provide to sponsors creates an opportunity for delegating various forms of duties in order to distribute risk.[90] Infrastructure investment through project finance, under its existing framework, is predicated on a highly leveraged financial arrangement.[91] However, the entire risk and cost of the

[89] See Georg Inderst, 'Infrastructure Investment, Private Finance and Institutional Investors: Asia from a Global Perspective' (January 2016) ADBI Working Paper 555 <http.ssrn.com/abstract=2721577> Accessed 23 March 2016.

[90] See Francesco Corielli, Stefano Gatti, Alessandro Steffanoni, 'Risk Shifting through non-financial contracts: Effects on Loans spreads and capital structure of project finance deals', (October 2010) Journal of Money, Credit and Banking, Vol 42, No 7, pp 1295-1320. The authors argue that 'because project finance makes extensive use of contracts, some people refer to it as contractual finance'. Also see Richard A Brealey, Ian A Cooper, and Michel Habib, 'Using Project Finance to Fund Infrastructure Investments', (1996) Journal of Applied Corporate Finance, 9, 25-38.

[91] Evidence suggests the idea that even if project finance infrastructure assets are highly leveraged, thinly capitalised special purpose vehicles with low financial flexibility, project finance debt contracts are still structured to be resilient to a wide range of potentially severe risks,

infrastructure development is not solely borne by the private parties. Infrastructure development is highly dependent on economic success, and consequently fiscal restraints, as governments increasingly endure fiscal tightening.[92] Whereas seemingly fiscal restraints may not have direct implications for the success of a project, they will affect the project's operations. An example from an energy project perspective are IPPs. An IPP is established to produce an agreed amount of electricity. These project companies are privately owned, often through support from the government of the host state. These IPPs can be owned by foreign entities or local businesses.[93] However, role of an IPP is limited to the production of the electricity. It will not be the role of a special purpose vehicle (hereinafter referred to as "SPV") as an IPP to transfer a product from the project to its final destination, the consumer. Transmission lines and other ancillary facilities will be the responsibility of the state.[94] These include providing adequate transport facilities, in order to provide furnace oil or coal to the project company. There has been an increase in the role of the private

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minimising in this way any post default loan economic loan. See Emanuele Rossi and Rok Stepic, *Infrastructure Project Finance and Project Bonds in Europe* (Palgrave MacMillan, 2015)

[92] Emanuele Rossi and Rok Stepic, *Infrastructure Project Finance and Project Bonds in Europe* (Palgrave MacMillan, 2015). The authors, whilst discussing the role of the government, highlighted that the European Market, which has been historically known as the largest infrastructure project finance market in terms of the number and volume of transactions, has been affected to a high extent due to the government fiscal tightening and cautious and progressively regulated credit markets; also interesting to note is the submission put forward by Jamie Logie, 'Restructuring natural resources projects in the emerging markets: features and challenges Part 2', (2016) 2 CRI 73. Logie argues that 'maintaining a good relationship with host governments is crucial for project sponsors operating in emerging markets'.

[93] Historically foreign entities have struggled to successfully operate under the IPP structures. A recent decision by ICSID against Pakistan establishes this. See Hasnaat Malik, 'International litigation: Pakistan slapped with $700m fine in RPP case' *The Express Tribune* (Islamabad, 20 September 2017) <https://tribune.com.pk/story/1511129/international-litigation-pakistan-slapped-700m-fine-rpp-case/> Accessed 20 September 2017.

[94] Despite an increasing demand for infrastructure investment, the transmission lines have generally been ignored. Recently, however the Government of Pakistan has agreed to attract investment in transmission facilities under the Pakistan-China Economic Corridor agreement; also see World Bank, *Making Politics Work for Development: Harnessing Transparency and Citizen Engagement* (Policy Research Report, 2016).

sector in facilitating and investing in such infrastructure facilities.[95] However in countries that have recently opened doors for foreign investment, or newly marketed opportunities for infrastructure development, the private sector is often reluctant, and demands such facilities to be provided by the state.

2.1.2 Understanding Project Finance and Corporate Finance Transactions

In order to understand the limited recourse nature of project finance, and distinguish between off-balance sheet and on-balance sheet finance, it is important to highlight the differential nature of corporate finance and project finance. In view of the project's reliance on future cash flows, this section highlights why there is a need to mitigate political risk within the ambit of project finance, and why it forms an important facet, especially in energy sector transactions.

A project finance transaction involves an independent, legally and economically self-contained legal entity[96] whose only business is the project that is being financed.[97] Within a project finance transaction, the purpose is to develop a

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[95] There has been an increase in the liberalisation of markets, recording a shift from vertical integration into an un-liberalised market. As discussed in International Energy Agency's report, spending on electricity networks and storage continued its steady rise of the past five years, reaching an all-time high of US$227bn in 2016, with 30% of the expansion driven by China's spending in the distribution system. Another 15% went to India and Southeast Asia, where the grid is expanding briskly to accommodate growing demand. See International Energy Agency, *World Energy Investment* (IEA, 2017).

[96] Also interesting to note the submission made by Yescombe. Yescombe argues that 'project finance is provided through a 'ring-fenced' project, one which is legally and economically self-contained through a special purpose legal entity'. See Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002).

[97] See Emanuele Rossi and Rok Stepic, *Infrastructure Project Finance and Project Bonds in Europe* (Palgrave MacMillan, 2015); also see Christa Hainz and Stefanie Kleimeier, 'Project Finance as a Risk-Management Tool in International Syndicated Lending', (December 2006). Governance and the Efficiency of Economic Systems (GESY), SFB/TR 15, Discussion Paper No 183 < https://ssrn.com/abstract=567112> Accessed 21 April 2017. Hainz and Stefanie submit 'project finance is defined as the creation of a legally independent project company that is

capital-intensive infrastructure project wherein the repayment will be entirely subject to internally generated cash flows.[98] Prima facie, it is for this reason that project finance has been an encouraged modus operandi for power producers.[99] Hainz and Kleimeier make an interesting observation in this regard. They argue that project finance is more commonly used where 'bank influence is stronger and political risk and the economic health and corporate governance systems are weaker'[100]. It would be appropriate to submit that project finance is a tool of financial engineering wherein finance is raised primarily on the project's construction, operating and revenue risk, and their allocation between investors, lenders and other parties through contractual and other arrangements.[101] As a consequence, project finance is a measure of ensuring an equitable distribution of risk. As outlined in the next section, each party within a project finance transaction bears a certain amount of risk proportionate to its contribution within the project in return for an agreed compensation.[102]

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financed with equity from one or more sponsoring firms, and which has non-or limited recourse debt for the purpose of investing in a capital asset'.

[98] See Emanuele Rossi and Rok Stepic, *Infrastructure Project Finance and Project Bonds in Europe* (Palgrave MacMillan, 2015). Rossi and Stepic argue that 'project finance as a method of raising of funds on a limited recourse basis, with a purpose of developing a capital intensive infrastructure project, where the sponsor is a special purpose vehicle (SPV) entity, and repayment by the borrower will be entirely dependable on internally generated cash flows produced by the project and not necessarily depending on the soundness and credit worthiness of the sponsors'.

[99] See Richard A Brealey, Ian A Cooper and Michel A Habib, 'Using project finance to fund infrastructure investments', (1996) Journal of Applied Corporate Finance 9, 25-38. Brealey, Cooper and Habib submit 'Project finance encouraged the formation of stand-alone power producers able to borrow large sums on the basis of the long-term power purchase agreements they had entered into with electric utilities'.

[100] See Christa Hainz and Stefanie Kleimeier, 'Project Finance as a Risk-Management Tool in International Syndicated Lending', (December 2006). Governance and the Efficacy of Economic Systems (GESY), SFB/TR 15, Discussion Paper No 183 <https://ssrn.com/abstract=567112> Accessed 21 April 2017.

[101] Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002).

[102] See Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002). It is interesting to note that 'the main security in a project finance transaction for lenders is the project company's contracts, licenses, or ownership of rights to natural resources; the project company's physical assets are likely to be worth much less than the debt if they are sold off after a default on their financing'.

In comparison, corporate finance structures are predicated entirely on the balance sheet strength of an existing corporation.[103] Corporate finance differs from the intricacies of project finance; the extent to which risk is hedged or mitigated in a project finance transaction insulates the final beneficiary from the project company.[104] A project company is more commonly known as the SPV.[105] Lenders have been wary of this within the current scenario for any project finance transaction amidst a seamless web[106] of various off-shore corporations in between the SPV and the main beneficiary of the project company.[107]

This complex web of contractual documentation also means that with the mitigation of risk, Estache and Strong argue that project finance is more expensive than a typical corporate finance transaction.[108] Within a typical project finance transaction there will be several companies behind the sponsors, in what can be termed 'a strategic outlay of companies', in order to isolate and insulate

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[103] See Emanuele Rossi and Rok Stepic, *Infrastructure Project Finance and Project Bonds in Europe* (Palgrave MacMillan, 2015). Rossi and Stepic argue that 'yields for debt infrastructure investments are much higher than those on governmental bonds and similarly rated corporate bonds under comparatively law default rates and high recovery rates.

[104] See Richard A Brealey, Ian A Cooper and Michel A Habib, 'Using project finance to fund infrastructure investments', (1996) Journal of Applied Corporate Finance 9, 25-38. Brealey, Cooper and Habib stress that one of the key comparative advantages of project finance is that it allows the allocation of specific project risks (ie completion and operating risks, revenue and price risk and the risk of political interference).

[105] See Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002). Yescombe argues that project companies or SPVs are often formed at a later stage of a project development process (unless project permits have to be issued earlier, or it has to sign project contracts), because it normally has no function to perform until the project finance is in place. From experience, it is submitted that sponsors tend to register the SPV/SPE/SPC beforehand, in order to secure finances, negotiate with the off-taker and various other contractors. However, this position varies on a case to case basis.

[106] See Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002). Yescombe argues that project finance, unlike other methods of finance, is a seamless web.

[107] See Stefanie Kleimeier and William L Megginson, 'An empirical analysis of limited recourse project finance', (July 2001). University of Oklahoma, Michel F Price College of Business Working Paper Series. <http://ssrn.com/abstract=283969> Accessed 22 May 2016. Kleimeier and Megginson argue that 'the observed level of loan fees and the number of participating bank do provide indirect evidence that project finance lending may well be considered relatively more risky than other types of lending'.

[108] Antonio Estache and John Strong, 'The Rise the Fall, and…the Emerging Recovery of Project Finance in Transport', (July 2000) World Bank Policy Research Working Paper No 2385 <https://ssrn.com/abstract=630757> Accessed 5 May 2016.

the final project company from the actual sponsors of the SPV.[109] Another interesting reason why sponsors may be discouraged from raising finance on-balance sheet is primarily because of costs associated with incorporating a new subsidiary. Certain jurisdictions have relaxed rules and regulations for a newly incorporated company, in comparison to the registration of a subsidiary.[110] As a result, companies are encouraged to register new corporations in order to facilitate investment. However, the mere registration of a new entity does not preclude the sponsors from lender scrutiny. It is argued that banks and other financiers would most certainly carry out extensive due diligence of the sponsors and the companies they own before lending money.

In view of the wider discussion undertaken throughout this thesis, this chapter reflects upon the differential nature of a project finance transaction in comparison to a corporate finance transaction. More importantly, it provides an outline of why lenders and sponsors seek risk mitigation in project finance transactions. In view of the discussion undertaken in this section, the next section elaborates on the 'strategic outlay' of parties within a project finance transaction.

2.2 Main Parties in a Project Finance Transaction

This section is an introduction to all the main parties involved within a project finance transaction. Whereas the concepts underlying this section are

[109] This insulation of project company from the main beneficiary sponsor is for two reasons: tax purposes and a friendly jurisdiction with a more stable legal regime.

[110] From Pakistan's standpoint, it is argued that a foreign company requires a permission letter under the Companies Ordinance 1984 from the Board of Investment. This permission letter stipulates a time period for its validity. After the time period has elapsed, the investors require further permission in order to continue. Moreover, some other countries require local members or partnerships in order to provide access to the local market and advantages of the legal regime. However, it is argued that 51% ownership in these cases can be cumbersome and risky.

rudimentary, they have been included to assist readers in understanding the nature of entities and their roles in the context of discussion undertaken in subsequent chapters. Figure 2.2 provides a structure used in project finance transactions.

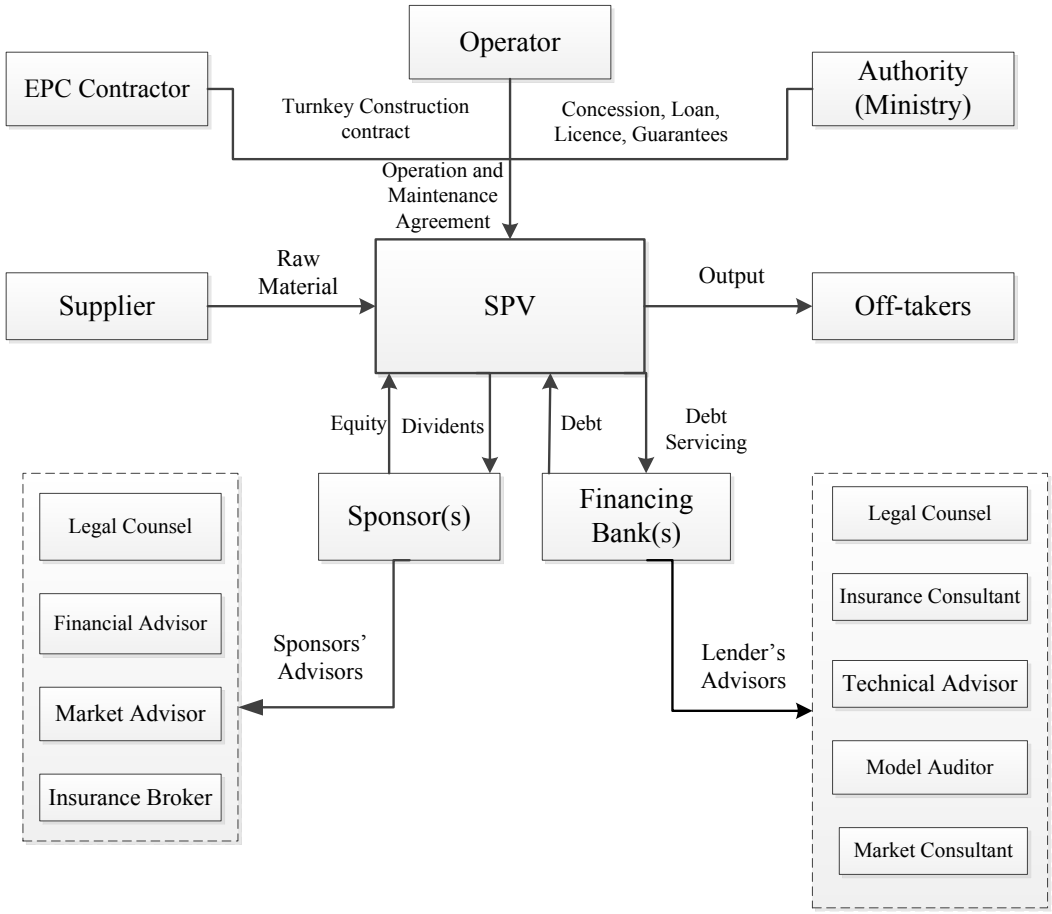

Figure 2.2: Typical Project Finance[111]

The main parties involved in a typical project finance transaction are the sponsors, EPC contractors, off-take agencies, and the government of the host state. Correlation between a government of the host state and the off-take agency

[111] See Emanuele Rossi and Rok Stepic, *Infrastructure Project Finance and Project Bonds in Europe* (Palgrave MacMillan, 2015); Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002).

has been discussed extensively in Chapter 4.[112] Involvement of various parties in a project finance transaction is prima facie geared towards combining and amalgamating various kinds of guarantees and undertakings from various interested parties, so that the financial burden and risk of any one party will not be onerous, but the combined guarantees and undertakings of all the parties will be bankable credit.[113]

2.2.1 Sponsors

Project finance transactions are highly leveraged, because this enables lower initial equity contribution, thereby making the project investment a less risky proposition for the shareholders.[114] Equity investment in a project finance transaction represents the risk capital.[115]

The sponsors, more commonly known as 'shareholders', are the 'active equity investors in a project', meaning 'their role is one of promotion, development and management of the project'.[116] Within the tranche of a sponsor there can be one or several sponsors contributing equity towards the project.[117] Yescombe notes

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[112] Chapter 4 has focused on Pakistan's off-take agency and the government institutions dealing with the transaction. However, research indicates that Kazakhstan faces a similar issue. See GRATA, 'Financing Renewable Energy Projects in Kazakhstan: Key Legal Challenges' *Gratanet* (March 2016) <www.gratanet.com> Accessed 03 May 2016. The report published by Grata argues that 'in practice, current mechanism of guaranteed off-take does not provide sufficient comfort for the lenders and investors, because the FSC is apparently, not credit worthy enough as a single off-taker to make the renewable energy projects bankable in Kazakhstan'.

[113] Peter K Nevitt and Frank J Fabozzi, *Project Financing* (7th Edition, Euromoney, 2004).

[114] See Emanuele Rossi and Rok Stepic, *Infrastructure Project Finance and Project Bonds in Europe* (Palgrave MacMillan, 2015).

[115] Peter K Nevitt and Frank J Fabozzi, *Project Financing* (7th Edition, Euromoney, 2004).

[116] Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002).

[117] It is interesting to note that a sponsor developing a project who brings in another sponsor to commit the required balance of the equity shortly before financial close has expectations to be compensated for undertaking the higher risk towards the earlier stages of the project. As a result, the new sponsor can be required to pay a premium for its shares, or credit the original sponsor with a notionally high rate of interest on cash already spent on the project, which is taken into account when calculating each sponsor's share of development costs, and allocating shares based

that project finance is often used where there are several sponsors.[118] Sponsor's equity contribution varies, and is structured according to the tax and accounting standards advisable by the sponsor's advisors. Ordinarily, it is thought that a sponsor's equity forms part of the project company through ordinary shares. Whereas this may be true for many corporate finance transactions, within the sphere of project finance, sponsors' advisors often recommend for the sponsors to provide part of this equity in the form of subordinated debt. The rationale surrounding this advice is predicated on the notion that interest on shareholder's subordinated debt may be tax-deductible, unlike dividends on ordinary shares.[119]

The SPV lies at the centre of all contractual and financial relationships in a project finance transaction; these relationships have been outlined in Figure 2.2, above.[120] The SPV is ordinarily incorporated only with one objective: to undertake and carry out the business of the project.[121] A typical project finance transaction will involve a 75:25 debt to equity ratio, respectively.

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on this. Moreover, in various projects, a sponsor joining the project at a later stage, after the development and construction stages, may be recipient of a lower Internal Rate of Return (IRR) due to the lower risk that they bear.

[118] Project finance is often used where the equity investment in the project company is split between several sponsors. The project company may not always be directly owned by sponsors; for tax reasons the sponsors often use an intermediary holding company in a favourable third-country tax jurisdiction. See Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002).

[119] See Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002), pp 262-263. Yescombe also argues that another reason for shareholder equity being provided as a combination of share capital and shareholder subordinated loans is that it leaves lenders in exactly the same risk position, provided the investors' rights are completely subordinated in payment and ability to accelerate, etc to those of the lenders.

[120] See Rajeev J Sawant, 'The economics of large-scale infrastructure FDI: The case of project finance', (August 2010), Journal of International Business Studies, Vol 41, No 6, pp 1036-1055. Sawant argues 'separate incorporation is therefore necessary and important to allow the sponsors to set up a capital structure of high-debt, syndicated lending that is rigid and tied to a single-purpose capital asset'.

[121] See Stefanie Kleimeier and William L Megginson, 'An empirical analysis of limited recourse finance', (July 2001). University of Oklahoma, Michel F Price College of Business Working Paper Series. <http://ssrn.com/abstract=283969> Accessed 03 May 2016. Kleimeier and

There is no hard and fast rule concerning the debt to equity ratios within a project finance transaction. These figures vary according to the by-product or the agreed output of the project company. Yescombe has discussed this notion extensively, arguing that from a lender's perspective leverage (equity: debt) should be[122]:

1. 10:90 for an infrastructure project with a project agreement with no usage risk (public hospital, prison).
2. 15:85 for a power or process plant project with an off-take contract.
3. 20:80 for an infrastructure project with usage risk (toll road or mass transit project).
4. 30:70 for a natural resources project.
5. 50:50 for a merchant power plant project with no off-take contract or price hedging.

In view of the highly-leveraged nature of a project finance transaction, sponsors are driven towards mitigation of risk. Moreover, due to the high debt nature of these transactions, lenders are motivated to provide better interest rates or credit facilities to projects that are in a good position to mitigate their risks. As a result, sponsors seek various legal and non-legal measures as a means to mitigate or diminish risk altogether.[123] Sponsors are a central part of the SPV. Since the entire premise within a project finance transaction is structured on the future

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Megginson argue that 'In project finance the general understanding is first, that creditors share much of the venture's business risk and, second, that funding is obtained strictly for the project itself without an expectation that the corporate or government sponsor will co-insure the project's debt at least not fully'.

[122] See Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002).

[123] See Emanuele Rossi and Rok Stepic, *Infrastructure Project Finance and Project Bonds in Europe* (Palgrave MacMillan, 2015). Rossi and Stepic argue that a high leverage enables lower initial equity contribution, thereby making the project investment a less risky proposition for the shareholders. An interesting misconception that exists amongst some prospective project financiers is that there is no or little requirement for equity investment by the owners or sponsors of the project. See Peter K Nevitt and Frank J Fabozzi, *Project Financing* (7th Edition, Euromoney, 2004).

revenue generation of a project, sponsors are likelier to seek sovereign guarantee measures from the host state.

2.2.2 Project's Sub-Contractors

In many ways, project finance is the process of cascading risk of one party to another, in return for an agreed consideration. Project construction / output risks are one of the major risks faced by a project company. For example, project construction risk involves the commencement of project works according to an agreed timeline, in addition to a specific use of technology to ensure maximum output. It also involves the technology that is being used in order to ensure maximum project output.[124] As a result, project companies are increasingly sub-contracting the project construction (and even operations) to other contractors as a method of mitigating their own risk and liability.

Amongst this seamless web of contractual documentation involved within a typical project finance transaction, EPC and operation and maintenance (hereinafter referred to as "O&M") contracts are fundamental for the smooth operation of a project finance transaction, especially within the energy sector.

The trickledown effect of risk is passed on from sponsors through the EPC contracts to the EPC contractor. This category of contractors, or in many cases, sub-contractors is primarily in place in order to shift liability of non-completion

[124] Contemporary literature on project finance refers to technology as a separate facet. In light of the increasing use of take-or-pay contracts, especially in the energy sector, it is argued that technology is very important. IPPs, especially in developing countries, tend to focus on generation capacity at 30-40% capacity. This can be improved by using better technology methods. However, with the provision of take-or-pay agreements, and absence of equipment warranty clauses, the likelihood of default increases. As a result, project companies tend to sub-contract construction to other contractors, for example, EPC contractors.

of project risk from the sponsor to the EPC contractor. It is also a mechanism used by sponsors to promote their project, convincing lenders by highlighting key strengths and previous successful projects undertaken by the contractors. As a result, any risk of non-completion of project is shifted to the contractor.[125] As discussed in the earlier section, sponsors arrange for the financial closing with the lenders and as a result, after the financial close (hereinafter referred to as "FC") is achieved, construction works are commenced. In the absence of an EPC contract or an EPC contractor, the sponsors will be directly liable for debt service and the non-completion of a project. Please refer to Figure 2.3. Thus, the additional financial liability that sponsor(s) incur may become very significant in the absence of an EPC contract.[126]

Whereas the financial viability of the EPC contractors is of prime importance to the sponsors and resultantly, to the lenders, it is submitted that O&M contractors have a vital role to play too. The entire future-earning portfolio of the SPV is predicated upon the capacity at which the project company operates. In an energy sector SPV, the required tariff per Kwh will have to be satisfied in order to generate enough cash flow to service its debt. In the event that the SPV is unable to service its debt or meet the required threshold of electricity as agreed under the PPA, the lenders can invoke a Material Adverse Change or more commonly known as the 'MAC' clause in the loan agreements.[127] In the event that a MAC

[125] See Francesco Corielli, Stefano Gatti, Alessandro Steffanoni, 'Risk shifting through non-financial contracts: effects on loan spreads and capital structure of project finance deals', (October 2010) Journal of Money, Credit and Banking, Vol 42, No 7, pp 1295-1320.
[126] See Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002), pp 155.
[127] Please see the following academic literature for a detailed discussion on MAC clauses: Frank Julien and Jean-Marc Lamontagne-Defriez, 'Material Adverse Change and Syndicated Bank Financing: Part 1' (2004) Journal of International Banking Law and Regulation 172; Frank Julien and Jean-Marc Lamontagne-Defriez, 'Material Adverse Change and Syndicated Bank Financing: Part 2' (2004) Journal of International Banking Law and Regulation 193; Rian Matthews, 'Are

clause is invoked, all funding facilities are suspended or permanently revoked. As a result, an O&M contract with an experienced operator provides the greatest comfort to lenders (and to the sponsors), ensuring there is an experienced operator for the project, and another entity to whom the risk of operation can be shifted.[128]

2.2.3 Off-Taking Body and Government of Host State

The host state government and off-takers have been intentionally included under one section. Whereas the two prongs originate from the same pivot, it is argued that the dual role played consequently has a direct correlation to the outcome of the success of a project. In recent years, due to the restructuring of public owned entities—and their subsequent privatisation in a bid to improve performance and promote free market economy—there has been an increase in quasi-government, parastatal, state-owned companies.[129] The widespread view within the industry outlines that a private party is in a far superior position to perform better, financially and economically, than the affairs of any such institution left at the behest of a public entity.[130]

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courts undermining the flexibility of MAC clauses in finance documents?' (2015) JIBFL 485; Also see *Pan Am Corp v Delta Air Lines Inc*, 175 B R 438, 514 (S D N Y 1994); *BNP Paribas SA and others v Yukos Oil Co* [2005] EWHC 1321 (Ch).

[128] See Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002). Yescombe argues that lenders have a strong preference for O&M contractors to be investors in the project, because an O&M contractor who has an equity investment stands to lose more than just the penalties for poor performance. There has also been a precedent in the past where one or more sponsors operate to provide the services under an O&M contract.

[129] See Cally Jordan, 'How international finance really works', (2013) 7(5) LFMR, 256-264. An interesting read on the global financial crisis because of the failure of formal, state-led regulation, and also a breakdown of lex mercatoria of finance.

[130] This argument is predicated on several factors. However, there is increasing academic literature that provides criticism for this contention. The conflicting roles of government as owner, provider and rule maker in the affairs of the SOEs have led to corruption and poor performance. Public bodies, due to lack of transparency and independence, are prone to

The off-taker or off-taking bodies play a pivotal role within the project finance framework. Moreover, in view of the assumption that the host state is in a better position to mitigate and manage risk, the SOEs play a pivotal role in assisting the host state to ensure timely payments. As outlined earlier, the entire project finance structure is predicated on future payments. The incorporation of the SPV is predicated upon the off-taker agreeing to off-take project's produced output. In addition to signing a commitment letter, the off-taker contractually provides a number of undertakings to the project company and the lenders, which may include credit support agreements[131] in respect of the procurer's payment obligations.[132]

Through various interviews and engagement with audience at a workshop organised in London, it has become apparent that there are common misconceptions surrounding off-taking bodies and role of the host state.[133] Some believe that the state's role is limited until the project commences its operation. However, 'comfort letters', letters of support—more commonly known as

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corruption and therefore ought to be privatised. A contrasting argument relates to the fact that changes in such circumstances are driven by vested interests to allow powerful multinational corporations to buy off the state's resources at bargain prices, and that they would ultimately pave the way for them to gain control over public programs and policies. See Navroz K Dubash and Sudhir Chella Rajan, *The Politics of the Power Sector in India* (The World Resources Institute, 2 April 2001) <http://www.wri.org/sites/default/files/powerpolitics_india.pdf> Accessed 17 April 2017.

[131] A credit support agreement should not be confused with a Government Support Agreement (GSA). GSA, like a sovereign guarantee, is a comfort letter from the government outlining their responsibilities in any event that the state owned entity defaults; also see Francesco Corielli, Stefano Gatti, Alessandro Steffanoni, 'Risk shifting through non-financial contracts: effects on loan spreads and capital structure of project finance deals', (October 2010) Journal of Money, Credit and Banking, Vol 42, No 7, pp 1295-1320 Corielli, Gatti and Steffanoni studied capital structure negotiation and cost of debt financing between sponsors and lenders using a sample of more than 1000 project finance loans worth around US$195 billion closed between 1998 and 2003. They concluded that lenders rely on a network of non-financial contracts as a mechanism to control agency cost and project risk.

[132] Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002).

[133] Information was gathered as part of the workshop agenda from speaker's presentations and by later interviewing some of the speakers, most notably Mr Rafael Molina and Ms Shamali De Silva.

sovereign guarantees—along with other contractual bundles, for example EPC and O&M contracts, are provided to the lenders in order to seek and confirm debt financing on the syndicated loan or the bond market.[134] This aspect has been highlighted in Chapter 4 wherein it is argued that sovereign guarantees are a mere 'comfort tool'[135] in order for lenders to feel secure whilst lending to risky jurisdictions, and having recourse to the state in case there is a breach on repayments.[136] These contractual bundles, especially the PPA, are an indication to the lender of a project's future cost and more importantly, revenues.[137]

2.3 Project Finance and Application: Gulpur Power Project

This section is an illustration of how all the parties discussed in the previous section are structured within a project finance transaction. In view of this chapter's focus on project finance, this section will aid in understanding the relationship that exists between the parties in conjunction with the discussion on sovereign guarantees in the following chapters. One of the key strengths of a

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[134] Also see Hugh G McCrory, Jr, 'Infrastructure Projects in Developing Countries', (April 1995) American Society of International Law, Vol 89, pp 19-36. McCrory argues that the extent of host country government support for infrastructure project continues to be a difficult issue. Governments would like the power sector to take more of the risk. As reforms in the pricing of electricity take effect in the coming years, the need for government guarantees regarding power purchaser obligations are likely to be re-examined.

[135] There have been reported instances where a sponsor has to issue comfort letters to the lender(s). See Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002). Yescombe submits that 'if a commercial risk involved in the project is not adequately mitigated by other means, the sponsors may have to step in to fill this gap. "Comfort letters" are sometimes offered to lenders as a risk mitigation in place of formal guarantees; for example, a sponsor may state that it owns the shares in the Project Company, that it presently intends to maintain this ownership and keep the Project Company in a sound financial condition, and that it provides management support'. Moreover, there have also been instances wherein the sponsors have had to issue comfort letters to lenders in order to confirm that there will be no change in management (ie sponsors), or a certain EPC or O&M contractor will be engaged with the SPV for a certain length of time.

[136] See Peter K Nevitt and Frank J Fabozzi, *Project Financing* (7th Edition, Euromoney 2004). Nevitt and Fabozzi argue that guarantees enable promoters to shift the financial risk of a project to one or more third parties. While guarantees are essential to project financing, guarantees can give lenders a false sense of security.

[137] See Francesco Corielli, Stefano Gatti, Alessandro Steffanoni, 'Risk shifting through non-financial contracts: effects on loan spreads and capital structure of project finance deals', (October 2010) Journal of Money, Credit and Banking, Vol 42, No 7, pp 1295-1320.

project finance transaction is the lender's focus on future revenue generated by the project company. However, lenders' consideration does not disregard the existing entities of the sponsors. It is quite the contrary; lenders are inclined to subdue their risk by reviewing a sponsor's existing business or businesses. Primarily, it is for this reason that some sponsors seek professional O&M or even EPC contractors in order to facilitate their application for financing from the lenders, as discussed in the earlier section. There is also an indication from some case study examples wherein the sponsor's use their existing companies as O&M and EPC contractors. Nevitt and Fabozzi have also addressed this misconception. They highlight that certain borrowers misinterpret the conception of 'self supporting' project. They understand that their borrowing is a completely self-supporting project without guarantees or undertakings from financially responsible parties.[138] Typically, it is argued that a lender would not be promiscuous when lending within a project finance transaction, knowing that there are higher returns with a higher risk involved.[139]

In order to better understand the parties involved, this section illuminates the role of various parties by applying these to a recent power project undertaken in Pakistan. Gulpur Hydro Power Project (hereinafter referred to as "Gulpur Hydro") is situated in the Kotli district of Azad Kashmir, Pakistan. Gulpur Hydro is a 102MW power project registered under the name Mira Power Limited. Mira

[138] See Peter K Nevitt and Frank J Fabozzi, *Project Financing* (7th Edition Euromoney Book, 2004). They argue 'there is a popular misconception that project financing means off-balance sheet financing to the point that the project is completely-self-supporting without guarantees or undertakings by financially responsible parties. This leads to misunderstandings by prospective borrowers who are under the impression that certain kinds of projects may be financed as stand-alone self-supporting project financings and, therefore, proceed on the assumption that similar projects in which they are interested can be financed without recourse to the sponsor'.

[139] Interesting observation made by Nevitt and Fabozzi: they submit that 'lenders, on the other hand, are not in the venture capital business. They are not equity risk takers'. See Peter K Nevitt and Frank J Fabozzi, *Project Financing* (7th Edition, Euromoney Book, 2004).

Power is a newly incorporated SPV. The figure below illustrates the involvement of various parties to this transaction. Primarily, MIRA's sponsors include Korea South-East Power Co. (KOSEP), Daelim, and a minority stake of Lotte. The project has several lenders, including the International Finance Corporation (IFC), Asian Development Bank (ADB), the Export-Import Bank of Korea (Korea Exim Bank) and FMO Entrepreneurial Development Bank. Figure 2.3 provides a detailed illustration of Gulpur Hydro project.[140]

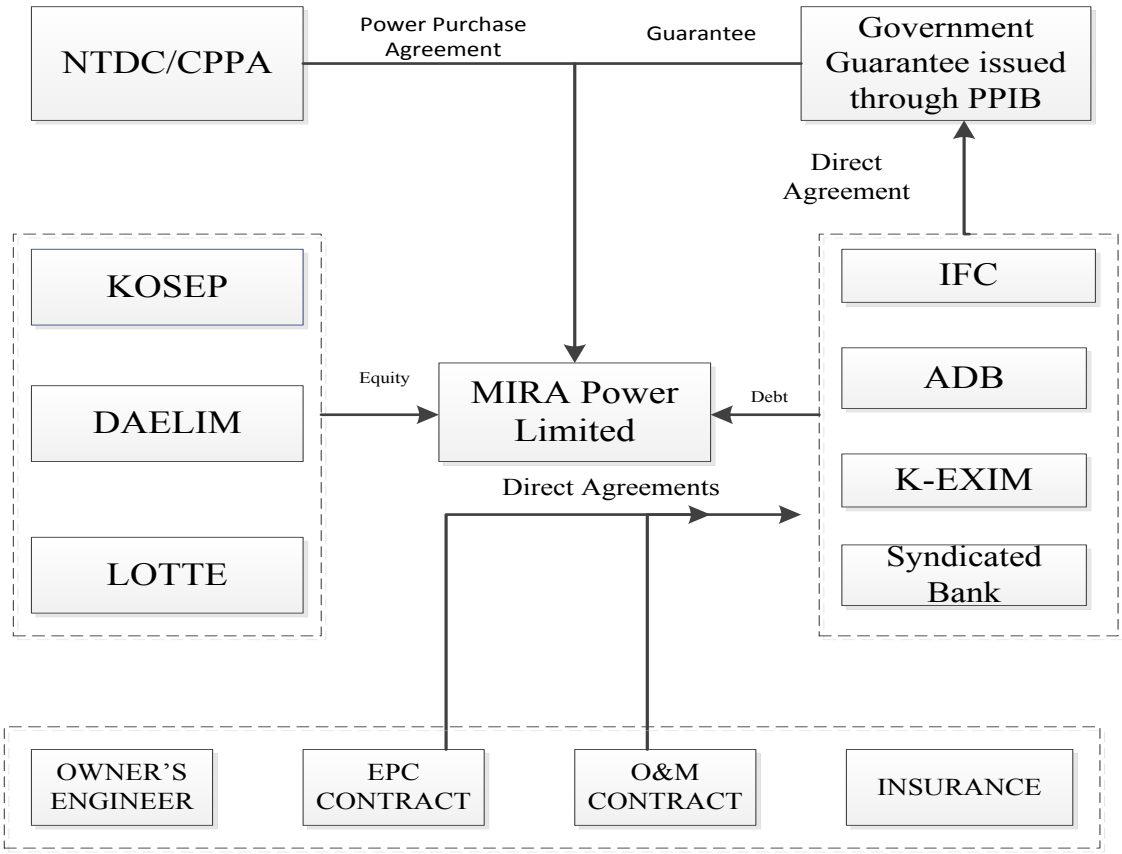

Figure 2.3: MIRA Power Project Finance Structure

[140] Work on this project has commenced recently. There is no literature available on the project, however for brief details please see: Asian Development Bank, 'Pakistan: Gulpur Hydropower Project. Non sovereign project, 47929-001' <https://www.adb.org/projects/47929-001/main#project-overview> Accessed 23 March 2017; also see Dawn, 'PM Nawaz inaugurates 102MW Gulpur hydropower project in AJK' *The Dawn* (Islamabad, 15 October 2015) <https://www.dawn.com/news/1213248> Accessed 15 March 2017.

There are two elements of this illustration that need to be highlighted. First, EPC and O&M contractors have direct contracts with the lenders, and second, the lenders have direct agreements with the Government of Pakistan. As discussed in section 2.2.2, Project's Sub-Contractors, it is argued that EPC and O&M contractors play a vital role within the administration and construction of the project. In order to mitigate their risk further, lenders have contracted directly with the contractors, in a bid to monitor their performance and as a result, the performance of the project.[141] The second prong to this figure is the lender contracting with the government of the host state. This can be sub-divided into two factions. One corresponds to the general assurance that the host state is deemed to provide to the lender(s). These can be comfort letters or other assurance letters concerning the smooth sailing of the project. The second faction relates to more onerous legal obligations. These relate to the indemnity and guarantee factions that we have extensively discussed in the Chapter 3.

2.4 Conclusion

This chapter provides an introduction to the underlying features of a highly-leveraged transaction. The entire premise of this study is predicated on the understanding that project finance transactions are highly leveraged. As a result of their highly-leveraged nature, they warrant increased or improved forms of risk mitigation measures in order to protect investment. In view of increasing

[141] This submission also relates to the argument forwarded by Corielli, Gatti and Steffanoni concerning risk. They have submitted that 'lenders rely on the network of non-financial contracts as a mechanism to control agency cost and project risk'. See Francesco Corielli, Stefano Gatti, Alessandro Steffanoni, 'Risk shifting through non-financial contracts: effects on loan spreads and capital structure of project finance deals', (October 2010) Journal of Money, Credit and Banking, Vol 42, No 7, pp 1295-1320. Essentially, a whole gamut of non-financial contracts is entered into with various sub-contractors directly by the sponsors and the lenders, in order to shift liability and to mitigate risk.

challenges and threats to projects, especially as a consequence of liquidity crises in developing country investment regimes, parties require more robust measures of security in order to mitigate risk. This chapter introduces project finance as a measure of securing finance through a limited recourse provision, with an intention to facilitate a newly incorporated project company to exclusively produce a product. Consequently, this chapter emphasises that the risk borne by the lenders and the sponsors is imminently higher in comparison to a typical corporate finance transaction.

In order to understand the nature of risk, this chapter outlines all the main parties involved within a project finance transaction. With a view to understanding the complex nature of sovereign guarantees, all the relevant parties and their roles are discussed, in a bid to explain the relationship that exists between these parties in the larger context of sovereign guarantees. The provision of a guarantee from a financial perspective cannot be explained without outlining the role of all the parties involved. This chapter accomplishes this task.

One of the contentions forwarded within this chapter is a discussion on the limited recourse nature of project finance transactions. Through a strategic outlay and structuring, the final beneficiary is isolated from the project company. Moreover, this chapter also highlights the use of other sub-contractors in a bid to mitigate the risk and exposure of the project sponsors. This chapter introduces project finance as a method of risk mitigation. However, the presence of all these parties within a project finance transaction caters for commercial risk, but not political risk. In view of the liquidity issues prevalent within Pakistan's

investment regime, it is submitted that project finance structures can be used to better understand risk—however they cannot mitigate them completely.

Project finance is an extensive study; a vast field that requires a more serious, independent undertaking of its own. In view of the complex nature of these project finance transactions, this chapter is an illustration of the parties that formulate a typical project finance transaction, and provides a canvas illustration to understand why sovereign guarantees are issued, especially in a project finance framework.

Chapter 3

Guarantee or Indemnity—An Old Chestnut Revisited

3.1 Introduction

It is understood that all complex financial arrangements require some form of security. These security measures can take the form of collateral, creation of a security interest or generally, structuring the transaction in a manner wherein the parties are cascading their risk from one party to another through contractual measures. However, in view of a project's heavy reliance on future cash flows and its highly-leveraged financial nature, such measures of risk mitigation may prove to be inadequate. Consequently, investors seek more reassuring measures to secure their investment, especially in a project finance context.

As a result, this chapter plays a central role in the prognosis of this entire thesis, in relation to the notion of security and its adequacy. It attempts to review a more robust measure of security: one involving a third-party guaranteeing the performance of another party. In a bid to explain the adequacy of a sovereign guarantee instrument, it is important to undertake a discourse, and explain the rationale of sovereign guarantee instruments by highlighting the underlying features of suretyship.

There are three primary contentions addressed in this chapter. First, in order to align the purpose of this study and create a background, a historical context for the use of suretyship instruments has been provided before dwelling further into the intricate nature of various forms of suretyship. Despite being an abstraction,

this section will provide an outline of how suretyship instruments play an eminent role in promoting free flow of capital in a private and a public sphere.

Second, reference is made to cases from common law jurisdictions, in an attempt to explain the two sub-categories of suretyship. The two main features of suretyship instruments, guarantee and indemnity, have been extensively discussed in this section in a bid to outline their general definitions. Whilst this section may seem abstract, it strongly rebuts the presumption that sovereign guarantee instruments are no longer pivotal planks within an investment regime. Moreover, in view of the discussion to be undertaken in Chapter 4, this section provides a background to the law surrounding the concept of suretyship. As a general overview, this section attempts to discuss how the courts interpret guarantees and indemnities. Academic text and case law surrounding the area of suretyship meticulously differentiates between an indemnity and a guarantee by employing primary and secondary notions of obligation. In order to understand these features, this section adopts a pendulum model to explain the shift in the nature of liability from the principal debtor to the surety provider. In an interesting twist, this section attempts to replace the usual method of explaining liability and discharge of responsibility by focusing on the pendulum's central pivot, hypothetically, as an agreement. In view of the host state courts declaring off-take agreements null and void, or in the event of the state's breach of such agreements, a contention emerges suggesting that it is unlikely that the state will honour sovereign guarantee provisions. Consequently, a structural change is proposed in the investment regime, wherein a sovereign guarantee instrument is re-named.

The third contention relates to the discussion surrounding the presence of both an indemnity and a guarantee instrument in one agreement. Despite a general belief that the two instruments cannot operate under one contractual document, this section refers to cases from private law wherein the two terms were indeed used under one contractual arrangement. Indemnity and guarantee agreements (or, as referred to in this chapter "InG" agreements) are a common measure of security, especially in a project finance context. Their immediate presence within a contractual framework may be ignored—primarily because a guarantee may exist in a 'vacuum', because the parties' real intention is to agree to indemnification. However, the inclusion of political risk insurers in a project finance context provides a reassuring account of the role of InG agreements under the framework discussed in Chapter 5.

3.1.1 Historical Significance

Guarantees, unlike many recent tools of financial engineering, are not a new concept.[142] Under the umbrella of suretyship, guarantee agreements are said to have come into existence as early as 4700 years ago.[143] Early traces of suretyship resemble those of the modern concepts of a guarantee and an indemnity. Morgan refers to a tablet found in the Library of Sargon I, King of Accad and Sumer. The tablet provides a stark reflection of the principles underlying modern concepts of guarantee. The tablet outlined the terms of a contract between two farmers: a

[142] See *Rederiaktiebolaget Amphitrite v The King* [1921] 3 K B 500. The facts of the case are as follows: the claimant steamship company had sent its vessel during the First World War to a British port. The claimants sought a guarantee from the British Legation in Stockholm that the boat should be allowed free passage without being detained in Great Britain. The vessel was detained by the Crown on its second journey, and the claimants sought damages for breach of contract.

[143] James O'Donovan and John Phillips, *The Modern Contract of Guarantee* (2nd Edition, Sweet & Maxwell, 2010) 4-8.

merchant from the City of Accad was appointed to act as a guarantor for the farmer's performance to cultivate and produce crops on the other farmer's land while he carried out military service.[144] Similarly, the Code of Hammurabi, enacted in 2250 BC, almost 500 years after the Sargon I regime, illustrates how the contemporary concept of guarantee has been derived from ancient times.[145] Under the Code, the governor insured the fidelity of any person who came within the jurisdiction of the city. As a result, any person who entered the city was insured against the dishonesty of others.[146]

Sargon's tablet is a reflection of the modern law on guarantees: in order to secure performance of a given transaction in a prescribed manner under the terms of the agreement, a third party guarantees or agrees to answer for the debt of the party whose performance is rendered. Therefore, a guarantee is to act as a collateral in case a party does not perform as promised under the terms of the contract.[147]

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[144] Willis D Morgan, 'The History and Economics of Suretyship' (1926-1927) 12 Cornell L. Q. 153; also see Philip K Jones, 'Roman Law Basis of Suretyship in some Modern Civil Codes' (1977-1978) 52 Tul L Rev 129; William H Loyd, 'The Surety' (1917) 66 Uni of Penn L Rev 40, 42; Thomas Hewitson, *Suretyship: Its Origin and History in Outline* (1st Edition, Sweet & Maxwell, 1927) 70.

[145] Willis D Morgan, 'The History and Economics of Suretyship' (1926-1927) 12 Cornell L Q 153.

[146] James O'Donovan and John Phillips, *The Modern Contract of Guarantee* (2nd Edition, Sweet & Maxwell, 2010); also see Claude Hermann W Johns, 'Babylonian and Assyrian Laws, Contracts and Letters (Library of Ancient Inscriptions) as quoted by Willis D Morgan, 'The History and Economics of Suretyship'(1926-1927) 12 Cornell L Q 153.

[147] A good illustration of this notion is illustrated in the case of *Spar Shipping AS v Grand China Logistics Holding (Group) Co Ltd* [2015] EWHC 718 wherein the following clause was used in all the three guarantee documents issued (save for the names of each vessel): "we hereby unconditionally and irrevocably guarantee as primary obligor the full and timely performance by the Charters of each and every obligation of the Charter Party, and in the event of any one or more defaults in performance by the Charters, we undertake on your first written demand to promptly rectify each and every default and hereby accept the responsibilities of any liability, losses or damages that you suffer as a result or arising out of any such default". The facts of the case are as follows: the respondents, GCS were in arrears. Spar recouped some losses by exercising lien over sub-freight, however these were still not adequate. Spar called GCL for payment guarantees, withdrew the vessels and terminated charters. Spar commenced arbitration proceedings against GCS. GCS went into liquidation in Hong Kong. Arbitration proceedings were stayed. Spar claimed against GCL under the guarantee for balance of hire under the

Modern facets of suretyship are not a conjured product of recent globalisation, which has led to the inception of many commercial instruments. Recent innovations within financial markets have only further distressed and damaged the harmony of the financial services industry.[148] Unlike an ordinary financial instrument, the underlying rationale of a guarantee instrument features execution of an agreed performance under a contract in the event there is a failure to perform. Moreover, it provides an ancillary form of security for lenders and creditors to seek recourse from principal debtor in an event there is a breach.[149] This ancillary framework of security under a guarantee or an indemnity has since been used in both national and international contexts to uplift the confidence of the parties within a financial transaction.

3.2 Definition of Suretyship

The underlying features of a surety are predicated upon the principles of obligation. Obligation, like many words ending in 'ation' in the English

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charters, damages for loss of bargain in respect of the unexpired term of the charters, and the cost of the arbitration proceedings against GCS. Spar were successful in their claim.

[148] The Economist, 'The Origins of the Financial Crisis: Crash Course' *The Economist* (London, 07 September 2013) <http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article> Accessed 14 January 2015; RPC, 'Sub-prime and related Northern Rock credit crisis force tighter lending criteria but put mortgage lenders and brokers at greater risk of mis-selling claims by existing customers' Lexology (Dec 13, 2007) <www.lexology.com/library> Accessed 22 March 2015; also see Barry Ritholtz, 'Lehman didn't cause the financial crisis, no matter what the partisans say' *The Washington Post* (21 September 2013).

[149] It can be derived from the academic literature that the modern facts of suretyship have been originally derived from Roman law. With the Romans, suretyship was the most important means of securing debts, a means that—especially because of the stringency and effectiveness of personal execution—surpassed even real security in practical importance and juristic-technical refinement. See Max Kaser, *Roman Private Law* (2nd Edition, Rolf Dannenbring Trans, 1968) 233; Gaius is quoted by James O'Donovan and John Philips, *The Modern Contract of Guarantee* (2nd Edition, Sweet & Maxwell, 2010). They explain how suretyship was incorporated by the Romans. The *adpromissor*, or surety, was of three varieties; the *sponsio*, the *fidepromissio,* and the *fideiussio*. Sponsors and *fidepromissors* could act as such only on verbal contract, where *jidejussor* could be a surety on any undertaking "whether re verbis, litteris, or consensus". The other two forms of securing obligation of another were *mandatum credendae precuniae* and the *constitutum debiti*; also see Philip K Jones, 'Roman Law Basis of Suretyship in Some Modern Civil Codes' (1977) 52 Tul L Rev 129.

language, can be used in both an abstract and concrete sense.[150] While the term in its abstract capacity highlights the need to do something, or have the sense to do something, the term under a suretyship framework refers to the financial protection offered by a surety in respect of payment obligations. In private law, matters involving breach of contract of suretyship involve repercussions oriented towards individuals who are party to these transactions. However, from a state's standpoint, breach of suretyship or guarantee obligation can have long lasting financial and economic repercussions.

Suretyship contracts can be defined as one where a party contracts with an actual or possible creditor of another to be responsible to him by way of security for the whole or part of the debt.[151] Seminal cases such as *Harburg India Rubber Comb Company*[152], *Yeoman Credit Ltd*[153] and *Thomas Lakeman*[154] point to the possibility of an obligation of a surety as a collateral postulating the liability of another, the principal debtor. In *Yeoman Credit Ltd*, a finance company entered into a lease agreement with the first defendant. The first defendant was an infant at the time of the signing of the agreement. In order to provide recourse for the finance company in case there is a default on payment(s), the finance company sought a 'hire-purchase indemnity and undertaking' from Defendant 2.

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[150] Inspiration derived from J Roland Pennock and John W Chapman, *Political and Legal Obligation* (Nomos XII, Yearbook of the American Society for Political and Legal Philosophy, 1970).

[151] David Marks and Gabriel Moss, *Rowlatt on Principal and Surety* (6th Edition, Sweet & Maxwell, 2011).

[152] *Harburg India Rubber Comb Company v Martin* [1902] 1 K B 778. Brief facts of the case are as follows: the plaintiffs a foreign company carrying on business in Germany were judgment creditors of an English company called the Crowdus Accumulator Syndicate Limited, of which the defendant was a director and held large number of shares. The defendant, in a bid to resolve the issue, met with the plaintiff's agent in England, Mr Winter. The defendant promised Mr Winter that he would endorse two bills of exchange, each for half the amount of the debt. The defendant failed, and the plaintiffs brought a claim against the defendant for breach of promise.

[153] *Yeoman Credit Ltd v Latter* [1961] 1 W L R 828.

[154] *Thomas Lakeman v J P Mountstephen* (1874-75) L R 7 H L 17.

Defendant 1 defaulted on his payments to the finance company. The finance company repossessed the car and sold it. The sums generated as a result of the sale of the car were inadequate, therefore the finance company sought indemnity against the loss suffered from Defendant 2. Holroyd Pearce LJ found that the agreement was one of indemnity and not a guarantee as held by the court of first instance. Holroyd Pearce LJ made an interesting observation, arguing that 'in its widest sense a contract of indemnity includes a contract of guarantee'. Broadly then, suretyship is an umbrella that encompasses both guarantees and indemnities. Despite various disputes before the courts, both terms have been used interchangeably. However, their differential characteristics set them apart. This chapter provides a discursive analysis of both terms, in a bid to explain the security arrangement involved in each legal concept.

Through research undertaken for the purposes of this study, it is argued that the term 'guarantee' is more commonly used in security arrangements than 'indemnity', in an international project finance transaction. However, as discussed in the following section and a theme recurrent throughout this thesis, it is argued that the wording and structural framework used in issuing guarantees in general, and sovereign guarantee in particular, resonate an indemnity. This legal conundrum is an exercise widely practised as outlined in *Vossloh*, wherein the court observed that 'due to the nature of the wording, similar characteristics, and similar rights and duties arising between the parties, it is not unusual to find the term guarantee used loosely to describe what is in reality an indemnity'.[155] In *Vossloh*, the Vossloh Group was a subsidiary of VAG, and entered into several

[155] [2010] EWHC 2443 (Ch), (2011) 2 All E R (Comm) 307. Also see Geraldine Andrews and Richard Millet, *The Law of Guarantees* (6th Edition, Sweet & Maxwell, 2012) 4.

agreements with Angel Trains (which was later renamed Alpha Trains) for the sale of locomotives. The Royal Bank of Scotland, former owner of Angel Trains, sought several guarantees in this regard from the VAG Group. Alpha Trains brought an action against VAG Group for sixty-three G1206 cargo locomotives, which suffered from engine and gearbox defect. An action was brought against VAG group under the 2009 guarantee. Whereas the primary issue underlying this was predicated on the construction of the words in an instrument, Sir William Blackburne noted that 'in the current context…a contract of indemnity denotes a contract where the person who gives the indemnity, guarantees to undertake his obligation…'[156]

Two conclusions can be drawn from the interchangeable use of 'guarantee' and 'indemnity' provisions. First, it highlights the lack of understanding by the parties as to what each term entails. Second, parties consider a 'guarantee' provision to be more reassuring than an 'indemnity' under similar circumstances. As Lord Diplock observed in *Moschi v Lep Air Services Ltd and others* '…even the use of the word guarantee is not in itself conclusive. It is often used loosely in commercial dealings to mean an ordinary warranty. It is sometimes used to mis-describe what is in law a contract of indemnity and not a guarantee'.[157] Case law

[156] *Vossloh AG v Alpha Trains (UK) Limited* [2010] EWHC 2443 (Ch).
[157] [1972] 2 W L R 1175. Brief facts of the case are as follows: creditors were forwarding agents for the Company (the principal debtor). The company's managing director held all but one share of the company. He was also the guarantor of the company to the creditors. By a written contract, the creditors agree to relinquish their lien over the debtor's goods in return for the debtor agreeing to pay £40,000 over a course of six weekly payments. The debtor defaulted and the creditors treated this as wrongful repudiation of the agreement. The appellant (previously the defendant) was held liable for the damages that ensued as a result of the breach.

indicates that without prejudice to whichever term incorporated in an agreement, both terms bear serious financial burden and risk.[158]

In an attempt to introduce the umbrella term, this section provided an introduction to the overarching concept of suretyship. Suretyship in this study has been used interchangeably with guarantee and indemnity provisions. This is primarily because the available text on this subject refers to indemnity providers and guarantors as surety. Moreover, in light of the submissions forwarded in *Vossloh* and *Moschi*, it seems that in a wider context, parties in a bid to secure a robust security framework often confuse the two main notions of suretyship, guarantee and indemnity. In order to understand the main features of an indemnity and a guarantee, the next section aims to provide a discursive analysis of both terms by reviewing case law available on the subject.

3.2.1 Principles underlying a guarantee

A contract of guarantee comprises binary responsibilities subject to the provisions of the contractual arrangement between the parties. The creditor can seek a guarantor's contractual assurance by which the surety agrees to answer for some existing or future liability of another party (the principal), to a third party (the creditor). Second, the creditor can seek a guarantor's assurance to 'see to

[158] James O'Donovan and John Philips, *The Modern Contract of Guarantee* (2nd Edition, Sweet & Maxwell, 2010) 11. The author also submits that 'indeed it is hard to imagine a more versatile arrangement than a contract of guarantee; Also see Lord Reid's explanation in *Hyundai Heavy Industries Co Ltd v Papadopoulos* [1980] 2 All ER 29 wherein it is expressed that a (Guarantee) is an 'accessory' obligation which is valid only if the borrower's obligations under the loan agreement are valid. If the borrower's obligations are or later become void or unenforceable, a conditional payment obligation has no advantage over a pure guarantee. Neither can be enforced; also see *General Produce Co v United Bank Ltd* [1979] 2 Lloyd's Rep 255, 258; also see Alan Berg, 'Rethinking Indemnities, Part 1' (2002) 9 Journal of International Banking and Financial Law 360.

it'[159] that the principal debtor performs. In the process of guaranteeing the performance or liability of one party to another, the party acting as a guarantor bears the liability in addition to, and not in substitution for, the liability of the principal.[160] An obligation for a guarantee can exist as a provision within a contract or in a scheme of larger arrangements, as a separate agreement. In the context of the theme of this study and the principal question—are sovereign guarantees an adequate measure of security?—it is argued that this chapter will emphasise the existence of a guarantee as a separate contractual arrangement, and as a 'see to it' transaction.

A guarantee is therefore an accessory contract providing an additional form of security wherein the promisor undertakes to pay the promisee, or be answerable for the debt, default or miscarriage of another party.[161] In essence, the liability of the principal debtor and guarantor is normative to a pendulum. The pendulum of responsibility shifts on the occurrence of an event. In a guarantee transaction, there are two pendulums deriving their motion from one pivot: the central

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[159] Also see Lord Diplock's submission in *Moschi v Lep Services Ltd* [1973] AC 331 '…at common law, a guarantee gives rise to an obligation on the part of the guarantor 'to see to it' that the debtor performs his obligations to the creditor. The obligation of the guarantor 'is not an obligation himself to pay a sum of money to the creditor, but an obligation to see to it that another person, the debtor, does something'.

[160] *Vossloh AG v Alpha Train (UK) Ltd* [2010] EWHC 2443 (Ch), [2011] 2 All E R (Comm) 307 per Sir William Blackburne; also see Yeoman Credit Ltd v Latter [1961] 1 W L R 828; also see Paul McGrath, 'The nature of modern guarantees: *IIG v Van Der Merwes'* (2009) 1 CRI 10; these cases need to be distinguished from *Thomas Lakeman v J P Mountstephen* (1874-75) L R 7 H L 17 wherein Lord Cairns submitted that Mr Lakeman stepped in and undertook himself, as a matter of primary liability. The construction of the words is a crucial element in determining whether liability is secondary or primary.

[161] See *Pitts and Others v Jones* [2007] EWCA Civ 1301 wherein Smith L J submitted 'a guarantee on the other hand is a specific type of indemnity whereby the guarantor promises to answer for the debt or default of another person'. In *Pitts and Others*, the defendant was a majority shareholder in a company. The Defendant made a provisional agreement with another party to sell his shares within the company. In order to convince the minority shareholders that they will be paid handsomely, the Defendant convinced them to waive their right of pre-emption. The purchase did not pay the claimants and this lead to the dispute.

agreement. The liability imposed on the principal debtor is primary, and the guarantor bears a secondary obligation.

This submission is illustrated in Figure 3.1 and Figure 3.2 below. Figure 3.1 (Pre-Default) illustrates the pendulum of responsibility affixed to the principal debtor. Figure 3.2 (Post-Default) illustrates the pendulum affixed to the guarantor in a different time frame, on the same level, corresponding simultaneously to any movement in the pendulum in Figure 3.1. When the principal debtor defaults on its payment, depending on the nature of a guarantee, the pendulum in Figure 3.2 comes into operation. Thus, depending upon the words within the guarantee instrument, this shift from one time frame to another, post-default, affixes the responsibility to discharge debt of the principal debtor (as illustrated in Figure 3.2) onto the guarantor. The trigger point in these time frames will be predicated upon the principal debtor's default under the payment terms or a prescribed act in the agreement.[162] From a project finance standpoint, it is argued that this prescribed term can be invoked upon the non-payment or default by the off-taking body under the PPA. However, as outlined earlier, the guarantor's liability will be in addition to and not as a substitution for the liability of the principal debtor.[163]

[162] See *Vossloh AG v Alpha Trains (UK) Limited* [2010] EWHC 2443 (Ch). As per Sir William Blackburne: 'There is no liability on the guarantor unless and until the principal has failed to perform his obligation. The guarantor is generally only liable to the same extent that the principal is liable to the creditor. This has the consequence that there is usually no liability on the part of the guarantor if the underlying obligation is void or unenforceable.'

[163] It is important to note that, as outlined by Lord Reid in *Moschi* 'where on the true construction of the contract, the surety undertakes that the principal will carry out his contract and will answer for his default. In such a case, if for any reason the principal fails to act as required by his contract he not only breaks his own contract, but he also puts the surety in breach of his contract with the creditor, thereby entitling the creditor to sue the surety, not for unpaid debt but for damages. See *Moschi v Lep Air Services Ltd* [1973] AC 331.

The pendulum of responsibility is suspended from the pivot representing the central agreement. Consequently, any movement in the pendulum of responsibility is derived through the same central agreement. If the central agreement is null and void, there will be no pendulum of responsibility, nor will the secondary guarantor be liable.[164] *HUBCO* and *Riqo Diq* are recent cases illustrating how this rule can prove detrimental for the investors and the project company in light of the treatment accorded to null and void agreements by local courts. *HUBCO*[165] and more recently *Riqo Diq*[166] illustrate the problematic nature of the 'old chestnut'. In *Riqo Diq*, public policy was employed as a ground for revoking the principal concession agreement.[167] Pakistan's Supreme Court found the principal agreements void for reasons of public policy, rejected the doctrine of separation for arbitration clauses within these agreements[168], and

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[164] See *Vossloh AG v Alpha Trains (UK) Limited* [2010] EWHC 2443 (Ch). Sir William Blackburne submitted that 'there is no liability on the guarantor unless and until the principal has failed to perform his obligation. The guarantor is generally only liable to the same extent that the principal is liable to the creditor. This has the consequence that there is usually no liability on the part of the guarantor if the underlying obligation is void or unenforceable'; James O'Donovan and John Phillips, *The Modern Contract of Guarantee* (2nd Edition, Sweet & Maxwell, 2010) 11. The author also submits that 'indeed it is hard to imagine a more versatile arrangement than a contract of guarantee; also see Lord Reid's explanation in *Hyundai Heavy Industries Co Ltd v Papadopoulos* [1980] 2 All ER 29 wherein it is expressed that a (Guarantee) is an 'accessory' obligation which is valid only if the borrower's obligations under the loan agreement are valid. If the borrower's obligations are or later become void or unenforceable, a conditional payment obligation has no advantage over a pure guarantee. Neither can be enforced; also see *General Produce Co v United Bank Ltd* [1979] 2 Lloyd's Rep 255,258; also see Alan Berg, 'Rethinking Indemnities, Part 1' (2002) 9 Journal of International Banking and Financial Law 360.

[165] *HUBCO Power Company Ltd v Pakistan WAPDA* (PLD 2000 SC 841).

[166] *Maulana Abdul Haq Baloch & Others v Government of Balochistan & Others* (PLD 2013 Supreme Court 641).

[167] Doctrine of separation was held not applicable; see *HUBCO Power Company Ltd v Pakistan WAPDA* (PLD 2000 SC 841) wherein HUBCO was restrained from invoking the arbitration clause of the agreement for the following reasons: 'the allegations of corruption in support of which the above mentioned circumstances do provide prima facie basis for further probe into matter judicially and, if proved, would render these documents as void, therefore, we are of the considered view that according to the public policy such matter…are not referable to Arbitration'. The court further expressed 'the disputes between the parties are not commercial disputes arising from an undisputed legally valid contract, or relatable to such a contract, for, according to the case of WAPDA on account of these criminal acts disputed documents did not bring into existence any legally binding contract between the parties, therefore, the dispute primarily relates to the very existence of a valid contract and not a dispute under such a contract'.

[168] The counsel relied on *Harbour Assurance v Kansa* (1993) 1 Lloyd's Rep 455 wherein the Court of Appeal held that an arbitration clause will survive where the main contract in which it

consequently rejected any application for arbitration proceedings in *ICSID*. Cases like *HUBCO* and *Riqo Diq* diminish the economic value of such guarantees, and illustrate that any guarantee provisions will eventually be circumvented by the host state.

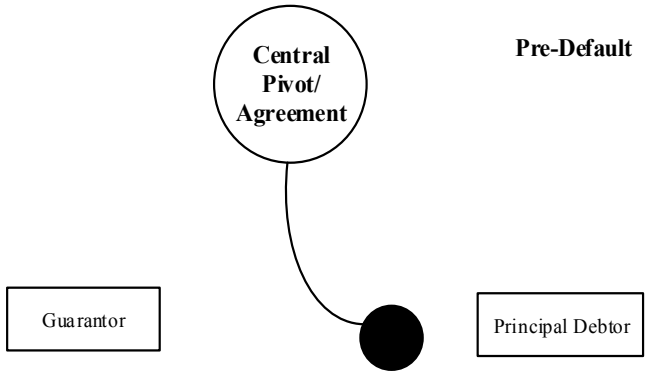

Figure 3.1: Pre-Default

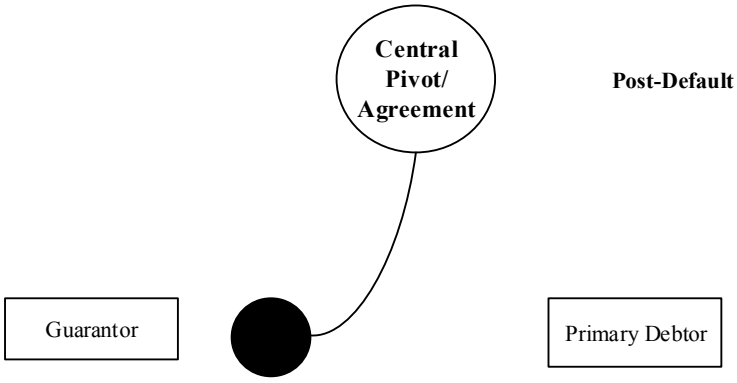

Figure 3.2: Post-Default

An agreement of guarantee is therefore an act of reassurance for the creditor. Several transactions, reviewed for the purposes of this study, illustrate that there are several names that can be accorded to such security arrangements. However,

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appears to be invalid ab initio on grounds of illegality—so that the illegality issues themselves can properly be referred to arbitration.

parties need to exercise caution in according a certain name to a security document. In *Kleinwart Benson Ltd v Malaysia Mining Corporation Bhd*[169] the Court of Appeal held that 'a letter of comfort in these terms was merely a statement of present fact regarding intentions and that it was not a contractual promise as to future conduct'.[170] In *Klienwort Benson Ltd,* the defendants indirectly, wholly owned a subsidiary to operate as a ring-dealing member of the London Metal Exchange. Due to the inadequacy of the capital available they sought financial help from the plaintiffs (Kleinwort Benson). The plaintiff sought from the defendants an assurance as to the responsibility of the subsidiary for the repayment by the London Metal Exchange of any sums lent by the plaintiffs. The defendants did not furnish a 'joint and several liability' or a guarantee to the plaintiffs. Instead, they gave them a comfort letter outlining that 'it is our policy to ensure that the business of [the London Metal Exchange] is at all times in a position to meet its liabilities to you under the above arrangements'. The tin market collapsed and the London Metal Exchange went into liquidation. Consequently, the plaintiffs sought money from the defendant under the 'comfort letter' that was issued to the plaintiffs. The court found in favour of Malaysia Mining Corporation. Ralph Gibson LJ observed that:

> the concept of a comfort letter, to which the parties had resort when the defendants refused to assume joint and several

[169] [1989] 1 WLR 379, CA.

[170] Also see *Associated British Ports v Ferryways NV, MSC Belgium N V* [2008] EWHC 1265 (Comm). The facts of the case are as follows: Ferryways signed a 5-year agreement with the claimant, Associated British Ports, under which ABP guaranteed a five-hour turnaround of 160 units at its port at Ipswich at designated slot times. ABP's charges for handling the units carried by Ferryways. At the time of the second agreement was executed, a written agreement was concluded between ABP and MSCB which, inter alia, included a comfort letter clause. The court held that the guarantor, MSCB, was not liable under the letter agreement for any sums due from Ferryways to ABP. The court discussed the letter of comfort issue in detail.

> liability or to give a guarantee, was known by both sides at least to extend to or to include a document under which the defendants would give comfort to the plaintiffs to assuming, not a legal liability to ensure repayment of the liabilities of their subsidiary, but a moral responsibility only.

It is therefore argued that it is the substance and not strictly the form of such security arrangements that determines its actual ramifications. Despite common use of letters of comfort in infrastructure development and in highly-leveraged project financings, it is argued that parties require more than letters of comfort from the host state. Sponsors and lenders need contractual reassurances from third parties in cases where the principal debtor defaults partially or fully in paying their debt. Developed and under-developed economies use guarantees as an accessory in their bond markets[171], project finance transaction and in infrastructure development projects.[172] These guarantees can relate to the completion of a project on time, supplying or generating an agreed capacity of energy, and more importantly, guarantee for payment if an off-taker breaches its contractual payment.

3.2.2 Underlying features of an Indemnity

Unlike a guarantee instrument, there is no dearth of definitions available for the term 'indemnity'. As stated earlier, a guarantee is, in an abstract sense, an indemnity. Without prejudice to some legal procedures the two terms entail

[171] See Marina Von Newmann Whitman, *Government Risk Sharing in Foreign Investment* (Princeton University Press, 1965) 67.
[172] Also see Comptroller and Auditor General, Amyas Morse, UK Guarantees scheme for infrastructure: report, National Audit Office (2015).

similar outcomes. Their primary purpose is to provide a robust means of security. An indemnity can be defined as:

> …[R]ecompense for any loss or liability which one person has incurred, whether the duty to indemnify comes from an agreement or not[173]…obligation to indemnify another may also arise out of a contract of indemnity, and the term "contract of indemnity" is also used in more than one sense…[174]

A more simple definition of the term indemnity is provided by *Chitty on Contracts*, wherein it is stated that an indemnity can be considered to be an undertaking to make good a loss suffered by another party.[175] An indemnity is a recompense for any loss or liability which one person has incurred, which may arise by contract or by operation of law. An example of an obligation to indemnify arising as a result of a contract can be contract of insurance.[176]

A contract of indemnity is essentially a contract between Party A and Party B wherein by the operation of the law or contract, Party B is to keep Party A from suffering loss or to make good any such loss suffered.[177] The aforementioned definition of the term 'indemnity' in *Chitty on Contracts* states that in its widest

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[173] *Pitts v Jones* [2007] EWCA Civ 1301, [2008] 2 W L R 1289.
[174] Hugh Beale, *Chitty on Contracts: General Principles Volume I* (31st Edition, Sweet& Maxwell, 2012).
[175] Hugh Beale, *Chitty on Contracts: General Principles Volume I* (31st Edition, Sweet& Maxwell, 2012).
[176] James O'Donovan and John Philips, *The Modern Contract of Guarantee* (2nd Edition, Sweet & Maxwell, 2010).
[177] *Yeoman Credit Ltd v Latter* [1961] 1 W L R 828 at 831; *Argo Caribbean Group Ltd v Lewis* [1976] 2 Lloyd's Rep. 289 at 296. In Argo Caribbean Group, L Co agreed to lend money to F Co. In return, F Co was to create a debenture in favour of L Co. Additionally, 'A' and 'R' were to guarantee Party F's performance to L. Party 'D' agreed to indemnify Party 'A' if there is a breach by Party 'F' for any of the terms of the agreement.

sense a 'contract of indemnity includes all contracts of guarantee…' however, legally and structurally, a guarantee is different from an indemnity not only in the outset but also procedurally. There are two fundamental differences that distinguish a guarantee from an indemnity. First, the statutory requirement of certain types of contracts to be evidenced in writing applies to contracts of guarantee (and not to a contract of indemnity)[178]. Second, the guarantor's liability is treated as being co-extensive with that of the principal; the guarantor's liability will be affected by the discharge of the principal or by the fact that the principal contract is void or unenforceable. It is however expressed that an indemnifier's liability is less likely to be affected by these matters.[179] The principal agreement being void or unenforceable needs to be distinguished from when a contract has been repudiated. In *Hyundai Heavy Industries Co Ltd v Papadopoulos and Others*[180] the court rejected the argument that acceptance of repudiation of contract was equivalent to its variation so as to release a guarantor from his obligations. The case concerned an agreement entered into between Pitria Pride Navigation Co, a Liberian company, and the respondent (hereinafter referred to as the "builder") whereby it was agreed that the builder should "build, launch, equip and complete" a 24,000 ton deadweight multipurpose cargo ship, and deliver and sell her to the buyer for US$14,300,000. This litigation arose from the non-payment of the second instalment on the due date, which the

[178] Refer to s 4 of the Statute of Frauds Act 1677. Harman L J submitted in *Yeoman Credit v Latter* [1961] 1 W L R 828 at 835 '…the need to distinguish guarantees from indemnities for the purposes of the statute of Frauds "has raised many hair-splitting distinctions of exactly that kind which brings the law into hatred, ridicule and contempt by public". Please note that the non-application of written requirements for an indemnity means that the institutional incapacities leading to declaration of an agreement being declared null and void will not lead the surety party to be discharged from their duty to make good the loss suffered.
[179] See *Yeoman Credit Ltd v Latter* [1961] 1 W L R 828; *Goulston Discount Co Ltd v Clark* [1967] 2 Q B 493.
[180] [1980] 1 W L R 1129.

appellant argues due to repudiation of the contract has discharged the guarantor from indemnifying the loss of the other party. Viscount Dilhorne submitted that:

> …[M]oreover, the suggested rule would make nonsense of the whole commercial purpose of suretyship: you would lose your guarantor at the very moment you most need him—namely at the moment of fundamental breach by the principal promisor. Take a usual case giving rise to suretyship that of a trader with a bank overdraft. The bank forebears to close the account in consideration of the trader finding a guarantor of overdraft and agreeing to pay it off by instalments. The Trader thereafter repudiates his obligation to pay off the overdraft by instalments; whereupon the bank closes the account, so terminating the contractual relationship of banker and customer. It would be absurd to suppose that the guarantor of the overdraft was thereby discharged from his liability as surety.

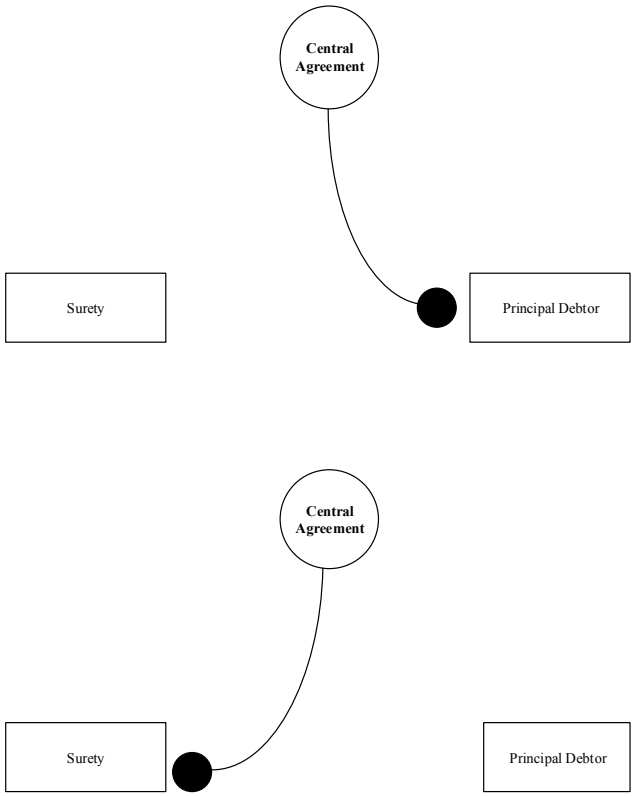

Figure 3.3: The Indemnity Pendulum of Responsibility

An indemnity poses a primary liability even if the principal agreement is held void.[181] The obligation of the party indemnifying the creditor shall be a continuing obligation, independent of the obligations of the principal debtor.[182] Referring to our example of an oscillating pendulum, please see Figure 3.3. It is submitted that the transaction for an indemnity provision is undertaken in two different paradigms, wherein the pendulum of responsibility will rest on both the principal debtor and the surety simultaneously. The liability of the two parties, ie the principal debtor and the surety, will exist separately. However, both parties will have a primary responsibility to discharge the debt, unlike in a guarantee

[181] See *Vossloh AG v Alpha Trains (UK) Limited* [2010] EWHC 2443 (Ch). Sir William Blackburne submitted that 'there is no liability on the guarantor unless and until the principal has failed to perform his obligation. The guarantor is generally only liable to the extent that the principal is liable to the creditor. This has the consequence that there is usually no liability on the part of the guarantor if the underlying obligation is void or unenforceable'.

[182] *Yeoman Credit Ltd v Latter* [1961] 1 W L R 828; also see James O'Donovan and John Philips, *The Modern Contract of Guarantee* (2nd Edition, Sweet & Maxwell, 2010).

transaction. An obligation to indemnify will accrue once the principal debtor defaults. Therefore, a time frame analogy can be used. This must however not be confused with the one discussed above.

In *Lakeman v Mountstephen*, the defendant provided a verbal assurance in the following words 'M, go on and do the work, and I will see you paid'. The claimant did indeed carry out the work and sought payment. The defendant refused the claimant's claim on the basis that the main contention in the case was concerning the debt of another, the council. Since, the transaction was one of a guarantee, it imposed a secondary liability on the defendant. Moreover, it did not satisfy the *Statute of Frauds Act* condition. The court of the first instance agreed with the defendant's argument. The House of Lords, with the leading judgment delivered by Lord Cairns, argued that there was strong evidence to suggest that Mr. Lakeman stepped in and undertook himself, as a matter of primary liability, to pay for the work done.[183] Therefore, the construction of the pendulum is predicated upon the words and the actions of the surety. Since the surety or the party that agrees to indemnify is acting as a principal debtor, in the event that the first primary agreement is declared null and void, the indemnity agreement or provision is still enforceable.

3.3 Co-Existence of Indemnity and Guarantee—The InG Agreements

The co-existence of a guarantee and an indemnity provision within one contractual arrangement is no legal anomaly. Whereas previous sections refer to the two terms in an independent, abstract sense, the use of an indemnity in a

[183] *Thomas Lakeman v J P Mountstephen* (1874-75) L R 7 H L 17.

guarantee framework is not an alien concept, especially in a political risk insurance context. For example, referring to our pendulum example in previous sections, it is argued that in an instance where there is a shift in the pendulum of responsibility from the principal debtor to the guarantor, the principal debtor must indemnify the guarantor. Subject to the rules of insolvency in a corporate finance context, this involves seeking repayment from whatever assets remain within the corporation. However, there is no absolute presumption that such right vis a vis indemnification will arise from the same contractual agreement.

Conversely, the two legal concepts can exist within a single agreement or a financial transaction. However, it is argued their operation within an agreement is in their own matrix. As a result, if the provisions contained within an agreement permit, the guarantee, and indemnity will have separate repercussions for the parties to the agreement. Consequently, both instruments will act as an additional form of security in the event of default. In *Vossloh*[184] the agreement was treated as a guarantee, with an indemnity as an additional form of security.[185]

Provisions in cases like *Vossloh* illustrate the parties' intention and their endeavour to protect themselves against any loss they may incur. However, this occurrence of the two legal instruments within a single agreement or provision can be problematic. In light of the discussion undertaken in the previous sections, it is argued that the underlying concepts of an indemnity and a guarantee within one agreement creates a discord and even conflict amongst the two instruments,

[184] *Vossloh AG v Alpha Trains (UK) Limited* [2010] EWHC 2443 (Ch).
[185] This is similar to the risk insurance model discussed in Chapter 5.

primarily because of their distinctive nature. Whereas an indemnity poses a primary liability upon the surety, the guarantee imposes a secondary liability. Incorporation of these words within one agreement may seem a robust form of protection for the parties; however, such an incorporation can create issues insofar as the interpretation of the two terms.

Alternatively, this predicament can be viewed from a creditor's lens. Project finance transactions are highly leveraged. Consequently, there is a certain degree of risk concerning the future revenue stream of the project company. Parties, especially the creditor, attempt to use both indemnity and guarantee as a method to secure payment. Another contention that seems relevant concerns the trigger of an event of default provision invoked by the creditor. This may have repercussions for finance arrangements between the project company and other lenders. Acceleration of loan agreements is predicated on the understanding that the primary debtor will be unable to pay.[186]

In any case, the existence of the security provisions within a single agreement can often create a discord between what the parties really intend. As outlined in *Alfred McAlpine*[187] the distinction between the two legal instruments is often blurred, and care must be exercised in drafting the two clauses. In *Vossloh*, the parties used the following provision in their agreement: 'the Guarantor hereby unconditionally and irrevocably as a continuing obligation and as a principal

[186] For an interesting discussion on acceleration clauses in loan agreements please see David Hahn, 'The Role of Acceleration' (2009-2010) 8 DePaul Bus & Comm L J 229.
[187] See *Alfred McAlpine Construction Ltd v Unex Corp Ltd* [1994] 38 Con L R 63. The facts of the case are briefly outlined hereinafter. The respondents, Alfred McAlpine, are contractors under a contract dated 2 November 1989 for the construction of a substantial office building and multi-storey car park in Cambridge. Their employers are the developers of the site, Panatown Ltd. Panatown Ltd is a subsidiary of Unex, and Unex is accordingly entered into a contract described as a parent company guarantee.

debtor and not merely as a surety, as a separate continuing and primary obligation…'[188]

In a bid to secure payment, the drafters of the agreement in *Vossloh* employed both a primary and a secondary liability. This illustrates the predicament highlighted earlier. Parties are implicitly drawn by the contextual, abstract use of the two legal instruments, without bearing in mind the legal ramifications of the provisions. Whilst relying on *IIG Capital LLC*[189] and *Marubeni Hong Kong*[190], Sir William Blackburne stated that within the context, the words were ineffective to convert secondary obligations into primary obligations. Sir William Blackburne submitted that 'the opening words were more consistent with an intention to set out in what followed a mixture of primary and secondary obligations'. Even though the main contention in this case did not concern the classification of whether such a security provision was an indemnity or a

[188] *Vossloh AG v Alpha Trains (UK) Ltd* [2010] EWHC 2443 (Ch).

[189] *IIG Capital v Van Der Merwe* [2008] EWCA Civ 542. The facts of the case are as follows: IIG entered into a loan agreement with Hurst Parnell Imports and Exports Ltd (HPIE). The Van Der Merwes were directors of HPIE and executed 'deed of guarantee' in favour of IIG. Before the court of first instance, the Van Der Merwes relied upon defences (under New York Law which was governing law of contract) that there would be implied covenant of good faith and fair dealing which would require IIG to have given reasonable notice of its demand and that such notice had not been given thereby providing HPIE a complete answer to the claim; also see *Trafalgar House Construction (Regions) Ltd v General Surety & Guarantee Co Ltd* [1996] A C 199.

[190] *Marubeni Hong Kong v Government of Mongolia* [2005] EWCA Civ 395. Brief facts of the case are as follows: Hong Kong Company agreed to supply a Mongolian company with textile plant and machinery in the sum of US$18million. The agreement was backed by a letter issued by the Minister of Finance unconditionally pledging on a simple demand payment of the amounts due under the agreement, and a letter of the same date issued by the Deputy Minister of Justice referred to the Finance Minister's letter as a 'guarantee' and stated that the Minister has full authority. Also see *Caja de Ahorros del Mediterraneo v Gold Coast* Ltd [2001] EWCA Civ 1806. In *Caja de Ahorros*, the claimant (the buyer) was the assignee of a contract with Spanish shipbuilder to build a tanker for approx. $38.5 million. The buyer's obligation to make stage payments was conditional on simultaneous delivery of refund guarantees in a prescribed form from issuers acceptable to the buyer's bank in the amount of the payment. The ship was due for delivery on 1st October 1999, however was not delivered. The buyer rescinded the contract for non-delivery and claimed repayment of the payment it had made amounting to 80% of the purchase price. The builder denied that the buyer was entitled to default and instead declared the buyer in default.

guarantee, the court expressed that under the current circumstances they are likely to find that it was the latter.

Moreover, in *Sofaer's* case, Lewison J reviewed the provision in the agreement containing both instruments. The agreement's provision stipulated as follows:

> [T]he guarantor (a) guarantees the payment and the discharge of the Liabilities and (b) undertakes on demand to pay the Lender any liability which is not paid and to perform any liability which is not performed when due to be paid or performed.[191]

This provision is a good example to illustrate the parties endeavouring to incorporate both primary and secondary means of liability, in order to strengthen the security framework. Lewison J's observation in *Sofaer* revolves around the determination of whether the liability arising in an agreement containing both instruments will constitute primary or secondary liability.[192] The rights ensued from the provision shall be determined by reviewing the substance of the provision and not merely the form. The court in *Vossloh* observed this conundrum and submitted: '…contracts of suretyship, of which 2009 guarantee is an example, are an area of law bedeviled by imprecise technology and where

[191] *Sofaer v Anglo Irish Asset Finance Plc* (2011) EWHC 1480 (Ch). The facts of the case are as follows: S had executed a deed of guarantee and indemnity in favour of X to secure the liabilities of various companies, together with charges over 12 properties owned by the borrower companies or their nominees. S's liability was capped under the guarantee. Following X's written demand to S, the appointment of a fixed charge receivers, X served a statutory demand on S stating that no sums had been received and that the whole amount of £8.4million under the guarantee now fell due. S, having failed to have the demand set aside, and in order to avoid bankruptcy, proposed an individual voluntary arrangement. At the subsequent creditor's meeting X voted against adopting an IVA, and voted in favour of a revised figure of £9.2million.

[192] See *Harburg India Rubber Comb Co v Martin* (1902) 1 K B 778; please note that the principal/primary obligation must exist, it must also remain unchanged through the life of the guarantee.

therefore it is important not to confuse the label given by the parties to the surety's obligation'.[193]

However, it can be argued that the operation of both instruments can be viewed as operating separately, in their own matrix. Consequently, they can exist together without interfering in the operation of the other matrix. For example, if an off-taker breaches their off-take agreement, the project company can invoke an indemnity clause within the agreement. Moreover, in an event that the state has issued a sovereign indemnity the project company can invoke the indemnity clause for payment. In light of the discussion undertaken in the previous section, concerning the validity of the agreement in an indemnity scenario, it will be irrelevant. Therefore, the surety—the party indemnifying—will be paying the dues as debt and not as damages.[194]

3.3.1 Guarantee or Indemnity? An Old Chestnut

The principal purpose of extensively discussing guarantee and indemnity as two separate legal instruments is to provide a basic understanding of the two concepts for the purposes of outlining the underlying frameworks for a sovereign guarantee framework. Guarantee and indemnity instruments have a binary use in security agreements. Within the security arrangements, the guarantee and indemnity can co-exist in one agreement, and separately define the relationship

[193] *Vossloh AG v Alpha Trains (UK) Limited* (2010) EWHC 2443 (Ch).

[194] The scope of this thesis does not allow for a detailed discussion on the issue concerning debt and damages. However, for the purposes of understanding their underlying nature, we have provided brief definitions. A debt is a definite sum of money fixed by the agreement of the parties as payable by one party in return for the performance of a specified obligation by the other party or upon the occurrence of some specified event of condition. Damages may be claimed from a party who has broken his contractual obligation in some way other than failure to pay such a debt. See Hugh Beale, *Chitty on Contracts: Volume I* (31st Edition, Sweet & Maxwell, 2012) 1762.

(and liability) of two separate parties. The presence of an indemnity provision within a sovereign guarantee framework is to the extent of the host state indemnifying the project company against a guarantee issued on behalf of the off-taking body. In PRI scenario, the host state indemnifies the multilateral risk insurer, and in return the risk insurer guarantees payment of the off-taking body.

Within these arrangements it can be submitted that the legal notion of guarantee and an indemnity has been used interchangeably, and therefore it is correct to argue that the two are elusive concepts. Andrew and Millet submit that the law surrounding guarantees and indemnities is inconsistent and arcane.[195] As outlined in the cases of *Vossloh*[196] and *Moschi*[197] the parties may have wished to use the term 'indemnity', however the features of the provisions were indicating otherwise. The courts have been explicit to highlight that the use of the words 'indemnity' or a 'guarantee' are not entirely conclusive by themselves. Parties loosely refer to or incorrectly describe a term wherein it may have completely different results.

The courts have attempted to address this ambiguity by reviewing the substance and not the form of both the legal instruments. However, this predicament is a vindication of the parties' endeavour to safeguard their interest and seek a robust form of security, even if such endeavour entails using and confusing both surety legal instruments. An interchangeable use of these two legal notions illustrates a commitment towards protection of investment and certainty of payment. It is

[195] Geraldine Andrews and Richard Millet, *The Law of Guarantees* (6th Edition, Sweet & Maxwell, 2012)
[196] *Vossloh AG v Alpha Trains (UK) Limited* [2010] EWHC 2443 (Ch).
[197] *Moschi v Lep Air Services Ltd and Others* [1972] 2 W L R 1175 Per Lord Diplock.

primarily because of this effort to secure payment and performance that recent project financings have incorporated escrow accounts and letters of credit as an alternative, or an additional means of creating a more robust security. In the *Chad-Cameron Oil Development and Pipeline Project*, the World Bank conditioned its financing of the project on the establishment of a petroleum revenue management plan (hereinafter referred to as "RMP"). Under the RMP, all revenues including royalties, dividends, taxes and custom duties would be deposited into a dedicated escrow account to be monitored by the World Bank.[198] Similarly, London's new drainage construction project involves payment of dues to the project company during construction work, even though the infrastructure will not be capable of supplying any services until the project completion. This measure is in addition to the government guarantee drawn under the *United Kingdom's Infrastructure (Financial Assistance) Act 2012*.

3.3.2 Release of a Guarantor?

In addition to the use of both an indemnity and a guarantee in one transaction or contractual frameworks, there is an increasing mention of 'unconditionally' and 'irrevocably'[199] in international lending agreements. Upon perusal of various energy agreements, one theme that emerges is the recurrent use of the 'separate continuing and primary obligation' notion upon a surety, in a bid to convert a

[198] See Alexander Van de Putte, David F Gates and Ann K Holder, 'Political risk insurance as an investment to reduce oil and gas investment risk and manage investment returns' (2012) Journal of World Energy Law and Business, Vol 5, No 4 284.

[199] The terms 'unconditional' and 'irrevocable' appear as rhetoric in all the government guarantee documents perused by the author. The use of these terms acts as a basis to describe the guarantee that can be enforced immediately on a default without a requirement that the project company first exhausts his remedies against the government; see Philip Wood, *International Loans, Bonds, Guarantees, Legal Opinions* (The Law and Practice of International Finance Series, Vol 3, 2nd Edition, Sweet & Maxwell).

secondary obligation into a primary obligation.[200] These efforts primarily rest upon the parties' intention to mitigate risk by incorporating the two instruments, as discussed earlier. This fusion of the two legal instruments creates a discord for courts to reconcile the intention of the parties and the legal outcome. As illustrated in various academic texts and cases, the distinction between an indemnity and a guarantee is often blurred.[201] As a result, the courts reconcile the two legal instruments by employing 'primary' and 'secondary' notions of responsibility, in order to resolve the co-existence of the two legal instruments. However, the determination of the characteristics of the two legal notions is fraught with implications insofar as the title that will be accorded to the instrument. As a result, the delay in payment under the relevant contractual framework will have repercussions for the parties.

In *Associated British Ports* (hereinafter referred to as "ABP") the claimant appealed against the decision of Field J[202], arguing that a letter agreement between ABP and the second defendant, MSCB, contained a guarantee, rather than an indemnity. This had been discharged by an agreement giving the first defendant and primary debtor (Ferryways) time to pay. In the preliminary proceedings by ABP against Ferryways and MSCB, Field J held that the time to pay agreement discharged the liability of MSCB under the letter agreement, which he construed as a guarantee and not an indemnity. ABP appealed against the court of first instance's decision arguing that the letter agreement was an

[200] Sir William Blackburn held that these words were ineffective to convert into primary obligations, obligations that were otherwise secondary in nature. See *Vossloh AG v Alpha Trains (UK) Ltd* (2010) EWHC 2443 (Ch); (2011) 2 All E R (Comm) 307; also see *Sofaer v Anglo Irish Asset Finance Plc* (2011) EWHC 1480 (Ch).
[201] James O'Donovan and John Philips, *The Modern Contract of Guarantee* (2nd Edition, Sweet & Maxwell, 2010); *Vossloh AG v Alpha Trains (UK) Ltd* (2010) EWHC 2443 (Ch).
[202] *Associated British Ports v Ferryways NV & Anor* [2009] EWCA Civ 189.

indemnity or a legally binding letter of comfort, so that in either case, the defendants would discharge any liability. Upon appeal the court dismissed the claimant's plea, Maurice Kay L J noted:

> Guarantee or indemnity? That old chestnut was one of the issues that fell to be considered by Field J in this case and it is the only part of his decision, which is challenged on appeal. The issue arises most often because the law treats the two concepts differentially when it comes to formality. A guarantee is subject to the formal requirements of section 4 of the Statute of Frauds 1677 but an indemnity is not.[203] A guarantee is, in the words of the Statute, a promise "to answer for the debt default or miscarriage of another person". There must be another person who is primarily liable. The liability of the guarantor is secondary. By an indemnity, on the other hand, the surety assumes primary liability.

Maurice Kay L J further went on to state:

> …[H]owever it illustrates another difference between a guarantee and an indemnity. Because the liability of a guarantor is secondary, it is usually discharged by a bilateral variation of the contract between the creditor and the debtor. In the absence of an express provision to the contrary in the contract of guarantee, the

[203] The need to distinguish guarantees from indemnities for the purposes of the Statute of Frauds 'has raised many hair-splitting distinctions of exactly that kind which brings the law into hatred, ridicule and contempt by public', as expressed by Harman L J at 835 in *Yeoman Credit Ltd v Latter* [1961] 1 W L R 828

giving time by the creditor to the debtor will generally discharge the guarantor.[204]

Maurice Kay L J's submission is relevant for two reasons for the purposes of this study. First, in light of the discussion concerning liquidity issues within distribution companies in Pakistan's energy sector, any variation in payment structure, late payment or no payment will mean that the government, as a guarantor, will be discharged from their duty to recompense or hold a secondary liability in any transaction unless the guarantee instrument states otherwise.[205] Maurice L J's remarks vindicate the pendulum analogy made earlier. In the context of the pendulum illustrating in Figure 3.1, it is argued that in the event of a breach, the pendulum oscillates from primary to secondary liability in a guarantee. In an indemnity context, the pendulum illustration features both a primary and a secondary liability on a parallel scale. Consequently, both parties assume primary liability. In the event that a concession agreement or the PPA is held void, the stronger protection offered under the security measure will be provided by an indemnity contract. As a result, in view of recent cases like *IPCO v Nigerian National Petroleum Company (NNPC)*[206] it is submitted that an

[204] See Hugh Beale, *Chitty on Contracts* (31st Edition, Sweet & Maxwell, 2012) wherein it is submitted that '…in practice any well-drawn contract of suretyship will nowadays expressly permit variation of the obligations or the giving of time, without discharging the surety'.

[205] The court in the case of Associated British Ports relied upon *Polak v Everett* [1876] 1 QBD 669 wherein Blackburn J said 'it has been established a long time, beginning with *Rees v Berrington* to the present day, without a single case going to the contrary, that on the principles of equity a surety is discharged when the creditor, without his assent, gives time to the principal debtor, because by so doing he deprives the surety of part of the right he would have had from the mere fact of entering into suretyship, namely, to use the name of the creditor to sue the principal debtor, and if this right is suspended for a day or an hour, not injuring the surety to the value of the one farthing, and even positively benefitting him, nevertheless, by the principles of equity, it is established that this discharges the surety altogether.'

[206] [2016] UKSC 16. The rationale in this case is not relevant for the purposes of this study, as they relate to monetary security and Arbitration rules derived from the New York Convention. However, the facts of the case are important for the purpose of highlighting an investor's dilemma. IPCO instituted a claim in the Nigerian National court in 2004. The case has still not

indemnity instrument impose a more reassuring, onerous obligation on the host state to discharge the sponsor's debt. Second, Maurice Kay L J's remarks 'there must be another person who is primarily liable' are of immense importance for the purposes of the discussion undertaken in Chapter 4. A logical conclusion that can be drawn from Maurice Kay L J's submission is that in order to satisfy a guarantee framework, there needs to be another party that guarantees the performance of another party. In the event that SOEs are incapable of operating at an arm's length with the state, will that render any guarantee instruments void due to procedural inadequacy?

3.4 Conclusion

This chapter is a primer to the law of suretyship from a common law perspective. There are three main contentions discussed in this chapter. First, in an effort to understand the two surety instruments, this chapter provides an outline of both guarantee and an indemnity instrument. A guarantee has been defined as an accessory contract providing an additional form of security wherein the promisor undertakes to pay the promisee or be answerable for the debt, default or miscarriage of another party.[207] A guarantee is thought of as a 'see to it' obligation, wherein the guarantor will not only indemnify the creditor in the event of a breach, the guarantor is to ensure that the principal debtor performs their contract. This definition varies according to the terms of the agreement.

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been resolved. Nigerian authorities are content to file another suit to discuss the merits of the actual contract. This case bears resonance with the case of Riqo Diq.

[207] See *Pitts and Others v Jones* [2007] EWCA Civ 1301 wherein Smith L J submitted 'a guarantee on the other hand is a specific type of indemnity whereby the guarantor promises to answer for the debt or default of another person'. In *Pitts and Others*, the defendant was a majority shareholder in a company. The Defendant made a provisional agreement with another party to sell his shares within the company. In order to convince the minority shareholders that they will be paid handsomely, the Defendant convinced them to waive their right of pre-emption. The purchase did not pay the claimants and this lead to the dispute.

This chapter adopts a pendulum of responsibility model to illustrate how the two instruments are different. These illustrations help to understand how the notions of 'primary' and 'secondary' liability work and function under a guarantee framework. Through aid from the illustration outlining the pendulum, it is argued that the guarantor and the principal debtor exist in a parallel time space. The concept of time space is contingent upon default by the principal debtor, at which point the guarantor's surety is triggered and he is to discharge the principal debtor's liability.

In contrast, indemnity instruments have been defined as an undertaking to make good a loss suffered by another party. The pendulum of responsibility illustrates the nature of liability in order to differentiate an indemnity with a guarantee. Unlike the time space argument submitted in the guarantee section, in an indemnity the pendulum is affixed on both the parties in separate matrices. As a result, both parties are primarily liable towards the creditor simultaneously.

The second contention refers to the nature of suretyship agreements involving guarantees. As illustrated in Figure 3.1, the liability of the guarantor is secondary to that of the principal debtor. Consequently, an extinguished liability of the principal debtor would discharge the guarantor. The illustration in Figure 3.1 assists in explaining this submission. However, from an indemnity perspective, it is argued that since the principal and the surety are both primarily liable, the

liability arising therefrom will exist even after the principal debtor has been discharged from performance.[208]

It is submitted that with a variation in a contract of guarantee, by allowing time to the debtor, the creditor extinguishes the secondary liability of the guarantor. This is an imperative feature of a guarantee contract that extinguishes any duty owed by the guarantor to the creditor. Within the ambit of investment in developing countries, it is argued that an extension in payment of dues is a common practice.[209] In reference to Maurice L J's submission, the guarantor will be discharged of their duty in case an extension in time is agreed between the project company (creditor) and the off-taker (debtor). An interesting facet of the investment regime through project finance is revealed through interviews conducted with various government officials and practitioners to discuss this predicament. In order to prevent SPVs calling on the sovereign guarantees, the Government of Pakistan restructures the outstanding dues under the PPA, and not under the guarantee agreement. As a result, despite a delayed payment, a fixed sum is paid out through the terms of the original PPA and not the sovereign guarantee agreement. This contention leads to create an ambiguity over the entire sovereign guarantee framework. It begs the question, is the guarantee provided by the sovereign, adequate? Or even necessary?

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[208] See *Yeoman Credit Ltd v Latter* (1961) 1 W L R 828; *Thomas Lakeman v J P Mountstephen* (1874) LR 7 HL 17 wherein Lord Selbourne expressed 'there can be no suretyship unless there be a principal debtor, who of course may be constituted in the course of the transaction by matters ex post, and need not be so at the time, but until there is a principal debtor there can be no suretyship. Nor can a man guarantee anybody else's debt unless there is a debt of some other person to be guaranteed…'.

[209] This study makes reference to these practices in the later chapter, however it is submitted that due to fiscal constraints and other unforeseeable circumstances, there are examples where the host state government or the off-taker within the host state has been unable to pay dues and requires an extension. This practice has been seen in Moldova, Hungary, India, Kenya, and more importantly in Pakistan, wherein off-taking bodies delay payments and seek extension in payment.

In view of the suggestion outlined in this chapter concerning a change in sovereign guarantee instruments to sovereign indemnity, this chapter contends that this re-shaping policy will address the primary rationale for adopting these security measures by securing robust measures of security. However, it is submitted that re-naming the sovereign guarantee structure alone will not address the primary issues. There is a need for a complete regulatory overhaul in Pakistan's energy sector.

The third contention reviews the InG agreements. This chapter refers to the co-existence of guarantee, and indemnity provisions under one agreement. In order to provide a general understanding of how political risk insurance framework functions, this chapter illustrates the existence of both these instruments existing in an agreement in a bid for the creditors to secure the performance of the principal debtor. Especially in a project finance context, InG agreements are in common use. However, it is contended that the use of the two is operationally predicated on their existence in their own matrix. As a result, for example, if an off-taker breaches their off-take agreement, the project company can invoke an indemnity clause within the risk insurance arrangement and still seek recourse from the host state. As such, both will run concurrently in their own matrices.

In addition to the use of guarantee and indemnities as a measure to secure performance, parties have adopted various additional measures in order to safeguard their investment. As highlighted in an example from Chad-Cameron and London's drainage project, there are other methods that can potentially create a more certain and robust security framework. It is however submitted that

the presence of the additional instruments does not displace or replace the security offered under the guarantee and indemnity instrument framework.

Chapter 4

Sovereign Guarantees: Post Gunboat Diplomacy to Trade Diplomacy

4.1 Introduction

Risk exists in various forms in a highly-leveraged energy project. Risk is multi-dimensional, and therefore is not limited to market or commercial risks. In view of risk in highly leveraged projects, it is argued that parties seek mitigation methods in order to protect their investment. Sovereign guarantees are one of the risk mitigation methods in a project finance transaction normative to Pakistan. The following discussion aims to review the underlying features of sovereign guarantee instruments, and attempts to determine its adequacy.

There is a close nexus between an efficient law for the creation, protection and enforcement of security interests, and an increased access to credit. These factors also directly contribute towards a reduction in the cost of credit.[210] In view of an increase in infrastructure development requirements and the scarcity of funds, investment portfolios have seen a rise in investment security instruments to mitigate risk.

Project finance alone cannot mitigate risk. Therefore, investors, especially in a developing country context, require the provision of sovereign guarantees as a measure of security. From a SPV context, sovereign guarantees are immensely important, as the entire transaction is predicated on the future revenue generated

[210] Rainer Haselmann, Katharina Pistor and Vikrant Vig, 'How Law Affects Lending' (2010) 23(2) Review of Financial Studies 549; George Affaki, 'Increasing Access to Credit: Reforming Secured Transactions Laws' (2010) International Trade Centre; Charles Calomiris, Mauricio Larrian, Jose Liberti and Jason Sturgess, 'How Collateral Laws Shape Lending and Sectoral Activity' (2014) Working Paper Draft < http://www.ier.hit-u.ac.jp/hit-refined/wp-content/uploads/2013/12/wp.020.pdf> Accessed 14 May 2017.

by the project company. Sovereign guarantees are therefore a form of contingent liability, with the states liability being co-extensive to the off-taking body. In the event that there is a breach by the off-take body for payments under a PPA, a sovereign guarantee offers protection to the SPV.

A detailed discussion on the nature of these sovereign guarantee frameworks is undertaken hereunder. This chapter is sub-divided into three sections, and reviews the central contention of this thesis: the adequacy of sovereign guarantees.

First, an introduction to the concept and context of sovereign guarantees is presented. In view of an increasing use of sovereign guarantee measures, the following discussion highlights the notion of sovereignty, in order to introduce the sovereign guarantee phenomenon. It attempts to establish the relationship that exists between the provision of sovereign guarantee and infrastructure development. Whilst providing a brief account of sovereignty in an abstract context, this section discusses the departure from a state-centred matrix to a more liberal, de-centralised mode of operation as a tool to facilitate free flow of capital. This section rebuts a common perception concerning states no longer exercising absolute sovereignty within their jurisdiction. It attempts to associate the issuance of sovereign guarantees as a favourable behaviour wherein the state plays a pivotal role.

Second, in order to forge an argument and canvass an understanding of sovereign guarantee instruments, three separate features of the sovereign guarantee instrument are reflected upon, in order to determine the instrument's adequacy in

an abstract and contextual sense. There are three strands to consider in examining the adequacy of the sovereign guarantee instruments. The first strand of this section should be read in conjunction with the basic features of a guarantee instrument. This section adopts the International Law Commission's *Draft Articles on the Responsibility of States for Internationally Wrongful Acts* (hereinafter referred to as the "Draft Articles"). In the past, enforcement of 'collateral engagement' was through invading countries to ensure that the debt of a country's citizen was honoured.[211] Wars were waged in an endeavour to meet a sovereign's quest for compensation or redress for the loss suffered by their subject, as a result of default by another sovereign. The multifaceted nature of threats posed to foreign investment in an alien jurisdiction has always been a cause of concern. There are numerous examples from history that facilitate this argument.[212] Investors have been subjected to prejudicial treatment by the host state in their application of laws, security of investment in general, host states exercising expropriation, and non-payment of dues to the project company. It was not until the eighteenth century that the notion of state responsibility emerged to address and hold states accountable for injuries to aliens within their jurisdiction.[213]

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[211] Also see Marina Von Neuman Whitman, *Government Risk Sharing in Foreign Investment (*Princeton University Press, 1962).

[212] See Jack Donnelly, *Realism and International Relations* (1st Edition, Cambridge University Press, 2000). Donnelly expresses that 'militarised debt collection was a well-accepted part of International relations in the nineteenth century'; also see Martha Finnemore, *The Purpose of Intervention: Changing Beliefs about the Use of Force* (1st Edition, Cornell University Press, 2003) expressed that militarised debt collection amongst powerful sovereign states was an "accepted practice" until the Hague Peace Conference of 1907. Also see Michael Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries* (Princeton University Press 2007).

[213] 'State responsibility' was originally conceived as a set of international rules governing states' international obligations in their relations with other states. A state's primary obligation is to pay compensation or make reparation for injuries suffered by nationals of other states. In traditional international law, state responsibility constituted a classic way of dealing with violations of

Draft Articles seek to formulate, by way of codification and progressive development, the basic rules of international law concerning the responsibility of state for their internally wrongful acts. These Draft Articles address state responsibility and its attribution to the state.[214] In order to discuss the adequacy of sovereign guarantees, this strand provides a useful discussion on whether the guarantee framework discussed in the previous chapter is satisfied. This section adopts Articles 4 and 5 as a starting point to conceive whether in reality, the SOEs engaged in facilitating the sovereign guarantee instruments are de facto the state, and whether the responsibility of discharging the off-taking body's debt rests with the state. Reliance has been placed on cases from international forums to address the question of what amounts to a SOE being part of the state, and what factors detest this contention. As an exercise, this section is useful towards the determination of the adequacy of sovereign guarantee instruments.

The second strand reviews an abstract argument. Predicated on the utility of sovereign guarantee instruments, this section is an extension on the discussion concerning sovereignty. This section argues that there is an 'expectation gap' between what the parties expect and what they are really offered under the sovereign guarantee framework. In view of the liquidity issues primarily due to T&D losses, this section argues that the state may not have the financial capacity to provide such guarantees and, therefore, there is a gap between what the investors expect under the sovereign guarantee framework.

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customary international law. See Sompong Sucharitkul, 'State Responsibility and International Liability under International Law' (1995-1996) 18 Loyola L A Int'l & Comp L J 821; also see Michael Feit, 'Responsibility of the State Under International Law for the Breach of Contract Committed by a State-Owned Entity' (2010) 28 Berkeley J Int'l L 142.

[214] International Law Commission, 'Articles on Responsibility of States for Internationally Wrongful Acts, General Commentary' [2001] 2(2) Y B Int'l L Comm'n 30, 31-32 <http://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf> Accessed 23 March 2017.

The third strand offers an economic perspective, and reviews the legislative impediments in issuing such guarantees. This section offers to review Pakistan's *Fiscal Responsibility and Debt Limitation Act 2005* (hereinafter referred to as "*Debt Limitation Act*"). The *Debt Limitation Act* outlines that the 'total public debt at the end of the tenth financial year does not exceed sixty percent of the estimated gross domestic product for that year'. An extensive discussion concerning the legitimacy of these sovereign guarantees is reviewed under the current legislative limitations in Pakistan's context. A wider approach is adopted to offer an economic perspective, insofar as the economic repercussions caused as a result of issuing sovereign guarantees in breach of the *Debt Limitation Act*. This section argues that in contravention of the *Debt Limitation Act*, there is likelihood that all sovereign guarantees issued are void.

Last, an alternative approach to the contractual guarantee instrument is discussed. This discussion is predicated on adopting a parliamentary insurance programme, wherein the sums are appropriated in view of the increasing demand for investment. As a measure of security, this section bases its reasoning on the model adopted in the United Kingdom, and suggests that blanket guarantees are a thing of the past; selective guarantees are a thing of the future.

4.2 Shifting Sands: Sovereign within Sovereignty?

The inception and evolution of 'gunboat' diplomacy to the present day 'trade diplomacy' can be traced back to the late eighteenth and early nineteenth

centuries.[215] These ideals were primarily focused to perpetuate and encourage further Industrialisation globally, and support influx of foreign investment in countries to promote infrastructure development.[216] Johnson & Gimblett have succinctly discussed the 'gunboat' diplomacy era in the *Yearbook on International Investment Law*.[217] They submit that the apogee of Britain's attitude towards ensuring redress was given as a result of the injuries inflicted upon a British subject in Greece, more famously known as the Dan Pacifico Affair. In this case, the Greek government refused to compensate a British subject. In response, the British sent their Royal Navy fleet to carry out a blockade of the Athenian port of Piraeus. Lord Palmerston rejected seeking redress from the court of a country where the wrong was committed, arguing that:

> [I]n the first instance, redress should be sought from the law courts of the country; but in cases where redress cannot be so had—and those cases are many-to confine a British subject to that remedy only, would be to deprive him of the protection which he is entitled to receive.[218]

Lord Palmerston's submission implicitly indicates that if the courts of a foreign jurisdiction will not be willing to correct or address a wrong that was committed

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[215] Surya P Subedi, *International Investment Law: Reconciling Policy and Principle* (Second Edition, Hart Publishing, 2012).

[216] This period also marks the shift in infrastructure development from a strictly public sphere to a deregulation, inclusive market involving private participation.

[217] Thomas Johnson and Jonathan Gimblett, 'From Gunboats to BITS: The Evolution of Modern International Investment Law' published in the Karl P Sauvant (eds), *Yearbook on International Investment Law & Policy* (Oxford, 2010-2011) 649-692

[218] Thomas Johnson and Jonathan Gimblett, 'From Gunboats to BITS: The Evolution of Modern International Investment Law' published in the Karl P Sauvant (eds), *Yearbook on International Investment Law & Policy* (Oxford, 2010-2011) 649-692.

on their soil, use of force is justified to ensure that those rights are safeguarded according to the rules of natural justice or contractual obligations. Similarly, as submitted by *Collier,* in 1833 the US military forces were deployed in Buenos Aires to protect the interests of the United States and other countries during an insurrection in Argentina.[219] The French too landed troops at Vera Cruz in 1838 to recover debt owed to its nationals by the Mexican Government.[220]

The situation has since improved.[221] The ideological driving force behind 'gunboat' diplomacy has now been replaced with 'trade diplomacy' in a bid to improve cross border relations by employing trade as a tool. Arch-rivals Pakistan and India have used this method in the past to promote peace talks, and promote stability in the region.[222] It is submitted that some authors are of the opinion that the use of military force against sovereign states in order to enforce judgements or to seek redress is predicated upon the occupation during the colonial era; enforcing rule of law through invasion. However, this shift in attitude is a

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[219] Ellen C Collier, 'Congressional Research Service, Instances of Use of United States Forces Abroad, 1798-1993' (Oct 1993) <http//www.history.navy.mil/wars> Accessed 23 February 2015.

[220] Rodrigo O Caminal, *Legal Aspects of Sovereign Debt Restructuring* (Sweet & Maxwell, 2009) 5.

[221] Rodrigo O Caminal, *Legal Aspects of Sovereign Debt Restructuring* (Sweet & Maxwell, 2009) 6, wherein it is expressed that the law did change (reference is made to *Twycross* case, discussed later) and this meant that foreign sovereigns could be hauled to court in a foreign jurisdiction (without their consent) for matters involving a sovereign's debt instruments; also see Hal S Scott and Anna Gelpern, *International Finance Law and Regulation* (3rd Edition, Sweet & Maxwell, 2012) 12. This literature discusses the benefits of globalisation of finance. An outline of the potential benefits of unrestricted capital flows are as follows: (i) access to worldwide capital markets allow the country to smooth its financial needs; borrowing in bad times and lending in good times (ii) international markets can promote domestic investment and growth by allowing countries to import capital (iii) removing restrictions on the movement of firms and capital may discipline regulator; Also see Hali Edison, Ross Levine, Luca Ricci, and Torsten Slok, 'International Financial Integration and Economic Growth' (2002) 21 Journal of International Money and Finance 749; Ayhan M Kose, Kenneth Rogoff, Shang-Jin Wei, and Eswar Prasad, 'Financial Globalisation: A Reappraisal' (August 2006) IMF Working Paper 06/189 <https://ssrn.com/abstract=934448> Accessed 15 June 2016.

[222] Pakistan, India and Iran agreed on a gas pipeline through Pakistan and to India. The volatile situation in this region can benefit significantly through measures such as these undertaken at a state level. See Kashif Kiani, 'Iran-Pakistan gas pipeline to be completed by 2017' *The Dawn* (Islamabad, 29 Jan 2015) <http://www.dawn.com/news/1160072> Accessed 29 January 2015.

consequence of an international endeavour to synchronise investment regimes, and to increase cooperation through creating global networks that perpetuate on formulation of a framework to enforce rights of foreign nationals.[223] Bilateral treaties and various International conventions are an example of this endeavour. To provide a more holistic view, it can be argued that these measures have been introduced to regulate market behaviour and to penalise any adverse behaviour impacting investment. This in effect has meant that there has been a dramatic shift from use of force to seek redress from international bodies, courts both within home states and in other states. Sovereignty is no longer subject to the rules of the state alone; the state is subject to a whole gamut of international obligations and factors governing or rather regulating sovereignty.[224]

Sovereignty is an elusive subject, which has confounded academic scholarship and has led to a whole gamut of opinion on the subject.[225] The aberration from a state centred matrix to a more liberal, de-centralised mode of operation insofar as

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[223] See Paul L Lee, 'Central banks and sovereign immunity' (2003) 41 Columbia Journal of Transnational Law 327, at 394. It is submitted that a disruption in the economy of a country might trigger a crisis of considerable magnitude to force creditors to examine their legal options for recovery. In case that recovery is not possible due to covenants as to filing suit against a state, it is expressed that this would lead to detrimental effects on the FDI regime across the board (not just for a particular country); Michel Troper, 'Sovereignty', in Michel Rosenfield and Andras Sajo (eds), *The Oxford Handbook of Comparative Constitutional Law* (OUP, 2012).

[224] See Max Rheinstein, 'Max Weber on Law in Economy and Society', Translated from Max Weber, Wirtschaft und Gesellschaft, (1954) wherein it is expressed that 'time and again international law has been said not to be "law", because it lacks a supra-national enforcement agency'.

[225] Jayan Nayar, 'On the Elusive Subject of Sovereignty' (Nov 2014) Legal Studies Research Paper No 2014/17, Warwick Law School; see Ashis Nandy, 'History's Forgotten Doubles' (1995) History and Theory 34, No 2: 44-66, at 54 expresses 'sovereignty, however problematised, is a thing-in-the-world, a 'reality', in some way intrinsic and indispensable to being-in-the-world, whether thought of as a 'cage'; Zygmunt Bauman, 'Utopia with a Topos' (2003) History of Human Sciences 16, no1:11-25 describes sovereignty as a malleable and floating possibility; also see Dora T Kostakopoulou, 'Floating Sovereignty: A Pathology or a Necessary Means of State Evolution? (2002) Oxford Journal of Legal Studies, Vol 22(1), pp 135-156; Martin Loughlin, *The Idea of Public Law* (Oxford University Press, 2003) regards sovereignty as a product of political relationship between the people and the state; Stephen Tierney, 'Reframing Sovereignty? Sub-state national societies and contemporary challenges to the nation state' (2005) 54 Int'l & Comp L Q 161.

commerce has allowed for capital to flow from one country to another, freely.[226] Some academics have termed this decentralisation as deregulation of economic policies under which the state previously operated. Deregulation of economic policies predominately occurred due to the values under which the contemporary international law operates. Without cooperation amongst countries, the concept of creating consistent global conditions to promote cohesive investment regime seemed bleak.

The term 'sovereign guarantee' consists primarily of two terms; sovereign and guarantee. Guarantees have been extensively discussed in Chapter 3. There is no strict definition of the term 'sovereignty'. There is quite a variance as to what amounts to sovereignty[227] and the impact it may have upon the areas that a state operates in. Sovereignty, in a broader context is the right of a state to enact laws[228] that are in accordance with the values and the norms within that state. A more apt definition of sovereignty can be inspired from Foucault's definition of 'liberalism'.[229] Sovereignty has evolved from a strict sphere dominated by

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[226] Aberration in this context refers to shift of states to exercise authority through State-owned entities (SOEs), effectively regulate them, and then privatise these institutions. For a detailed discussion on SOE, see World Bank Group, *Corporate Governance of State-Owned Enterprises: A toolkit'* (Washington, International Bank for Reconstruction and Development/World Bank, 2014).

[227] Also see Jean J Rousseau, *Social Contract, in Rousseau, Social Contract and Discourses* (London: Everyman, 1993) wherein it is expressed that 'sovereignty' is inalienable, indivisible, and it cannot err.

[228] See Karl Popper, *The Open Society and its Enemies [1945]* (Routledge, 2002) wherein Hobbes has argued that a sovereign authority is a necessary guarantor of peace and security within a society, but liberals have claimed that on the contrary, an unchecked power is dangerous, and asked 'whether we should not strive towards institutional control of rulers by balancing their powers against other powers?'; also see Neil MacCormick, *Questioning Sovereignty: Law, State, and Nation in the European Commonwealth* (Law, State, and Practical Reason, Oxford, 1999) wherein it is expressed that sovereignty is not like property 'which can be given up only when another person gains it', but 'more like virginity, something that can be lost by one without another's gaining it'.

[229] Andrew Barry, Thomas Osborne, and Nikolas Rose (eds), *Foucault and Political Reason: Liberalism, neo-liberalism and rationalities of government* (1st edition, University College London Press Limited, 1996). Foucault submits that 'liberalism is not a theory, an ideology, judicial philosophy, or any particular set of policies adopted by a government. Liberalism is

outdated values and norms to a thinkable and practicable art. It does not denote or prescribe a set of policies, ideology, judicial philosophy; it is merely a term that has evolved from the strict sphere of unfettered, absolute authority within a certain jurisdiction, to being more accountable and judicial comity.[230] Despite being considered 'degraded, suspended'[231], Nandy submits that 'sovereignty, however problematised is a thing-in-the-world, a "reality", in some way intrinsic and indispensable to being-in-the-world, whether thought of as a "cage".[232] This definition, which may seem open ended, draws us to the concept that the enactment of a state's laws, as it pleases, may be prejudicial towards the interests of a foreign state. Therefore, the shift from the strict definition of sovereignty under the 'Westphalian' model, to a more liberal and 'global' concept of sovereignty has been facilitated. Therein was a model that made the state from national to (inter) national. This shift was conducive towards establishing a model that promoted infrastructure development, flow of capital and human resource to previously restricted, highly regularised jurisdictions.

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described as a particular way in which the activity of the government has been made both thinkable and practicable as an art'.

[230] See Janet McLean, 'Government to State: Globalisation, Regulation, and Governments as Legal Persons' (2003) Indiana Journal of Global Legal Studies, Volume 10, Issue 1. In this academic literature, the question 'is the state dead, in retreat, or increasingly significant?' is raised. It is further contended that the state's 'sovereignty' depends as to which discipline is invoked; however as dominant legal conceptions are shifting, fresh insights into the phenomenon can be provided.

[231] Dora T Kostakopoulou, 'Floating Sovereignty: A Pathology or a Necessary Means of State Evolution? (2002) Oxford Journal of Legal Studies, Vol 22 (1), pp 135-156.

[232] Ashis Nandy, 'History's Forgotten Doubles' (1995) History and Theory 34, No 2: 44-66, at 54.

The normativity of sovereignty from a philosophical scope, and as a legal-economic concept has provoked academic debate.[233] A US official described sovereignty as:

> Historically, sovereignty has been associated with four main characteristics: First, a sovereign state is one that enjoys supreme political authority and monopoly over the legitimate use of force within its territory. Second, it is capable of regulating movements across its borders. Third, it can make its foreign policy choices freely. Finally, it is recognised by other governments as an independent entity entitled to freedom from external intervention. These components of sovereignty were never absolute, but together they offered a predictable foundation for world order. What is significant today is that each of these components—internal authority, border control, policy autonomy, and non-intervention—is being challenged in unprecedented ways.[234]

This challenge that Haas refers to has been highlighted by various academics. Jackson submits that the term 'sovereignty' is 'invoked in a context or manner

[233] Some argue that sovereignty has been compromised to achieve globalisation which is more beneficial to the investment state than to the host state. See Peter Payoyo, 'Economic Sovereignty in International Law: The state of the art' (1990-1991) 65 Phil L J 129. Payoyo expresses 'contemporary international law is based, more and more, on values whose satisfaction cannot be achieved other than through cooperation, including the creation of a global conditions for making expanding cooperation possible. This idea of an emerging "international law of cooperation" indeed provides a satisfactory framework for the identification and analysis of principles and norms in international economic law'.

[234] Richard N Haas, former ambassador and director of Policy Planning Staff, US Department of State, Sovereignty: Existing Rights, Evolving Responsibilities, Remarks at the School of Foreign Service and the Mortara Centre for International Studies, Georgetown University, at 2 (Jan 14, 2003) <http://www/georgetown.edu/sfs/documents/haas_sovereingty_20030114.pdf> Accessed 13 September 2015.

designed to avoid and prevent analysis, sometimes with an advocate's intent to fend off criticism or justifications for international infringements on the activities of a nation-state or its internal stakeholders and power operators'.[235] Henkin wants to do away with the concept of sovereignty altogether.[236] While there is a variance of opinion as far as the concept in its abstract and concrete sense, it is submitted that we cannot completely dispense with the concept of sovereignty. It will exist in one form or another: the right of a state over its resources, the right to legislate, and the supreme right to enforce the laws that a state determines are right.

It is, however, contended that the time of absolute sovereignty has passed; its theory was never matched by reality.[237] While Jackson finds that the concept of sovereignty is fundamental to the logical foundations of international law, and any effort to do away with the concept will create a discord that undermines the very existence of international law, he proposes a new paradigm. He submits that the concept of sovereignty modern is a more analytical and dynamic process of disaggregation and redefinition than a 'frozen-in-time' concept or technique.[238] To an extent, it is submitted that perhaps the definition of sovereignty is stagnant, and there is a need to evolve the definition as per the requirements of the market. As otherwise contended, it is submitted that there has not been a reduction in the

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[235] John H Jackson, 'Sovereignty—Modern: A new approach to an outdated concept' (2003) American Journal of International Law, Vol 97 (4), 782-802.

[236] Louis Henkin, 'That "S" Word: Sovereignty, and Globalization, and Human Rights, Et Cetera, 68 Fordham L Rev 1 (1999). <http://ir.lawnet.fordham.edu/flr/vol68/iss1/1> Accessed 01 October 2014.

[237] As per the submission of the Secretary General United Nations, Boutros Boutros-Ghali in the Security Council. An Agenda for Peace Preventative Diplomacy, Peacemaking, and Peacekeeping, Report on the Secretary General, UN Doc. A/47/277-5/24111 Para/17 (1992), UN Sales No E 95 1 15(1995).

[238] John H Jackson, 'Sovereignty—Modern: A new approach to an outdated concept' (2003) American Journal of International Law, Vol 97 (4), 782-802.

role of the state. In order to achieve 'economic integration', there has been a shift towards more open policies, as submitted earlier. Picciotto argues that:

> [T]he privatisation of state-owned assets and the reduction of direct state economic intervention have not led to a reduced role of the state but to changes in its form, involving new types of formalised regulation, the fragmentation of the public sphere, the decentering of the state and the emergence of multilevel governance.[239]

Dwelling further and exploring the concept of sovereignty will require a separate, more serious undertaking. This section now aims to focus on the concept of 'sovereign' within the sovereign guarantee framework. There is no strict definition of the term 'sovereign guarantee'.[240] Despite being used by

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[239] Sol Picciotto, 'The retreat of the state: challenges to law and lawyers' (2006) Regulatory Networks and Global Governance Paper presented at the WG Hart Legal Workshop. Institute for Advanced Legal Study, University of London, London, 27-29, June 2009.

[240] See *Rederiaktiebolaget Amphirite v The King* (1921) 3 K B 500 as per Rowlatt J: '…all I have got to say is whether there was an enforceable contract, and I am of the opinion that there was not. No doubt that government can bind itself through its officers by a commercial contract, and if it does so it must perform it like anybody else or pay damages for the breach. But this was not a commercial contract; it was an arrangement whereby the government purported to give assurance as to what its executive action would be in the future in relation to a particular ship in the event of her coming to this country with a particular kind of cargo. And that is, to my mind, not a contract for the breach of which damages can be sued for in the court of law…my main reason for so thinking is that it is not competent for the government to fetter future executive action, which must necessarily be determined by the needs of the community when the question arises. It cannot by contract hamper its freedom of action in matters which concern the welfare of the state'. Also see Olugbenga Shoyele, 'State succession and governmental contracts in African states' (1997) 9 Srilanka J International 125; also see *Birkdale District Electric Supply Co Ltd v Southport Corporation* (1926) AC 355 at 364, wherein it was expressed 'if a person or public body is entrusted by the legislature with certain powers and duties to expressly or impliedly for public purpose, those persons or bodies cannot divest themselves of these powers and duties. They cannot enter into any contract or take any action incompatible with the due exercise of their powers or the discharge of their duties'. Brief facts of the case are as follows: by a provisional order of 1898, Birkdale Council were constituted as electricity undertakers in Birkdale. Birkdale Council transferred these powers to an electric supply company with a provision for retransfer if the company made default in their obligations as undertakers. The electric company charged more than the agreed maximum tariff. Council brought an action to restrain the company's breach of agreement. The company contended that that supplemental agreement was *ultra vires*

numerous emerging and developed countries[241] in their bond markets, debt-restructuring mechanisms, and under various contexts at the sovereign state level, the term has not attracted its due share within the academic literature. For the purposes of discussing sovereign guarantee, it is argued that role of a sovereign within a commercial sphere exists in various tiers; fragmented. The academic literature available mainly consists of either a critical review of the contours of sovereignty, or how the shift from a strict state orientated concept to a more liberal, deregulated form has been beneficial. Sovereignty co-exists with deregulation and liberalisation. Consequently, sovereignty and the role of the sovereign in its strict form still exists in three tiers.

First, sovereignty exists in a meta-sovereign form. Essentially all states are commercial actors in some of their dealings as a state.[242] 'Meta' within this context for the purposes of the 'sovereign' form denotes the commercial dealing of the state with other sovereigns and their subjects. In this situation the sovereign has relinquished most of its contractual rights, for example, immunity.[243] The state retains the right to regulate within their jurisdiction,

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both under the Electric Lighting Act 1882, which prevented the Council from divesting themselves of their statutory powers without the consent of the Board of Trade, and under the general law.

[241] See National Audit Office's Report on UK Guarantees Scheme for Infrastructure, HM Treasury (Jan 2015). <https://www.nao.org.uk/wp-content/uploads/2015/01/UK-Guarantees-scheme-for-infrastructure-summary.pdf> Accessed 22 March 2015.

[242] A state's decision to enact a new tax law is predicated on economic principles and the impact it may have on the economy in general and a government's political ambitions. A state's commitment to eradicating poverty, improving the health benefits or generally a foreign policy decision has economic repercussions. This renders the state to be a commercial actor.

[243] See Vicki C Jackson, 'Suing the Federal Government: Sovereignty, Immunity, and judicial independence', (2003) George Washington International Law Review 35, 521; for a detailed discussion see *NML Capital Ltd v Republic of Argentina* (2011) 2 AC 495. Facts of the case are that the claimant, NML Capital sought enforcement in England of a judgment given in its favour by a court in New York against the D state, Republic of Argentina. One of the primary issues before the UK Supreme Court was whether the present proceedings for recognition and enforcement of the New York Court's judgement were "proceedings relating to…a commercial transaction"; *Knighthead Master Fund LP and Others v Bank of New York Mellon and Another* [2014] EWHC 3662 (Ch); *Rahimtoola v Nizam of Hyderabad* (1958) AC 397. Case concerns an

however, in a capacity wherein there is mutual consent between the investor and the host state.[244] The second tier of sovereignty exists in relations between the subjects of the state A, and subjects of another state B. Seemingly, the role of the state A in this instance might seem trivial, however there are aspects that only the state can play (reference can be made to bilateral investment treaties and protections offered therein). The wide array of expertise brought into a transaction can all be void if the host state changes their policy surrounding an investment. The state plays a pivotal role therein, regulating the relationship that exists between subjects of their state and those of the foreign state. Finally, the third tier establishes the relationship that exists between the state and its subjects. This study will primarily be dealing with the first two tiers, due to their significance within the sovereign guarantee structure.

From an energy sector standpoint, even though there are various parties involved in a typical project finance transaction, there are always the financial lenders[245], the EPC contractors, sponsors and an SPV. The relationship that exists between the investing state and the host state is crucial. The host state, by allowing a

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amount in Nizam of Hyderabad's account transferred to the Pakistani High Commissioner's account for and on instructions of the State of Pakistan. See the judgment delivered by Lord Denning; Seema Bono, Mark Hilgard, Sarah Reynolds and Others, 'Sovereign immunity and enforcement of Arbitral Awards: Navigating International Boundaries' (2012) Working paper published by Mayer Brown <www.mayorbrown.com/publications/sovereign-immunity-and-enforcement-of-arbitral-awards- navigating-international-boundaries-02-21-2012> Accessed 14 April 2015.

[244] The idea of a state relinquishing its rights or retaining them is questionable. It is submitted that some BITs and other investment agreements provide favourable rights to the investor such as tax holidays, exemption from customs etc. This is considered an encroachment on a state's sovereignty, if looked at from a strict sovereign perspective.

[245] These financial lenders are primarily foreign banks interested in higher returns for undertaking higher risks. Author's fieldwork has revealed that local banks have also started to participate in domestic syndicates to finance energy projects. However, they are not as widespread and limited to a few projects. See Nexif, 'Financial close of 50 MW Metro Wind and signing of debt agreements for 50MW Gul Ahmed Wind – two power projects developed by Nexif in Pakistan' *Nexif Singapore* (23 February, 2015) <http://www.nexif.com/news/pakistan-wind/> Accessed on 23 February 2015.

subject of the investing state to invest in their jurisdiction is exercising their sovereignty. Wood succinctly explained this concept in the following words: '…state in-charge of its own law making machinery can therefore change its laws and compel its court to give effect to changes'.[246]

In essence, the exercise of sovereignty forms part of the security package that the host state has to offer. Security, like sovereign guarantee, is a nebulous term; some might argue, one with no precise meaning.[247] In its earliest form, the term 'security' did not specifically refer to a document or arrangement, which was either secondary, or formed part of a collateral obligation. Bamford submits that in some circumstances the term security could refer to the instrument that created primary obligation.[248] This is an interesting remark, and leads to the debate whether an indemnity would fit the definition that Bamford associates with security more appropriately than a guarantee?

4.2.1 Sovereign Guarantees and Infrastructure Development

Sovereign guarantee frameworks serve two purposes. First, they are risk mitigation tools; second, they provide an ancillary support for attracting capital. All investments are predicated on risk[249]; some are risker than others. Risk associated with a transaction determines the cost of return. As a result, risker

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[246] Philip Wood, *Project Finance, Subordinated Debt and State loans* (Sweet & Maxwell, 1995) 99; Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002); David Gardner and James Wright (HSBC) 'Project Finance' <www.hsbcnet.com-gbm_attachments_products - services_financing-project- finance> Accessed 12 April 2015.

[247] See Colin Bamford, *Principles of International Financial Law* (Second Edition, OUP, 2015). The term security is also looked at in a wider context to mean 'something which makes the enjoyment or enforcement of a right more secure to certain'. See Jowitt's Dictionary of English Law (2nd Edition, Sweet & Maxwell, 1977).

[248] Colin Bamford, *Principles of International Financial Law* (Second Edition, OUP, 2015); also see *Jones v IRC* (1895) 1 QB 484.

[249] Alistair Hudson, *The Law of Finance* (2nd Edition, Sweet & Maxwell, 2013) 109.

transactions bear higher rewards.[250] Complex financial instruments packaged to allure investors to invest are a good example of how risky investments can be rewarding. Parties investing in volatile, under-developed economies seek methods to either mitigate risk or diminish them altogether.[251]

Sovereign guarantee, like a guarantee, is a contract wherein the state agrees to act as a collateral to indemnify the SPV against any breach of contract or delay in timely payments by the off-taker. Traditionally, sovereign guarantees were regarded as instruments designed to assist developing countries to attract foreign investment, managerial know-how and infrastructure for economic development.[252] They are now increasingly considered as risk mitigation provisions that allow greater access to credit for a developing economy. However, as discussed later, the provision of sovereign guarantees has now become more obscure and merely a condition precedent. Lenders require state guarantees for projects to achieve financial close (hereinafter referred to as "FC").[253]

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[250] See Peter K Nevitt and Frank Fabozzi, *Project Financing* (7th Edition, Euromoney Books London, 2000) 131.

[251] While there are several financial mechanisms employed in order to mitigate risk ie leveraged finance (debt to equity ratio) these have been discussed in project finance chapter, insurance (discussed in the political risk insurance chapter), sovereign guarantees are widely used in the infrastructure industry as a tool to mitigate risk, or rather to give the impression that the host state sovereign undertakes to protect such investment; also see Arghyrios A Fatouros, *Government Guarantees to Foreign Investors* (Columbia University Press, 1962). This book largely revolves around the limitations and effectiveness of state guarantees in international law.

[252] See *Barcelona Traction, Light and Power Co case (Belgium v Spain)*, ICJ Reports 1970, 3, para 33 wherein the court submitted 'when a state admits into its territory foreign investments of foreign nationals, whether natural or juristic persons, it is bound to extend to them the protection of the law and assumes obligations concerning the treatment to be offered to them'.

[253] Fatouros offers an insight into the primary purpose for government guarantees. He argues that 'the primary goal of such measures is designed to promote stability. Their ultimate purpose should be to assist growth by eliminating some of the unfavourable consequences of instability. But to recognise the dangers of uncertainty and instability is not to consider instability as the principal aim'. He further adds that 'it is prudent, however, to avoid exaggerating their importance or the extent to which they can affect economic development. Such guarantees relate

In essence, the sovereign guarantee framework can provide such assurances that are deemed necessary by the investor, however, in this present instance this assurance is two pronged. The guarantee not only assures the lenders that their investment is secure[254] against any regulatory change or expropriatory measure, it also promises the SPV that the off-taker, an SOE, will purchase the electricity from the SPV via an off-take agreement[255] and make timely payments. The latter form of security is vital for project finance purposes. The entire structure of a project finance transaction is predicated on a smooth future revenue stream for a project company, and as a result secures debt payment obligations for the project company. Sponsors and lenders seek legal certainty when making investment decisions.[256]

One of those certainties sought by investors is a credible mechanism for securing their investment against contractual breaches, expropriation etc.[257] This

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only to a few of the factors affecting the international flow of private capital, namely, the factors generally included under the heading of "investment climate"'. See Arghyrios A Fatouros, *Government Guarantees to Foreign Investors* (Columbia University Press, 1962) 6.

[254] Reference has been made to an agreement perused by the author. It is submitted that the agreement expresses this in the following manner section 15.6(a)(ii) 'if there occurs a PPFME or a CLFME that prevents or delays the construction of the complex or reduces the Company's ability to declare available capacity, the Power Purchaser shall within 30 days of the delivery by the Company for an invoice there for, pay to the Company, for each Month an amount equal to (i) the carrying cost if the PPFME or the CLFME occurs prior to the occurrence of the Commercial Operations Date, or (ii) the full capacity payment if the PPFME or the CLFME occurs after the Commercial Operations Date'. There are also generally provisions relating to expropriation, change in law to the detriment of the company etc.

[255] See Edward R Yescombe, *Principles of Project Finance* (Academic Press, 2002); see section 15.5 of the PPA reviewed wherein it is expressed that 'upon the occurrence of any Force Majeure Event after the Commercial Operations Date, then during the pendency of a Force Majeure Event, the Power Purchaser shall pay to the Company Energy Payments for Net Electrical Output delivered during the pendency of such Force Majeure Event plus Capacity Payments for the prevailing Tested Capacity that the Company has been able to demonstrate through testing that it can make available during the pendency of such Force Majeure Event'.

[256] See Marina Von Neumann Whitman, *Government Risk Sharing in Foreign Investment* (Princeton University Press, 1965). The general rule recognised by economists is that fear of the unfamiliar will often lead an investor to keep his money at home, even when he could earn more on it abroad; also see Adam Smith, *Wealth of Nations* (Fourth Edition, Penguin Classics, 1999).

[257] Such assurances outline and work as an underlying assurance for investors and the project company that the sovereign will pay the project company/SPV under the implementation agreement, if and when a sovereign guarantee is called upon.

obligation perpetrates the suggestion that in such scenarios, a foreign investor is assured that in the event of a dispute, as a result of breach of contract, expropriation or any contingency arising as a result of governmental action, the host state will compensate the sponsors.[258] Recent examples from various countries indicate otherwise. Evidence from countries such as Pakistan, India[259], Kenya and Nigeria[260] highlight a precarious financial chasm, due to liquidity issues faced by off-taking bodies, and the direct consequence of such issues resulting in default on payments despite sovereign guarantee assurances.

Inability to meet expectations of the sponsors under a sovereign guarantee framework lead to the following narrative: either there are procedural inadequacies in Pakistan's sovereign guarantee framework, or there is an expectation gap between what the investors expect, and what is being offered. Delayed payments due to fiscal constraints can create an environment of uncertainty and lead to a crisis of enormous magnitude.[261] It is submitted that

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[258] This also builds on the argument submitted in Chapter 2, concerning risk mitigation in project finance. As Nevitt and Fabozzi submit, the key to successful project financing is when there is as little recourse available to a sponsor as possible, while at the same time providing sufficient credit support through guarantees or undertakings of a sponsor or a third party so lenders can be satisfied of credit risk. See Peter K Nevitt and Frank Fabozzi, *Project Financing* (7th Edition, Euromoney Books London, 2000).

[259] See the Dabhol Power Project; see Kenneth Hansen, Robert C O'Sullivan, W Geoffrey Anderson, 'The Dabhol Power Project Settlement—What Happened? And How?' The Infrastructure Journal <http://www.chadbourne.com/files/Publication/a5aa1e52-4285-4bb5-87e6-7201123895a0/Presentation/PublicationAttachment/352f8f09-ae96-40fc-a293-720d0b8f0ca8/Dabhol_InfrastructureJournal12_2005.pdf> Accessed 03 May 2016; also see Kiran Stacey, 'Debt burden slows India's rollout of reliable electricity supply' *Financial Times* (New Delhi, 20 February 2017).

[260] See Timi Soleye, 'Guest post: The imminent collapse of Nigeria's power privatization is a good thing' *Financial Times* (Lagos, 14 Oct 2014) <www.ft.com> Accessed 14 October 2014.

[261] Specific reference is made to issues pertaining to acceleration clauses and material adverse change (MAC) clauses in syndicated loan agreements. See *Concord Trust v Law Debenture Trust Corporation plc* [2005] UKHL 27; *BNP Paribas S A & Others v Yukos Oil Company* [2005] EWHC 1321 (Ch). Brief facts of the case are that a Russian oil magnate was subject of major investigations by the Russian tax authorities. As a result, the defendant company, which was subject of majority shareholding of the magnate, was adversely affected. The claimant accelerated their loans and the case was surrounded by debate around MAC clauses; also see Paul

default on payments by a government on their contractual obligation results in the lenders restricting the flow of investment.[262] This means that infrastructure development is adversely affected. Concrete evidence supporting the use of sovereign guarantees in infrastructure development indicates a fierce competition amongst emerging economies and even developed countries for FDI. Sovereign guarantees in infrastructure development can, inter alia, be considered as an additional form of security[263], incentivising investment to flow to a jurisdiction that would otherwise not attract the same.[264]

L. Lee, 'Central Banks and Sovereign Immunity' (2003) 41 Columbia Journal of Transnational Law 327, at 394.

[262]See Arghyrios A Fatouros, *Government Guarantees to Foreign Investors* (Columbia University Press, 1962) wherein it is argued that 'the lack of security in investments in foreign, and especially underdeveloped, countries is due to, and is manifestation of, the general lack of stability in today's economic and political situation. It is not possible to provide complete security for investment where the underlying economic and political conditions are unstable'; see Guido Sandleris, 'Sovereign Defaults, Credit to the Private Sector, and Domestic Credit market institutions' (March-April 2014) Journal of Money, Credit and Banking, Volume. 46, No 2-3. This paper analyses whether there is a relationship between the sovereign defaults and decline in foreign and domestic credit to the domestic private sector; also see Arteta Carlos and Galina Hale, 'Sovereign Debt Crises and Credit to the Private Sector' (2008) Journal of International Economics, 74, 53-69; Sturzenegger Federico, Jeromin Zettelmeyer, *Debt Defaults and lesson from a Decade of Crises* (Cambridge MA MIT Press, 2006); also see Douglas Baird, Robert H Gertner, and Randal C Picker, *Game Theory and the Law* (Harvard University Press, 1994) wherein it is expressed that a law that gives lender the ability to call upon the state to enforce its claim provides parties with a way of transforming a game with a sub-optimal equilibrium into another game with an optimal equilibrium. To say that legally enforceable contracts facilitate mutually beneficial trade is not to say that the existence of such trade depends on it. Trade can exist and indeed flourish in the absence of legally enforceable contracts. Mechanisms such as reputation can bring about long-term cooperation even if there is no enforceable contract. The prospect of losing future deals both with another party and with people who know that party may be sufficient to ensure that each party performs.

[263] Security was defined by Sir Nicholas Browne-Wilkinson in *Bristol Airport Plc v Poudrill and others* [1990] 2 WLR 1362 as follows: 'security is created where a person (the "creditor") to whom an obligation is owed by another (the "debtor") by statute or contract, in addition to the personal promise of the debtor to discharge the obligation, obtains rights exercisable against some property in which the debtor has an interest in order to enforce the discharge of the debtor's obligation to the creditor'. Brief facts of the case are as follows: an insolvent charter airline had debt totaling £11 million. The applicants, airport operators, were two of its unsecured creditors and were owed £1.5m. Administrators were appointed for the charters, and they told the creditors that there is a prospective sale that could equally beneficial for the creditors. At a meeting between the representatives of the four airport operators, including the two applicants, it was agreed that none of them would exercise power of detention over the aircraft, which were operated by the airline under leasing agreements.

[264] Surya P Subedi, *International Investment Law: Reconciling Policy and Principle* (2nd Edition, Hart Publishing, 2012). Also see Marina Von Neumann Whitman, *Government Risk Sharing in Foreign Investment* (Princeton University Press, 1962). It is argued that British investment in

This study focuses on black letter law perspective, highlighting what constitutes sovereign guarantee and its ability to act as a risk-mitigating measure. It would be appropriate to briefly highlight that the concept of risk mitigation is not only contained within the perimeter of guarantees, it also correlates to regulatory means present within a jurisdiction. Effective regulation is one of the endemic features of effectively mobilising investment finance, ensuring good performance insofar as meeting contractual expectations. An alternative initiative to effective regulation, as illustrated in EBRD's working paper, is sovereign finance. However, sovereign finance is neither practicable nor desirable from an incentive standpoint.[265]

4.3 Are Sovereign Guarantees Absolute or Obsolete? The Case for a Faulty Structure

Developing countries have become increasingly concerned about the lack of infrastructure to facilitate their rapid growth supplying cheaper products to the developed countries. It is estimated that by 2030, Asia alone will require approximately US$24 trillion in order to sustain and meet its infrastructure demands.[266] These competitive market conditions create a space for investors, both domestic and foreign, to provide access to capital to facilitate local

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infrastructure abroad increased steadily, other countries caught the fever, and by the 60's and 70's, Canada, France, Russia, Austria, Hungary, and Turkey were all using the guaranty system to attract foreign capital into the railway department; Nick Seddon, 'The Interaction of Contract and Executive Power' <flr.law.an.edu.au/sites/flr.anu.edu.au/files/flr/Seddon.pdf> Accessed 20 November 2015.

[265] David Kennedy, 'Power sector regulatory reform in transition economies: program and lessons learned' (Feb 2003) EBRD Working Paper No. 78 <http://www.ebrd.com/downloads/research/economics/workingpapers/wp0078.pdf> Accessed 23 May 2016.

[266] See Asian Development Bank (ADB), 'Asia Infrastructure Needs Exceed $1.7 Trillion Per Year, Double Previous Estimates' *ABD News Release* (28 February 2017) < https://www.adb.org/news/asia-infrastructure-needs-exceed-17-trillion-year-double-previous-estimates> Accessed 05 March 2017. The total figure is approximately US$26 trillion if climate change and other costs are taken into account.

businesses to compete in the international markets. This study has made continuous references to the government's inability to participate and invest in infrastructure development. A better means of being able to facilitate private investment, provide the requisite conditions, and provide a collateral safety net is through sovereign guarantees. As outlined in a report from the International Monetary Fund (hereinafter referred to as the 'IMF'), 'guarantees are a form of government intervention. Their general motivation is to respond to market failure, tempered by concerns that inappropriate or excessive intervention can lead market failure to give way to government failure'.[267]

The state employs an indirect approach through the utility of sovereign guarantee frameworks to avoid and deter government failure to enhance investment regime. The current framework of guarantee contracts used globally involve either a contractual provision within the PPA, MOU, or are executed in a separate agreement, more commonly known as a letter of support (hereinafter referred to as "LoS"). Over the past 25 years, governments of all persuasions in Western democracies have increasingly resorted to contracts as a means of carrying out governmental tasks and achieving policy outcomes.[268] Whilst an attempt has been made in the preceding chapter to explain what guarantees are, and what constitutes an indemnity, this section aims to discuss the sovereign guarantee structure normative to these principles.

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[267] See IMF, *Public-Private Partnerships, Government Guarantees, and Fiscal Risk* (Washington, IMF, 2006).

[268] Nick Seddon, 'The Interaction of Contract and Executive Power', <flr.law.an.edu.au/sites/flr.anu.edu.au/files/flr/Seddon.pdf> Accessed 14 November 2015

There are two main issues that need to be addressed in order to establish the adequacy of sovereign guarantee: first, whether sovereign guarantees are a robust measure to avoid or deter default by SOEs. Second, whether the reasons for these defaults are predicated upon the lack of defined frameworks that exist within the state's organic structure. Subsequent to this lack of defined framework is the notion of whether these SOEs are in fact organs of the state, and therefore fall within its organisational structure.[269] The first issue is fairly straightforward. This study has extensively discussed the failure of Pakistan's SOEs to fulfil and make timely payments to the project company. India, Kenya, Nigeria, Cameroon and other developing countries are experiencing similar difficulties. India's circular debt is ten times that of Pakistan, standing at approximately US$64bn.[270] Similarly, Armenia, Georgia and Ukraine have made progress towards independent regulation, in addition to the privatisation of the distribution companies.[271] Dabhol Power Project's failure is a good example of state failure to provide adequate protection under a sovereign guarantee framework.[272] It is therefore submitted that the implicit argument concerning any real security being accorded under a sovereign guarantee is inadequate due to the non-payment and default on payments by the off-taking bodies, and the state's failure to indemnify private parties subsequently.

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[269] See R Doak Bishop, James Crawford and W Michael Reisman, *Foreign Investment Disputes: Cases, Materials and Commentary* (Second Edition, Kluwer Law International, 2014).

[270] See Kiran Stacey, 'Debt Burden slows India's rollout of reliable electricity supply' *Financial Times* (New Delhi, 20 February 2017); also see Victor Mallet and James Crabtree, 'India restructures $35bn of power debt' *Financial Times* (New Delhi, 24 September 2012).

[271] David Kennedy, 'Power sector regulatory reform in transition economies: program and lessons learned' (Feb 2003) EBRD Working Paper No 78 <http://www.ebrd.com/downloads/research/economics/workingpapers/wp0078.pdf> Accessed 23 May 2016.

[272] It is interesting to note that there were two guarantees issued to the Dabhol Power Project. One was issued as a 'letter of comfort' by the Ministry of Power, India. Another guarantee agreement titled 'state support agreement' was signed between the State of Maharastra and the Dabhol Power Project.

The second issue is more complex. From Pakistan's standpoint, there have been numerous efforts by multilateral agencies to secure divestment of the state from the affairs of the SOEs. The more prominent example of this deregulation strategy was the 'Energy Sector Restructuring Program' (hereinafter referred to as the "ESRP"), using financial support from the IMF, the World Bank and the Asian Development Bank.[273] Almost two decades later, there has not been a complete overhaul in Pakistan's energy sector. In the event that the off-taking body breaches their PPA provisions, and fails to make timely payments, it is argued that the burden shifts to the state. The primary contention adopted for the purposes of this project is whether the off-taking body is an organ of the state, and as a result, forms an integral part of the state's organic structure. Consequently, in view of the principles of guarantee law, the state is guaranteeing its own performance.

The primary rationale to undertake this study was prompted by the inadequate nature of these sovereign guarantees. This has primarily been due to the endemic circular debt crisis and limited fiscal space for state to finance, and meet the financial cost of issuing such guarantees. Inter alia, sovereign guarantee structures also reflect upon the lack of understanding insofar as to what is being offered by the state. In broad terms, the sovereign guarantee is a promise associated to the off-taking bodies' performance in meeting their contractual commitment towards the project company. Therefore, a sovereign guarantee acts

[273] Asian Development Bank, *Pakistan: Energy Sector Restructuring Program* (Performance Evaluation Report, Feb 2014) <www.adb.org/documents/pakistan-energy-sector-restructuring-program-0> Accessed 14 January 2017.

as a deterrent, or an instrument of deterrence, that facilitates unqualified access to foreign capital for infrastructure development.[274]

The concept of a sovereign guarantee derives its existence from the very idea of security, and is predicated upon the principles of collateral obligation. The sovereign authority, through its delegated power to a SOE, guarantees the performance of the off taking body in a bid to provide robust protection. This study primarily focuses on Pakistan as a case study, and as a result reviews existential issues facing the investment regime therein. This sovereign guarantee model is prima facie followed globally, especially in developing, emerging economies. As a result, the failure of robust protection offered under sovereign guarantee indicates a proposition that in the absence of a well-defined regulatory framework, their purpose is fallacious. This submission is predicated on the following three strands: first, a guarantee instrument involves a guarantor promising the creditor to be responsible for due performance or discharge of contractual promise by the principal of their existing or future obligations. This obligation is predicated on the failure of the principal to perform any part of these obligations.[275] Whereas it seems implausible to displace the long standing principle regarding companies' separate legal status, this section argues that these SOEs are organs of the state and, as a result, the ultimate responsibility to

[274] See Jonathan Eaton, 'Public debt guarantees and private capital flight' (May 1987) The World Bank Economic Review, Vol 1, No 3, pp 377-395, wherein Eaton argues that deterring a default by the central government will have a much stronger incentive to maintain access to foreign capital markets for other potential borrowers within the host country. Moreover, he also contends that 'an inability to enforce contracts between private agents without public intervention can generate capital flight'.

[275] See *Vossloh AG v Alpha Trains (UK) Ltd* (2010) EWHC 2442 (Ch), as per Sir William Blackburne; also see *IIG Capital LLC v Van Der Merwe* (2008) EWCA Civ 542; *Associated British Ports v Ferryways NV & Anor* (2009) EWCA Civ 189; also see Gautam Bhattacharyya, Victoria Reynolds and Antony White, 'Differentiating and Identifying Primary and Secondary Liability Instruments in the Law of Guarantees' (2005) Journal of International Banking Law and Regulation 488.

honour the sovereign guarantee lies with the state in any case.[276] The second strand relates to what is being offered under a sovereign guarantee, and what is really being accorded under a sovereign guarantee instrument. This section discusses the 'expectation gap' within the provision of these instruments. The third strand discussed in this chapter is predicated on economic principles that underlie the basic mechanism involved in legislative restrictions, and their ability to fetter any sovereign undertaking. It reviews the enforceability of such undertakings in light of legislative restrictions, and aims to discuss whether such restrictions affect the sovereign guarantee undertaking.

4.3.1 Sometimes A Cigar Is Just A Cigar[277]

There is no unequivocal evidence to suggest that the provision of sovereign guarantee facilitates investment and increases investor confidence. However, interviews conducted for the purpose of this study suggest that sovereign guarantees facilitate and help in the uplift of creating the impression that the host state is favourable towards investors.[278] This section reviews the structural inadequacies of sovereign guarantee framework by employing Article 4 and Article 5 of the Draft Articles. The underlying purpose of this section is to determine whether the entities involved within the sovereign guarantee framework are independent of the state. This exercise is imperative, in

[276] James Crawford, 'Investment Arbitration and the ILC Articles on State Responsibility' (Spring 2010) ICSID Review, Foreign Investment Law Journal Vol 25 Number 1. Crawford argues that 'the state is regarded as a single person in international law and is responsible for the conduct of all its organs, whatever their status… for the purposes of attribution, it is irrelevant whether the constitutional structure of the state gives the federal government power to compel the component unit to abide by the state's international legal obligations. These units are nonetheless organs of the state and their conduct is attributable to the state'.

[277] Quote taken from Sigmund Freud's expression.

[278] Interviews involved engaging with members of PPIB, NTDC and attendees of workshop hosted in London.

establishing whether, from a guarantee law perspective, there are three parties involved in the sovereign guarantee framework.[279]

In the absence of an international framework designed specifically to determine whether an entity is an organ of the state—the purposes of sovereign guarantee adequacy determination—the Draft Articles will act as a guide to perform the same. A typical sovereign guarantee structure involves a government agency acting on behalf of the state, guaranteeing the project company against any breach perpetrated on behalf of the off-taker under the PPA. Prima facie, this contention is not as straightforward as it may seem. Since the inception of SOEs, states in a bid for excessive economic power have refashioned themselves.[280] The state is no longer content to wield traditional forms of public power. As a result, some of the strategic functions of the state are now carried out by SOEs.[281] However, in the absence of well-defined regulatory frameworks, there is ambiguity surrounding the independence of the entities that facilitate a sovereign guarantee structure. Unlike privatised entities, SOEs do not operate in a regulatory or institutional vacuum. Their existence per se, along with their operational abilities, is in close nexus with the state. As a result, the performance of these SOEs in execution of sovereign guarantees, and contracting abilities insofar as PPAs and IAs, is the state discharging its contractual liability under the guarantee contract. Without a clear legal framework, and without the state

[279] This submission has been extensively discussed in Chapter Three. See Lord Selbourne's dicta in *Thomas Lakeman v J P Mountstephen* (1874-75) L R 7 H L 17 wherein he argues that 'there can be no suretyship unless there be a principal debtor… nor can a man guarantee anybody else's debt unless there is a debt of some other person to be guaranteed'.

[280] Larry C Backer, 'Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State-owned enterprises, and the Chinese Experience' (2010-2011) 19 Transnt'l L & Contemp Probs 3.

[281] Michael Feit, 'Responsibility of the State under International Law for Breach of Contract committed by a State-owned entity' (2010) 28 Berkley J Int'l L 142.

completely divesting itself of the function and structure of these entities, it seems futile to award sovereign guarantees through SOEs.

The structure of this section is divided into two. First, this section endeavors to discuss the nature of the SOEs under Article 4 of the Draft Articles. Several arbitral tribunal awards have been reviewed hereunder, and consequently the possibility of the National Transmission Despatch Company (hereinafter referred to as "NTDC"), the Private Power and Infrastructure Board (hereinafter referred to as "PPIB"), and the Central Power Purchasing Agency Guarantee Ltd (hereinafter referred to as "CPPAG") as part of the state's organic structure are discussed. Thereafter, this chapter progresses to discuss the nature of the act that these entities exercise, and review their nature under Article 5 of the Draft Articles. This discourse will attempt to assist in the determination, and highlight whether for the purposes of a guarantee law context there are in fact two different entities: the principal debtor and a guarantor.

4.3.1.a Separation of the State from SOE: Myth and Delusions revisited under Article 4

Article 4 of the ILC's Draft Articles on State Responsibility states:

> The conduct of any state organ shall be considered an act of that State under International law, whether the organ exercises legislative, executive, judicial or any other functions, whatever position it holds in the organisation of the state, and whatever

> its character as an organ of the central Government or of a territorial unit of the state.

The state is viewed as a group comprising individual units. Unless these entities can be recognised as duty bearing units, acting on their prerogative, possessing rights-obligations, it is hard to see how these units can be considered as separate legal entities. Draft Articles commentary expresses this notion in the following manner '…the reference to "state organs" covers all the individual or collective entities which make up the organisation of the state and act on its behalf'.[282] As early as 1897, the courts concluded that the company at law is a different person altogether from the subscribers to the memorandum.[283] Lord McNaughten in *Saloman* submitted that:

> [T]he company is at law a different person altogether from the subscribers to the memorandum; and though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them.[284]

It is submitted that displacing the long-standing principle of separate legal personality is neither desirable nor the primary contention of this study. The separate legal personality is considered an important cog in the present financial

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[282] International Law Commission, 'Articles on Responsibility of States for Internationally Wrongful Acts, General Commentary' [2001] 2(2) Y B Int'l L Comm'n 30, 31-32 <http://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf> Accessed 05 May 2017.
[283] *Saloman v Saloman & Co Ltd* (1897) A C 22.
[284] *Saloman v Saloman & Co Ltd* (1897) A C 22.

world. From doctrinal company law perspective, little has changed.[285] A company remains a separate legal personality to its subscribers, deeply insulated from them. However, it is subject to some exceptions.[286] The underlying argument deals with the notion of sovereign guarantees. The narrative discussed in this study would be different if the term sovereign guarantee was rephrased as sovereign indemnity.

As part of the support provided by the IMF, the World Bank and the Asian Development Bank under ESRP, Pakistan's Water and Power Development Authority (hereinafter referred to as "WAPDA") was restructured in order to enhance governance and strengthen regulatory frameworks.[287] NTDC and subsequently CPPAG were formed as companies registered under Pakistan's Companies Ordinance 1984, to provide a restructured model for foreign investors. PPIB's role was previously being carried out by the Ministry of Planning and Ministry of Finance. Through funding from the World Bank, in

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[285] See Eilis Ferran and Look Chan Ho, *Principles of Corporate Finance Law (*Second Edition, OUP, 2014); also see a contrasting view in *Prest v Petrodel Resources Ltd* (2013) UKSC 34. Brief facts of the case are as follows: concerns a divorce case wherein the wife claimed that the husband was using several off-shore companies to hold various properties as the beneficial owner. She therefore sought relief under the relevant provisions of the Matrimonial Act. The court of first instance found in favour of the wife. The CA allowed an appeal by the companies. On wife's appeal, after an extensive review of the area surrounding corporate legal personality and lifting of the corporate veil, the Supreme Court found in favour of the wife.

[286] See Eilis Ferran, 'Company law reform in the United Kingdom' (2001) 5 Singapore Journal of International and Comparative Law 516. Ferran argues that 'there is an administrative process involving form-filing and the disclosure of information but the requirements are not burdensome. Making the corporate form so readily available is a deliberate policy choice, which is intended to encourage entrepreneurship and enterprise; also see *Barclay Pharmaceuticals Ltd v Waypharm LP* (2012) EWHC 306 (Comm). In *Prest v Petrodel Resources Ltd* (2013) UKSC 34, Lord Sumption went to the extent to submit that the use of the corporate form for the purposes of concealment is required.

[287] Asian Development Bank, *Pakistan: Energy Sector Restructuring Program* (Performance Evaluation Report, Feb 2014) <www.adb.org/documents/pakistan-energy-sector-restructuring-program-0> Accessed 14 April 2017.

1994 Pakistan decided to create a 'one window facilitator'. It was not until 2012 that PPIB was instituted as a statutory body.[288]

Section 3(2) of the *PPIB Act* outlines that '… (PPIB) shall be independent in the performance of its functions and shall be body corporate having perpetual succession and a common seal, with power, subject to the provisions of this Act'. Under its current regulatory framework, it is hard to imagine how PPIB can operate under the auspices of a corporate body and still exercise *puissance publique*. However, all three bodies under their ostensible structures are body corporates. The Commentary on the Draft Articles submits that the status and function of various entities cannot alone be determined by law, but also need to be reviewed by practice.[289] As a result, this section reviews the position of NTDC, CPPAG and PPIB in light of Article 4 Draft Article, and reviews relevant case law to discuss the attribution of responsibility to discharge SOE's debt.

An SOE is a double-edged sword. Their role within current international capital market creates confusion insofar as their structure. States, on the basis of the nature of a particular dispute, determine the character or persona that they wish to associate with a SOE, or an organ of the state. In the seminal case of *Trendtex Trading Corporation*, the Central Bank of Nigeria claimed immunity against a claim for repudiation of contract, and damages pursuant to such breach. The Central Bank claimed that they are an emanation of the state and therefore immune from proceedings. Upon the Plaintiff's appeal, it was held that the

[288] Private Power Infrastructure Board <http://www.ppib.gov.pk/N_legislation.htm> Accessed 23 March 2017.

[289] International Law Commission, 'Articles on Responsibility of States for Internationally Wrongful Acts, General Commentary' [2001] 2(2) Y B Int'l L Comm'n 30, 31-32 <http://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf> Accessed 02 April 2017.

bank—which had been created as a separate legal entity with no clear expression of intent that it should have governmental status—was not an emanation, arm, alter ego or department of state of Nigeria, and was therefore not entitled to immunity.[290] The court in this case was primarily driven by the rationale upheld in the case of *Rahimtoola*, wherein Lord Denning submitted that:

> [I]f the dispute brings into question, for instance, the legislative or international transactions of a foreign government, or the policy of its executive, the court should grant immunity if asked to do so, because it does offend the dignity of a foreign sovereign to have the merits of such dispute canvassed in the domestic courts of another country.[291]

This principle has been upheld by courts today insofar as sovereign immunity for entities claiming to be an emanation of the state. An important observation made by the court in *Trendtex* was regarding the relationship that exists between a SOE and the state. The court pointed out that the proper test of a body is what it does, and what its relationship is with the Crown or the state.[292] While this position resonates with the discussion of a SOE's separate legal personality in view of a claim under sovereign immunity, various disputes in international arbitration

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[290] *Trendtex Trading Corporation v Central Bank of Nigeria* [1977] Q B 529.

[291] See *Rahimtoola v Nizam of Hyderabad* [1958] A C 379, 422; this principle was restated in *Thai-Europe Tapioca Service Ltd v Government of Pakistan, Directorate of Agricultural Supplies* [1975] 1 W L R 1485, 1491.

[292] *Trendtex Trading Corporation v Central Bank of Nigeria* [1977] Q B 529. The court further outlined that 'if the instrument which establishes the body says it is to be a government department that is conclusive. If it does not, it does not enable to court to say that is conclusive. One looks at the nature of the body itself'.

have further expanded on the principle normative to the actions perpetrated by states. This study refers to the principle outlined in *Maffezini*.[293]

In *Maffezini*, the primary contention of the claimant was that prima facie, SODIGA is a state entity acting on behalf of the Kingdom of Spain. As a result, all its acts and omissions are attributable to the Kingdom of Spain. The tribunal, whilst following a similar line of reasoning in *Trendtex*, submitted that a structural test alone could not be used to determine responsibility for organs of the state. The tribunal introduced a functional test within the existing equation of determining responsibility of the state. This test has been widely accepted in various arbitrations to determine and associate responsibility of SOEs to the state. As a result, the following discussion adopts both tests in order to discuss whether the aforementioned SOEs are in effect organs of the state.

First, this section reviews the position of the SOEs involved in the sovereign guarantee framework from a structural test standpoint. In *Noble Ventures Inc.*, the claimant argued that with regard to the purported violations, Romania is responsible for the breach since both entities involved were acting as organs of the Romanian state.[294] Prima facie, the claimants argued that the tribunal should consider whether an entity is a state organ, whilst employing the structural and functional test. The claimants cited the appointment procedures of the board and the chairman of the State Ownership Fund (hereinafter referred to as "SOF"), and submitted that 'SOF was no mere commercial enterprise, but a state agency subordinated directly to the Prime Minister'. While the claimant's contention

[293] *Emilio Agustin Maffezini v The Kingdom of Spain*, ICSID Case No ARB/97/7.
[294] See *Noble Ventures Inc v Romania*, ICSID Case No ARB/01/11.

was unsuccessful for the purposes of Article 4, this structural debate plays a pivotal role in determining whether an entity is in fact an organ of the state. Section 3(2) of the *PPIB Act* outlines that PPIB '…shall be independent in the performance of its functions and shall be a body corporate…'. It is questionable whether PPIB is an independent entity. Section 6 and section 7 of the *PPIB Act* outline the composition of the board of directors, and the appointment procedure for Managing Director, respectively.

Section 6. Composition of the PPIB-

(1) The general management and administration of affairs of the PPIB shall vest in the Board, which shall consist of the following, namely:-

a) Minister for Water and Power, Government of Pakistan-Chairman;
b) Secretary, Ministry of Water and Power, Government of Pakistan-Member;
c) Secretary, Ministry of Finance, Government of Pakistan or his nominee not below the rank of Additional Secretary or equivalent-Member;
d) Secretary; Ministry of Petroleum and Natural Resources, Government of Pakistan or his nominee not below the rank of Additional Secretary or equivalent-Member;
e) Secretary, Planning Commission, Government of Pakistan or his nominee not below the rank of Additional Secretary or equivalent-Member;
f) Chairman, Federal Board of Revenue-Member;
g) Chairman WAPDA-Member;
h) Managing Director, PPIB-Member;
i) Chief Secretaries of Provinces and AJ and K or their nominees not below the rank of Additional Secretary or equivalent-Member;

j) One representative each from Gilgit-Baltistan (GB) and FATA to be nominated by Chief Minister, GB and Governor Khyber Pakthunkhawa respectively; and

k) One representative from private sector from each Province to be nominated by the respective Provincial Government"[295]

Section 7. Managing Director and other members-

(1) There shall be a Managing Director of PPIB who shall be appointed by the Federal Government"[296]

The composition of the board consists primarily of members from the federal government (with an exception of one member from the private sector). Moreover, the appointment procedure of the Managing Director rests with the federal government. These are strong indications that PPIB is an organ of the state. This endemic issue is practiced throughout the developing world with some exceptions. These issues exist primarily due to an absence of clear legal frameworks.[297] SOEs can be considered a legal hybrid between state organs and privatised entities. However, despite multitude of recommendations by multilateral institutions to privatise NTDC and CPPAG, privatisation of these entities is often viewed as problematic. As outlined in the World Bank's report, the likelihood of scandal accompanying privatisation may create issues for an elected government in the future. Moreover, the results achieved through

[295] PPIB Act 2012, section 6 < http://www.ppib.gov.pk/ppibact.pdf> Accessed 03 May 2017.
[296] PPIB Act 2012, section 7 << http://www.ppib.gov.pk/ppibact.pdf> Accessed 03 May 2017.
[297] International Energy Agency, *World Energy Investment* (IEA, 2017). The report argues that in 2016, nearly two-thirds of global investment in power generation and networks took place in countries with single-buyer or vertically integrated systems. This share, the report argues, is set to change in the near future, with China, Japan, Mexico and Korea moving towards more open wholesale markets and retail price competition, creating opportunities for new players. Japan introduced full liberalisation of the retail market in 2016. This eliminates boundaries for vertically integrated, regional electricity companies (EPCOs) and opens their markets to new entrants.

effective privatisation are medium to long term, whereas its costs are concentrated and often subjected to critique by vocal, and powerful groups.[298]

Another issue that perpetrates confusion regarding the character of SOEs is predicated upon the power of appointment, dismissal of senior management, and members of the board.[299] Exercise of such power rests with the government. The World Bank's toolkit concludes that these practices promote corruption in these legal hybrid institutions.[300] However, a more endemic issue relates to lack of corporate governance measures that are internally regulated in order to deter any government influence.

NTDC was recently divested of its central power-purchasing arm, and formed into a new entity, CPPAG. This divestment has created further legal issues insofar as the existing regulatory problems for Pakistan. One benefit that can be drawn from the divestment of the CPPA's role from NTDC is that it can be privatised, at a later date as a distribution arm. However, it is to be noted that WAPDA's restructure took place in 1998. Approximately, two decades later, there is yet to be an extensive, formal privatisation plan within Pakistan's energy sector.[301] In an informal interview, the Managing Director of PPIB outlined the goals of this divestment.[302] His primary contention was that the divestment of NTDC's CPPA role 'outlines the government's further commitment to ensure

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[298] World Bank Group, *Corporate Governance of State-owned Enterprises: A toolkit* (Washington, International Bank for Reconstruction and Development/World Bank, 2014).
[299] In the case of PPIB, such powers rest with the Federal Government under section 7(5) of the PPIB Act wherein the Act states 'The Managing Director shall, unless he resigns or is removed from office earlier by the Federal Government…'.
[300] World Bank Group, *Corporate Governance of State-owned Enterprises: A toolkit* (Washington, International Bank for Reconstruction and Development/World Bank, 2014).
[301] With the exception of Karachi Electric Supply Company (KESC).
[302] An informal discussion with the Managing Director of PPIB at a workshop organised by the author.

independence of the off-taking body'. It is unusual for senior members of the bureaucracy to admit influence exercised by government functionaries on various SOEs. However, two recent events involving NTDC and NEPRA, Pakistan's energy regulator, contradict the notion of 'independence' of these SOEs.

The World Bank's toolkit recognises the endemic issues concerning the absence of ill-defined legal frameworks, and argues that 'the state often assumes the functions that should in essence be carried out by the board'.[303] The inconsistency that is existential within the preamble of these SOEs outlining their 'independence' has allowed scope for political interference in their management. As a consequence, NTDC's top management was suspended and later dismissed through direct orders from the Prime Minister.[304] Reports published around this time make no reference to any summary/recommendation being sent to NTDC's board to initiate any disciplinary procedure. Conversely, this practice also proposes that SOEs boards are a mere 'rubber stamp' for government decision making.[305] Similarly, Pakistan's energy regulator NEPRA was recently restructured to be directly under the administrative control of the Ministry of

[303] World Bank Group, *Corporate Governance of State-owned Enterprises: A toolkit* (Washington, International Bank for Reconstruction and Development/World Bank, 2014).
[304] See Sohail Iqbal Bhatti, 'Top NTDC, NPCC officials suspended over power breakdown' *The Dawn* (Islamabad, 30 January 2016) < http://www.dawn.com/news/1160445> Accessed 05 February 2016; Iftikhar Alam, 'Power Ministry all set to remove NTDC chief' *The Nation* (Islamabad, 23 January 2016) < http://nation.com.pk/national/23-Jan-2016/power-ministry-all-set-to-remove-ntdc-chief> Accessed 05 February 2016.
[305] See World Bank Group, *Corporate Governance of State-owned Enterprises: A toolkit* (Washington, International Bank for Reconstruction and Development/World Bank, 2014). The report outlines that board members are often government employees without experience in managing companies and are appointed for political reasons rather than on the basis of technical and financial expertise.

Water and Power. ADB's report observes that 'although NEPRA is autonomous to set electricity tariffs, its rulings are often overridden by government'.[306]

In view of this submission, it seems anomalous to mention 'independence' and the 'overriding' power of the government in one sentence. An institution may be independent to determine tariff rates; however, a regulator's role is rendered redundant where such authorities do not have the power to enforce such tariffs. These examples illustrate further the conundrum that exists within Pakistan's energy sector, insofar as the independence of the concerned SOEs.

The fabric of this entire argument rests on the presumption and indicates that the entities involved in performing, and satisfying the sovereign guarantee structure ought to be viewed as organs of the state under Article 4. However, this is not a straightforward presumption to adopt. In *Jan de Nul N V* the claimant was a leading dredging company that was awarded the tender for dredging the Suez Canal. However, the claimants demanded further compensation as a result of an increase in costs associated directly with the nature of drilling. This request was refused and a dispute arose. The claimant decided to file an action in court claiming that the actions of the Suez Canal Authority (SCA) are attributable to Egypt. The tribunal after reviewing submissions made by the parties submitted that:

> …[I]t (SCA) is a public entity, created to take over the management and utilisation of nationalised activity. There is no

[306] Asian Development Bank, *Pakistan: Energy Sector Restructuring Program* (Performance Evaluation Report, Feb 2014) <www.adb.org/documents/pakistan-energy-sector-restructuring-program-0> Accessed 15 January 2017.

> doubt that from a functional point of view, that the SCA can be said to generally carry out public activities, as acknowledged by the Respondent. However, structurally it is clear that the SCA is not part of the Egyptian state.[307]

It is clear after reviewing *Noble Ventures Inc* and *Jan de Nul N V* that there is no yardstick to measure whether an entity will or will not be part of the state's organic structure. It is not a straightforward determination. As a result, the structural test can be difficult to establish for the purposes of Article 4.

In another case, *Deutsche Bank AG*[308], the claimant's primary contention was concerning an oil hedging agreement between Deutsche Bank and Ceylon Petroleum Corporation (hereinafter referred to as "CPC"). The claimant was arguing that the actions of the CPC should be attributable to Sri Lanka. The claimant made three important submissions that are relevant for the purpose of this study. First, in order for an entity to be considered as an organ of the state, it must act in "complete dependence". Second, the state ought to exercise control over the day-to-day affairs of the entity to an extent that the entity lacks any real autonomy. Third, an entity's fabric gives the impression that the conjecture of separate legal personality is to give it an aura of independence.

The first two submissions are predicated on the rationale outlined in *Bosnia and Herzegovina v Serbia and Montenegro.*[309] For the purposes of Article 4, it can be

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[307] *Jan de Nul N V Dredging International N V v Arab Republic of Egypt,* ICSID Case No. ARB/04/13

[308] *Deutsche Bank AG v Democratic Socialist Republic of Sri Lanka, ICSID* Case No ARB/09/02

[309] Application of the Convention on the Prevention and Punishment of the Crime of Genocide (Bosnia and Herzegovina v Serbia and Montenegro) Judgement ICJ Reports 2007, p 43.

argued that an entity will be considered an organ of the state, if the state exercises control over the affairs of the entity. Even though control has not been defined in the Draft Articles per se, upon construction from the submissions made in case law it is argued that control would mean that the 'entity lacks any real autonomy'. As outlined in the above submissions concerning the appointment procedures it can be submitted that these SOEs in Pakistan's context lack any real autonomy. In *Deutsche Bank AG*, the tribunal looked at the state's control over CPC. There was discussion on the CPC's 100% ownership stake by the state, and reference was also made to the Minister of Petroleum reserving the right to appoint directors in the CPC. It can be construed from the tribunal's analysis that an entity ought to be genuinely independent, and its form as a separate legal entity cannot be conclusive alone. This is an interesting remark.

The third strand outlined in the claimant's submission, and to which the tribunal made reference, was upon reliance on a Sri Lankan case, *Dahanayaka v De Silva and others*.[310] In *Dahanayaka* the domestic court held that:

> [A] legal hybrid bred by the Government to engage in commercial business tailor made to suit its style of business. It is a Government creation clothed with juristic personality so as to give it an aura of independence, but in reality it is just a business house doing only the State's business for and on behalf of the State.

[310] *Dahanayaka v De Silva and others* [1978] 1 SLR 41, 10 September 1979, paras 53-54

While it is difficult to displace the separate legal personality presumption, as discussed in the previous section, it is argued that the reality of these SOEs is to facilitate the state's business under the fabric of a separate legal personality. In light of the dismissal of the NTDC's top management and sections outlined from PPIB's *Act*, it is argued that there is a strong presumption that these bodies under Pakistan's existing regulatory framework are in fact organs of the state.

If both the *Jan de Nul N V* and *Deutsche Bank AG* cases are compared, one conclusion that can be drawn is the subjective nature of these cases.[311] While the standard of proof is high in order to attribute responsibility, it can be argued that where the evidence supports the contention that an entity is highly dependent upon the state, it is likely that the entity will be considered an organ[312] of the state. More recently in *Flamingo Duty Free Shop*[313], the Flamingo Group acquired a struggling Polish duty-free operator, BH Travel, along with BH Travel's fixed-term leases with PPL at Warsaw's Chopin Airport in 2010. Within two years, Flamingo Group transformed BH Travel's business into a successful, profitable establishment at Chopin Airport. In early 2012, PPL, Poland's state-owned airport authority took a series of steps to evict BH Travel from Chopin Airport without compensation. The tribunal in this case was faced with a question of determining whether the actions of PPL can be attributed to Poland.

[311] The Commentary on Draft Articles describes the element of attribution as 'subjective'. However, as outlined by Bishop, Crawford and Reisman, the Articles avoid using such terminology. See R Doak Bishop, James Crawford and W Michael Reisman, *Foreign Investment Disputes: Cases, Materials and Commentary* (Second Edition, Kluwer Law International, 2014)

[312] It is important to note that the term organ is to have a very broad meaning and is not limited to the organs of the central government but extends to organs of government of whatever kind of classification, exercising whatever functions, and at whatever level. International Law Commission, 'Articles on Responsibility of States for Internationally Wrongful Acts, General Commentary' [2001] 2(2) Y B Int'l L Comm'n 30, 31-32 <http://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf>. Accessed 06 June 2017.

[313] White & Case, 'White & Case Wins Award for Indian Investor Against Poland', White & Case <https://www.whitecase.com/news/white-case-wins-award-indian-investor-against-poland>

The claimant's primary contention was predicated on the notion that the airport, even though managed by the Director General, comes under direct control of the minister responsible for transport and infrastructure—who, in essence, appoints and dismisses the Director General. The respondent's contention was to dismiss these allegations, arguing that the PPL was 'an independent and commercially run entity and that approvals by the Ministry of certain PPL actions were mere formalistic rubber-stamping'.[314] This contention revolves around the submissions made in the case of *Bayindir Insaat Turzim Ticaret*, wherein the tribunal stated that 'state entities and agencies do not operate in an institutional vacuum. They normally have links with other authorities as well as with the government'.[315] This argument also relates to the submission made earlier, concerning various tranches of sovereignty, wherein one of the tranches relate to the relationship that exists between the host state government and its subject, implicitly referring to state organs.

The claimant's in *Flamingo* were arguing that PPL was an organ of the state. They relied upon the regulatory structure of PPL as a de facto organ of the state, with powers to appoint and dismiss the management of PPL resting with the relevant Ministry. Moreover, the claimant also argued that the Ministry conferred the powers exercised by PPL. These, the claimants argued, were subject to supervision and change as per state policy. As a result, the tribunal was of the considered view that these notions of quasi independence did not tip the scales and therefore the respondent is in fact an organ of Poland. Similarly, as discussed

[314] *Flamingo Duty Free Shop Private Limited v The Republic of Poland*, UNCITRAL, 12 August 2016; also see <http://0-www.iareporter.com.pugwash.lib.warwick.ac.uk/articles/in-new-bit-award-arbitrators-deem-state-owned-company-to-be-a-state-organ-and-see-fet-and-expropriation-violations-due-to-contract-termination/> Accessed 25 September 2016.
[315] *Bayindir Insaat Turzim Ticaret Ve Sanayi A S v Islamic Republic of Pakistan*, ARB/03/29.

earlier, in the *Deutsche Bank AG* case the tribunal found that a state-owned petroleum company was a de facto State organ, having noted, in particular, that the relevant minister exercised significant control over the company's personnel, finances and decision-making.

It is argued that in the absence of a formal legal framework, PPIB, NTDC and CPPAG are operating under the auspices of the state, and more importantly, PPIB is "within the structure"[316] of the state for the purposes of a structural test. Conversely, the corporate fabric of NTDC and CPPAG can be subjected to debate insofar as their structure as organs of the state, their board's composition and the powers of appointment and dismissal resting with the Ministry of Water and Power renders their exclusion from the state's structure very unlikely for the purposes of a structural test. The state is an organisation comprising individual units acting in consonance with each other. As illustrated in Figure 4.1, it is argued that SOEs should not be viewed as mutually exclusive entities. SOEs are a sub-set of the state. In fact, SOEs are an extension of the state and its interests. Their primary objective is to perform and facilitate the state's policy objectives. In order to satisfy the test of independence for these SOEs, Michoud, in his seminal work, outlined that 'for legal science, the notion of person is and should remain purely juridical notion. The word signifies simply a subject of rights-duties, [sujet de droit] a being capable of having the subjective rights properly belonging to him'.[317] In the absence of clearly defined concession agreements, the contention that a body is a 'being capable of having subjective rights properly

[316] *Ioannis Kardassopoulos v Georgia*, Award dated 3 March 2010, ICSID Case Nos ARB/05.18 and ARB/07/15.
[317] Michoud, *La Notion de Personnalite Morale*, (1899) 11 Revue Du Droit Public, 1, at 8 quoted by John Dewey, 'The historic background of corporate legal personality' (1925-1926) 35 Yale L J 655.

belonging to him' is problematic. Therefore, the state ought to be viewed as an aggregation of head and body with neither a head by itself or a body by itself.'[318]

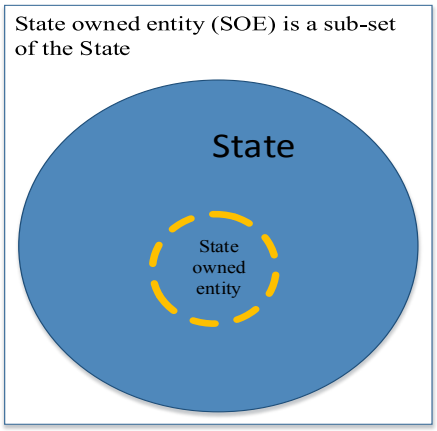

Figure 4.1: Illustration of SOE and State

In light of the aforementioned discussion, it is argued that there is strong evidence to suggest that PPIB, NTDC and CPPAG are organs of the state for the purposes of a structural test for Article 4 determination.

The second contention relates to the functional test outlined in *Maffezini*. Unlike the determination of structural test, a functional test is not as straightforward. This section is a continuation of the discussion concerning attribution under Article 4. This section will address the same issues as outlined in the previous paragraphs, however, with a view to discuss the functional element normative to PPIB, NTDC and CPPAG.

As discussed earlier, sovereign guarantees are used as a tool to promote investment in otherwise challenging, volatile jurisdictions. The primary function

[318] Inspiration of the phrase taken from Frederick W Maitland's submission in David Runciman and Magnus Ryan, *Fredrick W Maitland's State, Trust and Corporation* (Cambridge University Press, 2003) 89.

of a sovereign guarantee is twofold: it aims to create a sense of security on behalf of the state to the sponsor (and implicitly the lenders), and it facilitates borrowing on more favorable terms with lower premiums. As a result, sovereign guarantees can cause a multiplier effect, wherein they provide conditions that lead to more investors and investment opportunities. Amidst these fancy words, a sovereign guarantee is essentially a contractual promise. The primary purpose of a contractual promise is to fulfil the subject matter of the contract, and seek recourse to the courts in case there is a breach on that contractual promise. A party cannot contract with another party knowing that they are unable to perform the contract. Similarly, a sovereign guarantee will no longer be a sovereign undertaking if such assurances are issued by private entities. In effect, an investor expects that the parties that are participating in the guarantee structure are contracting as organs of the state, and not as corporatised bodies.[319] This brings us to the second strand of the test laid out in *Maffezini*. The debate within arbitral awards reviewed for the purposes of this study are encircled around three primary issues. First, whether an act in question is a commercial or a governmental act, and whether for the purposes of determination of an entity's status, are they are performing a sovereign power? Second, whether this exercise of power bears strategic significance? And third, whether for the purposes of issuing a sovereign guarantee, the entity is financially reliant upon the state?

[319] This principle is also based on the academic literature in international law highlighting that the state is, generally speaking, responsible for acts of its organs and officials, not private parties. As a result, in order determine any legitimacy driven towards the sovereign guarantee structure it is outlined that the state needs to be viewed to cover all the individual or collective entities, which make up the organisation of the state and act on its behalf. See R Doak Bishop, James Crawford and W Michael Reisman, *Foreign Investment Disputes: Cases, Materials and Commentary* (Second Edition, Kluwer Law International, 2014).

These issues are interconnected insofar as the determination of whether an entity is an organ of the state under the functional test. There is some ambiguity surrounding arbitral awards insofar as whether an act is governmental or commercial in nature. In *Maffezini*, the tribunal's analysis provides two categories of acts for the purposes of application of Article 4. The tribunal was of the opinion that whereas commercial acts cannot be attributed to the Spanish state, governmental acts should be attributed. The tribunal, whilst reviewing the existing structure within this transaction between SODIGA and the claimant, argued that there has been a transition in the nature of entity in question. As a result of this transformation, 'while originally a number of SODIGA's functions were closer to being governmental in nature, they must today be considered commercial in nature. But at the time of transition, there was in fact a combination of both, some to be regarded as functions essentially governmental in nature and other essentially commercial in character'.[320]

One can infer from the tribunal's argument that if a perpetrated act is of a commercial character, then it is very unlikely that an act can be attributed to the state. In addition to the respondent's argument in *Noble Ventures Inc v Romania*[321] concerning the acts of the SOF not being attributable to Romania on the grounds that the SOF was a separate entity, and therefore not an organ of the state, the respondents also submitted that SOF's actions were commercial in nature. The tribunal referred to *Maffezini*, wherein it was submitted that a commercial and governmental activity need to be distinguished, the former not being attributable to the state. Whereas the tribunal concluded that for the

[320] See *Emilio Agustin Maffezini v The Kingdom of Spain*, ICSID Case No ARB/97/7
[321] ICSID Case No ARB/01/11.

purposes of Article 4, the SOF was a legal entity distinct from the Respondent, the tribunal found in favour of the claimants under Article 5. Article 5 is discussed in the next section.

A conclusive argument drawn from the rationale adopted by the tribunal in this case is that generally the use of commercial and governmental activity is commonly referred to in cases of sovereign immunity. In the proceedings concerning attribution of responsibility and determination of an entity's status, it is argued that 'it is difficult to see why commercial acts, *acta jure gestionis*, should by definition not be attributable while government acts, *acta jure imperii*, should be attributable'. Consequently, it can be argued that the defining line between the two notions, *acta jure imperii* and *acta jure gestionis* has diminished due to the transition of former state organs into parastatal entities or corporatised bodies.[322]

In view of the exercise of powers by PPIB, it is submitted that it issues a sovereign guarantee to the project company and thus exercises sovereign power. Whereas the *PPIB Act 2012* states that PPIB is an independent body, it is argued that the measure of exercising and contractually binding the sovereign, until the PPA extinguishes, is problematic insofar as the categorisation of the power that is conferred. Findings from the workshop and interviews with sponsors provide an insightful conclusion. A general expectation by the investors and sponsors inter alia is that a sovereign guarantee entails the pinnacle of secure measures. This level of security cannot be provided by any entity other than the state itself.

[322] See *Jan de Nul N V Dredging International N V v Arab Republic of Egypt*, ICSID Case No ARB/04/13.

Any body providing such assurance is in fact conducting its affairs as a representative of the state, exercising government powers. A disposition outlining otherwise would be a travesty insofar as the underlying rationale of a sovereign guarantee.

Providing a security measure under the auspices of sovereign guarantee is an exercise of sovereign power. 'Sovereign power' is, however, an elusive term. The exercise of sovereign power can span from protection of rights of the state's subjects to providing basic facilities. However, it is questionable whether an off-taking activity, in this instance electricity, will constitute exercise of sovereign power. This study has intentionally used the notion of what the nature of the act is, and whether it will amount to sovereign power in one section. Primarily, the two are inter-connected inter alia given the composition of the body that is exercising these powers. In *Bayindir Insaat*[323], the claimant argued that Pakistan exercised its sovereign power to undertake the breach exercised through the National Highway Authority (hereinafter referred to as "NHA"). The claimant's primary contention was that the NHA is an organ of the state. The tribunal discarded the idea that the NHA was an organ of the state in light of the evidence presented. One way of looking at the tribunal's analysis is that the act of breach was viewed in isolation from the exercise of a sovereign authority, and as a result the tribunal was not satisfied that the breach itself was the NHA exercising their sovereign power. The tribunal held that the breach in question was a contractual right being exercised, and therefore not within the purview of sovereign power. In reference to PPIB issuing a sovereign guarantee, can one apply the same

[323] *Bayindir Insaat Turzim Ve Sanayi A S v Islamic Republic of Pakistan*, ARB/03/29 August 2009.

analogy? A sovereign guarantee is therefore a mere contract. It is interesting to note that the same would be true for an off-taking body that purports to purchase electricity from the IPPs. There is some ambiguity insofar as the off-taking body purchasing electricity from the IPPs; one can argue that the act needs to be determined in isolation from the general powers that are exercised by the state over the entity. In more general terms, the act of purchasing electricity is a contractual right that is being exercised by CPPAG under the PPA.

The second strand addresses the 'strategic significance' notion in order to determine the functions of the SOE. Strategic significance can be determined by reviewing two sub categories; whether the act itself was of strategic significance, and whether that act served a strategic purpose. These questions evaluate whether an act exercised by the entity bears strategic significance through the operations that it carries out. Cases such as *Trendtex Trading*[324], *Jan de Nul N V Dredging*[325], and even *Bayindir Insaat*[326] illustrate that the act itself, and the purpose for which they are being rendered, need to be evaluated in order to determine whether the function being performed forms part of the organic structure of the state.

In *AMTO*, the claimants contended that Energoatom was a strategically significant state entity through its participation in the highly centralised and totally state controlled wholesale energy market. After due consideration by the tribunal, Energoatom was held as a separate entity despite the centralised

[324] [1977] Q B 529.
[325] *Jan de Nul N V Dredging International N V v Arab Republic of Egypt*, ICSID Case No ARB/04/13.
[326] *Bayindir Insaat Turzim Ve Sanayi A S v Islamic Republic of Pakistan*, ARB/03/29 August 2009.

structure of the market. The tribunal's rationale in reaching this decision was predicated upon the consideration that despite the claimant's submission that Energoatom was an organ of the state due to the significance of the functions being carried out. The tribunal found that 'the conduct of Energoatom is attributable to Ukraine, in accordance with established principles of international law, when it is shown that Energoatom was exercising puissance publique or acted on the instructions of, or under the direction or control of the state in carrying out the conduct'.[327] In light of PPIB's mandate to grant sovereign guarantees, it can be argued that the act constitutes puissance publique due to the social impact that a sovereign guarantee bears in order to attract investment. The role of CPPAG and NTDC are debatable insofar as their function being considered as *puissance publique*. On the analysis undertaken above—the level of control being exercised along with the functions being carried out—there is a strong likelihood that PPIB will be considered an organ of the state.

As a result of discussions held with various government officials in view of the level of control exercised by the state, and as outlined in PPIB's yearly report[328], it is questionable whether PPIB is a separate legal personality operating at an arm's length from the state. Moreover, the role of NTDC and CPPAG in Pakistan's energy framework cannot completely be ruled out for the purposes of establishing that their characteristics do correlate with the submissions regarding the level of independence exercised in their existing framework. There is lack of evidence to suggest that NTDC and, more recently, CPPAG have been awarded

[327] *Limited Liability Company AMTO v Ukraine*, ARB No 080/2005.
[328]PPIB, *Annual Report 2012-13* (2014) <http://www.ppib.gov.pk/PPIB%20Annual%20Report%202012-13.pdf> Accessed 25 April 2017.

responsibilities, and carry out their functions as a result of well-defined concessions. In the absence of clearly defined framework, the presumption that these SOEs form part of the organic structure of the state cannot be ruled out.

Despite ambiguity surrounding the determination of SOEs' position in Pakistan's energy sector, one prudent conclusion indicates that these entities are not entirely operating at an arm's length from the state. However, such presumption has not been conclusively established, because of the subjective nature of the tribunal's analysis in the cases discussed above. Consequently, their position perhaps needs to be discussed under Article 5.

The third element for the purposes of the functional test relates to the financial independence of the entities involved in the energy framework in Pakistan. Parties' contention in cases such as *AMTO*, *Deutsche Bank*, and *Flamingo* indicate that tribunals review the financial independence of the parties involved within the structure of the state in order to determine their independence. Whilst *AMTO* briefly reviews the financial model existing in Energoatom's structure, in *Flamingo Duty Free* the tribunal draws on the claimant's argument that Energoatom was part of the organic structure of the state since 'the regulatory framework delegates to the Ministry of Transport the duty to audit and assess PPL's operations and establish a structure to exercise control over PPL's finance and staff salaries…'[329] The initial funding stream to establish PPIB was provided by multilateral agencies, in order to further facilitate investment framework in

[329] *Flamingo Duty Free Shop Private Limited v The Republic of Poland,* UNCITRAL 12 August 2016; also see http://0-www.iareporter.com.pugwash.lib.warwick.ac.uk/articles/in-new-bit-award-arbitrators-deem-state-owned-company-to-be-a-state-organ-and-see-fet-and-expropriation-violations-due-to-contract-termination/. Accessed 04 August 2017.

Pakistan's infrastructure development industry. The federal government has since supported PPIB financially over the years. Recently however, PPIB's primary source of revenue has been through the funds received from bank guarantee encashment.[330] Even though there is no conclusive evidence available for perusal, senior members of PPIB submit that they are an independent entity from the state. The introduction of the *PPIB Act* almost a decade after the inception of PPIB further draws attention to the ambiguity that exists in the current regulatory regime.[331]

The financial position of NTDC/CPPAG is more precarious. Their primary source of funding is derived from power sales to the distribution companies. However, after careful review of the energy sector's structure, explained in Figure 1.1 and Figure 1.2, it can be gauged that government subsidies are paid to the CPPAG in order to ensure payment to the IPPs. Moreover, the endemic circular debt crisis has caused severe disruption in revenue generation from the IPPs. The lack of actual collection of revenues, and other issues discussed in the introduction of this study illustrate that there is likely to be a significant proportion of financial assistance being exercised by the state. In the absence of clear frameworks, a conclusive determination cannot be made insofar as whether PPIB, NTDC or CPPAG are financially dependent upon the state. Consequently, it is argued that unless a complete overhaul insofar as their deregulation through corporatisation or privatisation, their status as 'independent' bodies will remain

[330] This statement was outlined by Director Law at the PPIB in an interview during fieldwork undertaken by the author.
[331] Informal discussions with the members of PPIB has led the author to believe that there is still some government funding involved. For example, PPIB uses state recourses such as government car for their officials. This might seem trivial, however demonstrates that perhaps a certain percentage of the funding is still being derived from the state's coffers.

questionable. This fabric of 'quasi-independence' and 'quasi-autonomous' framework further provides evidence that these entities are mere formalistic rubber-stamps, and conversely they will not tip the scales for an independent entity unless they are actually formulated into independent, self-governing and self-financing organisational units.

4.3.1.b Hc Svnt Dracones: Article 5 and Exercise of Government Authority

The Latin aphorism '*hc svnt dracones'* was used in early 15th century to denote unexplored areas on the map. Application of Article 5 of the Draft Articles denotes an uncertain, 'unchartered' territory. As outlined in the previous section, there has been a transition from the orthodox exercise of power of the state. Whereas distinguishing between *acta jure imperi* and *acta jure gentionis* might have been relatively straightforward, the evolution of the state's structure and particularly due to attempts to increase participation in the capital markets, the state is now involved in exercising commercial acts. However, the nature of the entities exercising these functions and the function itself make these transactions problematic. Article 5 of the Draft Articles is as follows:

> Article 5. Conduct of persons or entities exercising elements of governmental authority
>
> 'The conduct of a person or entity which is not an organ of the State under article 4 but which is empowered by the law of that State to exercise elements of the governmental authority shall be considered an act of the State under International law,

provided the person or entity is acting in that capacity in the particular instance'

Draft Article's commentary state that Article 5 is intended to take account of the increasingly common phenomenon of 'parastatal entities, which exercise elements of governmental authority in place of state organs, as well as situations where former state corporations have been privatised but retain certain public or regulatory functions'.[332] In a bid to determine whether an entity can be classified as exercising governmental authority for the purposes of Article 5 it is not decisive whether the entity can be classified as public or private, the existence of state participation in its capital, or more generally, in the ownership of its assets. Article 5, as outlined in the commentary on the Draft Articles refers to 'these entities being empowered, if only to a limited extent or in a specific context, to exercise specified elements of governmental authority'.[333]

In *Eureko B V* the issue related to the sale of 30% in PZU. The respondent contended that the actions undertaken by the Minister of the State Treasury with respect to the Share Purchase Agreement and its first Addendum are not the result of the exercise of governmental executive powers, and thus are not attributable to the Republic of Poland. In essence, the respondents were arguing that the actions of the Minister of State Treasury were commercial in nature. The tribunal found that the State Treasury was acting pursuant to clear authority

[332] See Comment 1, Article 5 of Draft Articles on Responsibility of States for Internationally Wrongful Acts, with commentaries (2001) < http://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf> Accessed 05 April 2017.

[333] See Comment 3, Article 5 of Draft Articles on Responsibility of States for Internationally Wrongful Acts, with commentaries (2001) < http://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf>

conferred on him by decision of the Council of Ministers of the Government of Poland in conformity with the officially approved policy of that Government. The tribunal's analysis was founded upon the submission of James Crawford's commentary on the ILC's Draft Articles wherein he submitted that 'it is irrelevant for the purposes of attribution that the conduct of a state organ be classified as "commercial" or as "acta jure gestionis".'[334]

In *Jan de Nul*[335], the tribunal approached the question of attribution by following a two-stage test. The tribunal outlined that there are two cumulative conditions that need to be fulfilled in order to attribute the responsibility of an entity to the state. First, the act must be performed by an entity empowered to exercise governmental authority. Second, the act must be performed in the exercise of governmental authority. Consequently, the two primary questions before the tribunal in order to determine whether the Suez Canal Authority (hereinafter referred to as 'SCA') will be an organ of Egypt under Article 5 is whether the SCA is empowered to exercise governmental authority function, and whether the SCA exercise governmental authority in its dealings with the claimant? The tribunal in *Jan de Nul*, after thorough review of the powers exercised by the entity, outlined that in answer to the first question, the SCA acted like any contractor trying to achieve the best price for the services it was seeking. It did not act as a state entity. In determination of the second question, the tribunal argued that the bidding process is not sufficient to establish the exercise of

[334] See Draft Articles on Responsibility of States for Internationally Wrongful Acts, with commentaries (2001) < http://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf> Accessed 06 May 2017.

[335] *Jan de Nul N V Dredging International N V v Arab Republic of Egypt*, ICSID Case No ARB/04/13.

governmental authority especially in relation to the acts and omissions complained of by the claimants. What matters is not the "service public" element, but the use of "prerogatives de puissance publique" or governmental authority. As a result, the tribunal concluded that although the SCA is a public entity empowered to exercise elements of governmental authority, the acts of the SCA vis a vis the claimants are not attributable to the respondent, since they are not performed pursuant to exercise of governmental authority.

From Pakistan's standpoint, PPIB—as discussed in the previous section—exercises the state's authority to grant a sovereign undertaking to guarantee the off-taker's performance. In their endeavor to provide such guarantees, PPIB is an entity that is authorised to exercise a governmental function, inter alia, issue a sovereign guarantee. Unlike the case of SCA, PPIB's issuance of a sovereign guarantee does not involve any tender process. The act, whilst being viewed in isolation, can amount to an exercise of governmental authority. It is pertinent to mention the discussion undertaken later in this chapter concerning the 'expectation gap' argument. PPIB's issuance of a sovereign guarantee cannot be viewed as anything but an exercise of sovereign power. The second contention relates to whether PPIB exercises this governmental authority in issuing a sovereign guarantee. The answer is unequivocally positive. PPIB's role as a one-window facilitator is predicated upon the exercise of its governmental power in order to provide recourse for the SPV to state, and an additional security measure for the lenders in the event there is a breach under the PPA. Any other conclusion would be a travesty insofar as the security that is being offered under the context of infrastructure development.

The determination of the status of NTDC and CPPAG as organs of the state is not as straightforward. Primarily, their functions as an off-taker and distribution company, with the state being a majority shareholder, makes the proposition of the two entities problematic. Their composite structure as corporatised bodies with state ownership creates a fusion of both commercial and governmental activities being exercised. However, it is questionable whether in their exercise of functions they are using their *prerogative de puissance publique*. On the balance of probability, it can be argued that the nature of the activity being undertaken (distribution of electricity and off-taking electricity from the IPPs), in the absence of complete divestment of the state, are actions being undertaken on the state's authority. Consequently, the act being exercised is that of a governmental nature. In *Noble Ventures*, the tribunal upon the determination of whether the SOF was exercising governmental authority concluded that '…no relevant legal distinction is to be drawn between SOF/APAPS, on the one hand, and a government ministry, on the other hand, when the one or the other acted as empowered public institution under the privatisation law'.[336] However, the tribunal's argument in *Jan de Nul* draws a closer connection with the present case. It can be argued that NTDC and CPPAG were authorised to exercise governmental authority, though no conclusive evidence to support this contention can be made; it can be submitted that the land ownership of the distribution framework for 500kv and 660kv transmission lines is facilitated through government owned land holding. However, the right to distribute and off-take electricity from the IPPs cannot be conclusively held as a governmental act, and can be argued to be an exercise of their contractual right in a competitive

[336] See *Noble Ventures Inc and Romania,* ICSID Case No ARB/01/11.

environment. Unlike in *Noble Ventures*, the case of *Jan de Nul* does not attribute the sourcing of best price under the tender process as a governmental act. Primarily, this contention underlies the entity's endeavor to find the most competitive price in order to off-take electricity, just as an independent contractor would 'try to achieve the best price' under a contract. For the purposes of academic debate, it can be argued that while the off-taking body, CPPAG, is not exercising governmental authority, NTDC, as a distribution company is so doing. It is interesting to note that in *Shehla Zia v Federation of Pakistan*[337], the Supreme Court of Pakistan held that under Article 9 of the Constitution of Pakistan, electricity comes under the guarantee of right to life. The distribution business, forming a vital component of the availability of electricity across the country, formulates a governmental activity and not a commercial activity. This contention however cannot be supported with substantial evidence.

It can be submitted that the nature of the quasi-independent bodies makes the application of Article 5 as a means to determine whether they are organs of the state, problematic. There is some evidence to suggest that PPIB is an organ of the state for the purposes of carrying out the implementation of the government's energy policy, and providing security measures vis a vis sovereign guarantees to the investors. Consequently, it can be indicated that PPIB is indeed exercising governmental authority. However, the case is not as straightforward for NTDC and CPPAG. The divestment of CPPAG's functions from NTDC has perhaps defined their roles more prominently. However, structurally, it has created more ambiguities insofar as their status within the state's structure.

[337] PLD 1994 Supreme Court 694.

4.3.2 The Expectation Gap

The previous section illuminates the issues surrounding the structural and functional framework of a sovereign guarantee. It reflects on the sovereign guarantee framework by using Pakistan's energy sector as a case study to outline the categorisation of entities involved in the sovereign guarantee framework. Conversely, this section reflects on a theoretical notion of sovereign guarantee framework. Sponsors, EPC contractors and practitioners working in the area of sovereign guarantees highlight a more subtle, abstract understanding of the security frameworks involved in attracting infrastructure development.

When a private party contracts with a body that is issuing a sovereign guarantee and is representing the state, the logical conclusion drawn indicates that such an entity is, invariably, the state. There is an 'expectation' facilitated through the use of state machinery for contract negotiation and even minute details inter alia the location of the meeting, leading to the conclusion that the state is undertaking these negotiations through its organs. Whereas from a doctrinal company law standpoint, these assertions may not stand ground, from an investor's perspective they are being given an assurance by the state through its machinery for recompense of any loss arising due to breach of PPA by a SOE. The primary significance of a sovereign guarantee, in an abstract sense, is its ability to provide a sense of security to investors by virtue of its association with the 'sovereign'. Similarly, such guarantees within the ambit of international project finance are a demonstration of a state's favourable attitude towards foreign investment.[338] The manifestation of a grant of such assurance by the state emphasises their

[338] See Arghyrios A Fatouros, *Government Guarantees to Foreign Investors* (Columbia University Press, 1962).

commitment to provide a sense of security to the investor insofar as their investment is concerned, and provides a deterrent against likelihood of any breach of contract. Providing such guarantees, as Fatouros has pointed out, is 'an acknowledgment of the investor's special position and it has induced him to act on the basis of this recognition'.[339] As a result, contracting with PPIB or any other body authorised to act on behalf of the state may be considered to be the state.[340] In the absence of the state taking ownership of the bodies that are in effect issuing these guarantees, prima facie, it seems futile to issue them.

As a result, it is argued that the underlying motive of issuing sovereign guarantees is to facilitate investment by providing a redundancy measure to satisfy and reassure the investors. Some of the SOEs discussed in this chapter are incapable of undertaking or providing guarantees to third parties due to financial limitations. Conversely, the sponsors are led to believe that the entities providing such guarantees are in reality state organs. Under its current framework, wherein corporatised bodies are issuing guarantees, there is evidence to suggest that there is no actual security being provided, unless a state organ issues these assurances. In view of the current framework, these assurances are supposedly issued by independent entities, which create an expectation gap, and challenge the very foundations of a 'sovereign guarantee'.

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[339] Arghyrios A Fatouros, *Government Guarantees to Foreign Investors* (Columbia University Press, 1962) 345.

[340] It is worth seeing the remarks made by Nick Seddon. Seddon argues 'A government department which enters into a contract through one of its officers is simply the Crown (it is not a separate legal entity) and the appropriate contracting body is the Crown in right of the relevant polity. The same is true of a body, which is established by legislation…the fact that a government is one, vast legal entity with many arms is not convenient and probably does not accord with lay people's expectations. A company or individual dealing with a department will naturally think that the department is the responsible body…The result would be a breach of contract by the government, albeit an inadvertent one. This appears to be a bizarre result but it follows inexorably from the concept of legal entity that is, in some senses, too crude'. See Nicholas Seddon, *Government Contracts: Federal, State and Local* (Fourth Edition, The Federation Press, 2009).

4.3.3 Legislative Limitations, Imbalance and Restrictions

Previous sections have extensively discussed the structural inadequacies and an expectation gap within the sovereign guarantee framework. Whereas the previous section has highlighted a more generic, abstract notion in consonance with a sovereign guarantee framework, this section is directly related to the investment guarantee regime rife in Pakistan. Statutory restrictions under Pakistan's law lead to question the validity of sovereign guarantees. The *Debt Limitation Act* came into force in order to eliminate revenue deficit and reduction of public debt. This section argues that the sovereign guarantee issued by the PPIB is contrary to legislative requirements enshrined under the *Debt Limitation Act*. Section 3(3) (b) of the *Act* provides that:

> … [T]he total public debt at the end of the tenth financial year does not exceed sixty percent of the estimated gross domestic product for that year and thereafter maintaining the total public debt below sixty per cent of gross domestic product for any given year.[341]

Moreover, section 3(3) (c) states:

> … [T]he total public debt is reduced by not less than two and half per cent of the estimated gross domestic product for any given year.

[341] <http://www.finance.gov.pk/publications/frdlo.pdf> Accessed 05 April 2015.

Under common law, there is no prerequisite for the existence of a statutory ground for the government entering into a contract.[342]As expressed by Seddon, there used to be a requirement that a government could not enter into a contract unless there was a specific statutory power to do so.[343] However, this position has since changed. The government started to be viewed under international and contract law as a legal person: a single authority representing 'all branches of the state and able to make commitment on behalf of the whole'.[344] It was this fervour that led to the government being viewed as the state, in order to make contractual settings more robust.[345]

However, in relation to the philosophical scope of sovereign guarantees acting as a collateral reassurance measure for investors, it is submitted that a limitation by the parliament upon government to contract in order to guarantee a debt obligation can prove fatal to the validity of the agreement, or render it void altogether.[346]

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[342] There may be few exceptions to this rule in various jurisdictions. In relation to disposal of Crown lands, it is a constitutional requirement that such a contract must be authorised by legislation. See the discussion in *Cudgen Rutile (No 2) Ltd v Chalk* (1975) AC 520, 533 (Lord Wilberforce). Another exception is that under the Financial Management and Accountability Act 1997 (Cth) s37 the Commonwealth cannot borrow money without specific legislative authorisation; see Nick Seddon, 'The interaction of contract and executive power' (2003) Federal Law Review, Vol 31.

[343] See Nick Seddon, 'The interaction of contract and executive power' (2003) Federal Law Review, Vol 31.

[344] Janet McLean, 'Government to State: Globalisation, Regulation, and Governments as Legal Persons' (2003) Indiana Journal of Global Legal Studies, Volume 10, Issue 1; Also refer to the previous section for a discussion on the state existing as one unit rather than individual units.

[345] Janet McLean, 'Government to State: Globalisation, Regulation, and Governments as Legal Persons' (2003) Indiana Journal of Global Legal Studies, Volume 10, Issue 1.

[346] See Hugh Beale, *Chitty on Contracts* (31st Edition, Sweet & Maxwell, 2012); *Commercial Cable Co v Newfoundland* (1916) 2 A C 610. Brief facts of the case are as follows: new premier provided access of laying down cable connection in Newfoundland. However, the premier was soon ousted from office. The successive premier and government were dissatisfied with the agreement, and announced that it was regarded as not being binding in the absence of legislative sanction. The court held that in the event of a legislative restriction, an agreement will not be

In *Yango Pastoral Company*, the court expressed that there are four main ways in which the enforceability of a contract may be affected by a statutory provision, and render such a contract unlawful.[347] One such way is wherein the 'contract maybe one which the statute expressly or impliedly prohibits'. Also see section 3(3)(d) wherein it is expressed that:

> [N]ot issuing new guarantees, including those for rupee lending, bonds, rates of return, output purchase agreements and all other claims and commitment that may be prescribed, from time to time, for any amount exceeding two per cent of the estimated gross domestic product in any financial year.

It is argued that under the provisions contained within the *Debt Limitation Act*, any amount guaranteed in excess of the sum of 2% of the gross domestic product shall be held to be contrary to the *Debt Limitation Act* and therefore void. While there is no specific requirement for the appropriation of the money, as may have been expressed earlier,[348] it is submitted that a limitation as to the guaranteeing of a debt can be contrary to the legislative requirements in Pakistan.

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binding in the absence of such approval; also see Wade W H, *Administrative Law* (11th Edition, OUP, 2014).

[347] *Yango Pastoral Company Pty Ltd v First Chicago Australia Ltd* (1978) 139 C L R 41. The facts of the case are as follows: the respondent lent to the first appellant the sum of $132,600, repayment of which was secured by mortgage which incorporated a guarantee given by the other appellants. Default having been made in repayment, the respondent sued the appellants on the personal covenant in the mortgage. The appellants pleaded illegality. The appellants argued that the respondent, at the time of the transaction was entered into, was carrying out the business of banking.

[348] There is no requirement that there be a legislative appropriation of money for the validity of contracts that involve the expenditure of public money. See *New South Wales v Bardolph* (1934) 52 CLR 455.

Seddon argues that any limitation insofar as the ability of a government to contract in order to guarantee its performance, such limitation or restriction is merely directory and not mandatory.[349] However, in *Project Blue Sky Inc v Australian Broadcasting Authority*[350] the court rejected the distinction between directory and mandatory, in favour of asking whether it was parliament's intention to render the relevant transaction as invalid if it was made in breach of the legislation. It is argued that the wording of the *Debt Limitation Act's* section 3 is coherent to this effect. The *Debt Limitation Act* explicitly outlines that public debt should not exceed 2.5% for any given year. This, in effect, is the Parliament's intention. As a result, it is submitted that the overall debt figures including sovereign guarantee issuance to power projects render the entire sovereign guarantee structure problematic.[351]

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[349] Nick Seddon, 'The interaction of contract and executive power' (2003) Federal Law Review, Vol 31

[350] (1998) 194 CLR 355, 389, 93.

[351] Pakistan's current GDP is $236.62Bn wherein the total debt figure exceeds USD$70bn. As of 2016, this figure is US$73bn <www.sbp.org.pk> Accessed 27 June 2016. Total debt percentage exceeds 60% limit (236.62-73=163.62. 163.62/236.62=0.69. 0.69x100=69%. It can be argued that even though this figure illustrates the entire debt (including that owed to multilateral agencies) as per the Act, the government can no longer issue guarantees; Kashif Kiani, 'Government breaches limit, adds $15.3Bn to external debt' *The Dawn* (Islamabad, 10 May 2014). A contrary view can be seen where a contract was held to be valid even though it was contrary to statutory procedures. See *Australian Broadcasting Corp v Redmore Pty Ltd* (1989) 166 CLR 454 in which the ABC failed to comply with a requirement in the Australian Broadcasting Corporation Act 1983 that certain contracts be approved by the Minister, but the contract was held to be valid. The facts of the case are as follows: the respondent (Redmore) became owner of premises in Sydney in which the appellant (ABC) was the tenant. Tenancy dispute arose between the two parties. Negotiations took place and subsequently an agreement resolving that original dispute was negotiated, providing for the grant of a new tenancy of the premises of Redmore to the ABC. ABC claimed that negotiations were of no use and relationship was beyond repair, however Redmore argued that matters had proceeded beyond the stage of negotiation and that a new binding agreement had been made. The ABC denied the presence of any such agreement. ABC claimed that if there was an agreement, such would be unenforceable since ABC failed to obtain the prior approval of the responsible Minister as required by the provisions of s70(1)(a) of the Australian Broadcasting Corporation Act 1983.

Despite repeated measures undertaken by the government[352], it is submitted that the debt/GDP ratio stands at 69%, a clear violation of the *Act*.[353] Comparing Pakistan's external debt/GDP ratio with India's, it is submitted that as of September 2016, India's external debt figure stood at US$485.6bn with a debt/GDP ratio of approximately 24%.[354]

The imposition of statutory limits on debt can be explained from an economic perspective. Rogoff and Reinhart submit that with the gross domestic debt (GDP)[355] accumulated to or exceeding 60% will cause an annual growth decline by about 2%.[356] Some academics argue that the implementation of such a law generally leads to decline in inflation and interest rate, mitigating the crowding of private investment and reducing external imbalance.[357] While the benefit of such enactment is beyond the purview of this study, it is submitted that such legislative measures have put a question mark on the validity of a sovereign guarantee, a concept that is already fraught with implications.

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[352] Please note that due to the FDI influx after 9/11, total debt/GDP ratio fell steeply from 81.4% in 2001-2 to 56% within a decade. This reduction in debt burden was due in part to the Fiscal Responsibility and Debt Limitation Act 2005. There has, however, been a change in the composition of the debt. From 40.4% of the total in 2001-02, domestic debt has risen to 55% in 2009-10. More recently to 68%; See Nadia Tahir, and Pervez Tahir, 'Public Debt and Fiscal Responsibility in a Federal Structure: The case of Pakistan' (2012) Romanian Journal of Fiscal Policy, Volume 3, Issue 2, Pages 27-47.

[353] Kashif Kiani, 'Government breaches limit, adds $15.3Bn to external debt' *The Dawn* (Islamabad, 10 May 2014).

[354] See <http://finmin.nic.in/reports/ExternalDebt_Dec16_E.pdf.> Accessed 05 April 2016.

[355] For a contrasting opinion on how GDP might not be a real indictor of growth see remarks of Joseph Stiglitz and Christine Lagarde in Stephanie Thomson, 'GDP a poor measure of progress, say Davos economists' *World Economic Forum* (23 January 2016) < https://www.weforum.org/agenda/2016/01/gdp/> Accessed 03 May 2016.

[356] See Kenneth S Rogoff and Carmen M Reinhart, 'Growth in a time of debt' (2010) American Economic Review: Papers and Proceedings, Volume 100, pp 1-9 wherein they found that when gross external debt reaches 60% of the GDP, annual growth declines by about 2% and unanticipated high inflation rate can reduce the cost of debt servicing but is effectiveness depends on debt maturity and its structure

[357] George Kopits, and Steven A Symansky, 'Fiscal Policy Rules' (1998) International Monetary Fund's Occasional Paper 162.

4.4 Conclusion

This chapter provides an outline of the concept underlying sovereign guarantee framework normative to Pakistan's energy sector. In an attempt to explain the notion of sovereign guarantee instruments, this chapter discusses the role of the state and its inherent powers to regulate the flow of investment by introducing measures that are favourable towards the investors. Whereas the concept of security is lucid, it translates into measures more elusive than the provision of a few security instruments. In view of the challenges that are faced by developing countries in an absence of liberalised policies and deregulated energy markets, there is a wide array of challenges. More importantly, non-payment of dues by the off-taking bodies is a direct threat to the prospect of future investment. In view of these discussions, the aforementioned discussion focuses on Pakistan's energy sector, discussing the adequacy of sovereign guarantee instruments and whether there is any plausible security rendered under these instruments.

Discussion in this chapter is important primarily because default by a project company on a debt servicing agreement will result in the lenders taking over the project operations or realising their debt by selling the project assets. Whereas the argument is plausible, it lacks any real substance. In the event that lenders accelerate their loan, the project company will default, and the lenders will take over the project company's assets. Consequently, the lender will have two options: first, they can consider selling the assets in a 'fire sale'. This method of sale, commonly used in such scenarios, is unlikely to recover the entire debt amount. The second method could potentially involve lenders running the project company themselves, for example, the lenders running the affairs of the project

company either directly or by appointing their own O&M operator. However, in the latter form of intervention, the bank still faces liquidity issues from an off-take body perspective. In the absence of any revenues being generated by the project company, there is little justification to undertake any measures unless the revenue stream is re-established.

One of the interesting discussions undertaken in this chapter relates to the expectation gap that exists between the investors and the host state's sovereign guarantee. A prudent conclusion drawn from this contention is predicated on the understanding that by including the term 'sovereign' within a guarantee issued by a state institution or SOE, there is given the impression that unlike a company, a sovereign cannot be dissolved or declared bankrupt.[358] Therefore, it is argued that this contention creates a false sense of security amongst lenders, sponsors and the project company, without any real ramification of security. Moreover, sovereign guarantees are perhaps only a measure of condition precedent in order to secure project finance through financial institutions. In order to match the real expectations of the lenders it is argued that a sovereign guarantee should be re-named as a sovereign indemnity agreement.

In general, a sovereign guarantee instrument is an indication of a state's favourable attitude towards foreign investment. A state never issues a guarantee with the expectation of default. [359] The ramifications of breaching a sovereign guarantee are immense. Particularly, such breaches can have adverse

[358] See Rodrigo O Caminal, *Legal Aspects of Sovereign Debt Restructuring* (Sweet & Maxwell, 2009) 41. A company, due to the separate legal principle, can be declared bankrupt with no recourse to its subscribers, directors unless there has been a fraud perpetrated against the creditors.

[359] Arghyrios A Fatouros, *Government Guarantees to Foreign Investors* (Columbia University Press, 1962).

implications from the World Bank, IMF and other multilateral institutions, and their tranche payments may be affected.

In view of the prevailing liquidity crisis, there are several questions that are raised as to the robustness of the sovereign guarantee frameworks. This chapter sheds light on the nature of the SOEs involved in a sovereign guarantee transaction by reviewing the structure and function of the entities involved in Pakistan's sovereign guarantee framework. One of the principal arguments forwarded in this chapter corresponds to the lack of framework that exists at an international level dealing with the notion of SOEs in international commercial contracts. Consequently, this chapter adopts the Draft Articles as a framework to determine whether an entity will be independent or considered an organ of the state. Consequently, it can be argued that the ill-defined premise of SOEs in domestic frameworks, lack of independence, and engagement in carrying out sovereign power whilst operating within a fabric of separate legal entity creates uncertainty insofar as the issuance of sovereign guarantee framework.

Sovereign guarantees are a response from the state to diminish market failure.[360] However, after reviewing the position of SOEs involved within Pakistan's sovereign guarantee framework, greater uncertainty has emerged due to the lack of character of these SOEs. It is submitted that during a workshop hosted by the author, MIGA's Senior Counsel, Shamali de Silva[361] made an interesting remark regarding the status of these SOEs. She argued that an endemic problem with

[360] Alexander Van de Putte, David F Gates and Ann K Holder, 'Political risk insurance as an instrument to reduce oil and gas investment risk and manage investment returns' (2012) Journal of World Energy Law and Business, Volume 5, No 4, 284.

[361] Shamali de Silva is a Senior Counsel at the Multilateral Investment Guarantee Agency (MIGA), the World Bank Group. These remarks were made by Shamali de Silva at the workshop hosted by the author in London.

SOEs is their status. Despite being referred to as 'independent entities' they are nonetheless heavily influenced by the state. As a result, it is difficult to contract with these entities, and any prudent investor would determine if the SOE has financial independence vis a vis raising its own finances on the capital markets.

Another aspect that is ancillary to this method of raising finance is predicated on credit ratings. Shamali argues that if an entity is independent and able to raise finance on the capital markets, they should also have a credit rating grade assigned to them. In view of Shamali's observations, it is argued that the question of independence is elusive. It cannot be defined conclusively without raising questions insofar as the entity's structure and function. The structural and function element of these SOEs under Article 4, and the exercise of their power under Article 5 have not been conclusively established in the discussion undertaken above. However, there is strong evidence to suggest that there is ambiguity surrounding the status of the SOEs in Pakistan's energy sector. In the absence of clearly defined concession agreements, independent boards, and formal privatisation, it is highly unlikely that a result to the contrary can be achieved.

Sovereign guarantees are a necessary evil. Whereas there is no available data to indicate that sovereign guarantees increase investment flow, there is a proverbial outline that sovereign guarantees are a sign that the host state will be favourable to the investor. As a result, providing sovereign guarantees can increase investor confidence. It is questionable whether sovereign guarantees offer any real protection. Sovereign guarantees may be thought of as a fire extinguisher: large construction projects, in order to secure health and safety and building approval

from local authorities, make provision for fire safety procedures. This is not because there is a likelier chance of a fire occurring—it is a precautionary measure that if there is a fire, there are tools to avert any major damage, as a sovereign guarantee similarly provides risk mitigation in the event of default.

In the event that developing countries like Pakistan, Nigeria and Kenya continue to use sovereign guarantee measures as an indicator of favourable treatment towards foreign investment, it is suggested that a more robust alternative legislative cover is required.[362] As outlined above, legislative restrictions inhibit the state's ability to issue such guarantees. Moreover, it is questionable whether such guarantees will be enforceable if called into effect. However, a more robust model can be derived from the *United Kingdom's Infrastructure (Financial Assistance) Act 2012* (hereinafter referred to as the "*Financial Assistance Act*"). *The Financial Assistance Act* was enacted aiming to stimulate infrastructure investment in the energy sector, among other sectors within the United Kingdom.[363] The *Act* stipulates that financial assistance, in the form of money, guarantee, or indemnity shall be payable to any person who in respect of provision of infrastructure has incurred such sum by undertaking the aforementioned agreement with the Treasury. This model ensures that the project company is contracting with the fiscal arm of the state, and as discussed throughout this chapter, contracting with a body that has the financial ability and fiscal space of its own. Whereas, amount of expenditure, actual or contingent

[362] For a detailed discussion of such guarantees being provided through parliamentary appropriation of money, see Colin Turpin, *Government Contracts* (1st Edition, Penguin).
[363] See <http://www.legislation.gov.uk/ukpga/2012/16/section/1> Accessed 23 May 2016. Refer to Section 2 wherein 'infrastructure' includes (a) water, electricity, gas, telecommunication, sewerage or other services, (b) railway facilities, roads or transport facilities (c) health or educational facilities (d) court or prison facilities, (e) housing.

liabilities incurred in giving, or in connection with giving, infrastructure assistance is capped at GBP£50 billion, it is submitted that the sum is likely to increase in the future given the increasing need for infrastructure development.[364]

The Financial Assistance Act stipulates that any guarantee undertaking entered into by a private party investing in the UK has parliamentary legitimacy. From Pakistan's infrastructure perspective in general and their energy sector in specific, it is submitted that unlike a sovereign guarantee, which is a contractual document[365], an Infrastructure Financial Assistance Act would actually indicate towards actual funds appropriated by the state. It would also be a more robust 'sovereign' guarantee, than a mere 'government' guarantee. Moreover, it reflects on the contention made earlier concerning such guarantee instruments to be renamed 'sovereign indemnity' instruments primarily because the state through the Ministry of Finance will agree to indemnify the project company as and when the off-taking body fails to pay under the PPA.

It can be argued that a sovereign guarantee is merely a transaction of honour.[366] Experience working with investors in the energy sector led to the revelation that

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[364] Patrick Mitchell, Adrian Clough, and David Wyles, 'The UK Guarantee Scheme—A Foundation for Infrastructure Development?' Sept 13, 2012. Herbert Smith Infrastructure e-bulletin < http://www.herbertsmithfreehills.com/-/media/HS/L-130912-6.pdf> Accessed 16 May 2015; an interesting argument concerning UK's infrastructure regime is the impact Brexit will have on the existing transactions. As of 12/10/2016, Teresa May the Prime Minister has expressed concerns that the UK must adopt a US style model where foreign investment in critical infrastructure development is reviewed and given approval before a go-ahead is given.

[365] In 2014, 10 IPPs called Pakistan's sovereign guarantee by issuing notices in this regard. Whether there is any practical implication for calling such guarantees and whether the issue feels obliged to issue payments after formal notices have been issued is questionable. See Khaleeq Kiani, 'IPPs suspend notices calling sovereign guarantees' *The Dawn* (Islamabad, 12 Dec 2014) <http://www.dawn.com/news/1150322> Accessed 09 October 2015.

[366] I refer to the Jessel MR in *Twycross v Dreyfus* (1877) 5 Ch D 605 '…the municipal law of this country does not enable the tribunals of this country to exercise any jurisdiction over foreign governments as such. Nor, so far, I am aware, is there any international tribunal which exercises any such jurisdiction. The result, therefore, is that these so-called bond amount to nothing more

a sovereign guarantee is one of the many conditions present within a list of documents required to secure debt financing. Protection under an Infrastructure Financial Assistance Act would not provide a blanket guarantee to every investor. It would involve a certain premium amount associated with any guarantee issued by the Ministry of Finance, payable by the project company on a yearly basis. Whether this premium will deter investment? Presumably not! As discussed in the next chapter, investors are willing to go out of their way to secure and mitigate risk. If certain recourse without the burdensome activity of going through courts can be avoided, investors would prefer taking out local, host state guarantee policies rather than seek the help of multilateral institutions.

In this scheme, it is difficult to sum up whether a sovereign guarantee is a façade, which encapsulates the reality of investment finance; it is all about returns with commercial risk inherent within the price that is paid.[367] Whether there is any real protection being offered under a sovereign guarantee is questionable. One of the conclusions that may be drawn from attending government meetings with sponsors reveal the lack of understanding of what real justification there is for

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than engagements of honour, binding, so far as engagement of honour can bind, the government which issues them, but are not contracts enforceable before the ordinary tribunals of a foreign government'. It is however submitted that countries that do not honour such engagements have a detrimental effect on their FDI regime. The facts of the case are as follows: the defendants were agents of the Peruvian government in the UK. Peruvian government issued bonds at 6 per cent. The Peruvian republic, upon the national faith, pledged the general revenue of the republic, and especially that free proceeds of the guano imported by the republic in to the UK. The agents did not give the plaintiff the agreed amount of the guano. The plaintiff brought an action on behalf of himself and all other holders of the bonds, stating in his claim that the republic had from time to time forwarded to the defendants large quantities of guano for the purpose of paying the interest on the bonds, which they refused to apply for that purpose.

[367] See Arghyrios A Fatouros, *Government Guarantees to Foreign Investors* (Columbia University Press, 1962). Fatouros argues that the investment of capital may then be regarded as the counter-promise of the investor, his 'payment' for the state's promises. Also see Hartley Shawcross, 'The Promotion of International Investment' (1960) 8 NATO Letter No. 2, 19 wherein the author argues that 'the quid pro quo for the borrowing states' undertakings is in fact, in the English Vernacular, the provision of the 'quids', that the capital importing countries, in return for agreeing to abide by the generally recognised procedure of International law, will receive more private investment than would otherwise be the case.'

using a sovereign guarantee in a project finance transaction. Radical shift in policy due to unforeseen circumstances, change in regime or deteriorating economic-fiscal conditions can have an impact on a state's ability to meet their contractual promises.[368] However, a state does not issue a sovereign guarantee to later revoke it. Whether a sovereign guarantee instrument is to be replaced with a more robust alternative is an anomaly. However, as suggested in the previous paragraph, legislative cover without offering a blanket guarantee can better facilitate infrastructure development security. The lack of infrastructure and electricity generation, as discussed in the earlier chapters, is taking its toll on the economy. Pakistan's external debt is at an all-time high.[369] Industries are relocating, and the change in weather conditions is adversely affecting the once agriculturally rich region. It is therefore submitted that the need for capital in such underdeveloped and developing countries is immense. Countries like Pakistan, Nigeria and even India cannot afford to alienate investors by failing to fulfil their contractual promises.

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[368] Arghyrios A Fatouros, *Government Guarantees to Foreign Investors* (Columbia University Press, 1962).

[369] IMF has painted a bleak and alarming picture of Pakistan's economy. It is estimated that Pakistan's external debt obligations would surge to USD$70.2 billion by the end of the current fiscal year, up from the USD$66.457 billion mark in September 2015. The debt to GDP ratio is set to surge to touch 65 percent mark. See Sabir Shah, 'Pakistan external debt, debt-to-GDP ratio alarming' *The News* (Islamabad, 01 February 2016) < http://www.thenews.com.pk/print/95260-Pak-external-debt-debt-to-GDP-ratio-alarming> Accessed 14 February 2016.

Chapter 5

Redundancy Measure: Political Risk Insurance

5.1 Introduction

An exponential increase in demand for infrastructure has created a significant burden on the existing state resources. Sovereign finance is no longer the answer to address these shortcomings within infrastructure development. As a result, states are increasingly content to seek financial assistance through private investment to facilitate these endeavours. However, as states understand their limitations, they are extending lucrative security packages towards investors in order to attract their investment portfolios. In cases where the state is only partially offering a security package, or the existing package is inadequate to provide a robust measure of security, investors are seeking alternative measures to mitigate existential risks within their targeted investment regime.

Sovereign guarantee frameworks provide reassurance to investors; however, in view of foreign direct investment (hereinafter referred to as "FDI") becoming increasingly important in financing growth, especially in developing countries[370], and liquidity issues constraining the state's ability to provide robust measures of security, investors are seeking recourse to alternative risk-mitigation frameworks. There are three types of measure that a host state can adopt in order to promote capital inflow. First, finding and publicising investment opportunities abroad, removing obstacles by providing one-window operations, influencing potential investors to utilise their funds in specific areas or specific types of loans

[370] IMF, 'Foreign Direct Investment in Emerging Market Countries' (September 18, 2003) *Report of the Working Group of the Capital Markets Consultative Group* (CMCG) <https://www.imf.org/external/np/cmcg/2003/eng/091803.HTM> Accessed 23 March 2016.

or investments. Second, providing adequately stable and protective measures to safeguard the foreign investor's capital, and adopt all necessary measures to maintain a stable economic climate.[371] Third, the state acting directly within the sphere of its power can facilitate the international capital market through providing state loans, guarantees, or even equity investments.[372]

The primary premise of the three contentions outlined by Whitman are predicated upon the understanding that in highly leveraged transactions, it is important that parties are provided with adequate measures in order to attract infrastructure development funds. The provision of a sovereign guarantee is a mere indication of a state's favourable attitude towards investment, and not an absolute security undertaking, per se. However, the premise of sovereign guarantees may be problematic in instances where blanket guarantees are offered by the host state. As Whitman submitted, these may increase the likelihood of attracting political interference.[373] Moreover, in the event that there are poor regulatory measures or inadequate fiscal space to honour them, the issuance of such guarantees seems futile, since the host state will be unable to meet any obligations outlined therein.

Countries like Nigeria, India, Pakistan and various other developing and developed countries have in the past offered blanket guarantees in their

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[371] Investing in emerging countries involves greater risk than investing in developed countries because of political, currency, liquidity, returns, contagion, and even systemic risks. See Serge Darolles, Jeremy Dudek and Gaelle Le Fol, 'Contagion in Emerging Markets' in Nigel Finch (ed), *Emerging Markets and Sovereign Risk* (1st Edition, The Palgrave Macmillan, 2015).
[372] Marina Von Neumann Whitman, *Government Risk Sharing in Foreign Investment* (Princeton University Press 1965).
[373] Marina Von Neumann Whitman, *Government Risk Sharing in Foreign Investment* (Princeton University Press, 1965) pp 151.

infrastructure development industries.[374] Pakistan, for example, has been adversely affected by an on-going electricity crisis. Pakistan's textile industry, which contributes 9.5% of GDP, and directly employs over 15million people[375] is experiencing 3.5% negative growth, due to ruptured growth directly associated with electricity crisis.[376] The state's inability to provide the requisite facilities to assist industries like textile has meant that industries are relocating to countries such as Bangladesh and India. There is an enormous deficit insofar as the demand and supply of electricity in Pakistan. As a consequence, the state is seeking to attract private sector participation in a bid to enhance generation and distribution facilities. However, in view of the risks posed to such investors, Pakistan is content to offer blanket guarantees as a measure to mitigate risk.

In view of the challenges that are exhibited by these volatile economies, especially in Pakistan, it is argued that there is a need to introduce a redundancy measure, in order to provide an additional layer of security within the infrastructure development regime. The following discussion provides an introduction to political risk insurance (hereinafter referred to as "PRI") as a

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[374] See Kenneth Hansan, Robert C O'Sullivan and W Geoffrey Anderson, 'The Dabhol Power Project Settlement: What Happened? And How?' *Infrastructurejournal.com* <http://www.chadbourne.com/files/Publication/a5aa1e52-4285-4bb5-87e6-7201123895a0/Presentation/PublicationAttachment/352f8f09-ae96-40fc-a293-720d0b8f0ca8/Dabhol_InfrastructureJournal12_2005.pdf> Accessed 23 March 2016. The Dabhol power project successfully raised US$1.9bn in project debt largely on the Power Purchase Agreement and the guaranties issued by the Government of Maharashtra and, subject to a roughly US$300 million cap, the Central Government.

[375] Editor, 'Statistics on Textile Industry in Pakistan' *The Tribune* (Islamabad, 18 March 2013) <http://tribune.com.pk/story/522292/statistics-on-textile-industry-in-pakistan/> Accessed 12 May 2016; also see Muazam Rashid Dar, Muhammad Azeem, Dr Muhammad Ramzan, 'Impact of Energy Consumption on Pakistan's Economic Growth' (2013) International Journal of Humanities and Social Science Innovation Vol 2 Issue 6 < http://www.superior.edu.pk/Images/Research/6.pdf> Accessed 21 May 2016. Wherein, the authors have argued that with Pakistan's current energy crisis, Pakistan will be unable to compete against countries like China, India and Bangladesh.

[376] Editor, 'Energy Crisis Besetting Industries' *The Dawn* (Islamabad, 20 July 2014) <http://www.dawn.com/news/1120432> Accessed 03 May 2016.

form of either an additional or alternative redundancy measure, in order to strengthen Pakistan's energy sector.

This chapter is predicated on three strands. First, it considers the notion of political risk in a larger context. In view of the discussion concerning liquidity issues, especially in a developing country context, this section provides a holistic picture of political risk in general. Whilst referring to various developing and developed countries, it outlines and compares how risk is outlaid in various contexts. In addition to providing a contextual comparison, this section also arrives at the conclusion that without limitation to the liquidity issues, there are other challenges that an investor may face. Thereafter, this discussion progresses to reflect upon political risk in Pakistan's context, with a view to outlining the political risk challenges in a contextual framework.

The discussion then shifts and progresses to political risk insurance. This section argues that in view of a state's inability to provide any real recompense under a sovereign guarantee framework, political risk insurance provides plausible additional security. In order to dispel the similarities between guarantee and insurance instruments, this section also provides a brief analysis of the different nature of the two security instruments. This discussion supports the contention that the two instruments can potentially co-exist, and attempts to highlight how guarantee instruments can be narrower in comparison to the speculative nature of insurance instruments. The discussion then builds the argument, using the political risk insurance products of the Multilateral Investment Guarantee Agency (hereinafter referred to as "MIGA") as an illustration. This section aligns the issues cognisant with Pakistan's energy sector with services offered by

MIGA. In a broader spectrum, it is argued that MIGA's political risk insurance is not a replacement for Pakistan's sovereign guarantee structure, but an additional measure of security that strengthens the existing security framework. Moreover, from an investor's standpoint, this section argues that MIGA plays a larger role in the context of providing robust measure of security. Involving a multilateral body, especially in a developing country context, involves an element of deterrence due to the larger role played by multilateral institutions in providing fiscal and economic stability. As a result, it is unlikely that a developing country will default on payments when a multilateral institution is involved.

The last strand within this discussion sails away from the usual arguments presented in support of political risk insurance. This section is predicated on the very substance and nature of political risk insurance instruments. It argues that risk insurance instruments breed moral hazard. Whilst relying on fieldwork and engagement with wider academic community, this section highlights the dilemma surrounding political risk insurance. It argues that risk insurance instruments are a mere condition-precedent for securing debt finance. Relying on evidence made available through various sources, this section demonstrates that investors cancel their insurance policies after securing such instruments.

The discussion undertaken in this chapter is an extension of the discussions undertaken in Chapter 4. The primary contention emerging in the following discourse refers to the inclusion of risk insurance frameworks as an additional form of security to sovereign guarantee measures, and not a replacement model.

5.2 Navigating Political Risk

5.2.1 What is Political Risk?

Political risk is an elusive concept, not always easy to define to the satisfaction of those concerned with its political ramifications.[377] In a broad spectrum, political risk is the risk of the uncertain.[378] A simple definition of the term 'political risk' is the risk or probability of occurrence of some political event(s) that will change the prospects of the profitability for an investment.[379] An event might occur due to the political-economic climate of a host country, or may be perpetrated due to a social change that has erupted within the host country, for example, a revolution. A good example of political risk is the liquidity crisis discussed in Chapter 1. A country's economic position and fiscal space might not allow provision for timely payments under the agreed PPAs, due to the lack of sufficient funds or inept regulatory measures. Good examples of this are India's Dabhol Power Project, and more recently Pakistan's Riqo Diq.[380] Another definition of 'political risk' may correlate to a material adverse change in the

[377] Hasan S Zakariya, 'Insurance against the Political Risk of Petroleum Investment' (1986) 4 J Energy & Natural Resources L 217.

[378] See Sam Wilkin, *Country and Political Risk: Practical Insights for Global Finance* (Risk Books, 2004). The author submits that 'country risk is, broadly speaking, the risk of business loss due to country-specific factors, usually related to political and economic instability.

[379] Paola Morales Torrado, 'Political Risk Insurance and Breach of Contract Coverage: How the Intervention of Domestic Courts May Prevent Investors from Claiming Insurance' (2005) 17 PACE Int'l L Rev 301. Paola argues that political risks in developing countries usually arise because many of those countries lack a well-tested legal framework to enforce contractual obligations and to fully recognise investor's rights to the proceeds of their investment.

[380] See Kenneth Hansan, Robert C O'Sullivan and W Geoffrey Anderson, 'The Dabhol Power Project Settlement' Infrastructurejournal.com <http//:www.chadbourne.com/files/Publications> Accessed 22 February 2016. The authors have argued that there can be little doubt, however, that all else being equal, the experience of Dabhol makes investors wiser and slower in committing their resources to India. The attraction is still there, but the calculation today has to compensate for risks that, before Dabhol, would not have been given as much weight.

commercial viability of the project, which is directly aligned with the political landscape of the host state.[381]

Risks faced by foreign investors investing in a developing country vary significantly, and take diverse forms.[382] Figure 5.1, below, provides an outline of a country risk profile of selected countries.[383]

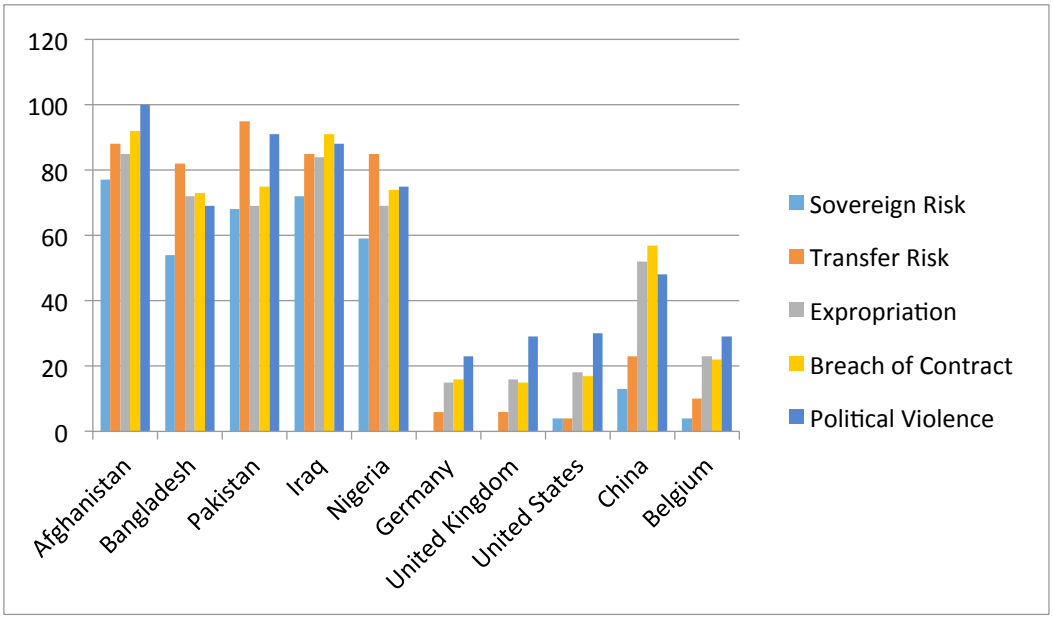

Figure 5.1: Selected Country Risk Profile

Reflecting on the data presented in the chart above, it is submitted that Pakistan, Afghanistan and Iraq illustrate similar patterns insofar as political risk. These countries have been economically unstable due to an on-going war and continued volatile fiscal position. As a result, their sovereign risk, expropriation, breach of

[381] See Thomas E Krayenbuehl, *Country Risk: Assessment and Monitoring* (2nd Edition, Woodhead Faulkner).
[382] See Elizabeth Kessler, 'Political Risk insurance and the Overseas Private Investment Corporation: What Happened to the Private Sector?' (1992) 13 N Y L Sch J Int'l & Comp L 203, 204.
[383] See Raoul Ascari and Federica Pocek, 'Country Risk from Theory to Practice' (May 2012) SACE <www.sace.it/docs/default/wp_sace_n15_countryrisk_en_pdf.pdf?> Accessed 12 April 2016.

contract and political violence indices are much higher when compared with countries like Belgium, United Kingdom and Germany.[384] Political risk plays a pivotal role in an environment that seeks to attract infrastructure development funds. The following sections illustrate upon some of the common forms of risk.

5.2.1.a Expropriation

A succinct definition of the term 'expropriation' was outlined by the tribunal in the *Middle East Cement* case. The tribunal submitted that:

> [W]hen measures are taken by a State the effect of which is to deprive the investor of use and benefit of his investment even though he may retain nominal ownership of the respective rights being the investment…the effect of which is tantamount to expropriation[385]

Under international law[386] a measure employed by the state need not deprive an investor of the title to his property rights in order to amount to an

[384] Reference to these jurisdictions is for comparative purposes only. It is important to draw comparison insofar as risk in relation to developed and developing countries.

[385] See *Middle East Cement Shipping and Handling Co SA v Arab Republic of Egypt*, ICSID Case No ARB/99/6.12 April 2002, para 107 <www.worldbank.org/icsid/cases/me_cement_award.pdf> Accessed 12 December 2016.

[386] Customary international law has long afforded states the authority to expropriate foreign investments, as long as the expropriation: (i) is for a public purpose (ii) is non-discriminatory (iii) complies with due process principles and (iv) provides the investor with prompt, adequate, and effective compensation. See L Yver Fortier and Stephen L Drymer, 'Indirect Expropriation in the Law of International Investment: I know it when I see it, or Caveat Investor' (2005) 13 Asia Pac L Rev 79, 81; also see Tamada Dai, 'Assessing damages in non-expropriation cases before international investment arbitration' (2009) 52 Japanese Y B Int'l L 309. Dai submits '…that in theory, as the payment of compensation is a condition under international law for that an expropriation be lawful, an expropriation without any compensation inevitably engages the state responsibility of the host-country, and the result of this involvement is "full reparation".'

expropriation.[387] Consequently, an act of expropriation is not limited to deprivation of the owner's title to the project company. It can also be perpetrated by measures that gradually adversely affect the project company. A definition encompassing this view is outlined by MIGA. MIGA defines expropriation as:

> [A]ny legislative action or administrative action or omission attributable to the host government which has the effect of depriving the holder of a guarantee of his ownership or control of, or a substantial benefit from, his investment, with the exception of non-discriminatory measures of general application which governments normally take for the purposes of regulatory economic activity in their territories[388]

Every investment is predicated upon risk; however, not every business problem experienced by an investor is an indirect[389] or creeping form of expropriation. Expropriation, in various forms, is one of the primary non-commercial risks investors and project companies face in developing countries.[390] Whereas direct expropriation is no longer a common instance, indirect expropriation through delayed payments, increase in costs (related to the project, for example), an increase in taxes, and introduction of laws that may be prejudicial towards the project company or its business are a common occurrence. Recently, the UK's

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[387] Zeyad A Al Qurashi, 'Indirect expropriation in the field of petroleum', (2004) 5 Journal of World Investment & Trade 897.

[388] Article 11 of the Convention Establishing the Multilateral Investment Guarantee Agency. <https://www.miga.org/who-we-are/miga-convention> Accessed 23 April 2016.

[389] The phrase 'indirect expropriation' denotes that the investor's assets were not seized directly. See Paul E Comeaux and Stephen Kinsella, *Protecting Foreign Investment under International Law: Legal Aspects of Political Risk* (Oceana Publications, Dobbs Ferry, New York, 1997).

[390] See Patrick J Donovan, 'Creeping Expropriation and MIGA: The need for tighter regulation in the political risk insurance market' (2003-2004) 7 Gonz J Int'l L 1.

Supreme Court overturned a Court of Appeal's ruling on a matter concerning s103 (3) of the *Arbitration Act 1996*. Whereas the court's rationale in this case is not relevant for the purposes of this study, the case has been pending execution of the award since the dispute was first instituted in 2004. This case is a stark reflection upon the state's ability to hinder project operation or to create barriers for compensation to hinder those operations.[391]

It is interesting to note, however, that investors address these acts of expropriation by assigning an increased economic value multiplier to reflect the risk that their capital bears. This sum represents a premium which reflects the increase in the amount of risk that the lenders are undertaking. As a result, cost of capital increases proportionally with an increase in risk.[392] However, these higher returns have not discouraged or deterred states from exercising measures that may amount to direct or indirect expropriation, as illustrated in the recent case of *IPCO*.[393]

A definition of expropriation acutely relevant to the liquidity crisis is outlined in a North American Free Trade Agreement (hereinafter referred to as "NAFTA") dispute resolution. The tribunal in *S D Myer's* expropriation claim stated that:

> An expropriation usually amounts to a lasting removal of the ability of an owner to make use of its economic rights although it may be that, in some contexts and circumstances, it would be

[391] See *IPCO (Nigeria) Limited v Nigeria National Petroleum Corporation* (2017) UKSC 16.
[392] See David Blumental, 'Sources of funds and risk management for international energy projects' (1998) 16 Berkeley J Int'l L 267, 271-72.
[393] See *IPCO (Nigeria) Limited v Nigeria National Petroleum Corporation* (2017) UKSC 16.

> apparent to view a deprivation as amounting to an expropriation, even if it were partial or temporary.[394]

Whereas academic literature on expropriation is predominately restricted to direct and indirect expropriation, there are instances where states are obligated to undertake indirect expropriation in order to facilitate or honour another transactional contract under necessity.[395] From Pakistan's standpoint it is submitted that the failure of the state to indemnify IPPs for the off-taking bodies' failure to honour contractual commitment is an important facet of this study. Delay or non-payment adversely affects the operations of the SPV, and as a result can be tantamount to an act of indirect expropriation. Al Qurashi illuminates this predicament, submitting that while looking beyond the issue of outright takings, one finds that under international law, expropriation need not be exercised only through a formal decree of nationalisation or legislation designed to adversely impact or separate altogether the owner from its belongings, in this instance the project company.[396]

Expropriation can also be achieved through other indirect means, which may have the same effect as direct expropriation.[397] Expropriation is a process, and

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[394] *S D Myers, Inc (US) v Canada*, First Partial Award, paras 117, 123, 127, 40 I L M 1408 (2001) (NAFTA Ch11 Arb Inb 2000) <www.naftaclaims.com/disputes_canada_sdmyers.htm> Accessed 17 May 2016.

[395]See George Chifot, 'Caveat Emptor: Developing international disciplines for deterring third party investment in unlawfully expropriated property' 33 Law & Policy Int'l Bus 179,183-84. Chifor argues '…that in the past two decades, indirect expropriation has supplanted direct takings as the dominant form of state interference with foreign investment, as host countries have learned that more value can be extracted from foreign enterprises through the more subtle instrument of regulatory control than outright seizures'.

[396] Zeyad A Al Qurashi, 'Indirect expropriation in the field of petroleum', (2004) 5 Journal of World Investment & Trade 897.

[397] Zeyad A Al Qurashi, 'Indirect expropriation in the field of petroleum' (2004) 5 J World Investment & Trade 897. Also see Barry Appleton, 'Regulatory Takings: The International Law

not so much an act, per se. It may be aimed at other legitimate regulatory objectives, and does not involve a single instance of an outright taking; nonetheless it has the effect, often degree-by-degree, of depriving an owner of fundamental rights associated with such property.[398] As a result, circular debt or liquidity issues discussed in Chapter 1 formed under the auspices of expropriation are a predicament loathed by most energy sector investors investing in developing countries.[399]

5.2.1.b Transfer restrictions

Transfer restrictions involve local banks or financial institutions not allowed to export or remit currency to the place agreed by the investor, or when an investor is unable to repatriate currency generated through the project company's revenues. MIGA's Convention broadly defines transfer restrictions as:

> [A]ny introduction attributable to the host government of restrictions on the transfer outside the host country of its currency into a freely usable currency or another currency acceptable to the holder of the guarantee, including a failure of

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Perspective' (2002) 11 NYU Env L J 35. Appleton argues that international judicial officers have found that there is no longer any distinction between direct, indirect or creeping expropriation.

[398] L Yves Fortier, CC, QC and Stephen L Drymer, 'Indirect Expropriation in the Law of International Investment: I know it when I see it, or Caveat Investor' (2005) 13 Asia Pacific L Rev 79.

[399] As discussed earlier, the circular debt or liquidity crisis discussed in the chapter below is no longer an anomaly, but is considered as a general occurrence due to the capped and constraints on fiscal means. Also see Timi Soleye, 'Guest post: The imminent collapse of Nigeria's power privatisation is a good thing' *Financial Times* (Lagos, 21 Oct 2014).

> the host government to act within a reasonable period of time on an application by such holder for such transfer.[400]

The imposition of such restrictions has been defined in order to encompass all new forms of direct restrictions, as well as any disguised indirect restrictions.[401] Currency transfer restrictions are deeply embedded in developing economies, due to their need to maintain foreign currency reserves within their jurisdictions and discourage flight of capital.[402] For example, in 2016, the Chinese government clamped down on capital outflows due to reported depreciation of renminbi against the dollar. The renminbi depreciated almost 6% against the dollar in weeks leading towards end of 2016. The Financial Times reported that investors and corporate industry faced difficulties in remitting dividends to stockholders abroad.[403]

Figure 5.2, below, illustrates how risk compares in Asia and Latin America. Pakistan has a higher risk of regulatory and transfer risk, illustrating the dangers faced by potential investors. Whereas currency transfer risk is characterised by a weak political and economic structure, and forms part of one of the main risks feared by investors, it is submitted that this does not form part of the purview of this study.

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[400] See Convention Establishing the Multilateral Investment Guarantee Agency, Art. 11(a)(i).
[401] See Multilateral Investment Guarantee Agency, Commentary on the Convention Establishing the Multilateral Investment Guarantee Agency <www.miga.org> Accessed April 2017.
[402] Ali Salman, 'Foreign exchange: An emerging black market from within a tight noose' *The Express Tribune* (Islamabad, 13 April 2015) <http://tribune.com.pk/story/868775/foreign-exchange-an-emerging-black-market-from-within-a-tight-noose> Accessed 13 April 2015.
[403] See Yuan Yang, 'China tightens control of personal forex purchases' *Financial Times* (Beijing, 1 January 2017).

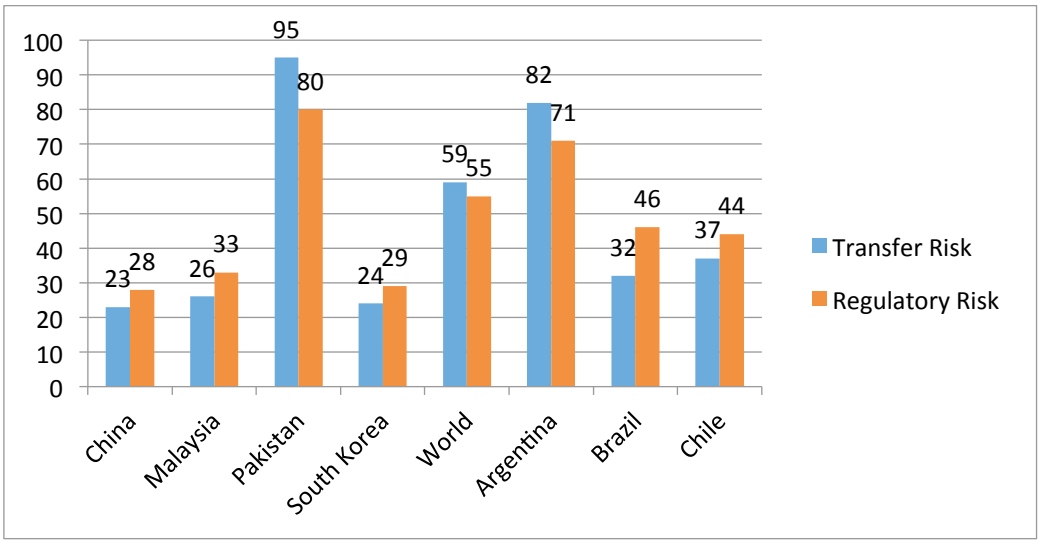

Figure 5.2: Transfer and Regulatory Risk in Asia and Latin America[404]

The currency transfer restrictions can amount to indirect expropriation. In order to address this issue, some projects in developing countries tend to raise money for a project in local currency. However, the risk then pertains to an increase in conversion rates, which can create a difference in debt service payments to foreign investors. Moreover, unlike currency transfer risk, that can be managed through robust contractual provisions in the PPA, currency convertibility risk is not within the purview of the host state.

5.2.1.c Contract repudiation[405]

Contract repudiation, contract breach or credit risk occurs when a state or a SOE does not honour or, fails to meet the commitments outlined within a PPA. This type of risk is usually present in project finance in oil, energy and water sectors,

[404] Transfer and regulatory risk in Latin America and Asia (2012). See Raoul Ascari and Federica Pocek, 'Country Risk from Theory to Practice' (May 2012) SACE <www.sace.it/docs/default/wp_sace_n15_countryrisk_en_pdf.pdf?> Accessed 24 May 2016.

[405] If a state breaches its contract with a foreign investor, there are consequences. This is particularly reflected in the fact that not only does the state have to pay compensation to the investor, the award for compensation may also include the payment of lost future profits. See Sangwani Patrick Ng'ambi, 'Permanent sovereignty over natural resources and the sanctity of contracts, from the angle of Lucrum Cessans' (2014-15) 12 Loy U Chi Int'l L Rev153.

wherein the private parties sign contracts with the state in order to ensure that the product produced by the SPV is off-taken by the state. Contract repudiation can be characterised as a form of indirect expropriation, however the entire premise of this study is predicated on the risk of SOEs not honouring their contractual obligations; as a result, this section has been discussed separately.[406] The host country's ability to fulfil its financial obligations depends not only on its creditworthiness or economic health, but also on a wide array of domestic and international elements that eventually have an effect on its ability to pay.[407] Both national and international factors play a role in a host state's ability to honour its contractual commitments. As discussed earlier, no state intentionally breaches its financial, contractual commitments. The repercussions of such breaches can be everlasting, and prove detrimental for the investment regime in emerging and developing economies.

Existential political risk can have far-reaching consequences for the host state. As illustrated in Figure 5.3, below, and briefly outlined in our earlier discussion, the higher the risk the higher the cost of capital. Developing countries offer higher returns in order to attract investment. Recently, the China-Pakistan Economic Corridor (hereinafter referred to as "CPEC") has been in the news for astronomical return figures on an investment of approximately US$50bn. Pakistan will pay China approximately US$90bn over a 25-year period under

[406] See Paola Morales Torrado, 'Political Risk Insurance and Breach of Contract Coverage: How the Intervention of Domestic Courts may prevent Investors from Claiming Insurance' (2005) 17 PACE Int'l L Rev 301.
[407] See Raoul Ascari and Federica Pocek, 'Country Risk from Theory to Practice' (May 2012) SACE<www.sace.it/docs/default/wp_sace_n15_countryrisk_en_pdf.pdf?> Accessed 03 May 2016.

CPEC related contracts.[408] There is some academic debate upon this issue, arguing that countries with low economic growth deliver lower equity returns. Conversely, countries with high economic growth do not necessarily deliver superior equity returns.[409]

Name of Country	Return on Equity Investment	GDP Growth (annual %)[410]
Brazil	18.6	2.2
Pakistan	16	3.8
India	13.4	6.5
China	12.3	8.1
United Kingdom	2.3	2.1
United States	0.5	2.1

Figure 5.3: Rate of Return on Equity vs. GDP Growth[411]

[408] Salman Siddiqui, 'Pakistan will be paying China USD90bn against CPEC-related projects' *The Express Tribune* (Islamabad, 12 March 2017).
[409] See R McFall Lamm, Jr, 'Economic Growth vs Equity Returns in Emerging Markets' in Nigel Finch (ed), *Emerging Markets and Sovereign Risk* (1st Edition, The Palgrave Macmillan, 2015).
[410] Annual percentage growth rate of GDP at market prices based on constant local currency. Data has been obtained from the World Bank's website and reflects an average growth rate from 2011 to 2014. Data available at <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG>. Accessed February 2017.
[411] See R McFall Lamm, Jr, 'Economic Growth vs Equity Returns in Emerging Markets' in Nigel Finch (ed), *Emerging Markets and Sovereign Risk* (1st Edition, The Palgrave Macmillan, 2015).

Consequently, as illustrated in Figure 5.4, developing countries attract more infrastructure development funds primarily because they offer higher returns. However, this presents another question: is risk a significant driving force for investment? Or is risk one of the many variables that are taken into account without the forbearance of its actual ramifications within infrastructure development?

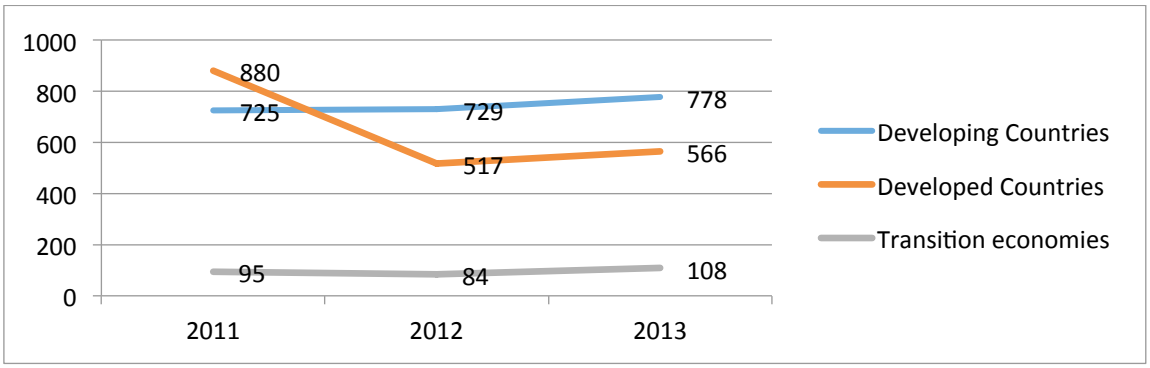

Figure 5.4: Change in FDI since 2011 (GBP£bn) [412]

Figure 5.4 demonstrates the constant variation of FDI in developed countries in comparison to FDI in developing countries. Since 2000, investment flows into developing countries nearly quadrupled from US$160bn in 2000 to US$580bn in 2008, with an annual growth of 17.5% annually.[413] In 2010, FDI flows to developing countries increased by 30% to US$507bn. ADB's 2017 report highlights that Asia alone will require approximately US$1.7 trillion on a yearly

[412] See George Arnett, 'Foreign direct investment: which countries get the most?' *The Guardian* (London, 24 June 2014) <http://www.theguardian.com/news/datablog/2014/jun/24/foreign-direct-investment-which-countries-get-the-most> Accessed 04 April 2016.

[413] MIGA, *World Investment and Political Risk* (2011) <www.miga.org; http://unctad.org/en/pages/PublicationArchive.aspx?publicationid=393> Accessed March 2016; also see United Nations Conference on Trade and Development, *World Investment Report 2015: Reforming International Investment Governance* (2015) UNCTAD <www.unctad.org/en/PublicationsLibrary/wir2015_en.pdf> Accessed April 2016.

basis in order to meet their growing infrastructure demand.[414] However, as illustrated in Figures 5.5 and Figure 5.6, below, it is argued that these figures are merely centred on a few countries, and do not necessarily reflect regional development.

Name of Country	FDI Inflow (In US$ billions)	Change from Previous Year
Iran	2.1	-31%
Pakistan	1.7	+31%
Bangladesh	1.5	-4.5%
Sri Lanka	0.9	+1.3%
India	34.4	+22%

Figure 5.5: FDI by Region[415]

[414] See Asian Development Bank, 'Asia Infrastructure Needs Exceed $1.7 Trillion Per Year, Double Previous Estimates' *ADB News Release* (Manila, 28 February 2017) < https://www.adb.org/news/asia-infrastructure-needs-exceed-17-trillion-year-double-previous-estimates> Accessed February 2017.

[415] See United Nations Conference on Trade and Development, *World Investment Report 2015, Reforming International Investment Governance* (2015) UNCTAD <www.unctad.org.en/PublicationsLibrary/wir2015_en.pdf> Accessed 04 April 2016.

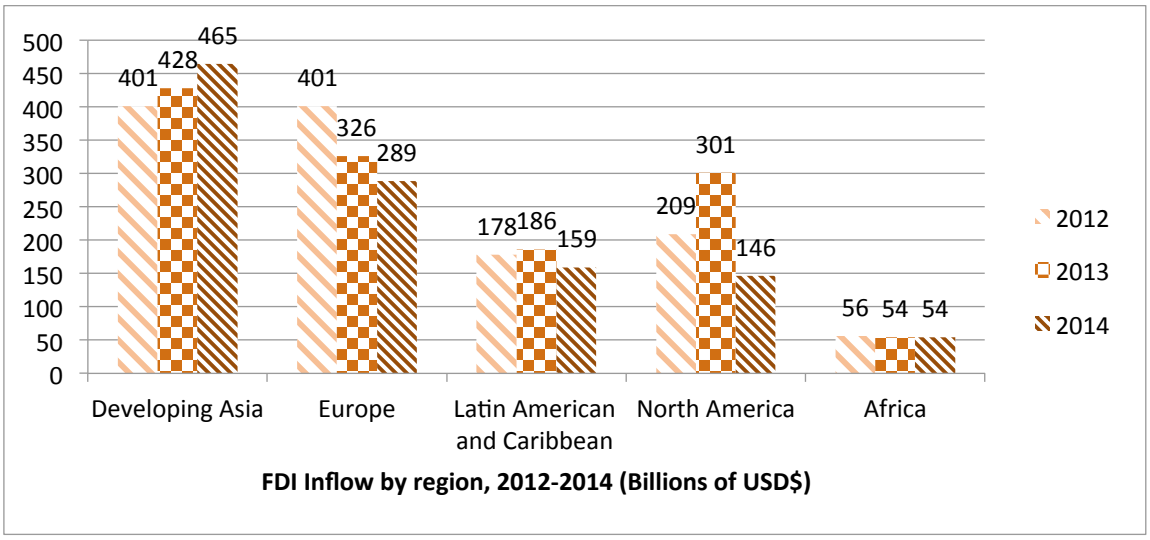

Figure 5.6: FDI Inflow by Region[416]

The UNCTAD makes a similar observation:

> Many developing countries, including least developed countries, have attracted only small amounts of FDI despite their efforts at economic liberalisation in an increasingly globalising world. Moreover, FDI inflows are highly concentrated in a small number of countries. It is generally well known that the modest levels of, and disparity in, the distribution of FDI inflows, are due to factors such as a deficient regulatory framework, a poor business environment and opportunities, weak FDI policies, poor institutional

[416] United Nations Conference for Trade and Development <www.unctad.org.fdistatistics> Accessed 04 April 2016.

frameworks, limited market access, unfavourable comparative costs and lack of political stability.[417]

However, it is argued that infrastructure funds are not necessarily an indicator of real development or growth. It is questionable whether investment flows have a real social impact through these infrastructure projects for the poor and needy segments within the society.[418] For example, Nigeria derives almost 80% of its revenue from oil, and attracts nearly US$5bn FDI on a yearly basis. Despite healthy FDI figures, Nigeria still has 61% of its people living in poverty.[419]

The focus of this section was primarily to review and discuss the nature of political risk and its impact on infrastructure development. It reviews some of the facets of political risk by referring to figures issued by various international bodies. Another brief argument reviewed under this section looks at the character of FDI, and whether it can indeed generate enough growth to affect the real impoverished segments of the society. The next section reviews political risk in the context of Pakistan, in order to better understand the nexus between political risk and risk insurance.

5.2.2 Political Risk in Pakistan

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[417] United Nations Conference on Trade and Development Division on Investment and Enterprise, *UNCTAD Training Manual on Statistics for FDI and the Operations of TNEs, Volume I (FDI Flows and Stocks).* <www.unctad.org/en/pages/PublicationsArchieve.aspx?publicationid=393> Accessed 04 April 2016.

[418] See Bruce Rich, *Mortgaging the Earth: The World Bank, Environmental Impoverishment and the Crisis of Development* (Island Press, The Centre for Resource Economics, 2013). Rich extensively discusses the plight of the poor communities in Brazil, Indonesia, and Thailand, where infrastructure has perhaps caused more harm than benefit to the impoverished communities.

[419] BBC, 'Nigerians living in poverty rise to nearly 61%' *BBC* (London, 13 February 2012) <http://www.bbc.co.uk/news/world-africa-17015873> Accessed in 26 April 2016.

In 2014, FDI inflow figures to South Asia experienced a 16% increase, compared to a downward trend for West Africa for a sixth consecutive year, decreasing by 4% to US$43bn. FDI flows to South Asia rose to US$41.2bn, primarily owing to growth in India, the dominant FDI recipient in South Asia. Whereas there is no conclusive evidence to suggest that risk is a major driving force insofar as infrastructure development funds, it is argued that it is one of the most important factors.

In addition to the circular debt issues, the prevailing political and economic issues in Pakistan make it an outfit satisfying the classic definition of political risk.[420] The previous section has illuminated the nature of political risk, and discussed the elusive concept of political risk, and some of the facets of foreign direct investment. Whereas the above-mentioned arguments shed light on the dominance of FDI geared towards less volatile, higher return regions, it is submitted that the abundance of un-tapped natural resources has led to a drive towards investment in more volatile regions subject to the provision of sovereign guarantees, a facet discussed in the previous chapter, and the availability of risk insurance. Most of the benefits of FDI are intangible in nature, and are particularly scarce in developing countries. Whereas infrastructure development and the availability of certain processed commodities are more visible, the introduction of technology, skilled work force are less obvious.

[420] See Paola Morales Torrado, 'Political Risk Insurance and Breach of Contract Coverage: How the Intervention of Domestic Courts may prevent Investors from Claiming Insurance' (2005) 17 PACE Int'l L Rev 301. Torrado argues that the probability of occurrence of an event will result in an adverse effect on the profitability of the project.

Pakistan labours under the reputation of being a volatile economy. Events, both political and non-political have had a direct impact on the risk exposure of potential foreign investors. State and non-state elements have perpetrated terrorist activities harming the investment prospects in an already almost non-existent investment regime. Unlike the Arab Spring, the woes of Pakistan are ongoing. The issues discussed in the introductory chapter concerning circular debt within the energy cycle have had an adverse impact on Pakistan and investment in Pakistan. FDI figures from 2006 to 2010 varied, as the country transitioned from a dictatorial regime to an elected government.[421] The years from 2010 to 2014 failed to attract FDI as originally envisaged by economists and political analysts. A continued political turmoil led to a fragile economy, which was unable to attract foreign investment. However, after the 2013 elections, FDI inflows to Pakistan increased by 3% to US$1.7 billion, as a result of rising Chinese FDI in the country. Figures Figure 5.7 and Figure 5.8, below, illustrate the change in trend after 2013. It is submitted that these figures are likely to increase as a result of the CPEC related work.

[421] Also see Bruce Rich, *Mortgaging the Earth: The World Bank, Environmental Impoverishment, and the Crisis of Development* (The Centre for Resource Economics, Island Press, 2013). Rich has criticised the Bretton Woods for supporting illegitimate regimes. The World Bank had refused to lend to the democratically elected Goulart government in Brazil in the early 1960s, but following the 1964 military coup, lending rose to average US$73 million a year. Chile, under the democratically elected regime of Allende, received no bank loans, but following the Pinochet coup in 1973, the country suddenly became creditworthy, despite a worsening economic situation.

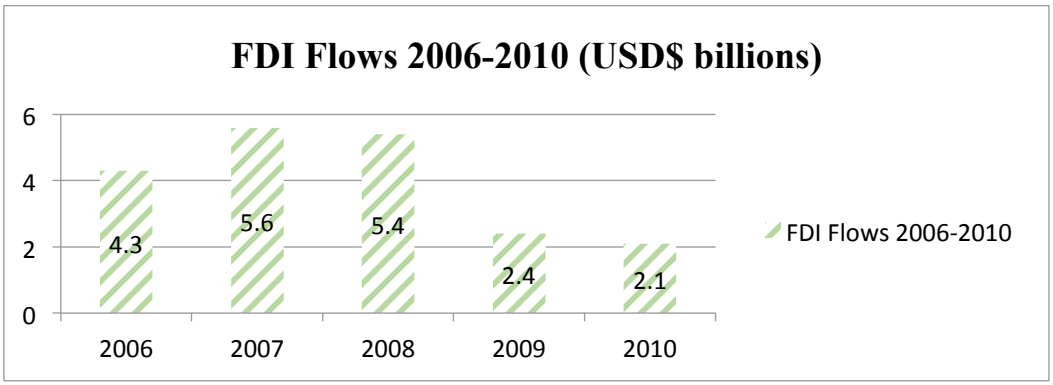

Figure 5.7: Pakistan's FDI Inflow 2006-2010[422]

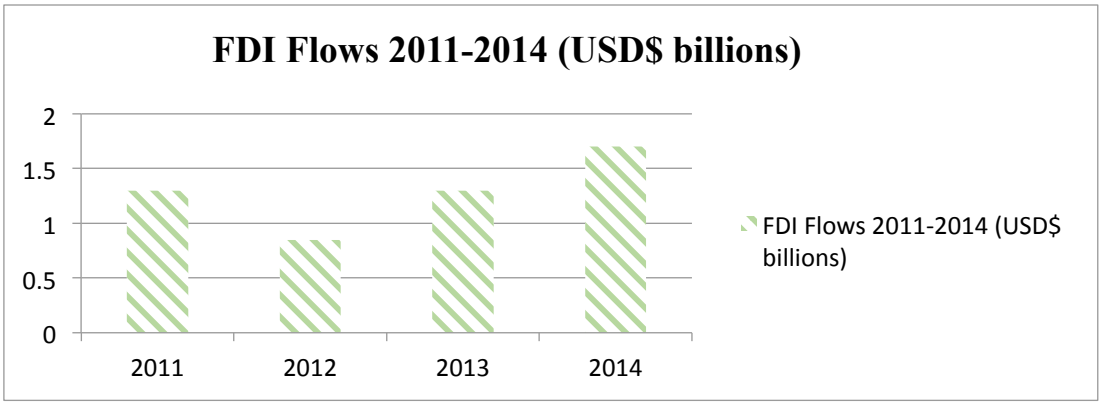

Figure 5.8: Pakistan's FDI Inflow 2011-2014[423]

China's commitment towards regional domination has led its private sector to invest heavily abroad. Whereas China has become the world's largest recipient of FDI, it is witnessed that many developing countries are increasingly becoming home countries for FDI flows. In fact, the outward FDI stock of developing countries has grown considerably since 1990, with a particular leap since 1995. In addition, FDI flows originating from, and going to, developing countries appear to be growing faster than those from developed to developing countries

[422]Data available<http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD/countries?page=1> Accessed 07 April 2016.

[423]Data available <http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD/countries?page=1> Accessed 07 April 2016.

since the late 1990s.[424] China's investment in Pakistan is part of the South-South FDI flow drive.

CPEC, more commonly known as 'economic corridor', is part of the overall context of implementing China's "one belt, one road" strategy.[425] The Chinese investment comprising approximately US$45.6bn (of which US$33.8bn will be invested in the electricity sector, and US$11.8bn in transport), is an effort to improve and facilitate the transmission and distribution component of electricity generation. Whereas both parties are committed to undertake this project and successfully complete it within the time frame, there are several political and non-political risks that threaten the completion of the project.[426] The project has already been delayed, as the original route went through the troubled province of Balochistan, a province rife with a separatist movement targeting foreign investors.

Whereas there is no extensive debate surrounding the 'war and civil disturbance risk' as a category that may affect investment prospects in Pakistan, there is a likelihood that they may prove problematic from an investment standpoint. Pakistan's support for the US's war on terror, and consequently, military operations against terrorist factions in the tribal areas, has had economic ramifications for the country. Modest estimates suggest that Pakistan has

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[424] United Nations Conference on Trade and Development (UNCTAD), *South-South Cooperation in International Investment arrangements*, (UNCTAD Series on International Investment Policies for Development, 2005) <http://unctad.org/en/pages/PublicationArchive.aspx?publicationid=424> Accessed 04 April 2016.

[425] See United Nations Conference on Trade and Development, *World Investment Report 2015: Reforming International Investment Governance* (2015) <www.unctad.org/en/PublicationsLibrary/wir2015_en.pdf> Accessed 03 May 2016.

[426] See Muhammad Amir Rana, 'The CPEC trick' *The Dawn* (Islamabad, 24 April 2016) <https://www.dawn.com/news/1253998> Accessed 24 April 2016.

suffered approximately US$188bn as a result of its war on terror.[427] Moreover, as outlined by MIGA, it is argued that terrorism risk is difficult to quantify and therefore not easy to insure.[428] As a result, there is a great potential for vast losses from large-scale terrorist attacks, especially in urban centres, which reduces the ability of the private sector to offer insurance. It is pertinent to mention, however, that from Pakistan's standpoint there has been no major terrorist attack on a project facility, and therefore the study primarily concentrates on contractual breach by off-taking bodies, and subsequently the government.

Unlike terrorism risk, other forms of risk discussed above can be quantified. Subsequently, this study partakes to draw attention to an ancillary security measure that can either strengthen the existing sovereign guarantee framework or replace it altogether.

5.3 Political Risk Insurance

Since time immemorial, investors have always been looking to mitigate risk. British and Portuguese traders during the eighteenth and early nineteenth centuries travelled across the Indian sub-continent. They would gamble on the ships leaving and arriving at the port. In order to mitigate their losses and diminish risk, these traders would seek insurance from wealthy traders, in order to ensure that they would be indemnified against any losses that they suffered as a consequence of an accident during their voyage.

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[427] See Editor, 'Pakistan suffered loss of $188bn during war on terror' *The Dawn* (Islamabad, 4 June 2016)
[428] See MIGA, *World Investment and Political Risk* (2012) <www.miga.org>

One theme that emerges throughout this study concerns the predicament that every business faces: risk. The degree to which an investor is ready to bear that risk varies from transaction to transaction, however there will always be an element of risk. As illustrated in Figure 5.1 read in conjunction with Figure 5.5, stable economies providing investment safety offer lower returns compared to more volatile economies. As a result, investors are increasingly drawn towards volatile economies, but are looking to mitigate their risk through, inter alia, guarantees, insurance instruments and subrogation.

In order to bring certainty within an investment regime and provide adequate recourse for investors, in case the SOEs or the state are unable to provide recompense for a breach of payment under PPA, political risk insurance (hereinafter referred to as "PRI") provides a plausible additional security measure. PRI is emerging as a pivotal plank for international investment regime. Investors' increasing endeavour to mitigate risk whilst investing in volatile economies is illustrated through the rising PRI issuance. In 2012, new PRI issuance reached a historic high, increasing by 33% even as global FDI flow declined.[429] PRI works as a sub-set of a broader arsenal of investment guarantees, offering investors security against a wide spectrum of risks in the host state. A PRI provision transforms an unpredictable or uncertain event into a calculable probability that can be assigned an economic value. If such an event occurs, what is insured against is not the loss or injury suffered as a consequence

[429] See Celine Tan, 'Risky business: Political risk insurance and the law and governance of natural resources' (2015) Int'l Journal of Law in Context, Vol 11, Issue 2, pp174-194.

of the occurrence of the insured event, but 'a capital against whose loss the insurer offers a guarantee'.[430]

MIGA's Economic Intelligence Unit (hereinafter referred to as "EIU") survey found that political risk was the second most significant factor in the decision-making process by investors in relation to making FDI decisions in developing countries, after 'macro-economic' instability.[431] In order to provide a more effective tool to mitigate inter alia, political and macro-economic risks, there are national, regional and international investment guarantee agencies. The scope of this study does not allow for a detailed discussion of all the insurance bodies (both private and multilateral) providing investment protection. However, a brief reference to the Overseas Private Investment Corporation (hereinafter referred to as "OPIC") has been made. This study then continues to extensively refer to MIGA's operations, in a bid to understand the wider influence exercised by such bodies in project finance transactions.

The PRI market broadly consists of three main risk insurance providers: public, multilaterals, and private PRI providers.[432] OPIC is a good example of a national investment security instrument. OPIC is the US Government's development

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[430] See Francois Ewald, 'Insurance and Risk', in Graham Burchell, Colin Gordon and Peter Miller (eds), *The Foucault Effect: Studies in Governmentality* (University of Chicago Press) 197-210.

[431] See MIGA, 2013 *World Investment and Political Risk (2013)* World Bank <www.miga.org/documents/WIPR13.pdf> Accessed 13 February 2016.

[432] See MIGA, *Strategic Directions FY15-17* <www.miga.org/documents/MIGA_FY15-17_Strategy.pdf> Accessed 22 March 2016. The PRI market includes three broad categories of providers: public PRI providers, multilaterals, and private PRI providers. Public providers include national export credit agencies, investment credit, investment insurance, and insurance entities, and are generally focused on border trade and investment for constituents in their own countries. Multilaterals include the African Trade Insurance Agency, the Inter-Arab Investment Guarantee Corporation, the Islamic Corporation for the Insurance of Investments and Export Credit, and MIGA; also see Robert B. Shanks, 'Insuring investment and loans against currency inconvertibility, expropriation, and political violence' (1985-86) 9 Hastings Int'l & Comp L Rev 417.

finance institution which mobilises private capital to help solve critical development challenges and advance the government's foreign policy objectives. OPIC's coverage is divided into two classifications: first, "the current insured amount", which is the amount of coverage actually in effect at a given time, and secondly, the "standby insured amount", which is assurance that OPIC will provide future coverage, up to the maximum stipulated amount specified in each contract.[433]

OPIC's status as a government agency has been beneficial for its operations and its investors. Investors have increasingly sought OPIC's services knowing that the U.S government will assist them in dealing with the host state government. This aspect has been discussed later in this chapter.[434] However, since OPIC's services are only limited to US nationals, OPICs insurance package will not be discussed extensively in this study.

Before providing an outline of MIGA's services normative to Pakistan's energy sector, this chapter provides a brief outline of the differences between insurance and a guarantee instrument. In view of the extensive discussion undertaken in Chapter 4, it seems appropriate to provide an insight and highlight the differences predicated in both instruments, in order to differentiate their presence in an investment regime.

5.3.1 Are Insurance and Guarantee instruments two sides to a coin?

[433] S Linn Williams, 'Political and other risk insurance: OPIC, MIGA, EXIMBank and other providers' (1993) 5 Pace Int'l L Rev 59.
[434] See Robert B Shanks, 'Insuring investment and loans against currency inconvertibility, expropriation, and political violence' (1985-86) 9 Hastings Int'l & Comp L Rev 417.

Insurance and guarantee instruments share an uncanny resemblance. First, both instruments are a means to mitigate risk, and perhaps even promote free movement of capital. The provision of another party agreeing to pay or hold harmless another party against any agreed loss creates an environment where there is more trust amongst parties to undertake financial transactions. Second, both instruments aim to protect a final beneficiary within a transaction, and ensure that a third party holds harmless the creditor. However, after careful review one can argue that an insurance instrument is in effect an indemnity instrument. A contract of insurance is a direct, positive and independent contract wherein the insurer agrees to pay money upon the happening of a specified event.[435] A contract for insurance, like a contract of indemnity, imposes a primary liability upon the party that agrees to indemnify. The creation of a primary liability usually ensures payment of money upon the occurrence of a specified event. As a result, unlike a contract for guarantee, it is not a collateral obligation to answer for the debt or default of another person.[436] The legal remedy that ensues from the application of both an indemnity and an insurance instrument are a form of indemnification.[437] This legal conundrum was explained in the seminal case of *Prudential Insurance Co v Inland Revenue Commissioners*[438], wherein Channell J submitted:

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[435] *Yeoman Credit Ltd v Latter* [1961] 1 W.L.R. 828. Also see James O'Donovan and John Phillips, *The Modern Contract of Guarantee* (1st Edition, Sweet & Maxwell, 2010).

[436] *Zuhal K* [1987] 1 Lloyd's Rep 151; *Prudential Insurance Co v IRC* (1904) 2 K B 658 at 663 per Channell J. A contract of insurance secures some benefit to the insured, but a guarantee generally involves no payment to the creditor.

[437] As per Richard Posner in *Harley Davidson, Inc v Minstar, Inc* 41 F 3d 341 (7th Cir 1994); similarly see Geraldine Andrews and Richard Millet, *The Law of Guarantees* (6th Edition, Sweet & Maxwell, 2012) pp 8. It is noted that contracts of insurance and contracts of guarantee are both examples of contracts which protect the creditor from loss.

[438] (1904) S K B 658.

> …[A]nd it seems to me that we must inquire a little further into the nature of a contract of insurance. Where you insure a ship or a house you cannot insure that the ship shall not be lost or the house burnt, but what you do insure is that a sum of money shall be paid upon the happening of a certain event…Then the next thing that is necessary is that the event should be one which involves some amount of uncertainty. There must be either uncertainty whether the event will ever happen or not, or if the event is one which must happen at some time there must be uncertainty as to the time at which it will happen...A contract of insurance, then must be a contract for the payment of a sum of money, or for some corresponding benefit such as the rebuilding of a house or the repairing of the ship, to become due on the happening of an event, which event must have some amount of uncertainty about it, and must be of a character more or less adverse to the interest of the person affecting the insurance.

The concept of uncertainty explained by Channell J is predicated upon the notion of speculation. It is interesting to note that a contract of insurance does not relate to the occurrence of default or lack of performance of a third party. Nor is it necessary for an insurance contract to relate to the conduct or performance of another person.[439] Lord Esher M R explained this central point, by reference to marine insurance 'a policy on a ship, for instance, is not an understanding to pay

[439] James O'Donovan and John Phillips, *The Modern Contract of Guarantee* (1st Edition, Sweet & Maxwell, 2010).

the amount insured, if somebody else, for example, the owner of another ship that has caused the loss, does not, but to pay such amount on the loss of the ship'.[440] Unlike a contract of insurance, a contract of guarantee is not based around speculation. Nor is the notion of a guarantee predicated upon the understanding that a party pays a premium in order to remain insured. At least from an investment regime standpoint, it is argued that guarantees involve no premium payable from the investor or sponsors to the host state. Moreover, there is an element of reliance upon the performance of another party and hence the entire structure relates to the imposition of a secondary obligation. In case of sovereign guarantees, the state guarantees the performance of the off-taker to purchase the electricity from the project company for a fixed period, or as stipulated within the provision of the PPA. As a result, under a sovereign guarantee framework the state will pay the project company any sums due under the PPA in case there is a breach perpetrated by the off-taker under the agreement.

Moreover, Andrews & Millet submit that a contract of guarantee is narrower in its scope in comparison to a contract of insurance.[441] As mentioned earlier, a contract of insurance comes into operation upon the occurrence of a specified event.[442] Therefore, it can be seen why they have made the aforementioned submission.

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[440] See *Dane v Mortgage Insurance Corp Ltd* [1894] 1 Q B 54 at 60.

[441] Geraldine Andrews and Richard Millet, *The Law of Guarantees*, (6th Edition, Sweet & Maxwell, 2012)

[442] *Prudential Insurance Co v Inland Revenue Commissioners* (1904) 2 K B 658; see *Seaton v Heath* (1899) 1 Q B 782, wherein it is expressed that the insurer undertakes to pay the loss incurred by the insured in the event of certain specified contingencies occurring.

This section provides a broad outline concerning the two legal instruments. The primary argument rests on the understanding that an insurance instrument is, in essence, a contract of indemnity. As a result, broadly speaking, it imposes a primary liability upon the insurer to protect the creditor in the event that a specified event has occurred.

5.3.2 MIGA's PRI: A Reassuring model?

There are several national, regional and international insurance agencies in the public and private domains that facilitate international investment and infrastructure development. This thesis specifically reviews MIGA's PRI model, as one which mitigates investor risk, and facilitates investment flow to impoverished economies. There are two reasons why this study investigates and focuses on MIGA. First, it is impossible to discuss and analyse all risk insurance providers.[443] The underlying contention of this study does not deal with political risk insurers per se, but the act of insuring through political risk insurance and providing an additional measure of security. Therefore, it seems more appropriate to focus on one agency, which demonstrates a stronger connection with infrastructure development. The second, and perhaps more compelling reason relates to MIGA being part of the operations and an arm of the World Bank Group (hereinafter referred to as "Group"). The Group has extensively advised Pakistan on several complex issues, and provided funding and technical expertise on fiscal and development issues. As a result, MIGA has a very close nexus with developing countries, especially Pakistan.

[443] This limitation is imposed due to the extensive products and the historical context of all the insurance providers. Moreover, since the primary focus of this thesis is to determine the adequacy of sovereign guarantee instruments, it did not warrant an extensive discussion on all the risk insurers.

A brief history of Pakistan's relationship with the Group is as follows: Pakistan became a member of the Group on July 11, 1950[444], three years after its independence. The World Bank's advice on external financial assistance, large resources at their disposal, and their influence exercised through conditionalities has contributed towards strengthening the macro-economic framework, efficient monetary control and misallocations of resources brought about by high rates of inflation.[445] Insofar as the influence exercised by the Group over Pakistan, Pakistan has been a beneficiary of the funds made available to it by the Group over the course of its six decades of membership. In a recent string of efforts to support Pakistan, the World Bank approved a loan of US$12bn, payable after thirty years. The World Bank highlighted that 'the Government of Pakistan deserves appreciation for stabilising the economy, initiating reforms in the power sector as well as revenue mobilisation and drawing in the private sector for spurring growth'.[446]

Over the last decade, Pakistan has received over US$49bn from various multilateral institutions.[447] A significant proportion of this constitutes the amount

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[444] Nigeria joined the World Bank on 30 March 1961; Kenya on 3 February 1964. Data available on <http://www.worldbank.org/en/about/leadership/members> Accessed on 15 June 2016. For a detailed account of the history of the formation of the Bretton Woods and especially the World Bank, see Bruce Rich, *Mortgaging the Earth: The World Bank, Environmental Impoverishment, and the Crisis of Development* (Island Press, Centre for Resource Economics, 2013) See Chapter 3 specifically; also see Asif H Qureshi and Andreas R Ziegler, *International Economic Law* (3rd Edition, Sweet & Maxwell, 2011).

[445] See Ariel Buira (ed), *Challenges to the World Bank and IMF: Developing Country Perspectives* (Published for G24 Research Program, Anthem Press, 2003); also see Heena R Bakshi and R B Saxena, 'IMF Conditionality—A Third World Perspective' (1988) 22 Journal of World Trade, Issue 5, pp 67-79; also see Corrado Pirzio-Biroli, 'Making sense of the IMF Conditionality Debate' (1983) 17 J World Trade L 115.

[446] Katharine Houreld and Maria Golovnina, '*World Bank approves $12 billion, five year-loan for Pakistan: Finance minister'* The Reuters (2 May 2014) <http://www.reuters.com/article/us-pakistan-worldbank-loan-idUSBREA4108N20140502> Accessed 02 April 2016.

[447] Bruce Rich, *Mortgaging the Earth: The World Bank, Environmental Impoverishment, and the Crisis of Development,* (Island Press, Centre for Resource Economics, 2013). Rich discusses the questions raised by Robert Thaft in the 1990s. Thaft argued 'the Bank and the Fund are seemingly permanent, eternally expanding institutions, and there is little possibility that most

received from the IMF and the Group.[448] Whereas the majority of the contributions made through the Bretton Woods organisations (IMF and World Bank) have been primarily as loans or aid, it is submitted that donor aid alone cannot build long-term, lasting economic growth.[449] It is for this reason that the role of political risk insurers in general, and role of MIGA in particular, is extremely relevant. MIGA's PRI helps to assuage any concerns highlighted by investors, and encourages them to invest in countries where they would otherwise hesitate without such assistance.[450]

Moreover, in light of Pakistan's energy crisis discussed throughout this study, MIGA's extensive expertise on advising various parties in the sector gives it an eminent position.[451] Amongst a list of recent transactions, MIGA provided AES Horizons Ltd with a guarantee for US$20million to cover part of US$223 million equity in the Maritza East 1 power project in Bulgaria. Another example of MIGA's contribution towards promoting investment in the energy sector and demonstrating its expertise in the area is Vietnam's Phu My Power Complex, which provides 8-10% of the country's electricity. MIGA provided a guarantee of US$43.2million for equity investment, US$75 million for a non-shareholder

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developing countries will ever pay off their burgeoning debts. The "solution" has been to lend them more and more, and to postpone the ultimate day of reckoning'.

[448] Shahbaz Rana, 'Pakistan has received $49 billion in the last 10 years' *The Express Tribune* (Islamabad, 7 August 2015) <http://tribune.com.pk/story/933617/foreign-loans-pakistan-has-received-49-billion-in-last-10-years/> Accessed 07 August 2015.

[449] MIGA, *Annual Report 2005* (Washington, MIGA) <www.miga.org> Accessed 02 June 2016.

[450] MIGA, *Annual Report 2006* (Washington, MIGA) <www.miga.org> 02 June 2016. One of the primary goals of MIGA is to encourage the return of traditional infrastructure investors who have abandoned developing countries in search for safer investment climates.

[451] See MIGA, *Annual Report 2003* (Washington, MIGA) <www.miga.org> Accessed April 2016. The report submits that 'as part of the World Bank group, MIGA brings a breadth of resources and experience that provides an added level of comfort for investors considering these types of water sector projects'. The report further touches upon an example: in the case of Guayaquil, MIGA's guarantees played a crucial role in insuring that the project got off the ground. At the time of signing, potential shareholders were concerned about the country's history of political risk. Without this insurance, the project was in danger of not moving forward.

loan, and US$15 million to cover a financing swap agreement.[452] There are numerous examples of how MIGA can prove beneficial in supporting and countering the acute energy crisis faced by Pakistan.

Pakistan's endemic electricity crisis situation resonates with Bulgaria's nuclear power projects in the 1980s. Seven nuclear power projects were issued LoIs to commence construction and development of nuclear energy. Only one of the seven projects, the Kozloduy Nuclear Power Project, is still active. This is primarily because Bulgaria was unable to provide any guarantees insofar as the risk undertaken by the investors. Eventually, through a public-private partnership structure, the Bulgarian authorities participated and shared the risk taken by the investors. In view of increasing budget constraints and fiscal stress, sovereign finance is no longer a viable option. As a result, PRI in Pakistan's energy sector can be viewed as an ancillary, additional form of security to promote and direct more investment in the energy market.

Through perusal of various reports, and informal discussions with members of the government, it is fair to argue that the strong relationship that exists between Pakistan and the Group can be used as a leverage point to further increase investor confidence in its energy sector. The next section aims to provide extensive information of the range of products offered by MIGA that could mutually benefit the parties in their endeavour to address the endemic energy crisis.

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[452] See MIGA, *Annual Report 2006* (Washington, MIGA) <www.miga.org> Accessed 06 April 2016. MIGA has been active in participating in transactions to guarantee an investor's interests and to promote investment in the infrastructure development. It is submitted that amongst the projects highlighted above, other notable projects MIGA was involved include: 450MW Ashyuganj Power Station Company Limited, the expansion of Angola's Cambambe Hydroelectric Power Plant and Pakistan's 147MW Star Hydro Power Ltd project.

5.3.3 Multilateral Investment Guarantee Agency (MIGA)

Insurance schemes are not a legal guarantee against the occurrence of an expropriatory measure or breach of contract by the off-taking body in a volatile jurisdiction. An insurance instrument simply guarantees the investor adequate indemnity when any such event occurs.[453]

One of the fundamental planks of an investment insurance instrument is predicated on the assumption that by purchasing political risk insurance, investors can spare themselves the expense, delay and inconvenience of pursuing claims against the host country's government. Consider the Nigerian National Petroleum Corporation (hereinafter referred to as "NNPC") case: IPCO instituted a claim against NNPC in 2004; at the time of writing, IPCO has received no compensation from the NNPC!

Referring to Lord Esher M R's remarks in *Dane v Mortgage Insurance Corp*, it is argued that the 'cause of loss' will result in the insured party reserving the right to payment from the insurance provider if a specified event occurred.[454] The introduction and rise of investment insurance instruments have become popular due to a decline in investment trend towards developing countries.[455] The perceptible decline in investment in developing countries was highlighted by the World Bank's report in 1985. The World Bank estimated that investment

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[453] See Hasan S Zakariya, 'Insurance against the political risk of petroleum investment' (1986) 4 J Energy & Natural Resources L 217.

[454] Vance R Koven, 'Expropriation and the Jurisprudence of OPIC' (1981) 22 Harvard International Law Journal 269, 270.

[455] See Marina Von Newmann Whitman, *Government Risk Sharing in Foreign Investment* (Princeton University Press, 1965). Whitman states that economists recognised that fear of the unfamiliar will often lead an investor to keep his money at home when he could earn more on it abroad. Whitman relies on Adam Smith, *Wealth of Nations;* David Ricardo, *Principles of Political Economy and Taxation, VII.*

amounting to about US$17bn in 1981 fell to US$12bn in 1982, and to US$8bn in 1983.[456] Investors were reluctant to invest, primarily due to the risk of either not being paid any revenue for the product offered by the project company or due to an imminent expropriation measure introduced by the host state.

During this time period, wherein FDI was faltering, and the existing national or regional investment insurance schemes either precluded certain form of investment or investors[457], there was a need for a multilateral insurance agency. Such an agency would address these shortcomings in order to facilitate and encourage investment flows to the developing countries.[458] Ibrahim Shihata was one of the strong advocates of capitalising on a growing opportunity to facilitate investment in developing economies.[459] This was a period when LDCs were cautious about foreign investment. They were suspicious that along with the investment, the Western political-economic agenda would also be forced upon various institutions within the host state, thus inculcating Western policies into the existing political regime's ideology.[460] These countries, often haunted by colonial times, viewed FDI as a means of economic imperialism. Perera, who

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[456] See The World Bank, *Report on MIGA: Multilateral Investment Guarantee Agency* (September/October, 1985) p 2; also see Hasan S Zakariya, 'Insurance against the political risks of petroleum investment' (1986) 4 J Energy & Natural Resources L 217.

[457] See Motomichi Ikawa, 'Multilateral Investment Guarantee Agency' (1999) 31 Stud Transnational Legal Policy 21.

[458] See Richard B Alsop, 'The World Bank's Multilateral Investment Guaranty Agency', (1986-1987) 25 Colum J Transnational L 101. Also see Ibrahim F I Shihata, 'The settlement of disputes regarding foreign investment: the role of the World Bank, with particular reference to ICSID and MIGA'(1986) 1 Am U J Int'l L & Policy 97.

[459] Richard B Alsop, 'The World Bank's Multilateral Investment Guaranty Agency', (1986-1987) 25 Colum J Transnational L 101; Paola Morales Torrado, 'Political Risk Insurance and Breach of Contract Coverage: How the Intervention of Domestic Courts may prevent investors from claiming insurance' (2005) 17 PACE Int'l L Rev 301.

[460] See Patrick J Donovan, 'Creeping Expropriation and MIGA: The need for tighter regulation in the political risk insurance market' (2003-2004) 7 Gonz J Int'l L 1; investment from foreign parties was also viewed as an extension of the economic colonialism. Local far-right political forces and pressure groups felt that by bringing investment the host country will be influenced over their policies.

made a valid submission concerning the introduction of a multilateral insurance body, noted another interesting submission. Perera[461] notes:

> Proposals for multilateral investments came at a time when the call for nationalism was at its zenith. Newly independent countries sought increasingly to control their own natural resources and at a minimum sought to shift the bargaining power away from large oil and ore producing corporation that were dominating the natural resource areas.

The increasing demand for a multilateral investment agency dealing with a widespread endemic issue concerning investment led to the inception of MIGA in 1988.[462] At the time only few people believed or anticipated the usefulness of a multilateral political risk insurer.[463] Since then, MIGA has grown as an organisation facilitating investment in developing and developed countries. While it can be argued that foreign investment in developing or LDCs is not a panacea for surmounting the challenges of poverty reduction, job creation and

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[461] See Srilal Mohan Perera, *Techniques in Protecting Foreign Investments Against Political Risk* (University Microfilms International, 1986). Perera's primary moot point in his doctoral thesis was that the MIGA did not come into play sooner due to the nationalist concerns raised various LDCs with the World Bank. Also see Don Wallace, Jr. and David B. Bailey, 'Exceptions and Conditions: The Inevitability of the National Treatment of FDI with Increasingly Few and Narrow Exceptions' (1998) 31 Cornell Int'l L J 615, 616. Wallace and Bailey note that historically: '[I]n the past World War II era, the initial concern was investment protection against expropriation, followed later by the desire of lesser-developed countries (LDCs) to create a "new international economic order" to replace the Bretton Woods System. LDCs wanted this new international economic order to include codes (the negotiation of which some thought would give rise to "soft law") that would control multinational corporations (MNCs) and their practices and have a general redistributive effect.

[462] See Patrick J Donovan, 'Creeping expropriation and MIGA: The need for tighter regulation in the political risk insurance market' (2003-2004) 7 Gonz J Int'l L 1; also note that even though MIGA was created in April 1988, it was only in 1992 that MIGA achieved, "critical mass"—country membership rose to about one hundred, and the guarantee business began a surge of growth. See Motomichi Ikawa, 'Multilateral Investment Guarantee Agency' (1999) 31 Stud Transnational Legal Policy 21.

[463] Motomichi Ikawa, 'Multilateral Investment Guarantee Agency' (1999) 31 Stud Transnational Legal Policy 21.

economic uplift, it is submitted that investment is a pivotal plank in the overall strategy towards successful and sustainable development, that ultimately creates jobs and economic growth.[464] MIGA's role primarily concerns encouraging the flow of investments for productive purposes among member countries, and in particular to developing member countries.[465] MIGA's preamble also highlights that the flow of foreign investment to developing countries would be facilitated and further encouraged by alleviating concerns relating to non-commercial risks, and can further strengthen international cooperation for economic development to foster private foreign investment.[466]

There is a sense of 'security by association' which arises when dealing with an organisation that has government backing, as in the OPIC model of providing assistance, where OPIC utilised their association with the US Government to facilitate investment and resolve investment disputes. During the Dabhol Power Project, MIGA too provided an ancillary service to its principal business (acting as a risk insurer), by bringing an aura of security arising from association with the Group. MIGA's interaction with political administrations in various parts of the world gives it an advantage in carrying out research, providing technical

[464] See Adam L Masser, 'The Nexus of Public and Private in Foreign Direct Investment: An analysis of IFC, MIGA, and OPIC' (2008-2009) 32 Fordham Int'l L J 1698. Masser also argues that FDI is, quite simply, the activities of private investors who are investing in the private sector of a foreign state. It is a key element of development; increasing the capacity of the private sector in the developing world will allow more the benefits of trade to reach the world's poorest people.
[465] See Article 2 of the Convention Establishing the Multilateral Investment Guarantee Agency. <www.miga.org>
[466] See Preamble of the Convention Establishing the Multilateral Investment Guarantee Agency. <www.miga.org>

assistance and policy advice to developing countries, in order to restructure or improve their investment regime.[467]

These ancillary benefits ensuing from involving MIGA may not be considered a secondary activity of MIGA, but a vital part of its mandate. Some criticism may be made as a result of these services: some argue that these services are an encroachment on a state's sovereignty. However, there is a widespread view that MIGA's role as an institution providing technical assistance, policy advice, and carrying out research is, in essence, their method of understanding the risks involved in a particular transaction and mitigating them.[468] Romer L J made a similar observation in *Seaton v Heath*, wherein he submitted that:

> [T]he person desiring to be insured has means of knowledge as to the risk, and the insurer has not the means or not the same means. The insured generally puts the risk before the insurer as a business transaction, and the insurer on the risk stated fixes a proper price to remunerate him for the risk undertaken…[469]

As discussed earlier, the principal purpose of MIGA is to remove barriers for FDI surrounding developing, volatile economies, insofar as the element of risk

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[467] See A F M Maniruzzaman, 'The pursuit of stability in international energy investment contracts: A critical appraisal of the emerging trends' (2008) Journal of Energy Law & Business, Vol 1, No 2 121; also see Celine Tan, 'Risky business: political risk insurance and the law and governance of natural resources' (2015) Int'l Journal of Law in Context, Vol 11, Issue 2, pp174-194.

[468] In an insurance rationality, risk transforms an unpredictable or uncertain event into a calculable probability that can be assigned an economic value if and when it occurs, so that what is insured against is not the loss or injury suffered as a consequence of the occurrence of the insured event but 'a capital against whose loss the insurer offers a guarantee'. See Francois Ewald, 'Insurance and Risk', in Graham Burchell, Colin Garden and Peter Miller (ed), *The Foucault Effect: Studies in Governmentality* (Chicago, University of Chicago Press) 197-210.

[469] See (1899) 1 Q B 782, 792-793; also see Michael C Blair, 'The Conversion of Guarantee Contracts', (1966) 29 Mod L Rev 522.

bars investment from developed or other developing/transition economies.[470] Article 11 of the Convention Establishing the Multilateral Investment Guarantee Agency (hereinafter referred to as "Convention") outlines risks covered by MIGA.

> Article 11. Covered Risk[471]
>
> (a) subject to the provisions of Sections (b) and (c) below, the Agency may guarantee eligible investments against a loss resulting from one or more of the following types of risk:
>
> (i) Currency Transfer
>
> Any introduction attributable to the host government of restrictions on the transfer outside the host country of its currency into a freely usable currency or another currency acceptable to the holder of the guarantee, including a failure of the host government to act within a reasonable period of time on an application by such holder of such transfer;
>
> (ii) Expropriation and Similar Measures
>
> any legislative action or administrative action or omission attributable to the host government which has the effect of depriving the holder of a guarantee of his ownership or control

[470] See Valentina Okaru-Bisant, 'Overcoming Challenges in the Multilateral Investment Guarantee Agency's Risk Insurance Coverage to Private Water Investors: Corruption and Consumer Risks', (2012) 57 S D L Rev 277. Bisant submits that 'MIGA has the ability to deter some harmful action to private investors. MIGA also has the ability to help investors access and obtain project financing and its guaranteed loans may help reduce risk-capital ratings of projects.

[471] See the Convention Establishing the Multilateral Investment Guarantee Agency <www.miga.org> Accessed 06 June 2017.

of, or a substantial benefit from, his investment, with the exception of non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territories;

(iii) Breach of Contract

any repudiation or breach by the host government of a contract with the holder of a guarantee, when (a) the holder of a guarantee does not have recourse to a judicial or arbitral forum to determine the claim of repudiation or breach, or (b) a decision by such forum is not rendered within such reasonable period of time as shall be prescribed in the contracts of guarantee pursuant to the Agency's regulations, or (c) such a decision cannot be enforced; and

(iv) War and Civil Disturbance

any military action or civil disturbance in any territory of the host country to which this Convention shall be applicable as provided in Article 66.

MIGA provides an extensive cover to potential investors in order to promote investment. As highlighted in the political risk section (section 5.2, Navigating Political Risk) risk cannot always be quantified.[472] However, it can be calculated by attaching a proximate numerical value based on the probability of its

[472] Raoul Ascari and Federica Pocek, 'Country Risk from Theory to Practice' (May 2012) SACE <www.sace.it/docs/default/wp_sace_n15_countryrisk_en_pdf.pdf?>. Accessed 03 May 2016. The concept of risk is not easily quantifiable, and the numerous steps compound the difficulty to its measurement involved.

occurrence: a premium. Consequently, if the anticipated risk occurs, the insured is indemnified against such occurrence. Article 11 discusses the forms of risks covered under the Convention. For the purposes of our study, it is submitted that 'breach of contract', and 'non-honouring of financial obligations by SOEs forms a fundamental part of this thesis.

In light of the discussion on liquidity crisis within the energy cycle in Pakistan, it is argued that breach of contract by off-taking bodies poses a significant risk. Moreover, MIGA's global survey in 2009 indicates that investors are more concerned about breach of contract, non-honouring of government guarantees and adverse regulatory changes, which can result in investment loss, than outright expropriation,[473] thus illustrating the trend that promotes use of more robust security measures. Research undertaken as part of this study illustrates that the topmost priority for Pakistan is to address the liquidity crisis. However, the notion of liquidity issues is not predicated on one strand. In order to address investor concerns, Pakistan's best hope is to encourage use of MIGA's PRI model to uplift the investment regime before a regulatory overhaul can be undertaken.

From an in-depth analysis of the reports published by MIGA from 2009 to 2016, it can be concluded that risk insurance has grown in popularity. However, despite an array of risks experienced by investors, the majority of investors are still either agonising over how political risk can be mitigated most effectively, or prefer the informal methods of risk mitigation.[474] Amongst a wide variety of risk-

[473] MIGA, *World Investment and Political Risk 2009* <www.miga.org> Accessed 03 May 2017.
[474] MIGA, *World Investment and Political Risk 2011* < www.miga.org> Accessed 03 May 2017.

mitigation methods present, investors feel that joint ventures (hereinafter referred to as "JVs") with local businesses in the host state, building relationships with key political leaders, or engagement with local community can informally support risk mitigation. Whether there is any credibility to such measures is questionable. It is argued that these measures might provide short-term remedies, however cases like *IPCO*, *HUBCO*, and *Riqo Diq* provide strong indications to dispel any suggestion contrary to an actual third party insurance scheme, separate from the state's formal risk mitigation.[475]

MIGA's published reports have one theme in common. All the reports maintain that governmental interference through breach of contract or SOE not honouring their financial commitments is the key risk that concerns an investor.[476] In view of the uncertainty surrounding SOEs and especially off-taking bodies in Pakistan's energy sector, it is suggested that the notion of independence of these entities is qualified. Despite increasing concerns regarding breach of contractual agreements or PPAs by host state or its agencies, investors are still looking at other alternative measures to mitigate such risks. One of the reasons why this may be the case is primarily because developing countries over-sell the idea of security to these investors.

For example, at a workshop hosted in London's Centre for Commercial Legal Studies, the Managing Director of Private Power Infrastructure Board

[475] MIGA's report argues that PRI can be a very effective tool to hedge against cataclysmic and unexpected risk events such as the Arab Spring. See MIGA, *World Investment and Political Risk, 2011*. The risk insurance model offered by MIGA ensures that any uncertain event is minimised due to the influence exercised through these multilateral bodies.

[476] MIGA, *World Investment and Political Risk, 2011*; MIGA, *MIGA Strategic Directions FY15-17*, MIGA (2015) <www.miga.org/documents/MIGA_FY15-17_Strategy.pdf> Accessed 01 January 2016; MIGA, *World Investment and Political Risk, 2009* <www.miga.org> Accessed 24 January 2016.

(hereinafter referred to as "PPIB") emphasised on the robust nature of the contractual security offered by Pakistan.[477] He further highlighted that the security features are exemplary. In light of the discussion undertaken in Chapter 1 concerning the circular debt nemesis, there is a discrepancy as to what is being offered (and sold) and what an investor actually receives once a project company commences operations. In fact, it is the lack of understanding amongst some investors concerning these government security packages that eventually lead to unfulfilled expectations.

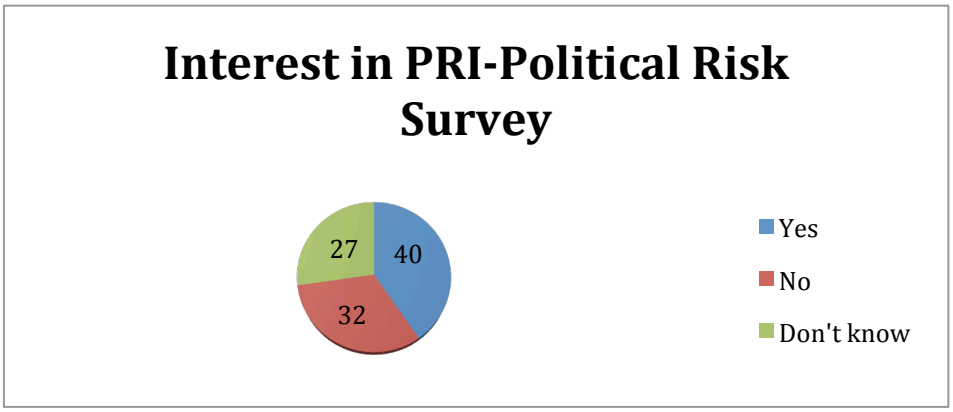

Figure 5.9: Interest in PRI [478]

As outlined in MIGA's PRI survey illustrated above in Figure 5.9, 40% of the respondents felt that PRI would be considered when investing abroad, 57% felt that they were either not sure or would not consider PRI. The results of this pie chart were gathered in 2009, and it is argued that the situation has changed since

[477] The workshop was hosted in London through funding from the Economic Social Research Council (ESRC) and in collaboration with Professor. Raphael Heffron (Queen Mary, University of London) on 26th January 2017.
[478] Interest in Political Risk Insurance. MIGA-EIU Political Risk Survey 2009. Question—do you expect your company to consider political risk insurance for its investment abroad? MIGA, *World Investment and Political Risk 2009* <www.miga.org> Accessed 13 January 2016.

then.[479] Whereas it is hard to judge the growing popularity of the risk insurance industry as a whole, figures drawn from the MIGA report indicate that there has been a rise in the number of PRI issued over the years, as the gross exposure of the agency grows amid signs of increasing political risk.

PRI is a redundancy measure to provide an additional recourse for the project company sponsors, or in cases where a party has breached their debt service repayment, the lenders, to be able to recoup their losses. However, seeking recompense is one of the reasons to draw a PRI.

Another prevalent view that demonstrates similarity between a sovereign guarantee and PRI instrument is predicated on the understanding that such security instruments are drawn to raise debt finance. As part of the research undertaken for this project, there is an implicit contention that shows PRI drawn in order to satisfy the lender's requirements to raise finance. After FC has been achieved, the insurance policy is generally cancelled. An extensive study of the reports published by MIGA vindicates this concern. In two instances, the reports have illuminated the aspect of MIGA's role wherein investors, EPC contractors, or the project company have used MIGA's services to illustrate to the lenders, mainly foreign financial institutions, that in case there is a breach on any of the contracted provisions, MIGA will indemnify the contracting party. However,

[479] See MIGA, *MIGA Strategic Directions FY15-17*, (2015) <www.miga.org/documents/MIGA_FY15-17_Strategy.pdf> Accessed 29 January 2016. The report discusses that 'the PRI market as a whole has grown at an average rate of 12% per year for the last seven years. The bulk of activity in the private sector PRI market is in countries rated investment grade (BBB-) or better, while MIGA has been most active in the higher risk countries rated BB, B, CCC, and below CC…MIGA's business has been growing at an average rate of 8% per year over the past 12 years, and that growth accelerated over the last few years, in part, as a result of the convention changes'.

once the project's FC has been achieved, the contract is cancelled. MIGA highlights this as follows:

> In fiscal year 2008, 50 contracts were cancelled. In addition, four contracts were replaced. The majority of cancellations took place when the investment was successful from a financial standpoint, and in most cases, the investor's perception of political risk had improved. Such cancellations illustrates that MIGA is achieving its mandate of encouraging foreign investors and lenders into markets they perceive as risky and supporting them until they feel comfortable enough to bear the risks on their own.[480]

MIGA's report outlines that cancellations only occur once an investor is instilled with confidence to proceed with an investment. The cancellation of the policy generally takes place when the investment is considered successful from a financial standpoint, or when perceptions of political risk have improved.[481] Banks, private equity firms and hedge funds are, primarily, in the majority of the cases, major contributors towards the finance raised. It can therefore be argued that PRI promotes moral hazard[482].

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[480] MIGA, *Annual Report 2008* <www.miga.org> Accessed 12 January 2016.

[481] MIGA, *Annual Report 2010* <www.miga.org> Accessed 12 January 2016. The report argues that MIGA's 2010 report submits 'that a total of 31 contracts were cancelled this fiscal year compared to 11 in 2009, and 54 in 2007. Cancellations generally take place when the investment is considered successful from a financial standpoint or when perceptions of political risk have improved.

[482] See Tom Baker, 'On the Genealogy of Moral Hazard' (1996-1997) 75. Tex L Rev 237, wherein Baker argues that Hazard has been imported from an old French word 'Hasart' in the mid-sixteenth century. Baker also argues that 'moral hazard has never been a straight forward,

This contention supporting PRI as a moral hazard can be explained using the example of a lifesaving vest. A lifesaving vest performs a dual purpose: first, it can be used to save an individual who is drowning, and therefore save a life. Second, it can be used to allow individuals who are learning to swim to enjoy deep-water swimming without fear of drowning. PRI instruments may be correlated to this concept. With an insurance instrument promising to indemnify an investor in case there is a breach, investors and lenders will be encouraged to invest in jurisdictions wherein they would not otherwise invest.

A classic example of moral hazard is reflected through the 2007 financial crisis. With central banks acting as 'lenders of last resort', the provision that there was an 'insurance' scheme effectively waiting to indemnify the losses incurred by the banks led to irrational, pervasive risk-taking behaviour, resulting in the financial institutions lending to individuals who were unable to pay and whom could least afford these services. These poor investments were then packaged together: multiple sub-prime mortgages rolled into one product, to sell onto other rich investors, even creating credit default swaps ("CDS") to bet against the market practices.[483] Consequently, banks and other financial institutions took more risk due to the presence of safety nets.[484]

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purely logical or scientific concept. It had a non-rational, performative dimension for the nineteenth century insurers who coined the term, just as it does today.

[483] See Nazanin Baseri, 'Credit Default Swaps and Clearing' (2011) American University Legislation and Policy Brief, 7-38; Angus Duncan, 'Loan-only Credit Default Swaps: The March to Liquidity' (Sept-Oct 2006) 21 Com Lending Rev 15, pp 15-18; Steven A Sibo, 'Credit Default Swaps: How should they be regulated' (2013) Dartmouth Law Journal, Vol 11, Issue 2, pp 54-81.

[484] See Henry Kolbus, 'The Moral Hazard and the Increased Risk' (1948) Ins L J 731; also see Omri Ben-Shahar and Kyle D Logue, 'Outsourcing regulation: How insurance reduces moral hazard' (2012-2013) 111 Mich L Rev 197 wherein it is submitted that 'Insurance arrangements—by using such tools as deductibles, exclusions, and experience rating—give private parties the incentive to reduce risks. Insurance is a business that specialises in risk management. Insurers

However, MIGA's report illustrates policy cancellation as a positive instruction. MIGA argues that their involvement and support leads investors to become more confident about investing in a volatile jurisdiction. This contention may be true to an extent; however, as there is an increasing chance of dispute arising as a result of scarcity of resources, it is unlikely that the investors, or their highly-leveraged enterprises, will be able to seek recourse without waiting in the host state courts. As agriculture and land investment in Africa is increasing, it is argued that most sellers or investors are taking account of the scarcity of water sources. This, in light of the cancellation of policies, can be problematic for investors in the long run.

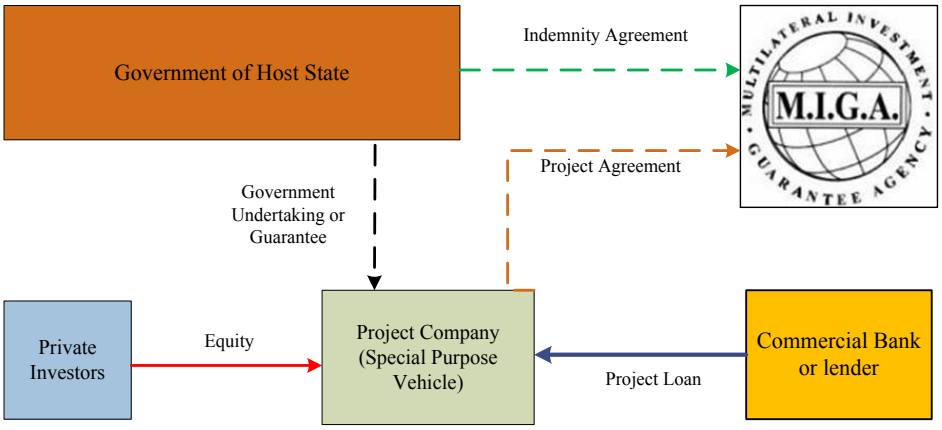

Figure 5.10: Illustration of how MIGA operates

The role of an insurance instrument in a project finance transaction is not to replace the sovereign guarantee framework altogether, but to provide an additional layer of security to further strengthen the sovereign guarantee. As outlined in Figure 5.10, above, both measures operate on a level-playing field, alongside each other. They are not competing against each other, but

assemble large actuarial databases and use them both ex ante in underwriting the risk they insure and ex-post in verifying claims by separating valid from frivolous ones.

complement each other. In a typical project finance transaction involving the provision of a sovereign guarantee and a PRI, there are three facets involved. First, the host state will sign a LoS, also known as a sovereign guarantee, with the project company. Second, the project company approaches the multilateral insurance agency, MIGA. This project agreement is an insurance document. The third contractual arrangement is between the host state and MIGA, wherein the host state agrees to indemnify the risk insurer in case there is breach of sovereign guarantee by the state or breach of the PPA. Consequently, there is a complex web of contractual arrangements, each dependent on the other. This arrangement illustrates that a sovereign guarantee framework is critical for the insurer too. However, it can be argued that the enforcement of PPAs and timely payments for a private investor will be different under the structure involving a multilateral institution like the Group, in comparison to a sovereign guarantee model acting in a vacuum. Moreover, historically, it is noted that sovereign states are reluctant to breach their contractual measures against multilateral institutions, due to the systemic effect such breaches may have with other contingent agreements.

5.3.4 Are Risk Insurance and Sovereign Guarantee Instruments different?

Unlike section 5.3.1, this section is not an illustration of the differences between the two instruments. This section highlights their characteristic value insofar as their incorporation within an investment regime to uplift investor confidence. The term ‘instrument’ refers to an apparatus. In an international investment context, these security arrangements, risk insurance, and sovereign guarantees are an apparatus to mitigate risk.

In a PRI model, the insurance is a guarantee, in its abstract sense, that reassures the sponsors (or the lenders) that they will be fully or partially indemnified by a third party. It is important to highlight the presence of a third party—unlike a sovereign guarantee arrangement, wherein the third party, along with the off-taker, is ostensibly part of the state's organic structure. From a project finance standpoint, it is submitted that in reference to the notion of certainty and security, an insurance model under a PRI is likely to provide a more robust form of security than a sovereign guarantee instrument under its current framework.

From the outset, the larger question presented in light of the above submission relates to the proposition: whether the presence of one instrument can replace the other? As illustrated in Figure 5.10, above, despite an insurance instrument signed with MIGA, the state still needs to provide a sovereign guarantee, along with an indemnity agreement to be signed with MIGA. This logical explanation subdues the suggestion that one framework can replace the other. A PRI model is an optional mode of operation. A sovereign guarantee, especially under Pakistan's existing framework, is offered as a blanket guarantee regardless of the size of the project being commissioned.

Moreover, in light of the liquidity crisis, it is questionable whether in the absence of effective regulation, either model will prove effective for the host state or provide any robust selection of security to the investors. For example, in Pakistan, the state pays as soon as the off-taking body defaults. However, a proposition to add a 'third wheel' to this arrangement, in the absence of clearly defined legal frameworks, is not addressing the real problem. As a result, in light of the proposition made in Chapter 3—renaming a sovereign guarantee

framework as a sovereign indemnity—one issue is being replaced with another. Similarly, replacement models such as PRI, especially when established by multilateral organisations like MIGA, will have significant ramifications in the event of default for the host state. As illustrated throughout this study, the state's inability to effectively manage SOEs and lack of regulation will cause defaults regardless.[485] However, any defaults under a multilateral arrangement will adversely affect other funding tranches. These may affect other development projects.

Without prejudice to the discussion undertaken above, it is argued that the primary machinery within PRI is contingent upon a sovereign guarantee, regardless of whether such is offered to a sponsor. However, it is pertinent to mention the secondary, implicit role of MIGA's PRI. As briefly mentioned earlier, the role of PRI is to enhance confidence and instill trust within lenders, in order to facilitate development projects.

Furthermore, the PRI instrument is inclined towards deterrence rather than an outright, complete protection.[486] Reviewing the reports published by MIGA, it is submitted that remarks made by MIGA's then Executive Vice President

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[485] MIGA, *MIGA Strategic Directions FY15-17* (2015) <www.miga.org/documents/MIGA_FY15-17_Strategy.pdf> Accessed 14 February 2016. The report submits that MIGA employs a risk-based pricing, based on country risk assessments for individual PRI covers (transfer restriction, expropriation, breach of contract, war and civil disturbance). Ratings for SOEs are prepared on a case-by-case basis, the approach for which is currently being refined.

[486] One can argue that the driving force behind the rapid growth of the political risk insurance market, which is estimated to be growing at 30-40% annually, is increasing the capability of private insurers to meet the insurance needs of international investors and lenders. It is also interesting to read another perspective wherein it is highlighted that PRI seems to remain discretionary purchase as margins became thinner and many established investors feel that their balance sheets are strong enough to warrant the risk of not insuring the investment. See MIGA, *MIGA Annual Report 2000* <www.miga.org>

(hereinafter referred to as "EVP") illustrate the binary character played by MIGA as an institution promoting investment. The EVP highlighted:

> [T]his past year, we registered one claim, which is under review, for a project that we have guaranteed in Argentina, linked to the larger financial crisis in the country. We are working closely with the investor and the Argentinian government to resolve the matter. This claim is only the second to have been registered with MIGA, which demonstrates the effectiveness of MIGA's umbrella of deterrence and ability to resolve investor disputes.[487]

MIGA's binary role: actively seeking to promote investment in LDCs and volatile jurisdictions, and to resolve disputes that may have an adverse impact on the investment regime overall or those guaranteed by MIGA. The latter function assumed by MIGA has worked to the benefit of both the parties; the host state and the investor. As a tool of deterrence, it is argued that MIGA's auspices under the umbrella of the Group gives it this unique, privileged position.[488] By actively seeking to resolve disputes, MIGA not only allows guaranteed investments to remain in the host country and operate as planned, but also avoids harming the investment reputation of the host country.[489] As of 2015, MIGA has paid five

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[487] MIGA, *Annual Report 2003* <www.miga.org>

[488] Also see MIGA, *Investment Guarantee Guide* (July 2015) <www.miga.org> Accessed 21 April 2016. The report submits '…unique strength from the World Bank Group and members including most countries of the world. This enables MIGA to provide an umbrella of deterrence against government action that could disrupt projects, and assist in the resolution of disputes between investors and governments. MIGA also adds value through its ability to offer clients extensive knowledge of emerging markets and of international best practice in environmental and social management'.

[489] MIGA, *Annual Report 2005* <www.miga.org> Accessed 21 June 2017.

claims in various investment disputes to investors. This figure does not reflect the number of disputes resolved by MIGA. However, as an agency with a US$64.2bn[490] in loans, grants, equity investments, and guarantees to partner countries and private businesses, and US$4.3bn in guarantees in the year 2016 alone, these figures are an illustration of a larger role played by MIGA as a deterrence instrument.[491] A similar submission was outlined in MIGA's Strategic Directions document. The report highlights that MIGA instils confidence among investors seeking to secure private investment flows against political and sovereign risks. MIGA has been able to do this by leveraging its strength as a member of the Group, with access to knowledge, experience, and key decision-makers that other providers cannot match.[492]

It is therefore argued that Pakistan faces immense challenges in addressing its existing energy crisis. Whereas the enhancement of sovereign guarantee framework is a long term, and even implicitly challenging exercise, the PRI

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[490] See MIGA, *Annual Report 2016* <www.miga.org> Accessed 21 June 2017. The report outlines the agencies exposure according to various regions. Latin America & the Caribbean: US$11.4bn, Europe & Central Asia: US$10.3bn, East Asia & the Pacific US$11.4bn, South Asia US$11.3bn, Middle East & North Africa: US$6.3bn and Sub Saharan Africa US$13.3bn.

[491] See MIGA, *Annual Report 2015* <www.miga.org> Accessed 21 June 2017. MIGA paid two claims during the fiscal year 2005. One was US$144,600 for a small war and civil disturbance claim filed in relation to a hydroelectric plant in Nepal that was the target of an attack by Maoist guerrillas in 2002. MIGA also paid a claim to Mitsubishi International Cooperation with respect to its loan guaranty to Bank of Tokyo-Buenos Aires Branch. While a decision to pay the claim in the amount of $1.396 million was made, only $55,311 has been paid to date; the remainder will be paid subject to the guarantee holder's compliance with certain requirements; no claims were paid in fiscal year 2006; no claims were paid in fiscal year 2007; no claims were paid in fiscal year 2008; two claims were paid during fiscal year 2009; no claims paid in fiscal year 2013.

[492] See MIGA, *MIGA Strategic Directions FY15-17*, <www.miga.org/documents/MIGA_FY15-17_Strategy.pdf> Accessed 22 March 2016. Another interesting observation made by the report highlights that MIGA has developed its role as a leader in the political risk insurance industry over the past several years, notably with the publication of its reports on political and FDI. Another interesting submission is made by Valentina Okaru-Bisant, 'Overcoming challenges in the Multilateral Investment Guarantee Agency's Risk Insurance Coverage to Private Water Investors: Corruption and Consumer Risks' (2012) 57 S D L Rev 277. Bisant argues that MIGA's risk insurance program has several advantages to private investors. One of these advantages is the access to finance, primarily due to the involvement of MIGA as a risk mitigator under the auspices of the World Bank Group, seems ideal to lenders.

model can uplift the country's investment outlook in the short term. Baird, Gertner & Picker[493] and Miranda make a similar observation concerning deposit insurance schemes. Miranda emphasised:

> …[T]hat the lender of last resort should not be a permanent practice of central banks, rather a temporary emergency measure applicable only when the whole economy is at stake. Hence, it should not aim at preventing key banks from failing as a consequence of its poor management, but to avoid a resultant wave of failures disseminating through the system. If banks are bad, they will probably become worse if the government sustains and encourages them.[494]

Similarly, the use of PRI in Pakistan's energy sector can provide a boost to capital inflow, and even strengthen the existing sovereign guarantee framework to the extent that investors understand the presence of an ancillary framework supporting the primary framework. It will not only provide a great stepping-stone for Pakistan's energy sector, it will also circumvent hurdles to attract investment.

[493] It is interesting to read the analysis undertaken in Douglas G Baird, Robert H Gertner, and Randal C Picker, *Game Theory and the Law* (Harvard University Press, 1994) 62. An interesting analysis follows course. It is argued that where banks knowingly enter into risky transactions, they do so on the basis that there is an insurance regime protecting their behaviour. It is submitted that whereas the risk of default is high (and so is the probability of a bank run) it is argued that banks in hindsight will not be promiscuous in their approach. They would exercise due care and due diligence in order to understand risk better, and make thorough decisions.

[494] Andres Curia Miranda, 'Moral hazard and how it was invoked in the Northern Rock crisis of 2007' (2010) 2 King's Student L Rev 27.

5.4 Conclusion

This chapter aligns well with the discussion concerning the inadequacy of sovereign guarantee instruments. The primary rationale for incorporating a third-party guarantor is predicated on the assumption that in the event the primary debtor is in breach of their contractual obligation; the surety will step into the principal debtor's shoes. As a result, the creditor is secure. Whilst providing a continuation of the discussion undertaken in Chapter 4, this chapter attempts to carry out a discursive analysis that highlights any additional security measures that can be incorporated in Pakistan's energy market to attract, sustain, and build a long-term investment regime.

The above discussion introduces the concept of political risk in a broader context, and then moves to address the critical issues from Pakistan's standpoint. In a bid to explain all the prevailing political risk issues, this chapter attempts to align the concepts of expropriation and contractual repudiation in view of the liquidity issues in Pakistan's energy cycle. Moreover, the proposition whether sovereign guarantees should be replaced with PRI has been discussed. It contends that PRI cannot replace the existing framework completely. As a result, the PRI framework ought to be viewed as an additional security framework. As discussed extensively, the PRI structure involves a sovereign guarantee framework in order to indemnify the risk insurer. Therefore, this chapter advances the thesis that host states generally, and Pakistan in particular, need to revamp their approach towards investment protection. In any case, the concept underlying PRI and the dual security approach is adopted herein.

The argument that investors may employ a wide array of informal risk-mitigation measures to counter breach of sovereign guarantees is rebutted. Involving local pressure groups, forging local partnerships, and seeking favourable terms within the project agreements are beneficial, however without any real recourse. Cases like *IPCO*, *HUBCO* and *Riqo Diq* provide evidence to negate such contentions. In view of short-term commitments, such measures provide some comfort to the sponsors. However, the PRI model is a long-term instrument of robust protection.

However, as discussed and highlighted in Figure 5.10, above, it is unclear whether PRI is an effective measure against contractual breaches by SOEs. It is understood that the SOEs play a pivotal role in ensuring compliance with PPAs. In view of the discussion undertaken above, it is illustrated that the PRI framework works on a parallel scale, in addition to a sovereign guarantee structure. The beneficiaries of sovereign undertakings are two parties: the project company and the risk insurer. However, in the absence of 'doing-away' with sovereign guarantees completely, the arguments presented in the previous chapter are defeated. In view of the PRI model discussed above, there is likelihood that debt sustainability still renders such measures problematic. The IMF's report highlights that guarantees are a 'legitimate form of government support' for infrastructure when the government is best placed to anticipate risk, control risk exposure, and thereby minimise risk.[495] Whereas PRI will provide certainty for investors and sponsors in a project company, it will not diminish risk altogether.

[495] See IMF, Public-Private Partnerships, Government Guarantees, and Fiscal Risk (Washington, IMF, 2006).

It can be concluded that the PRI model will further constrain a host state. The pressures of meeting contractual commitments may be directly contingent for tranche payments, or other extensive reforms. However, from an investor's standpoint, incorporation of the PRI model would prove beneficial. Bodies like MIGA and OPIC are not just risk insurers. Their role as an advisory body, and their principal objectives associated with their parent bodies are an attractive prospect for investors to secure payment and deter default through the exercise of those powers. An interesting example is India's Dabhol Power Project. As a consequence of non-payment by the State of Maharashtra's Electricity Board, OPIC compensated sponsors for alleged expropriatory acts. As a result, OPIC sought to recover from the Indian Government the compensation it had paid to the insurance holders. On 10 October 2003, the United States Embassy in Delhi delivered a request to the Indian Ministry of Finance to commence negotiations for the reimbursement of OPIC for its losses with respect to the investment insurance. Later, an official request from OPIC's president demanded a settlement under the India-United States bilateral treaty, and in 2005, almost two years after the initial request by OPIC to reimburse for the payment made to the investors on account of default by the State Electricity Board, a settlement was reached.[496] It can thus be argued that the ancillary support for investors under a PRI instrument is favourable for the investors.

It is interesting to conclude that even though the PRI model is not short term, neither is it a long-term solution. Its incorporation in Pakistan's investment regime is fraught with both economic and policy implications in the longer run,

[496] Preeti Kundra, 'Looking Beyond the Dabhol Debacle: Examining its Causes and Understanding its Lessons' (2008) Vanderbilt Journal of Transnational Law 41(3) 907-936.

especially for the state. However, from an investor's standpoint there is no better additional measure of security. The expertise that is associated with seeking PRI from multilateral bodies like MIGA will help not only to address short-term issues, but will assist in addressing the vacuum that exists in formulating long-term policy, to avert an electricity crisis of a larger magnitude.

Chapter 6

Conclusion: Investment Security Reappraisal

The premise of this thesis rests on the proposition that the issuance of security measures, albeit favourable for investors, are inadequate under the guise of sovereign guarantee. This thesis has undertaken an extensive review of the underlying features of the sovereign guarantee issued by the host state in the context of Pakistan's energy sector. A detailed analysis outlines that investors are increasingly seeking measures in order to diminish or mitigate risk in highly-leveraged debt-financed energy projects.

In the context of rapid expansion, and in a bid to keep pace with the growing demand for infrastructure, host states have resorted to the private sector as a means of facilitating such projects. However, in view of the increasing challenges faced by host states, both politically and economically, it is hard to envisage how developing countries taking the shape of host state can provide robust measure of security to investors. This study approaches the question of adequacy of sovereign guarantees by introducing the highly-leveraged nature of infrastructure projects. An extensive discussion on project finance provides and facilitates a rudimentary understanding of this area: high debt to equity ratios within finance secured for the purpose of an infrastructure project. Furthermore, the highly-leveraged nature of project finance promotes sponsors and lenders to incorporate robust measures to not only deter default, but also provide a contractual assurance that is operative, in the event of a default perpetrated by the host state. Albeit such assurances are reflected in the cost of capital, and act as an aid to promote investment to developing countries, this environment of

security creates a multiplier effect, wherein one investment project creates opportunity for other projects to be initiated.

In view of the highly-leveraged nature of the project finance transaction, one of the most commonly used measures of security offered by host countries is a sovereign guarantee. A succinct introduction to the concept underlying suretyship is provided. In order to understand the intrinsic nature of guarantee and indemnity instruments, a seamless transition from the underlying procedural and legal requirements in a guarantee transaction normative to the sovereign guarantee instrument is provided. This thesis has introduced and adopted a 'pendulum of responsibility' model, to assist in understanding the dynamics of a guarantee and an indemnity instrument. The key feature of the two instruments is predicated on the understanding of secondary and primary liability. The imposition of such liability is contingent upon the default perpetrated by the principal debtor. The period of default has been categorised in pre-default and post-default scenarios. The repercussions of the two are different in view of the name accorded to each instrument being used.

In addition to providing a reliable, more robust measure of security in an inhibited investment regime, the premise of a sovereign guarantee is also predicated upon the understanding that the host state is a superior risk bearer. Richard Posner submits that the superior risk bearer is 'the party that is the more efficient bearer of the particular risk in question, in the particular circumstances of the transaction'.[497] As a consequence, a party that can diversify and spread

[497] See Eric D Beal, 'Posner and Moral Hazard', (2000-2001) 7 Conn Ins L J 81.

risk[498] is far more efficient than another party, and therefore such risk should be borne by the party that is best capable of spreading risk. In a sovereign guarantee spectrum, the state is the superior risk bearer. The state has the ability to avert any crisis, or manage a certain crisis in a manner that will avert the risk of default. In light of the discussion concerning the liquidity issues within the energy cycle in Pakistan, this study mainly focuses on the breach of contract by SOEs. There are two categories or dimensions of country risk. First, the political willingness to honour financial obligations is a concrete part of the risk at the time of investing. Second, the economic capability and capacity to honour financial obligations determines risk in a wider spectrum. Together, they are an integral part of the country risk dimension.[499] Whereas it can be argued that political willingness will always be present to honour financial commitments in order to further political and economic agendas, fiscal constraints will be beyond a government's capacity.

One of the arguments that emerges in favour of a provision for a sovereign guarantee is predicated on the understanding that a host state, the state's instruments, and functionaries are in a better position to manage and mitigate risk than a private investor. However, in view of restructured and decentralised role of the state, and the discussion concerning sovereignty, there is a presumption that the state is no longer wielding absolute power over the instruments within the state. There are external factors that are larger and perhaps not within the domain of the host state to manage. An extensive discussion in Chapter 1 highlights the lack of regulation and inconsistency in policy as a critical factor

[498] See Eric D Beal, 'Posner and Moral Hazard', (2000-2001) 7 Conn Ins L J 81.
[499] See David Chaikin, 'The political risk of offshore financial centres: The Cyprus bailout', in Nigel Finch (ed), *Emerging Markets and Sovereign Risk* (1st Edition, Palgrave Macmillan, 2015).

affecting the energy sector and inhibiting development. Moreover, superior risk bearer phenomenon will not always lead to sensible results. For example, in Pakistan's case there is an increasing concern demonstrated amongst investors that the SOEs will default on payments. As a result, it can be submitted that perhaps the risk of payment is better suited to be left at the behest of a third party, rather than being dependent upon the host state.

In the event that the host state fails to provide adequate security measures to promote and sustain a consistent flow of investment funds, investors are increasingly seeking third parties to mitigate their risk. This model of security is predicated upon idea of redundancy inspired from the field of Engineering. The provision of two engines in a Boeing 747 provides a 'safety net', in the event that one of the engines fail.[500] Similarly, a political risk insurance model is a redundancy method. If a state or SOE defaults on its payment tariff, then there is recourse that can be sought from the multilateral guaranty agency to indemnify the SPV.

At a workshop hosted by the author in London, there was consensus amongst practitioners and academics that informal methods of risk mitigation, inter alia the use of joint ventures with local firms and engaging local leadership, are equally effective methods of mitigating risk. Some participants argued that they might be more efficient than more formal methods of risk.[501] This study does not approve the informal approach, primarily because no concrete measures are

[500] For a brief introduction into the concept of redundancy in engineering please see the following article: John Downer, 'When failure is an option: Redundancy, reliability and regulation in complex technical systems', May 2009. Discussion Paper No 53 <http://www.lse.ac.uk/accounting/CARR/pdf/dps/disspaper53.pdf> Accessed 3 May 2016.
[501] Workshop hosted in London on 26th January 2017 at London's Centre for Commercial Legal Studies.

being agreed. Local leadership and their interests are like shifting sand; they change with the wind and waves. In the event that there is a change of political leadership, there may be adverse repercussions for the project company. Cases like *HUBCO* and *Riqo Diq* are a grim demonstration of how national courts are favourable towards their own governments.[502] Despite forging local partnerships and engaging the political leadership, the principal sponsors in these cases suffered heavy losses, and in the case of *Riqo Diq* are still seeking compensation from the competent authorities.

Despite project companies being issued a sovereign guarantee in both cases, it is clear that on grounds of public policy, the courts in *HUBCO* and *Riqo Diq* restrained the project companies from invoking arbitration proceedings. The court forged an argument for not referring matter to arbitration because, they contended, there was prima facie no legally enforceable/binding contract. The general belief is that a state will honour its transactions, because it owes this as a moral obligation to the investor, and by issuing a sovereign guarantee, their unfettered, unconditional and irrevocable support is with the project. However, in view of procedural impediments, and uncertainty pertaining to the corporate structure of the SOEs involved in the sovereign guarantee structure, it can be argued that the utility of such guarantees is tainted.

This study then progresses further to discuss the primary contentions surrounding the sovereign guarantee structure normative to Pakistan's energy sector. This discussion provides a seamless transition from the arguments presented in Chapter 3, in order to determine whether the current sovereign guarantee

[502] *HUB Power Company Ltd v Pakistan WAPDA* (PLD 2000 SC 841).

framework is adequate for the purposes of a guarantee structure under common law. Sovereign guarantee is a contract of obligation. Irrespective of the title accorded to the document, the primary purpose of such an obligation is to answer for some existing or future liability of another party, the principal, to a third party, the creditor.[503] In an event where there is a default by a SOE, it is the state that resumes responsibility for the fulfillment of any obligation arising under a PPA or LoS. As a result, this section attempts to discuss the possibility that the current sovereign guarantee structure is problematic, because there is only a primary obligor, and consequently the state is guaranteeing its own performance. An attempt has been made to discuss the underlying adequacy of sovereign guarantees. This discussion attempts to evaluate whether for the purposes of a sovereign guarantee structure, there is a primary debtor and a guarantor; and secondly, whether the primary debtor's obligations can be attributed to the guarantor.

A discursive analysis of the nature of entities involved within a sovereign guarantee framework is presented. It is contended that the state is viewed as a group comprising individual units. If the responsibility of discharging the debt of the SOE rests with the state, there is no meaningful protection being offered. The prognosis of this thesis is threaded upon a thin line, wherein the corporate personality of the SOEs is being challenged. However, this thesis is not suggesting a displacement of company law's cardinal rule of separate legal personality. Instead it refers to the Draft Articles as a measure of gauging whether the ultimate responsibility of discharging the debt of the project company does in fact rest with the state. Therefore, in view of the discussion

[503] *Vossloh AG v Alpha Train (UK) Ltd* (2010) EWHC 2443 (Ch).

undertaken surrounding suretyship structures, there is a likelihood that the guarantee framework is not being satisfied. This thesis undertakes an extensive review of the bodies involved in the sovereign guarantee framework and determines their position in light of Articles 4 and 5 of the Draft Articles.

Whereas there are grey areas insofar as the functions that are carried out by PPIB, NTDC and CPPAG, it is submitted that there is no unequivocal evidence to suggest that these entities are in fact working within the organic structure of the state. However, neither is there a strong presumption that suggests that these entities are working at an arm's length from the state. The current SOEs within Pakistan's energy cycle currently have an ambiguous structure. They have been corporatised to the extent that they have separate boards, and in the case of NTDC and CPPAG, a corporate personality. However, the state still exercises some vital functions on behalf of these SOEs. In view of the discussion concerning sovereignty, it can be suggested that whereas these entities have been restructured, it is unlikely that the state's involvement can be diminished altogether. It is therefore argued that even though this discussion is not conclusively suggesting that the sovereign guarantee framework is obsolete, there are some procedural inadequacies that taint the very foundations of such frameworks.

In addition to reviewing the sovereign guarantee structure from a common law perspective, an extensive discussion on the expectation gap and the lack of conformity with legislative requirements is undertaken. The expectation gap argument extends the debate concerning the SOEs being part of the state's organic structure. This section contends that the primary association of a

sovereign guarantee with the state is the real essence of its robust security measure. Whilst this argument is an abstract augmentation of the discussion, concerning the position of the law under guarantee provisions, there is an increasing association of such assurances with the state. Consequently, sponsors are led to believe that the entities providing such guarantees are, in reality, state organs. In the absence of such contention, the provisions of such guarantees resonate with an empty promise.

The third strand of discussion refers to the legislative restrictions within Pakistan's energy sector that may affect the issuance of such guarantees. This section provides an outline of the *Debt Limitation Act 2005*, which provides whether the provision of sovereign guarantee under the current rising debt figures expressly prohibits issuing such guarantees. The underlying rationale for employing such prohibitions is predicated on the economic scholarship that gross domestic debt accumulated to or exceeding 60% will cause an annual growth decline by 2%. The provision of sovereign guarantee is affected by such laws in place, which cater to wider economic stability within the country.

In view of the three strands that have been discussed, this thesis submits that there is no unequivocal evidence to suggest that sovereign guarantees are an obsolete security measure; however, in view of the inadequacies that have been discussed, there is an increasing concern that there may be more efficient ways to mitigate risk than outright guarantees from states that are financially unable to satisfy debt.

In view of the ambiguities surrounding sovereign guarantees issued by host states, especially in Pakistan's context, this thesis refers to the political risk insurance model as a measure of robust security. Without prejudice to the discussion on sovereign guarantees, this thesis refers to the risk insurance model not as a complete replacement for sovereign guarantees, but an additional form of safety net. It refers to the World Bank's Multilateral Investment Guarantee Agency, popularly known as MIGA. One of the primary themes that emerges throughout this study is predicated on the understanding that a 'sovereign guarantee' sounds more reassuring simply by virtue of containing the word 'sovereign'. However, the real application of a sovereign guarantee is contingent upon a state's ability to pay. A weak fiscal regime or unstable economic conditions—rife in a developing country—will not facilitate a request made by the investor or the investment vehicle for payment of outstanding dues. On the contrary, prima facie risk insurance may seem beneficial for the investor or the lenders; they too are predicated on the state's ability to pay. However, if a cognitive, normative analysis of the two is undertaken, it can be argued that risk insurance provides a far more robust protection package than the sovereign guarantee regime from a sponsor's perspective.

The PRI market as a whole has grown at an average rate of 12% per year for the last seven years, and MIGA's business has been growing at an average rate of 8% over the past 12 years.[504] This growth is anticipated to expand even further, with the wide variety of products being introduced by MIGA and those already

[504] See MIGA, *MIGA Strategic Directions FY15-17* <www.miga.org/documents/MIGA_FY15-17_Strategy.pdf> Accessed 06 May 2017; See Oliver Ralph, 'Future Risks'. *Financial Times* (London, 26 May 2016) 9. It is interesting to note that while MIGA observes that risk insurance is growing, this article notes a decline in the risk insurance market. The article notes that profits across the markets as a whole in 2015 were the lowest since 2011.

being offered by the Agency.[505] MIGA's Operational Regulations and Convention changes since 2009 have introduced new risk-mitigating measures. These measures will expand the agency's coverage for risk, and prove beneficial for lenders and other capital market investors, especially in light of defaults due to state entities' inability to meet their financial obligations. MIGA's new credit enhancement products include: i) non-honouring of sovereign financial obligations[506] and ii) non-honouring of financial obligations of SOEs.[507] Unlike MIGA's 'breach of contract' coverage, the recent introductions do not require a final arbitral award or court decision as a condition of payment of a claim. Breach of contract coverage has been subjected to criticism over the years, due to the judicial process which the investor has to undergo in the host countries.[508] To an extent, developing or emerging economies like Pakistan, Nigeria, and India lack the technical knowledge or legal expertise within their judicial system to administer these complex cases. Even if they did, the time line for resolving such disputes is several years before any real outcome. The *Nigerian National Petroleum* case, discussed in Chapter 4, is stark reminder of this endemic issue. The international dispute resolution arena is full of examples of host states

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[505] Also see Valentina Okaru-Bisant, 'Overcoming challenges in the Multilateral Investment Guarantee Agency's Risk Insurance Coverage to Private Water Investors: Corruption and Consumer Risks', (2012) 57 S D L Rev 277. Bisant argues that 'MIGA's decision to expand its risk insurance guarantee to cover terrorism risk is commendable because it shows the agency's willingness in some instances, to be flexible in responding to global political and economic changes and needs.'

[506] Introduced in 2010. Non-honouring of a sovereign financial obligation covers the risk that a sovereign fails to honour an unconditional financial payment obligation or guarantee, where the underlying project meets all of MIGA's normal eligibility requirements.

[507] Introduced in 2013. See above.

[508] Breach of Contract is interpreted in slightly different ways across providers. For MIGA, breach of contract cover protects against loss arising from a government (including, in certain cases, SOEs) breach or repudiation of a contract with an investor, but requires that the investor invoke the dispute-resolution mechanism. In a study conducted in 2013, breach of contract and regulatory issues remained the most important political risk concerns for investors into developing economies, according to the annual MIGA-EIU Political Risk Survey. 45% of respondents named breach of contract and 58% named adverse regulatory changes as the most important political risk they face in the next three years.

adjudicating disputes in their own judicial system and receiving favourable decisions. A brief outline of the recent cases concerning investment disputes highlights the poor measures and non-investor friendly approach by the Pakistani courts. This also provides a vindication of how poor is the quality of the 'breach of contract' provision within Article 11 in the Convention. It is primarily for this reason that MIGA has introduced new and innovative products in its scheme to promote investment.[509] Insofar as the utility of MIGA's risk insurance is concerned, it is argued that with the limitation of US$720million[510] per country in a given year limits MIGA's scope to promote investment.[511] However, in view of the extensive projects undertaken by MIGA in the domain of the energy sector, it is an illustration of MIGA's commitment to address the prevailing energy crisis in various developing countries. Whether MIGA will be effective on the scale required in order to tackle the energy crisis is questionable. However, the Gulpur Power Project[512] provides evidence to suggest that MIGA's

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[509] Also see Valentina Okaru-Bisant, 'Over-coming Challenges in the Multilateral Investment Guarantee Agency's Risk Insurance Coverage to Private Water Investors: Corruption and Consumer Risks', (2012) 57 S D L Rev 277.

[510] MIGA currently has a limit of US$720 million per country on a net basis. There is no minimum size limit for a project. At present, MIGA can cover up to $US220 million on a net basis per project. As outlined below, this can be supplemented through MIGA's coinsurance and reinsurance programs. <https://www.miga.org/Pages/Who%20We%20Are/Frequently-Asked-Questions.aspx#con4> Accessed 23 May 2017.

[511] Since 1997, MIGA has successfully used reinsurance to leverage its investment guarantee capacity. The methods used by MIGA are as follows: i) Syndication/ceding risk—whenever a project exceeds MIGA's own capacity, the agency reinsures itself, through a syndication process, with private and public sector (re)insurance companies in order to meet its clients' needs. MIGA's main programs are facultative reinsurance and the cooperative underwriting program (CUP). ii) Assuming risk—in addition to attracting capacity from private and public insurers in order to support projects in its member countries, MIGA also provides such capacity to primary insurers. Currently MIGA providers this kind of assistance mainly to public insurers, but also welcomes inquiries from private insurers. MIGA's ability to provide reinsurance is conditioned on, among other factors, whether the agency's environmental and social policy clauses can be included in the contract of the primary insurer. <https://www.miga.org/Pages/Investment%20Guarantees/Reinsurance.aspx> Accessed 14 August 2017.

[512] Gulpur Hydro Power Project is a project being undertaken by Mira Power Limited, a special purpose vehicle. The company is to design, construct, own, operate and maintain (in other words a BOOT project). The project's total output is 100MW and is being adopted under the Government's Pakistan Policy for Power Generation Projects 2002; see Report, 'IFC offers

involvement can provide the safety net investors so eagerly desire. It can also be considered as a tool fit to encourage investors to direct their investment to economies like Pakistan.

The debt-financing element or off-balance sheet finance aspect of project finance is ideal, primarily because debt is being raised on a newly incorporated entity's future revenue stream. Project finance is used primarily to mitigate and manage risk. Its popularity is predicated upon the self-regulatory method, wherein risk is dealt with within the project company. However, project finance is often viewed as a short-term method of mitigating such risk. The negative implications of employing project finance are its debt-servicing aspect, which can be problematic in the medium and long run.[513] Issuing ancillary instruments, inter alia sovereign guarantees, not only shifts risk from the SPV to the state, they are also supposedly more robust and certain. An interesting contention insofar as debt servicing from an emerging economies' perspective, it is argued that countries like Pakistan, Nigeria, and other economically fragile countries have to borrow more to service their existing debt.[514] This means that in order to make payments for a previously borrowed debt, they have to borrow more. This

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$1.2bn to power, banking sectors in FY15' *Dawn Newspaper* (Islamabad, 15 August 2015); MIGA has issued guarantees totalling US$82.7 million for the sponsor's equity investments into the SPV. MIGA is providing coverage for up to 15 years against the risk of breach of contract. <https://www.miga.org/Lists/Press%20Releases/CustomDisp.aspx?ID=496> Accessed 08 May 2017.

[513] Stanley Fischer, 'The Economics of the Government Budget Constraint' (1989) Policy Planning and Research Working Paper 224, The World Bank Office of the President, Washington DC.

[514] An interesting account on this is in Bruce Rich, Mortgaging the Earth: The World Bank, environmental impoverishment, and the crisis of development (Earthscan, 1994).

borrowing is affixed with a relatively higher rate of interest, further increasing the debt levels.[515]

The importance of security measures in an investment regime can be gauged from the fact that Asia alone will require approximately US$24 trillion by 2030 in order to meet its infrastructure demands. Consequently, it can be argued that capital flow will be determined not only by return, but risk will play a pivotal role to ensure that sufficient capital needs are met. As outlined earlier, risk cannot always be quantified. However, with the relevant risks mapped out, there is likelihood that they can be mitigated. There are significant measures that need to be enforced in order to meet and re-develop Pakistan's energy sector. These measures include a complete overhaul within the regulatory framework, an extensive review of the policies, and, at least for the time being, a risk insurance model as a basis for large infrastructure projects. It is understood through research that blanket guarantees are not a measure of a successful investment regime. In fact, they prove to be unhealthy for such initiatives. Sovereign guarantees may be an indicator of a healthy investment forum, but in view of the default on payments it seems that such provisions have no real value. Instead an alternative approach to sovereign guarantees ought to be adopted. Conditional financial guarantees or indemnities, issued through contracting with the Treasury or Finance Ministry, and subject to a yearly premium, will not only provide a real measure of security, but may also diminish the risk of default under the current blanket guarantees, thus significantly improving the security regime in countries like Pakistan.

[515] Nadia Tahir, and Pervez Tahir, 'Public Debt and Fiscal Responsibility in a Federal Structure: The case of Pakistan' (2012) Romanian Journal of Fiscal Policy, Volume 3, Issue 2, pp 27-47.

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