



BRIEFING

SUMMARY

JULY 2007

Infrastructure development in Vietnam

A NEW BOT DECREE

The Vietnamese Government has issued a new decree relating to BOT projects. Although the decree takes some steps forward, it is insufficient to make large scale foreign investment in BOT projects more likely to succeed. A truly common and clearly defined legal framework has not yet been achieved. This briefing examines the provisions of the decree.

There is a growing need for the development of Vietnam's poor physical infrastructure. As the American Chamber of Commerce stated at the Vietnam Business Forum in May 2007:

'Infrastructure, especially seaports and electric power, is the most important factor now for firms considering investment in Vietnam. Infrastructure constraints threaten foreign direct investment in manufacturing and exports. Private sector participation in infrastructure development, finance, and management is needed urgently, especially in electric power and deep-water seaports.'

Port congestion is particularly acute in the Ho Chi Minh City area, where foreign direct investment has been concentrated. As shown in the chart below, container shipping demand will begin to exceed terminal capacity in 2007. The situation will worsen in 2008 and 2009 before the deep-water terminal at Cai Mep becomes operational in 2010. (See graph overleaf.)

A similar story could be told about electricity. Unfortunately, the state budget is not large enough to solve the problem on its own. Knowing that the country cannot develop quickly without proper infrastructure, Vietnam has implemented policies to encourage private investment in infrastructure. But over the 13 years that this author has practised in Vietnam, there have been only two successful foreign-invested build, operate, transfer (BOT) projects in the power sector and one (arguably irrelevant) small foreign-invested BOT project in water. No foreign-invested BOT contracts have been

signed since 2001. Since 1995, numerous foreign-invested BOT projects have been tried; some have been licensed before failing at the financing stage; and others have failed completely to get off the ground.

The Government has now issued a new decree relating to BOT projects. The important question for Vietnam is whether this will make any difference or whether, like second marriages, this will prove to be a triumph of hope over experience.

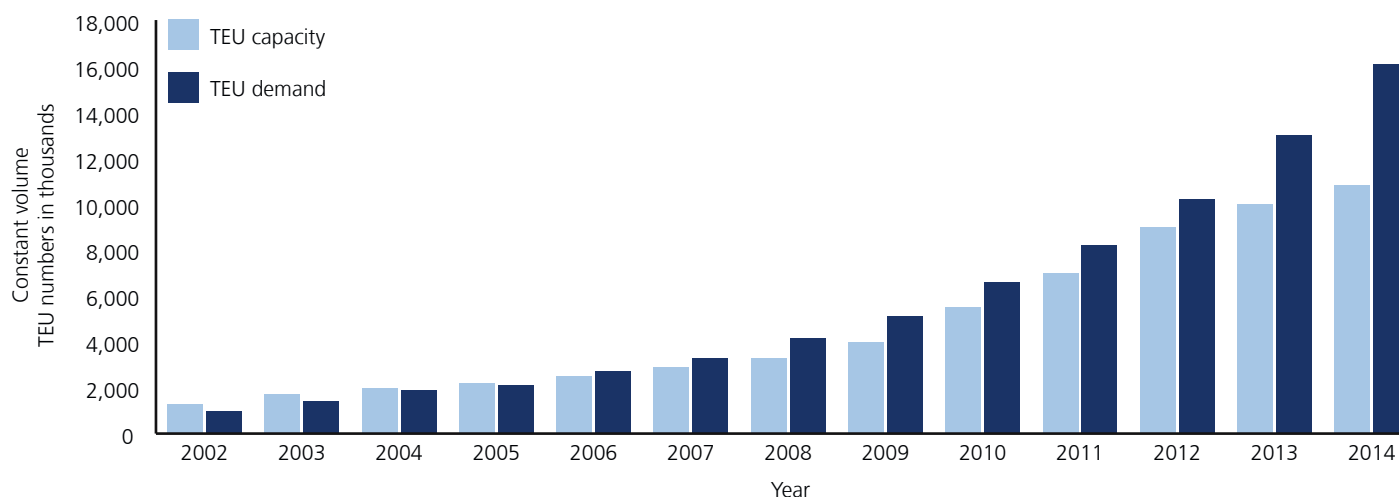
The decree in question, Decree 78 of the Government dated 11 May 2007 on investment in the form of BOT, BTO and BT contracts (the New BOT Decree), replaces the previous BOT regulations applicable to foreign investors, Decree 62 of the Government dated 15 August 1998, as amended, and regulations applicable to domestic investors, Decree 77 of the Government dated 18 June 1997. These replaced even earlier BOT decrees dating back to 1993. Our view is that the New BOT Decree is insufficient to make large-scale foreign investment in BOT projects more likely to succeed and to reverse the rather sorry record of the last decade. A truly common and clearly defined legal framework has not yet been achieved. The New BOT Decree in particular takes some steps forwards and some steps back. It fiddles at the edges without making any quantum leaps.

Scope of application

The New BOT Decree introduces some new ways for the private sector to invest in infrastructure. Up until now, foreign investors have only really focused on BOT

Supply and demand at HCM City ports

Shipment delays can be expected beginning 2007



Source: Vietnam Business Forum, May 2007

projects. The regulations always allowed build and transfer (BT) projects, but these foundered on the fact that there was no certainty of return for the entity that undertook such a project. This fundamental flaw has been remedied. Parties are now allowed to specify in the BT contract itself the means through which they will have the right to try to obtain a return. For the first time, the New BOT Decree specifies that the other projects undertaken by a BT developer as the quid pro quo for the build and transfer are entitled to the incentives contained in the Decree.

The New BOT Decree also provides that in addition to BOT, build, transfer, operate (BTO) and BT contracts (together the BOT Contracts), investors may invest in other derivative contract forms subject to the approval of the Prime Minister. Although the New BOT Decree does not specify which derivative contract forms (eg build, operate, own (BOO); build, operate, sell (BOS); build, lease, transfer (BLT)) would be permitted, the Prime Minister has the discretion to decide on different methods of investment in infrastructure by the private sector. The problem – as for BTs before – is that in the absence of detailed regulations, such projects get bogged down in a myriad of details, on all of which the bureaucracy has to obtain time-consuming instructions from above before proceeding.

Encouraged sectors

Under the New BOT Decree, the Government will in theory take a special interest in projects concerning (i) land roads, bridges, tunnels and related utilities; (ii) railways and tramways; (iii) airports, seaports, river-ports and ferry-landings; (iv) water plants, drainage and waste or sewage treatment systems; (v) power plants and power transmission lines; and (vi) other infrastructure sectors as decided by the Prime Minister. It is also prepared to examine projects outside this list, if proposed by investors.

The Ministry of Planning and Investment (MPI), together with other relevant ministries and provincial people's committees, will issue an annual list of projects calling for investment in the form of BOT Contracts. This list, however, is not intended to be exhaustive: the Prime Minister has the discretion to decide on other infrastructure sectors or projects.

It would appear that distribution infrastructure (eg water, gas or electricity distribution – all of which require large amounts of capital) and telecoms cannot be built by way of BOT projects unless the Prime Minister makes a special decision.

BOT Contracts

A BOT Contract is executed between investors and an authorised state body (ASB). This is normally a ministry (such as the Ministry of Industry for power projects) or a provincial people's committee (for example, in water projects). Under the old regulations, a foreign-invested BOT project had to be effected through a 'project company' (the project company) structured either as a wholly foreign-owned company or as a joint venture.

The New BOT Decree does not make it clear whether a foreign-invested project company can take any of the corporate forms recently introduced under the Enterprise Law and the Investment Law of the National Assembly, which took effect as of 1 July 2006 (the Investment Law) – the limited liability company, shareholding company, private company or partnership – or whether it will be restricted to a limited liability company as before. In practice, there is now substantial pressure for foreign investors to form joint ventures to undertake infrastructure projects. The Vietnamese party may only have a small minority interest, but the goal is for that entity to learn the tricks of the trade.

Reaching agreement on price has always been the hardest part of negotiating a BOT deal in Vietnam. As was the case under the old regime, tolls, fees or other revenue derived from the operation of the BOT project must be stipulated in the BOT Contract within an agreed ceiling. The New BOT Decree allows the parties to provide in the BOT Contract for increases in price and for the conditions applicable to such price increases. Any changes in tolls, fees and charges other than those contemplated in the BOT Contract must be approved by the ASB. This may cause difficulties for investors and financiers of projects in certain sectors. In some fields, such as power, price formulae can protect investors against the main risk. In other sectors, such as transport, there may be greater exposure due to the lack of independent regulators.

Parties to the BOT Contract

Investors must enter into a BOT Contract with the ASB. This has two consequences in practice.

- First, the BOT Contract must be signed by investors, who may thereby be exposed to liability that would normally be contained within the project company

itself. Following the incorporation of the project company, Vietnamese law allows that company to become a signatory to the BOT Contract and to assume rights and responsibilities set out in the BOT Contract. Alternatively it can assume the investors' rights and obligations. In practice, investors prefer to draft BOT Contracts to impose rights and obligations directly on the project company and to limit the investors' obligations regarding the implementation of the BOT project to certain agreed areas.

- Second, the BOT Contract has to be signed with an agency of the Government, not with a state-owned enterprise (SOE), which only acts (if at all) as an offtaking entity or other project counterparty. This can complicate the contractual structure of a deal, especially compared to non-BOT structures.

Under the old regulations, ASBs entering into BOT Contracts were appointed by the Prime Minister. Accordingly, the investor had to ensure that such body was properly authorised, but once this was ascertained the chain of authority to the Government was relatively (though not completely) clear. The right of the Prime Minister to authorise a BOT Contract is now less clear: the MPI, whose role in investment licensing has declined under the Investment Law, has clawed back some power by gaining the right in the New BOT Decree to decide whether to issue an investment certificate to a BOT project. This may presage a greater use of BOTs. But it may also result in questions about the extent to which the State of Vietnam stands behind a BOT project and whether there is any room for a future Government to assert that it is not bound by a particular BOT Contract that turns out to be disadvantageous.

Selection of investors

Under rose-tinted pressure from international organisations, the New BOT Decree puts more emphasis on the tendering process than on the direct selection of project sponsors. Many believe this is misguided, as Vietnam has demonstrated in Phu My 3 that it can protect its interests in negotiated deals. Furthermore, tendered deals in Vietnam have tended to be slow and often less than completely clean. The vague language in the New BOT Decree will do nothing to make these deals swifter or cleaner.

The old regulations did not set out the circumstances in which an open tender process was compulsory and (with the exemption of the Phu My 2-2 BOT project) all BOT projects to date, successful or otherwise, have been negotiated deals. By contrast, the New BOT Decree requires tenders in all circumstances, with a few exceptions where selection of contractors and direct negotiation with investors is allowed. The tender process is not required when:

- only one investor satisfies the pre-qualification requirements;
- the project is needed to satisfy an urgent need for infrastructure facilities or to ensure continuity in the use of products or services;
- an investor proposes its own project and does its own pre-feasibility study (unless two investors propose a similar project, in which case a tender is required); or
- other special cases are involved, as determined by the Prime Minister.

Given that the Government does not have much of a record in preparing project tenders, the third exception enables developers to take the initiative. But it is likely that the trend will be towards more tendered projects. The International Finance Corporation has been mandated by the Ministry of Industry to develop a pilot power project (sadly, in these days of climate change, a coal-fired project) that is bankable and replicable. But this is taking longer than anticipated.

Negotiation of BOT and ancillary contracts

One of the more welcome improvements in the New BOT Decree is that it provides for the establishment of an inter-branch working group, funded by the state budget, to support the negotiation of BOT Contracts. If state budget funds for this come through (the experience to date is not so positive), then investors may no longer need to negotiate with numerous cumbersome authorities to reach an agreement or, if they do, there should at least be a central co-ordinator to resolve conflicts between different authorities and SOEs.

The New BOT Decree allows investors to negotiate a wide range of ancillary contracts such as contracts for land lease, construction, installation of machinery and equipment, consultancy services, inspection, purchase of raw materials, sale of products, services, provision

of technical services, loans, mortgage or pledge of property and 'other contracts' at the same time as they are negotiating the BOT Contract. Indeed, the New BOT Decree requires the ASB to 'urge' the negotiation of ancillary contracts so that such contracts are consistent with the BOT Contract.

Perhaps odder, though good if it works, is that any investor that needs a Government guarantee for the project will need to make sure that the 'guarantee request' is approved by the Prime Minister before the BOT Contract is negotiated. It is not clear whether it is just the principle that will need to be negotiated or the details, but there are some indications from existing projects that it may actually be the latter.

Unfortunately, the bureaucratic approval process is as opaque as ever. While various short time frames are provided for obtaining decisions from Government authorities on BOT projects, they all start to run from the receipt of all 'eligible documents'. One of the deterrents for investors is the slow speed and lack of transparency in the evaluation process. To increase private investment in infrastructure, it would help if the comments from relevant ministries were required within a specified time from a determinable starting point. Furthermore, such comments should be made available to the investors.

Terms of the BOT Contract

The BOT Contract is essentially a licence to implement a project and it is important that this document is 'bankable'. It must not only be satisfactory to the contract parties but also ultimately address the requirements of project investors and lenders. It is a hybrid document that contains both commercial and financial terms.

There is, perhaps, an understandable tendency on the part of governments when putting concessions out to tender to concentrate on commercial terms to the detriment of financial terms. However, unless the project provides a satisfactory return on the international financial markets, it will not be brought to completion, at least by international investors and financiers (we do not comment on the domestic BOT projects financed by domestic state-owned banks).

The New BOT Decree requires a BOT Contract to include certain main terms. Failing to include these terms may render the BOT Contract invalid. However, as the authorities will not approve the BOT Contract until these terms are included, the risk is minimal. The New BOT Decree broadens the content requirements in BOT Contracts: the investor's responsibilities regarding the supply of services and the operation of the project, as well as the transfer to the Government, are in increased focus.

BOT Contracts may include other terms agreed by the parties. In the power context, the Phu My projects provide a clear reference point for future negotiations, even under the New BOT Decree.

Security for construction

A new requirement for foreign investors under the New BOT Decree is that the parties will have to provide security that the project will be built. It appears the security must be provided when the BOT Contract is signed, which implies it cannot be provided by the project company, but this will have to be clarified because the BOT Contract is often signed immediately after the investment is licensed and the project company is established. The security will be 1 per cent of investment capital for projects of over about US\$94m, 2 per cent of investment capital for projects of between \$4.5m and \$94m and 3 per cent for those under about \$4.5m.

The New BOT Decree does not state the circumstances under which the security will be forfeited or what link, if any, there will be to liquidated damages in the BOT Contract.

Capital

In the past, there was no restriction on the capital that could be contributed to a project company by an entity using a state budget fund. Now state budget funds may only be used to contribute capital in a BOT project of up to 49 per cent of the investors' equity. This may slow down domestic BOT projects by SOEs.

Although the Investment Law imposes no required debt to equity ratio, the New BOT Decree reintroduces one.

Under the New BOT Decree, the equity of the project company has to constitute at least 30 per cent of its investment capital if the investment capital is less than about \$4.5m. This is reduced to 20 per cent for projects that have investment capital of between \$4.5m to \$94m and 10 per cent for projects that have investment capital of more than about \$94m.

Licensing a project company

Under the old regulations, domestic and foreign project companies were established under two separate legal regimes. Domestic project companies simply registered their business with the relevant business registration authority, whereas foreign investors had to prepare a voluminous file for the licensing authority, which had discretion over whether or not to issue an investment licence.

Now all BOT projects must be evaluated by the authorities. Investors in domestic project companies must carry out business registration procedures after being granted an investment certificate. Investors in foreign-invested project companies are not required to do so: the investment certificates for foreign-invested project companies also serve as business registration certificates.

Unlike normal companies, which are licensed by the provincial people's committees or the relevant export processing and industrial zone authorities, all BOT projects will have to be licensed by the MPI (after consulting with the relevant ministries and provincial people's committees and/or the Prime Minister for projects requiring Government guarantees).

There is one caveat for large projects with state involvement. Article 47.3 of the Investment Law provides generally that the National Assembly will decide the policy and criteria for important national projects. The National Assembly has passed a resolution on 'key national investment projects' that doubled the threshold (to over \$1.5bn) at which it must approve big projects (the term is undefined). Foreign-invested projects with less than 30 per cent of the capital coming from state funds do not need National Assembly approval.

Preferential treatment

The New BOT Decree provides certain incentives to BOT projects, which may be summarised as follows.

- Project companies are entitled to the same corporate income tax incentives as are available to special preferential investment projects (although the current list of special preferential investment projects does not expressly include BOT projects). Under the current regulations on corporate income tax, projects on the special preferential investment projects list will be entitled to a corporate income tax of 10 per cent (instead of the standard rate of 28 per cent) for at least the first 15 years (or for the whole duration of the project, if so approved by the Prime Minister). Article 35.1 of the New BOT Decree, however, provides that preferential corporate income tax rates applicable to project companies will be applied for the whole duration of the project. It is unclear whether project companies would automatically enjoy a corporate income tax of 10 per cent for the whole duration of the project or whether they are still required to obtain the approval of the Prime Minister on the same. Project companies will also be granted a tax holiday of four years starting with the first profit making year and a 50 per cent exemption for a further nine years.
- Project companies and their contractors may be exempt from payment of import duties with respect to certain items imported for implementation of a BOT project.
- Project companies are exempt from taxes on any technology transfers needed to carry out the project.
- Project companies may open and operate offshore accounts, subject to the approval of the State Bank of Vietnam. The New BOT Decree provides no special rights to such accounts that are not otherwise provided under the Investment Law.
- The Government may guarantee the conversion of Vietnamese dong into foreign currency in respect of projects in the power, traffic infrastructure and waste treatment sectors.
- The Government may provide loan guarantees, guarantees in respect of offtake obligations, raw material input obligations and other contractual obligations, and specifically guarantees of the obligations of state monopolies regarding the sale of raw materials to, and purchase of products

and services from, the project company. The old regulations were less expansive, though the broader language in the Foreign Investment Law meant that broad guarantees have been issued in practice to project companies. Now the Investment Law is more restrictive, which presages a gradual tightening of what the Government will offer in practice. Investors have argued that in the absence of a quantum improvement in the legal environment this would be premature. It remains to be seen what will occur in practice in the first sizeable BOT project to occur after Phu My 3.

- The Government will ensure that the project company will be given the right to use land free of land rent for the whole duration of the project.
- Project companies may grant a mortgage over equipment, plant, factory, contractual rights, other assets and land use rights in favour of lenders in accordance with the prevailing regulations. This still does not allow foreign lenders to directly take mortgages over the land use rights. The New BOT Decree requires that any mortgage or pledge of property by a project company must be approved by the ASB, a requirement that does not exist for a normal company.

The New BOT Decree is silent on whether the parties may agree in the BOT Contract on additional incentives for investors.

Rights of lenders

Lenders to the project company are given the right to step in and take over the BOT project in the event the project company defaults on a loan agreement or the BOT Contract. The New BOT Decree requires such step-in rights to be set out in the financing documents and agreed by the ASB. It is not clear if this language will be broad enough for lenders or if the details can be contained in financing documents that go beyond the language in the New BOT Decree. Issues include the following.

- Lenders will need rights of remedy for a sufficient period of time, step-in, appointment of an interim operator and/or substitution. There is no specific confirmation that the ASB will provide such consents and acknowledgements of lender rights as are

necessary in the absence of relevant regulations. For example, if there is a pledge of legal capital and this pledge is enforced, the lenders will need to know through prior consent by the ASB or the MPI that the enforcement will be effective.

- Lenders must fully perform all of the respective obligations of the project company or the investor(s) as stipulated in the BOT Contract. Lenders will not want to be responsible for obligations that have accrued prior and up to the date of the step-in notice.

Management

In line with the Investment Law, which no longer requires MPI approval for management contracts of foreign-invested companies, project companies can contract out the operation of their plants. Issues remain about the means through which foreign entities can enter into long-term management agreements in Vietnam and the best tax structure for any such contract.

Termination

Upon the expiry of the BOT Contract, the investors and the project company must transfer their entire BOT project to the Government free of charge. Certain conditions on quality, maintenance, warranty, environment protections and other conditions necessary for operation of the project must be satisfied by the investors upon the transfer.

Dispute resolution and governing law

Disputes between domestic investors or between domestic investors and ASBs under the BOT Contract must be referred to either Vietnamese arbitrators or Vietnamese courts.

By contrast, disputes involving a foreign-invested project company (Vietnamese law is no longer clear on what would be considered a foreign-invested project company) may be referred to foreign, international or ad hoc arbitration.

Likewise, if so agreed in the BOT Contract, disputes between foreign investors, foreign-invested project companies and the ASB may be referred to arbitration or courts outside of Vietnam.

Under the old regulations, the application of foreign law was only possible for contracts guaranteed by the Government and the choice of foreign law had to be approved by the Ministry of Justice. This requirement, which has been a burden for investors, no longer applies under the New BOT Decree. In the case of foreign investment, the New BOT Decree allows the application of foreign law with respect to BOT Contracts, contracts guaranteed by the Government and, most importantly, 'other contracts connected to the project'. The qualification, troublesome as ever, is that the foreign law must not conflict with the basic principles of Vietnamese law. This may require investors to obtain a Ministry of Justice opinion each time the application of foreign law is desired.

Conclusion

The New BOT Decree has failed to address adequately many of the issues that rendered the law ill-equipped to support foreign involvement in sizeable infrastructure projects up until now. While the BOT framework is now marginally more developed, it still contains too many gaps, uncertainties and potential conflicts to cause one to expect a boom in BOT activity.

For further information please contact

Tony Foster
T + 84 4 8247 422
F + 84 4 8268 300
E tony.foster@freshfields.com

Nguyen Thi Lang
T + 84 4 8226 680
F + 84 4 8268 690
E lang.nguyen@freshfields.com