The Political Economy of Private Electricity Provision in Southeast Asia

by

Witold J. Henisz and Bennet A. Zelner

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Reginald H. Jones Center

The Wharton School
University of Pennsylvania
Abstract:

In this paper, we demonstrate the importance of institutions that support credible government commitments to infrastructure investment. We look specifically at how differences in the level of policy credibility affect investors’ choices of strategic safeguards, and also at how the level of policy credibility affects the efficacy of safeguards in the presence of a shock that strengthens political officials’ incentives to behave opportunistically. The empirical setting for our analysis is the development of private power provision in four ASEAN countries: Thailand, the Philippines, Malaysia and Indonesia. These countries provide the basis for comparative analysis because all four undertook privatization at roughly the same time and all four experienced the same shock in the form of the 1997 East Asian financial crisis, but the level of institutional support for private property rights in Thailand and the Philippines is considerably greater than that in Malaysia and Indonesia. Our analysis of the four countries leads to two main conclusions. First, investors in Thailand and the Philippines chose to rely more heavily on contractual safeguards whose efficacy depended more heavily on credible enforcement, while investors in Malaysia and Indonesia chose to rely more heavily on non-contractual safeguards whose efficacy was less dependent on the institutional environment. Second, despite the differences in strategies meant to align governance with the institutional environment, investors in Thailand and the Philippines fared considerably better following the crisis than did investors in Malaysia and Indonesia.
1. Introduction

In this paper, we examine the development of private power provision in four ASEAN countries: Thailand, the Philippines, Malaysia and Indonesia. In undertaking our study, we seek to make two main contributions. First, as governments around the world have begun to privatize and deregulate infrastructure industries, the process of market liberalization has grown in interest to policymakers, managers and academics alike. Case studies like the current one help to illuminate the liberalization process and may thus provide lessons that can shape future policy proposals, investment plans and research agendas.

Second, the four countries on which the study focuses provide a particularly illuminating natural experiment for assessing the importance of political and regulatory institutions in shaping privatization outcomes. All four countries undertook electricity privatization at roughly the same time and for roughly the same reason. Additionally, although the details of the individual countries’ reform programs differed, all shared the common feature of using long-term power purchase agreements (PPAs) with guaranteed offtake provisions to induce entry by private investors. Subsequently, the four countries experienced the same macroeconomic shock in the form of the 1997 East Asian financial crisis.

However, there were differences as well. First, investors in Thailand and the Philippines placed greater weight on certain of the strategic safeguards against opportunistic government behavior available to them than did investors in Malaysian and Indonesia. Second, investors in the first two countries fared considerably better following the crisis than did investors in the latter two countries.
In this paper, we locate the source of these differences in characteristics of the political institutions of the four countries. We argue that investors chose the types of strategies that they thought would be most effective given the extent to which the relevant institutions supported credible commitments to private property rights. However, regardless of the strategies chosen, investors in the two countries with stronger institutions—Thailand and the Philippines—received considerably better treatment following the crisis than did investors in Malaysia and Indonesia, despite the fact that the governments of all four countries faced strong incentives to engage in opportunistic behavior toward investors. To be sure, the expected returns in the latter countries may have justified the higher risk; however, the comparison still provides a useful lesson about the importance of designing sophisticated political and regulatory risk mitigation strategies.

2. Safeguarding Against Political and Regulatory Hazards

In this section, we provide a conceptual backdrop for the case analysis that follows. We begin by discussing the policy hazards that infrastructure investors face from potential opportunistic behavior by government officials. We then review some of the contracting strategies that investors may take to safeguard themselves from these hazards. We also discuss the critical role that a country’s political, legal and regulatory institutions play in determining the level of risk that investors face and thus the efficacy of various contracting strategies. We conclude our conceptual discussion with the suggestion that, if the institutions in place are sufficiently weak, contracting strategies are unlikely to protect investors from unfavorable policy treatment in the event of a shock that strengthens government officials’ incentives to behave opportunistically.
2.1. Hazards

As emphasized in the international business literature on the “obsolescing bargain” (1) and more recently by Spiller (2), infrastructure investment is particularly susceptible to opportunistic behavior by government officials as a result of its economic and political characteristics. The long lifespan of an infrastructure asset implies that any variation in future pricing, taxation or regulatory policy has a particularly large effect on the investment’s projected rate of return. Moreover, because operating costs are a relatively small percentage of total costs, operators of infrastructure assets will rationally continue to operate even when their revenue falls short of a fair \textit{ex ante} economic return. This willingness to operate in the face of a noncompensatory revenue stream creates tempting opportunities for politicians who may gain favor with various political constituencies through expropriation of the investor’s revenue stream.

The political characteristics of infrastructure projects heighten these incentives. The presence of economies of scale may lead to a small number of infrastructure service providers that can easily be labeled monopolists and accused of extortionary abuses. Furthermore, because infrastructure services are widely consumed, the reallocation of returns from investors to consumers may significantly affect the level of popular political support for the government in the short-term. The combination of the economic opportunity to expropriate returns to infrastructure, together with the political benefits from doing so, creates an inherent commitment problem: governments may make pledges regarding the stability of the policies under which infrastructure projects are begun, but face strong incentives to renege on their promises once capital has been sunk into the ground. Moreover, in addition to the possibility that the government will expropriate the
revenue stream of the infrastructure investor for its own purposes, other interested parties—e.g., consumers of infrastructure services, competitors, upstream suppliers or downstream buyers—may also compete in the political arena for any profits obtained by the investor. Risks of both types are especially likely to manifest themselves when an economic or political “shock” (e.g., a financial crisis) occurs, strengthening the incentives for government officials to behave opportunistically.

2.2. Strategic Safeguards

Far-sighted investors do not enter institutional environments characterized by high political and regulatory risk blindly. One option, of course, is simply not to invest at all if the risk of opportunistic treatment by the government is perceived to be too great. However, as discussed by Wells (8) and other scholars concerned with multinational strategy in emerging markets, investors may also adopt specific strategies designed to safeguard themselves against such treatment. For example, when selecting a project to undertake, investors are advised to scrutinize capacity utilization projections once the project is operational: while a capacity shortage often precipitates the call for private investment in the first place, the possession of excess capacity substantially weakens an investor’s bargaining position.

In the project design stage, Wells suggests relying more heavily on debt relative to equity because lenders receive favored treatment in the case of bankruptcy or liquidation. Other suggestions for the project design phase include sharing ownership or

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1 Existing empirical support for these arguments comes in several in the form of case studies and statistical evidence. Levy and Spiller undertake a series of five country case studies that examine the impact of core political and social institutions on telecommunications regulatory structures and utility performance outcomes (3; 4). Large-sample empirical tests in both telecommunications (5) and electricity (6; 7) lend further support.
control of the project with the local government, local partners or local shareholders; designing a payment schedule that increases prices prior to privatization and then decreases them steadily over time, so that consumer associate private participation with price reductions rather than price increases; sharing ownership and financing with a broad range of international partners and securing risk insurance from them; negotiating for the government to accept as many of the non-construction risks as possible; pushing for the development of an independent regulatory body; and, at least as an interim measure, relying upon international dispute resolution mechanisms.

Although these strategies may help to mitigate political and regulatory risk, each has the potential to backfire as well. Local partners, for example, may become liabilities if they exploit their ability to lobby or influence the government policy at the expense of the multinational firm; the front-loading of returns may invite excessive scrutiny of the project; the use of foreign partners may create a perception that the project is not “local” enough; risk insurance is costly and limited to short time periods; government commitments are not necessarily credible; foreign lobbying is often perceived as meddling; and, finally, international arbitration works only when accepted by all sides.

2.3. **Institutional Supports**

Potential safeguards against opportunistic treatment of infrastructure investors may also lie in the political, legal and regulatory institutions that govern relevant policies or contracts. Institutions that support private property rights create confidence among investors that governments will honor their commitments, and that disputes will be resolved in an impartial and timely manner (9; 10; 11).
The presence of good institutional safeguards may reduce the need for investors to employ the types of strategic safeguards described above. However, the converse is not necessarily true: strategies may not function as effective substitutes for institutional safeguards when the latter are weak or absent. The reason is that the efficacy of many strategic safeguards depends heavily on the credibility of government commitments in the first place. Employing a local partner, for example, is only an effective safeguard to the extent that a government’s commitment not to favor local partners at the expense of the multinational is credible. Similarly, obtaining various types of government guarantees—for example, by taking the government on as a partner, or by having the government agree to assume specific risks abide by international arbitration—only provides good safeguards to the extent that these guarantees are credible in the first place. In the absence of credible commitments by the government, investors are left to rely on safeguards such as the repeated nature of firm-government interaction and pressure exerted on government by public and private international partners. The efficacy of these safeguards, in turn, depends on the government’s time horizon and degree of dependence on international finance and reputation.

Assessing the extent to which institutions support credible government commitments requires analysis of the extent to which relevant institutions raise the costs that government officials incur in altering existing policies or contracts. When these costs are high, government officials are less likely to act on whatever incentives they may face to engage in opportunistic behavior toward private investors. Checks and balances that force government officials seeking to change the status quo to secure the agreement of representatives of other branches of government, and of other political parties, create
such costs and thereby increase credibility. In contrast, when individual government officials have unilateral autonomy to alter existing policies or contracts, credibility is weak.

These arguments suggest two main hypotheses. First, the types of strategic safeguards employed by investors should depend on the credibility of government commitments, and thus the level of institutional checks and balances that characterize a political or regulatory system. Investors operating in environments characterized by stronger institutions will be better able to protect their investments using a wider array of strategic safeguards. In contrast, those operating in less credible environments must rely more heavily upon their partners to exert pressure on their behalf. Second, although the expected returns on projects may in some cases be high enough to justify entry into environments characterized by weak checks and balances, strategic safeguards of any type—and the project itself—will be more likely to fail in these environments.

2.4. Outline

In the remainder of this paper, we examine these hypotheses with reference to the development of private power provision in Thailand, the Philippines, Malaysia and Indonesia. We begin by documenting the roots of the power crises that created the impetus for private investment in the four countries. We then document the power crises themselves and trace out the course of privatization. With this information as a backdrop, we undertake an analysis of the political institutions of the four countries, and use the results of this analysis to link the level of policy credibility in each country to the strategies chosen by investors and to the treatment of investors in the aftermath of the East Asian financial crisis.
3. Roots of the Power Crises

We begin our analysis by tracing the roots of the Southeast Asian power crisis. As in the rest of the world, the provision of electricity in Thailand, the Philippines, Malaysia and Indonesia was typically a government affair conducted exclusively through state-owned enterprises (SOEs) prior to the 1990s.

Thailand’s system consisted of three SOEs, of which one—the Electrical Generating Authority of Thailand (EGAT)—was solely responsible for generation and transmission (12, 259). In the Philippines, the National Power Corporation (NPC) owned generation and high-voltage transmission facilities (Ibid., 206).

Three SOEs divided responsibility for different regions of Malaysia: the National Electricity Board (NEB, also know as Lembaga Lektrik Nagara) in peninsular Malaysia, Sabah Electricity Board (SEB) in the state of Sabah, and Sarawak Electricity Supply Corporation (SESCO) in the state of Sarawak (13).

Indonesia’s electricity supply was provided by Perusahaan Umum Listrik Negara (PLN), although a large number of privately-held entities owned generating equipment not connected to the public grid especially outside the main island of Java (12, 167). The total capacity of these private facilities reached as high as 70 per cent of the level of generating capacity on the PLN grid (14).

Several factors conspired to create power crises in the four countries in the late 1980s or early 1990s and ultimately created a need for private sector involvement. First, all four countries experienced rapid economic growth during this period. Economic growth increases the demand for electricity as both the total amount of economic activity

2 The one notable exception prior to 1990 was the United States.
grows growth (15; 16; 17; 18; 19) and the composition of economic activity shifts toward more electricity-intensive applications (7). Between 1985 and 1990, the Philippines and Malaysia exhibited healthy average annual real GDP growth rates of 4.7 and 6.8 percent, respectively (20), while Thailand and Indonesia exhibited respective double-digit growth rates of 10.3 and (approximately) 16.8 percent (Ibid.).

However, despite the increased demand for electricity and the macroeconomic benefits of promoting infrastructure growth, governments in all four countries faced public financing constraints. Much of the economic growth in the ASEAN had been fueled by public spending (21). In Thailand and the Philippines, central government expenditures on development ranged from 13.9 and 13.1 percent to 18.9 and 24.0 percent of GDP, respectively, during the period 1981 through 1990 (20). In Malaysia, central government spending on current consumption and development (including loans to state governments) ranged from 29.1 percent to 43.8 percent of GDP during the same period. In Indonesia, central government expenditures on development alone ranged from 7.6 to 13.1 percent of GDP (Ibid.).

The substantial public spending programs in the four countries had pushed central governments toward their debt ceilings and left them unable to finance the massive investments that capacity expansion through existing SOEs would have required. For example, in Thailand, EGAT’s debt had grown by 1990 to more than US $4 billion, equal to more than one quarter of total state and state-guaranteed debt. The central government rejected a proposal by EGAT for an additional US $8.3 billion expansion, which in turn ultimately led to the initiation of Thailand’s electricity reform program (22).
In the Philippines, the cost of meeting capacity forecasts would have been additional government spending of US $0.5 billion per annum for eight years—equivalent to seven percent of GDP—and as much as $35b over 22 years (23). Malaysian peak demand was forecast to rise from 4,545 MW in 1992 to 9,517 MW in 2000, and 35,428 MW in 2020 (24) requiring projected investment of more than $40b (25).

Finally, forecasts made in 1990 for Indonesia called for 12,000 MW of new capacity to come on line by the year 2000, compared to existing infrastructure of 11,000 MW (26). This dramatic increase was deemed necessary to meet expected annual increases in electricity consumption exceeding 20 per cent (27). Estimates of the amount of capital needed to finance the expansion ranged as high as $20 billion (28). Moreover, by 1993, projected demand had increased even more, leading to a revised estimated need for 12,000 MW of new capacity within five years at a cost of US $13 billion (29).

4. Power Crises

The combination of rapid demand growth and public financing constraints ultimately created power crises in the four countries in the late 1980s or early 1990s. In Thailand, electricity consumption grew at an average annual rate of 13.5 percent during the period 1985 – 1994 and 14.1 percent from 1990-97, but installed capacity grew at an average annual rate of only 7.7 percent during this period (12). Reserve margins fell from approximately 40 percent in 1985 to a low of just over 10 percent in 1989.

The most serious shortage began in 1989 in the Philippines, where brownouts often ranged from four to 10 hours a day. Moreover, in 1992, excess demand corresponded to 48 percent of total system capacity, and was estimated to cost the country between US $1.6 billion, or 1.5 percent of its GDP (23), and US $29 million, or
over $20 billion a year (30). Shopping malls were ordered to reduce their hours of operation by two hours and industrial areas of the country faced twelve-hour blackouts three times a week (31). Of 512 international companies that had Asian regional headquarters or plans to open them in Manila, 123 closed their operations and 226 canceled their registrations. The crisis reached such heights that the government leased nuclear submarines and ice breakers from Russia and employed their reactors as floating generators (32).

In Malaysia, annual average reserve margins had fallen to 19 percent, compared to the desired level for rapidly industrializing economies of 30 to 40 per cent. The power supply shortage was as high as five percent of peak load. In September 1992, 80 percent of the population on Peninsular Malaysia suffered a blackout for 33 hours.

Indonesia’s power shortage began in 1991, after electricity demand had grown for several years at an average rate of 17 percent per annum, while the incumbent SOE, PLN, had been able to expand capacity by an average of only 15.3 percent per annum (33). Sporadic blackouts occurred in both 1991 and 1997.

5. Privatization Begins

The four ASEAN countries faced their power crises against the backdrop of deregulation and privatization in the electricity sectors of several developed economies.

3 A secretary in an insurance company reports on a typical day during the power shortage: "I get up in the morning, but can't take a shower because there is no electricity, and we have an electric water pump. I take a bucket bath, but still feel sticky. I can't even make a cup of coffee. Then I endure a two-hour commute by bus to Makati. The traffic is three times its usual mess when there is no electricity because then there are no traffic lights. I arrive hot and sticky and overdosed with car fumes. In the office, I can't do anything for four hours a day. The phones don't work. My electric typewriter doesn't work. We are in a sealed glass high-rise building, so we can't open the windows, so we suffocate when there is no air conditioning. At closing time, the whole miserable scene is repeated in reverse. Two hours later, I arrive home only to find the power off. I can't even cook dinner or take a shower or relax in front of the fan," she says.
In the US, for example, wholesale deregulation had begun with the Public Utilities Regulation and Policy Act of 1978 (PURPA), and gathered additional steam with the advent of “competitive procurement” between 1988 and 1990 and the Energy Policy Act of 1992 (EPAct). In the UK, the central government published a “White Paper” proposing privatization of the electricity supply of England and Wales in 1988, and a revised version of this proposal became law in the Electricity Act of July 1989. These highly visible examples, together with numerous examples of privatization and deregulation of other industries that had previously been operated by the state or subject to substantial government intervention, suggested that private investment might be the key to solving the ASEAN power crises. Each country thus turned for the first time to the private sector.

In Thailand, reform of the electricity sector began with a series of small steps designed to address the difficulties faced by a politically powerful industry lobby. Sugar farmers and factories faced a grave crisis in 1992 that led the government to pass a legislative amendment removing a restriction on private generation of electricity, allowing the sugar industry to make use of its waste to generate power. In the face of the power crisis and strong private sector interest in the program, small power producers (SPPs) expanded more than fivefold in scale and the scope to include other fuel sources such as non-conventional energy, residual fuels, waste, garbage and wood chips (34). Over 80 bids were received for more than 5,000 MW of generating capacity.

In December, 1994 the next step toward more widespread reform took place with EGAT’s solicitation of independent power projects (IPPs) with a total capacity of 1,000 MW to come on-line in 2000, and another 2,800 MW to come on-line between 2001 and
2003. Compared to the 3,800 MW of demand, EGAT received 50 proposals from 32 international consortia for a total of 39,067 MW of supply. After several interim increases in the amount of capacity that EGAT would permit to be built, seven contracts were awarded for a total of 5,800 MW in December 1996.

The 1992 reforms that led to the advent of SPPs also established the objective of the privatization of EGAT. In December 1994, the 1,232 MW Rayong combined cycle plant and the 824 MW Khanom plant were sold from EGAT to its newly formed wholly owned subsidiary EGCO. This subsidiary was then listed on the domestic share market in 1995, with 73.59 percent of the shares ultimately going to private investors (53.40 percent to individual shareholders plus a 20.19 percent strategic stake held by China Light & Power, Thailand).

In the Philippines, the initial opening for private sector provision came in the form of 1987 Executive Order 215, which was modeled after PURPA in the US and allowed private entities to construct and operate power plants (35). By 1992, 10 percent of the country’s power was being generated by entities other than NPC. By 1997, privately owned and operated generating facilities selling power directly to NPC accounted for 16 percent of total installed capacity, and privately-operated NPC-owned plants accounted for another 22 percent of total installed capacity (12, 220). During the period 1993 – 1999, a total of 6000 MW of private power came on line. The forecast was that by the year 2000, 57 percent of all power would be privately generated (36).

Malaysia began its privatization process in September 1990 when it “corporatized” NEB as Tenaga Nasional Berhad (TNB). In 1992, 22 percent of the shares of TNB were floated on the Malaysian stock exchange with the Ministry of Finance
 retaining a 71 percent share. In response to the blackout of September 1992, the government accelerated its reform program and, consistent with prior announcements, ended the TNB monopoly on generation by issuing two IPP licenses. The first was awarded to a partnership between the Malaysia construction conglomerate YTL Corp. and the British firm National Power (37). The ownership of this contract was later transferred to a consortium of YTL, TNB, the state-run employee pension fund, a Malaysian banking syndicate and a British entrepreneur. Subsequently, 80 separate entities bid for IPP contracts and additional licenses were issued to several prominent Malaysian industrial groups.

In Indonesia, a considerable amount of privately owned capacity that was unconnected to the grid had been in place for some time, but it was not until 1995 that the Indonesian government committed itself to signing agreements worth more than $9 billion USD to bring 5,500 MW of private capacity online between 1997 and 1999. Around the same time, the status of PLN was changed from an SOE to a limited liability company permitted to raise private capital, and the Indonesian government announced plans to proceed further in this direction.

As the first IPP plants came on line at the end of 1995, forecasts were for 40 percent of total generation to originate from these firms within three years. The pace of IPP involvement in the power sector and the privatization of TNB were further accelerated after a second blackout on August 3, 1996 that lasted for over sixteen hours (38). However, in the wave of IPP projects that followed and the restructuring of some existing IPPs, TNB acquired substantive minority holdings in many of the IPP contracts.
6. Policy Credibility

Although the details of each of the private investment programs differed, investors in all four countries pursued strategies to safeguard themselves against the risks associated with making large sunk investments in nascent power markets. In all cases, investors obtained long-term contracts known as power purchase agreements (PPAs) that obligated the government-controlled SOE to purchase privately generated electricity for transmission and distribution through the public power grid. A critical feature of the PPAs was that they offloaded demand risk onto the government through “guaranteed offtake” or “take-or-pay clauses,” which required the incumbent SOE to purchase a stated level of output—typically a fixed percentage of the total output of the IPP’s plants, ranging from 55 to 100 percent—for a specified price or, in the event of a demand shortfall, pay for the unneeded electricity anyway.

In the context of the conceptual discussion provided in section 2, the PPAs represent the “policy” of central interest. The potential opportunistic behavior of central concern—and against which investors needed to safeguard themselves—was the possible “renegotiation” of these PPAs by the governments following the deployment of sunk capital by the private investors. The types of strategic safeguards chosen by investors in each country thus depended on the extent to which they believed the PPAs would be enforced, and ultimately on the level of checks and balances provided by each country’s institutional environment. Moreover, even in the presence of “appropriate” safeguard strategies, the ultimate efficacy of many of these strategies depended on the level of checks and balances as well.
In this section, we operationalize and assess the level of check and balances in each country—and thus the level of credibility—by examining the number of independent veto points faced by an institutional actor who unilaterally attempts to alter policy. In the current context, the two levels of government at which relevant veto points might be found are the “macro” level at which broad policies are made and enforced—i.e., the national political structure that includes the executive, legislative and judicial branches—and the subordinate regulatory level that executes these policies. A notable feature of the four countries under study, however, is the relatively late development of regulatory institutions for each country’s power generation sector. In fact, while each country is currently considering constitutional changes that would create an independent regulatory authority and further liberalize its power sector, none had yet undertaken such a reform at the inception of the financial crisis. Our analysis therefore focuses on the structure of national political institutions. In the subsequent two sections, we link our analysis of checks and balances to investors’ choices of safeguard strategies and then to post-crisis outcomes.

6.1. Stronger Institutions: Thailand and the Philippines

We first consider Thailand and the Philippines. The institutional configurations in both of these countries provided relatively large numbers of veto points and thus higher levels of policy credibility than Malaysian and Indonesia institutions did.

Since 1996, Thailand has operated under a new constitution that separates the branches of government and supports relatively rigorous democratic debate among multiple parties. Though formally a constitutional monarchy, political power in Thailand rests with the Prime Minister who is appointed by the elected lower chamber of
Parliament. At the time of the financial crisis, the 393-seat lower house of the legislature was divided among 10 parties: the New Aspiration Party (125), the Democrat Party (123), Chart Pattana (52), Chart Thai (39), Social Action (20), Prachakorn Thai (18), Solidarity (8), Seritham (4), Palang Dharma (1) and one Independent. This heterogeneity of partisan affiliations in the legislature ensured that the Prime Minister was beholden to multiple parties in order to maintain power. Any new policy proposal or change in the status quo policy thus required the approval of multiple parties with their own competing interests. Further, Thailand had begun to develop an independent judiciary over the past decade, providing an additional institutional safeguard against abrogation or unilateral renegotiation of the contracts.

In the Philippines, institutions have evolved considerably since the fall of the Marcos government in 1986. The Philippine national government consists of a directly elected executive and a bicameral legislature. At the time of the East Asian crisis, President Ramos of the National Unity Coalition held the presidency; his party controlled 126 of 201 seats in the lower legislative chamber and six of 24 seats in the upper house. In 1998, President Estrada replaced President Ramos; Estrada’s Party of the Philippine Masses held 110 of 221 seats in the lower legislative chamber and 10 seats in the 22-seat senate. The new government thus faces a razor-thin majority that relies upon the support of independents and other allies in both chambers. The judiciary also begun to play a more independent role in after 1986, and even more so under the Ramos administration in the mid-1990s.
6.2. Weaker Institutions: Malaysia and Indonesia

In comparison to those of Thailand the Philippines, the institutions of Malaysia and Indonesia provide weaker safeguards for investors. Malaysia is a federation of 11 states with an elected National Parliament that appoints a Prime Minister. While there exists a strong heritage of an independent judiciary and bureaucracy stemming from the British colonial administration, the United Malays National Organization of Dr. Mahatir Mohammed has increasingly come to control these institutions. Moreover, Dr. Mahatir is the longest-serving Prime Minister in Asia—he has been in power since 1982—and his party has been in power since Malaysia gained its independence in 1965. Thus, while the Parliament appears fractionalized among multiple parties, the independence of those parties is suspect. Specifically, several of the opposition parties were created by Mohammed’s United Malays National Organization and vote with his party as members of the National Front Coalition. Similarly, although the courts are de jure independent, the fact that the sitting Prime Minister has appointed more than 80 percent of high court justices and his party 100 percent of the high court calls into question the independence of the judiciary.

The situation in Indonesia is clear-cut. The President is elected by a People’s Consultative Assembly that consists of the directly elected members of Parliament (425), the Presidentially appointed members of Parliament (75), and an additional set of Presidential appointees (500). Not surprisingly, given the guaranteed majority in this body, President Suharto was reelected in each meeting of the Assembly from the time he assumed the office in 1965 until his resignation in 1998. Suharto’s Golkar Party also controlled no less than 64 percent of the elected seats in the lower legislative chamber.
during this time. Only two officially sanctioned opposition parties are allowed to contest elections. The legislature typically ratifies bills proposed by the executive and tends to operate under consensus (if a vote is required, a 2/3 majority is needed for approval). Moreover, according to the International Commission of Jurists, “the judiciary remains an arm of the executive…The minister of justice controls all matters relating to judges…” The Supreme Court can exercise no effective control over executive and legislative action. Compounding the dilemma is the absence of adequate mechanisms to call judges to account” (39). The National Law Commission of Indonesia found that 80 percent of Supreme Court justices are tainted by bribes (40). The newly appointed ombudsmen for the Indonesian law enforcement system announced “Indonesia may be the most corrupt nation in the world, but it is also where the least number of people are tried for corruption” (41). The Attorney General of Indonesia agreed: “Our current judicial system is an embarrassment” (42).

7. Strategic Safeguards

The level of institutional credibility in each country dictated the nature of the strategic safeguards that investors in each country employed. Because Thai and Philippine institutions supported stronger government commitments, foreign investors in these countries relied more heavily on contractual safeguards whose ultimate efficacy depended on credible ex post enforcement by the government. In contrast, because Malaysian and Indonesian institutions provided lower levels of credibility, investors in these countries relied less heavily on contractual safeguards, and more heavily on local partnering and external enforcement by international financiers and multilateral agencies.
7.1. Thailand and the Philippines

In Thailand and the Philippines, investors relied heavily on sophisticated contracts. The use of such contracts implies investor confidence in supporting institutions. The first IPP project in Thailand (Independent Power Thailand, or “IPT”), a joint venture between Thai Oil (56 percent), Unocal (24 percent), and Westinghouse (20 percent), provides a good example. Investors secured international finance in the amount of US $383 million from a consortium of seven Japanese and German banks which provided a 15-year, US $176 million loan, and from a domestic consortium that provided the remaining $207 million. The investors hedged their foreign exchange rate exposure using currency swaps. They also purchased insurance to cover their plant facilities against physical loss or damage including loss or damage in transit, the potential for loss of revenue due to such damage, and the potential for third party claims including worker’s compensation due to such damage. Additional insurance was purchased against physical loss or damage due to mechanical breakdown, fire, strikes, riots, malicious damage, earthquakes, and the like, and also against loss of revenue associated with any potential third party claims resulting from such damage.

The 25-year power purchase agreement (PPA) between EGAT and IPT is quite sophisticated as well. It outlines four forms of payment. First, EGAT commits to provide an availability payment based upon the plant’s available capacity which was partially indexed to the Thai Consumer Price Index (in baht) to account for increases in the fixed costs of operating and maintaining the plant. The second payment is made for the actual energy consumed by EGAT and is intended to reimburse IPT for the fuel input associated with electricity production. This payment is a complex function of the energy provided,
the costs of fuel, the baht/dollar exchange rate, and a schedule of efficient fuel-energy conversion factors. Third, a variable operations and maintenance cost payment is made that is indexed to the Thai CPI. Finally, EGAT agrees to compensate IPT for new transmission facilities constructed over the course of the 25-year contract.

In the Philippines, the contracts that investors signed with the government in the early 1990s were perhaps the most “complete” of those in any of the four countries. This is no doubt due in part to the fact that the contracts were signed in the shadows of the severe power crisis that gripped the country at the time. However, the completeness of the contracts is also evidence that investors in the Philippines were confident in the prospects for reliable ex post enforcement. As in the other countries, the contracts had numerous guarantees written into them which offloaded risk onto the National Power Corporation (NAPOCOR). For example, in the case of the first IPP project (Hopewell Pagbilao), NAPOCOR assumed the market risk through a take-or-pay clause; the exchange rate risk through dollar indexed payments; currency conversion risk through dollar-denominated payments in an off-shore account; fuel supply risk through the guaranteed free provision of coal; regulatory risk through an agreement to compensate Pagbilao fully for any adverse changes or, at Pagbilao’s discretion, purchase the plant at dollar cost plus a minimum guaranteed return; and risk of political force majeur through take-or-pay clauses that specifically accounted for changes in the political regime. Only the operating risk was borne by Hopewell. An interviewee at another firm highlighted his company’s willingness to threaten to alert the rating agencies of worsening relations between his firm and the government. Still other investors spoke of the leverage provided by international banking syndicates, government-sponsored political risk underwriters
(OPIC, the Export-Import Bank, COFACE, ECGD, MITI etc.) and multilateral lending agencies such as the Asian Development Bank and International Finance Corporation. All of the interviewees cited confidence that buyout clauses, government guarantees and other contractual terms were credible. In one manager’s words, “unlike China, a contract is a contract [sic.]”

7.2. Malaysia and Indonesia

Consistent with the weaker institutional environments in Malaysia and Indonesia, the strategic safeguards adopted by investors in these countries relied less on efficacious contractual enforcement by the government and more on local ties. Indeed, Malaysia found it difficult to attract Western investors in the first place. Financing for its projects was raised domestically, circumventing the exchange rate risk faced by investors in other countries (43) and limiting the pressure applied on the Malaysian government by international financiers, but also scaring off many Western firms. An executive at a local IPP alluded to this possibility when he cited higher risk estimates for and thus higher expected returns required by foreign firms as the main reasons for their absence.

Difficulty in explaining the need for certain local partners to international financiers may also have played a role. A US energy industrialist discussed the importance of involving local Malays but cautioned “You try going to a hard-bitted New York banker, asking for backing for a project and at the same time try to explain the bumipatra (need to involve a native Malay) business. It would be a real struggle, believe me” (25). One western interviewee summarized, “Malaysia is a difficult place to understand. The electricity sector is closely interwoven with the political process. You can only try to get the tightest kind of contractual arrangements, then you have to work
Another interviewee reiterated this point: “You have to use the culture… a certain amount of patronage is necessary in any government project… there’s a price for everything.” Indeed, one foreign firm expressed confidence in the profitability of their operation because they believed that their Malay partner would not be allowed to fail.

Even more so than in Malaysia, the importance of relationships and family ties as contractual supports rose to the surface in Indonesia. According to one interviewee, “an Indonesian partner was suggested to us. There was no way to avoid that.” The experience appears to have been repeated in virtually every IPP contract there. Cikarang Listrando, the first major private power project in Indonesia and, later, the first to sell power back onto the national grid, was owned by President Suharto’s cousin. President Suharto’s son had a 10 percent stake in next major project to be signed through his business concern the Humpuss Group. The infamous Paiton project passed from President Suharto’s second son to the brother of President Suharto’s son-in-law. Bambang, the second son, later resurfaced as a director for the company that took over East Asia Power in 1997. The three-phase Tanjung Jati plant included among its many investors Suharto’s second daughter (phase A); eldest daughter (phase C); and a close associate of the Minister of Planning who was brought into the venture by an adviser to the Minister of Mines Energy (phase B). Suharto’s eldest daughter also controlled a 20 percent state in another project although this stake was subsequently reduced to five percent. Cal Energy shared ownership of its Dieng project with the Association of Retired Officers Businesspeople (Himpurna); and of its Patuha project with the son of the Minister of Mines and Energy. Additionally, Suharto’s oldest son was reputed to be a partner of CalEnergy, although the
firm vigorously denied this link (44). Finally, presidential confidante Mohammed Bob Hasan owned 10 percent of another prominent IPP. In all, 26 IPP projects were approved or, in the words on one interviewee, “shoved down the throats of PLN [the incumbent SOE] as all the kids and cronies elbowed in and demanded their own PPAs.”

8. The Efficacy of Safeguards in the East Asian crisis

The massive East Asian financial crisis that began in 1997 tested the credibility of the power purchase commitments made by the governments of the four countries. Suddenly, the entire region faced a severe reduction in expected electricity demand, the result of which was the “freezing of Asia’s pipeline” of new power projects (45). For example, an industry trade publication reported in late 1998 that:

“An examination of 140 ‘solid’ Asian projects resulted in the conclusion that no more than 14,000 MW or 41 projects will come on-line in the next four years compared to 26,000 MW forecasted 14 months ago. ‘This is at least a 45 percent loss in capacity development. At the low end, as little as 7,000 MW to 8,000 MW or 19 projects, may actually start up.’ Representing a worst case loss of 75 percent. The most likely scenario is a 65 percent loss” (45).

Further, privatization of independent power assets plummeted from $46 billion representing 28 GW in 1996 and $30 billion representing 24 GW in 1997 to $10b representing 10 GW in 1998 (46).

The reduction in demand strained existing PPAs. The guaranteed offtake clauses in the contracts left cash-strapped government entities with contractual obligations to pay private generators for unneeded electricity. To citizens and interest groups in the four countries, which were already experiencing some degree of social and political strife as a result of the severe economic downturn, the PPAs simply appeared to place added fiscal strain on struggling economies with little apparent near-term benefit. Political officials were thus left in the tenuous position of having to choose between honoring the contracts
with the risk of a political backlash, or renegotiating the contracts in order to increase
popular support while incurring whatever “costs” the relevant institutions imposed on
them for reneging on policy commitments.

Several interviewees highlighted the importance of this tradeoff in their
comments. In Thailand, for example, one interview commented that “economists always
say that with competitive markets, consumers get the benefit. Not the case here. After the
crisis, who pays? Consumers.” Another investor also highlighted the tension between
economists pushing for a free market and technocrats who favored government control of
capacity, asking, “Who pays for 40 percent overcapacity? The consumer….The problem
is the PPAs guarantee a return.”

In the Philippines, one investor spoke of the pressure from Congressmen and
Senators to renegotiate the PPAs and the government’s reservations about doing so for
fear of potential problems with the IPPs’ lenders. Another emphasized the importance of
educating consumers and politicians of the costs of a forced renegotiation. Similarly, a
Malaysian investor highlighted the government’s reluctance to renegotiate IPP contracts
due to the concern that this action would invoke among foreign investors. Yet another
Malaysian interviewee claimed that “much pressure on pricing comes from consumers
but it will go away when they see the benefits in the long term…starting point is the hard
part…locals have to take on the majority of the risk as we don’t want to burn the fingers
of the foreign investors.”

The most glaring evidence of the nature of this tradeoff comes from Indonesia,
where one interviewee explained that, since street protests had occurred in opposition to
rate increases in May 1998, “tariff increases are now seen as a key factor that can lead to
political change.” Another Indonesian interviewee elaborated that “Parliament will not accept using price increase to provide efficiency in electricity. You have to consider public sentiment… If we talk about private power, the only response from the public is anger.”

The upshot is that even though government officials may have recognized the potential negative ramifications of altering or abrogating the PPAs, they also felt strong political pressure to do so. In this section we therefore evaluate the efficacy of the safeguard strategies adopted by investors in the four crisis-stricken countries in providing protection against opportunistic renegotiation. We find that in the two countries with stronger institutions, Thailand and the Philippines, investors by and large weathered the crisis fairly well. In contrast, investors in Malaysia and Indonesia received considerably worse treatment, despite their adoption of safeguard strategies that were better matched to the weaker institutional environments in these two countries.

8.1. Thailand and the Philippines

The institutional configurations in Thailand and the Philippines appear to have provided electricity investors with reasonable safeguards in the wake of the financial crisis. The crisis began in Thailand in July 1997 when the government facing a foreign exchange crisis, elected to float the Thai Baht. Over the course of the next twelve months, the Thai stock exchange lost 82 percent of its peak value, the baht depreciated 40 percent and the annual rate of economic growth plunged from 8.6 percent in 1995, 7.8 percent in 1996 to -1.0 percent in 1997 and –8.0 percent in 1998. The reduction in electricity demand was severe: in contrast to the double-digit-growth rates of the prior decade, power demand in Thailand actually declined by 2.4 percent in 1998. Moreover, the
annual reserve margin for the electricity system, which had averaged 8.6 percent during the period 1990-97, was forecast to rise to 50 percent by the year 2000 (47).

Private electricity investors in Thailand faced an especially dire situation because, even if the Thai government chose to honor the guaranteed offtake clauses, the Thai PPAs (in contrast to those in the other countries) left the exchange rate risk with the investor. The contracts specified power purchase prices denominated in Thai Baht, while the capital investments were financed mostly in foreign currencies (primarily US dollars). Thus, if the Thai government had chosen simply to devalue the Baht, investors would have absorbed the full brunt of the devaluation.

However, the Thai government did not choose to devalue the Baht. Instead, it chose to shift the exchange rate regime from “fixed” to “floating.” Because this act constituted a change in law—which a simple devaluation of the currency to a new fixed rate would not have—it triggered a clause in the PPAs that required the government to renegotiate the contracts. In the renegotiations, the government assumed a considerably larger fraction of the costs of the currency depreciation than it would have under the original contracts. This fact, together with the recognition that the government could have avoided the renegotiation process altogether by simply changing the exchange rate rather than changing from a fixed regime to a floating regime, suggests restraint on the part of Thai officials, who, as described above, certainly faced strong incentives to redistribute returns from private investors to the suffering Thai populace. The National Energy Policy Office summarized its recognition of this tension:

“Contract negotiations have to be carefully undertaken so as not to jeopardize investor confidence and the investment climate. Obviously, investors do not like contract renegotiations which do not run in their favor, such as the reduction of prices in the gas supply agreements, or the delay of the commercial operation date
of an IPP. Without renegotiations, however, the country and consumers could be left with an unmanageable financial burden” (Ibid.).

Our interviewees reinforced this notion of an orderly and “clean” renegotiation that led to confidence in the regulatory authorities and the future viability of private power generation in Thailand. “Private investors appreciate the cooperation from NEPO and EGAT. The government has demonstrated their clear support of our position.”

Several interviewees highlighted the consultative process that began with a series of letters from the IPPs to NEPO, which then served as a mediator among the investors, EGAT and the various ministries (that themselves were headed by different political parties that were members of the coalition government); this, culminated in a collective understanding that, without a renegotiation, “private industry would not survive. We then sat down and all tried to be reasonable.” Payment schedules were recalculated based on the foreign exchange exposure of the various IPPs. While some companies had hedged their foreign exchange exposure and thus profited relatively more from the scheme than others, “there wasn’t time to create an issue that would have stirred problems and made things more complicated.”

To be sure, investors did share some of the suffering: EGAT, the Thai SOE, responded to the crisis in part by delaying for as long as possible independent power projects that had not yet been fully negotiated. Two of these projects, at 700 MW each, came on line in the summer of 2000, 11 months and two months behind schedule, respectively. The remaining five are scheduled to go into operation between July 2002 and February 2007 instead of January 2001 to February 2003. Additional cross-national projects involving EGAT and the governments of Oman, Indonesia and Laos were similarly delayed. Even these delays are notable, however, for their relatively short
duration in the face of such a large reduction in demand. Several investors highlighted their firms’ satisfaction both with the structure of the workout and the speed with which it was negotiated.

However, the consultative process described above has created its own difficulties in other instances where local or environmental concerns were allowed to derail or severely delay projects that investors feel were economically viable. Efforts to streamline the regulatory process and concentrate more power in the hands of a single entity thus pose potential benefits and certain hazards especially if that regulatory authority lacks *de jure* and *de facto* independence from political authorities.

In the Philippines, the financial crisis struck at the very end of the Ramos administration and was quickly inherited by the Estrada administration. Though somewhat less severe than in the other countries in our study, the impact of the crisis was nevertheless quite pronounced. The rate of economic growth slowed from 6.8 percent in 1995 to 2.0 percent in 1998. In 1998, electricity consumption in the country declined by 2.5 percent compared to previous growth rates of 12 percent per annum. Furthermore, forecasts at the time indicated that no new construction would be required until 2003.

The Philippine government’s initial response to the crisis appeared to be as favorable to investors as that of the Thai government. Unlike investors in Thailand, investors in the Philippines did not bear any exchange rate risk, so the primary concern would have been the government’s failure to honor take-or-pay clauses. However, the government chose to absorb the demand risk by honoring its contractual commitments to various IPPs, even though this meant mothballing several NPC generating facilities and procuring electricity at prices that were sometimes substantially higher than what it
would have cost NPC to generate the electricity itself. The resultant losses to NPC have
grown over time and, in mid-2000 equaled roughly US $10 million per week. In the face
of mounting losses, Napocor sought to renegotiate some of its contractual obligations as
early as November 1998. However, its president, Federico Puno, made clear that “We
have no intention of amending [the contracts] without the consent of the IPPs. Napocor
will continue to honor the minimum off-take agreements specified in the contracts and
the take-or-pay obligations” (48).

As in Thailand, a well-organized industry lobby (here formally constituted as the
Philippine Independent Power Producers Association) engaged in a series of complex
negotiations and discussions with multiple ministries including the Department of Energy
and Finance, multiple branches of government including the courts, both legislative
chambers and multiple executive agencies and, finally, a raucous press. Several
interviewees highlighted the extent of their involvement in the reform process going so
far as to provide us with the detailed documentation that they have presented to various
political and regulatory authorities at a series of conferences and industry summits.
However, in contrast to the experience of Thailand and more akin to the experiences of
investors in Malaysia and Indonesia, many investors also indicated that firms owned by
certain individuals with close ties to the government were seen as favored in the process.
Investors were also notably less optimistic regarding future reforms than were investors
in Thailand.

In October 1999, the government took a somewhat harder line, announcing that it
would allow IPPs to expand their existing facilities and guarantee their participation in a
planned power pool only if they agreed to renegotiate existing PPAs. One investor
claimed that, “It is no different from what is happening in Pakistan and Indonesia.” NPC is still trying to reduce the guaranteed take-or-pay ratio from 70 – 75 percent of capacity to 55 percent. Even these attempts to renegotiate, however, must be viewed in the proper context. A recent consultancy report prepared for the government by Credit Suisse First Boston and SGV/Anderson Consulting recommending that it renegotiate its three most expensive IPP contracts for a potential savings of US $1 billion. What is more notable than the fact that NPC has pressured IPPs to negotiate is that it is only pressure that has been exerted—as opposed to an outright unilateral change by the government in the PPAs’ terms—in the face of such massive potential cost savings. Also under consideration is a straight buy-out of all 42 IPP contracts for roughly $10 billion (49). While this sum would compensate IPPs for the value of their investments, it is likely beyond the ability of the Philippine government to raise the necessary funds.

8.2. **Malaysia and Indonesia**

Despite their greater reliance on local partners and reduced reliance on contractual safeguards, electricity investors in both Malayisa and Indonesia experienced much less favorable treatment once the financial crisis began. In 1997, the Malaysian government floated the ringgit, and shortly thereafter announced the suspension of its largest IPP contract (the 2,400 Bakun hydroelectric project) (50). TNB’s bond rating was cut from A+ to A- by S&P as the cost of IPP contracts soared 42 percent from the previous year (51). As annual demand increases in electricity plummeted from 12 – 15 percent in the 1986-97 period to 5 percent in 1998 (52, p. 11), overcapacity in Malaysia was forecast to climb as high as 55 percent in the year following the East Asian crisis (53, p. 9). TNB requested assistance from the IPPs to help meet its growing financial obligations (54).
also asked to the government to place on hold all new IPP projects, including those with government approval and signed PPAs (53, p. 9). TNB also requested a 90-day deferment for payments to IPPs and a 12 percent reduction in existing PPA payments (55).

These proposals were met with some shock by investors, including our interviewees, many of whom displayed little hope for the ability of the government to attract new private investment in the energy sector especially from abroad. “A lot of investment has been lost due to anti-foreigner rhetoric.” “The transition from Mahatir will be a political mess. Why should the future be better?” However, many displayed confidence that despite the posturing, the final outcome would be one that all sides could live with. “The sanctity of contract must be observed. I never imagined that contracts would be abrogated without mutual agreement… We’ll come up with some small compromises.” Others expressed confidence, “Malaysian investors will not be allowed to fail.” Similarly, in a separate interview, “Malaysian financiers will not be allowed to fail.”

Foreign investors, in contrast, were clearly at a disadvantage. One interviewee mapped out the surviving IPPs in the following fashion “One furthers the interests of the BumiPatra and was supported by the ex-deputy Prime Minister who is now in jail, one furthers the interests of Mahatir, another supports Mahatir’s good friend who had had difficulty in his other businesses, the remaining two are large diversified Bumipatra multinationals that are shrewd political operators…great at balancing…”

Turning to Indonesia, response of the government to the crisis was by far the most severe. On September 23, 1997, the government announced that it would postpone or review infrastructure projects worth more than 50 trillion rupiah ($6 billion), leading to
the postponement of 13 projects and the review of 6 more (out of a total of 26) (56). Just over a month later, PLN approached the IPP PT Energi Senkang and “asked them if they [were] willing to decrease their tariffs.” The firm was “informed” that the average tariff price was less than 5 cents per kilowatt-hour while the plant charged six to seven cents per kilowatt-hour (Ibid.). S&P placed the IPP projects in Indonesia on their credit watch list in December, 1997 and downgraded them to BB- in January(57). By March 1998, PLN had refused to pay for the power at the current exchange rates, as stipulated in the PPAs. John D. Hushon, President of El Paso, reflected after negotiations with PLN that “we understand that circumstances are such that we must be flexible in working out at arrangement so we can adjust to the reality that we share” (58). Despite the implicit threats, Minister of Mines and Energy Sudjana reaffirmed that “in principle, we never want to make investors suffer losses. We shall never break the power purchase agreements we have signed… We are looking for a solution which will at least prevent investors from suffering losses and make them still able to operate” (Ibid.). During the month of March, El Paso secured payment from the Ministry of Finance, which had guaranteed the payments of PLN under the PPA.

In May 1998, President Suharto was replaced with his longtime confidante, B.J. Habibe. The profile of the dispute between PLN and the IPPs was soon raised to new heights on June 7, 1998 when Djiteng Marsudi, chairman of PLN, announced that he had notified Cikarang Listrindo, one of the operating IPPs, that PLN would stop buying power from the company on June 15th. “I am ready to face a lawsuit as a result of this move,” Djiteng asserted, and “emphasized that PLN would not pay the company despite a contractual take-or-pay clause stating PLN has to pay the company for 80 percent of its
power generation capacity, whether or not it used the power.” In PLN’s defense, Djiteng claimed that “PLN has no money now… There is already oversupply in the province… Most of the power projects were given without tender. I was in one way or another pressured to sign the contracts” (58). After a day of confusion, Djiteng extended this policy to the other operational IPP, Sengkang (59) and threatened to take similar action against the remaining IPPs (60). PLN explored the possibility of invoking a “force majeure” clause in its contract with Hopewell Holdings on the Tanjung B project (60). Djiteng later retracted the extension to Sengkang, saying “the guarantee from the government of Indonesia that PLN will meet its contractual obligations remains in full force and effect.” However, PLN then sent the letter to its IPPs informing them that, “…in light of the current monetary crisis… payment for purchase of geothermal steam and electric energy… will be in rupiah with an exchange rate of $1 = 2,450 rupiah” (61). The actual exchange rate at the time 10,000 rupiah / US $1. It became increasingly clear that, in the words of one interviewee, “the government has the ability to make us healthy or unhealthy. It’s a government decision.”

Over the first six months of 1998, PLN recorded a net loss of US $1.4 billion, mostly due to its foreign exchange rate exposure (62). In August, 1998, Djiteng was replaced as President of PLN (58). In September, President Habibe announced his intention to eliminate 13 of the 26 IPP contracts “without significant compensation” and six more “with some compensation” (62). In the case of the remaining seven contracts, the government announced its intent to “reduce PLN’s obligation (to those producers) via a combination of buy-out and/or contract restructuring” (Ibid.). The new policy was
strongly denounced by the CEO of the U.S. Overseas Private Investment Corporation, who claimed that the Indonesian government must honor contracts with the IPPs (63).

Firms were faced with a choice: whether to sever their ties with Indonesia by bringing suit or staying in for what could be a long recovery process. CalEnergy chose the first strategy and filed suit at the U.N. Commission on International Trade Law. The CEO of CalEnergy stated “The fundamental basis of the international power industry is the sanctity of contracts. It’s one thing to talk about mutually beneficial contracts. What we’re talking about is the unilateral wish to cancel contracts (64). Cal Energy did win a $572 million judgment against PLN, but has received only $290 million in compensation, which actually came from OPIC, which is in turn seeking repayment from the government of Indonesia. The Indonesian government is resisting efforts to collect, claiming that the contracts were the awarded on corrupt terms and are thus invalid (65).

El Paso chose the second path and committed to finding a solution that would be amenable to both sides. The company first announced its intent to buy out Suharto’s daughter’s share in the project in October 1998 (66). The government sought to renegotiate the IPP contracts, using as a base for negotiations the price of 3.0 cents/kwh, based on financing costs to PLN including 30-year loan terms with 10 years free of interest (30). Such terms are obviously unavailable to private sector investors in Indonesia, especially after the contract abrogations detailed above. However, Tanjung B did agree to reduce its price to 2.3 cents/kwh conditional on the receipt of a soft loan from the Japanese government of over US $1.15 billion with a 40-year term, no interest payable for the first ten years and an interest rate of one percent (67). Similarly, after six months of negotiation, El Paso and Energy Equity accepted an interim agreement in
which the Indonesian government would pay their operating costs and interest
commitments (68). Nonetheless, the Indonesian state audit agency recently reported that
it had “found indications of corruption, collusion and nepotism on all 27 [IPP] contracts’
and thus believes that it has legal standing to terminate these agreements (60). After
intervention from the IMF that explicitly linked future lending to an amicable resolution
of the IPP disputes, the government partially relented, although both sides remain far apart
regarding a final settlement (65). The merits of the confrontational strategy adopted by
Cal Energy relative to the more conciliatory efforts of other players will only be evident
in time. In the words of one interviewee, “If the current restructuring program is
acceptable, foreigners may come back. If it isn’t acceptable, I foresee more arbitration
and then the wheels come off for real.” And, even more pessimistically: “I can make my
own calculations, in two or three years….”

9. Conclusion

In this paper, we have attempted to demonstrate the importance of institutions that
support credible government commitments to infrastructure investment. We have looked
specifically at how differences in the level of policy credibility affect investors’ choices
of strategic safeguards, and also at how the level of policy credibility affects the efficacy
of safeguards in the presence of a shock that strengthens political officials’ incentives to
behave opportunistically.

The empirical setting for our analysis has been the development of private power
 provision in four ASEAN countries: Thailand, the Philippines, Malaysia and Indonesia.
These countries provide the basis for comparative analysis because all four undertook
privatization at roughly the same time and all four experienced the same shock in the
form of the 1997 East Asian financial crisis, but the level of institutional support for
private property rights in Thailand and the Philippines is considerably greater than that in
Malaysia and Indonesia.

Our analysis of the four countries leads to two main conclusions. First, investors
in Thailand and the Philippines chose to rely more heavily on contractual safeguards
whose efficacy depended more heavily on credible enforcement, while investors in
Malaysia and Indonesia chose to rely more heavily on non-contractual safeguards whose
efficacy was less dependent on the institutional environment. Second, despite the
differences in strategies meant to align governance with the institutional environment,
investors in Thailand and the Philippines fared considerably better following the crisis
than did investors in Malaysia and Indonesia.

Looking forward, we believe that the institutions in these countries will continue
to have a major impact on the shape and success and of privatization efforts as the four
countries’ economies develop. Each of the four countries is currently engaged in a serious
effort to reform its power sector and move towards a wholesale or retail pool structure.
Our analysis suggests that investors should have more confidence in the commitments of
the Thai and the Philippine governments to compensate them for any financial or
operating losses engendered by these reforms, and we believe that it is no accident that
Thailand and the Philippines have moved considerably farther down the road to full
liberalization than have Malaysia and Indonesia. Still, the Thai election of 2001 and the
uncertain future of the Philippines in the aftermath of their first-ever Presidential
impeachment trial demonstrate the tenuous nature of reforms even in these two countries.
Investors in Malaysia and the Philippines likely have greater cause for concern. To be sure, this analysis abstracts away from the potential returns available in these riskier markets. Some firms may continue to find the tradeoff worth making. We close by suggesting that the probability that investors will succeed in such environments would be enhanced if they undertook careful analysis of the extent to which the political institutions in target countries offer credible commitments against arbitrary and/or capricious policy changes, and designed appropriate hazard-mitigating strategies accordingly.


34. EGAT http://www.egat.or.th/dppd/eng_spp_bg.html.
52. Electricity Supply Industry in Malaysia.