

Decision Framework for Processing the Proposed NT2 Project

Proposed NT2 Project

1. The proposed private sector investment project includes the development, construction, and operation of a thousand Megawatt trans-basin diversion power plant on the Nam Theun river, a tributary of the Mekong, in the central region of the country, about 250 kilometers east of Vientiane. The main features of the project are a 48-meter high gravity dam on the Nam Theun river, a 450 sq. km. reservoir, the powerhouse, and a 130 km long double-circuit 500 kV transmission line to deliver the electricity produced to the Thai grid. A 70 km. long single-circuit 115 kV transmission line will also be included to carry the small portion of total electrical output that will be dedicated to domestic uses.
2. The project is structured as a BOOT (Build-Own-Operate-Transfer) arrangement. The Government asked a foreign consortium, Nam Theun 2 Electricity Consortium (NTEC), comprised of EdF (France) in a head-contractor partnership with Montgomery Watson Harza of USA (35 percent), EGCO of Thailand (25 percent) and Ital-Thai Development also of Thailand (15 percent), to assist in constructing and operating the project. NTEC, currently representing the private sector interests, will shortly be incorporated with the Lao Government's investment entity (Electricité du Laos, with 25 percent of equity) to form the operating company, Nam Theun 2 Electricity Company (NTECO), for a concession period of 25 years. The developer has informed the Bank that it expects to sign, by September 2002, a Power Purchase Agreement (PPA) with EGAT (the Thai public-sector power entity) for export of over 90 percent of the energy generated by NT2 and also sign a Concession Agreement (CA) with the Government of Lao PDR in the same month.
3. Estimated project cost (excluding contingencies) is US\$1.075 billion (about 65 percent of GDP in Lao PDR) and is expected to be funded using loan facilities of \$752 million and shareholders' equity of \$323 million. Export credits to the tune of \$270 million, commercial loans from Thai banks amounting to \$375 million and commercial loans from developed countries' banks to the extent of \$107 million, make up the loan financing (\$752 million) for the project.

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4. A broad decision framework was shared with the Government of the Lao PDR during a Management mission led by the Country Director in August 2001. Project processing would be linked to progress shown by the Government on: (a) implementation of a development framework characterized by concrete performance that aims at poverty reduction and environmental protection; (b) ensuring that the technical, financial and economic aspects of the project and the design and implementation of safeguard policies were of a standard acceptable to the Bank; and, (c) obtaining broad support from international donors and civil society for the country's development strategy and the NT2 project itself. The three elements of the decision framework are elaborated upon below.

5. ***Policy and Institutional Reforms.*** Less than ten percent of the power produced by NT2 will be used in Lao PDR; the rest is to be sold to Thailand. Therefore, the major benefit from the NT2 project would be sizable incremental revenues (through royalties, taxes and return on equity) flowing to the Government of the Lao PDR for several decades starting from 2008 -- not the direct benefits of power production. Global experience has clearly shown that such additional revenues can be put to the most productive uses when governance improvements and human capital development go hand in hand with project initiatives. Currently, the policy and governance framework in Lao PDR is flawed and capacity in the public sector is woefully weak. Substantial sustainable improvements to these policy and institutional areas are needed to achieve macro-economic stability and pave the way for sustainable broad-based growth. While it is appreciated that such reforms take time to complete, a serious start and demonstrated progress is necessary before sufficient confidence can be gained that these reforms will indeed be accomplished. Such demonstration is all the more important to assuage lingering doubts in the community of international financial institutions and donors, dating back to the macroeconomic missteps taken in 1997-1999 that exacerbated the effects of the regional crisis.

6. The IMF-backed Poverty Reduction and Growth Facility (PRGF) and the government-driven Interim Poverty Reduction Strategy Paper (I-PRSP) lay the foundations of such policy and institutional reforms. An overall poverty reduction framework (PRSP) is needed to lay out the strategy for the sustainable and environmentally responsible use of revenues derived from natural resources such as hydropower, forestry, and mining. The full PRSP, that is expected to be discussed at the Bank Board in FY 2003, is expected to set the agenda for further Bank support through a series of Poverty Reduction Support Credits (PRSCs) to strengthen governance and promote human development in Lao PDR. Furthermore, expected annual budgetary revenues from NT2 would be, in part, channeled directly to initiatives aimed at poverty reduction and a portion of the proceeds would also partially fund long-term conservation efforts (for several decades) in designated conservation areas.

7. Meanwhile, building on the efforts of the past SACs and the recently-completed Public Expenditure Review (PER), the Financial Management Adjustment Credit (FMAC) and its companion Financial Management Capacity Building Credit (FMCBC) seek to strengthen GOL's capabilities through financial and public sector reforms. Key areas being addressed include: i) *financial sector* -- stabilize financial condition of the banks (SCBs), strengthen banks to support broad-based economic growth, and launch micro/rural finance for poverty reduction; ii) *public sector* -- improve budget planning, streamline budget execution and control, make the budget process more transparent and launch participatory forestry framework which has significant budgetary implications; and, iii) *SOEs* -- strengthen oversight of financial and operational performance of SOEs, restructure enterprises, rationalize the regulatory framework (*power sector* SOEs are addressed here as well -- especially EdL, the entity that would carry GOL's equity share in the NT2 project). A Poverty Reduction Fund (PRF) Project would complement these efforts through direct targeting of funds for poverty-reducing investments at the village level. A separate forestry operation will also address improvements in forestry management at the regional level. Improvements in public expenditure management would lead to better poverty targeting.

8. The health of the overall IDA portfolio in Lao PDR must also be addressed. There are nine active IDA projects in the portfolio at this time. In recent years, performance of the portfolio has been mixed, but with an improving trend.

9. Success on the policy and institutional reform front will be measured through progress on the development and implementation of a comprehensive government-driven reform program, articulated in the PRSP and other policy statements and supported by the Bank, IMF and other donors through instruments such as the PRGF, FMAC, PRSCs and various investment operations as well as maintenance of good standing on the overall project portfolio. Therefore, a *sine qua non* for Bank support to the project is an agreement upfront on a set of policy and institutional reforms and demonstrated progress on the implementation of these reforms. Progress on all these operations will be guided and measured by a set of performance benchmarks. This prerequisite for Bank support for NT2 has been accepted by the Lao PDR Government.

10. ***Project Standards and Safeguards.*** The NT2 project is being designed and will be implemented by NTEC (or NTECO). The head contractor -- EDF/Montgomery Watson Harza -- is strong and each is highly rated as a leader in the field. Therefore, unlike public sector energy projects, cost overruns or completion delays are not serious risks. The project sponsors have amassed substantial analysis affirming that NT2 is technically sound in terms of hydrology and dam design and also economically and financially viable. The Bank is in the process of re-confirming these findings through ongoing due diligence. The project is well-managed to date and the Developer is capable and responsive to Bank suggestions. NT2 is a priority for the Government while also being financially attractive to the Developer. This provides incentive for all parties to find workable solutions when problems arise. With this said, the Bank must still, *inter alia*, perform due diligence on the PPA and other legal agreements covering the project, the case for additional power purchase by Thailand, the design of the dam and associated construction (a Bank supported Dam Safety Panel is operating) and the detailed implementation arrangements. The satisfactory completion of due diligence -- and any remedial actions that the Bank may propose -- is an integral component of the Bank's decision-making framework for processing the project and this has been recognized by the Lao PDR Government.

11. The NT2 project involves application of all ten Bank safeguard policies. The project demands effective conservation and management of the watershed areas due to possible negative environmental and social impacts. These relate to the construction of the dam and flooding of land to fill the reservoir. Other impacts include resettlement of nearly 5000 persons, flooding of dry season cultivation zones on the Xe Bang Fai river, ecological impacts relating to changes in water quality and flow on the Xe Bang Fai and Nam Theun rivers, possible endangerment of certain rare fish and animal species, changes in the stock and migration of fish, and loss of habitat in the reservoir area from inundation. Unless these negative impacts are carefully mitigated, the net benefits flowing from the project may not be attractive enough to justify it.

12. Project preparation has focused on mitigating these negative impacts by ensuring that the design and implementation of plans pertaining to all of the Bank's safeguard policies are carried out so as to meet or exceed Bank standards. Furthermore, the proposed Nam Theun Environmental and Social Project (NTSEP) supports, *inter alia*, resettlement and community development, environmental capacity-strengthening, watershed area management and

environmental mitigation, and poverty reduction in the project area. Through these efforts, the Government seeks to ensure that the livelihoods of all who live in the project area are enhanced and that the environment -- in the project area and possibly beyond -- is conserved for the long-term. Potential conservation benefits warrant special mention, as NT2 would help to preserve one of the few remaining pristine rainforest regions in the world. Without NT2, it is not clear if or how such conservation could be ensured. An independent International Advisory Group and a Panel of Environmental and Social experts advise the Bank and Government, respectively, on these critical issues.

13. The design of risk mitigation measures is contained in three document packages (which are governed by the Bank's disclosure policy): the Environmental Assessment and Management Plan (EAMP), the Resettlement Action Plan (RAP) including an Ethnic Minorities Development Plan (EMDP), and the Watershed Conservation and Management Plan -- also including an EMDP. The preparation of these plans has been carried out by experts working for the Government and the Developer, with substantial input from Bank staff (including the provision of detailed comments and discussions on application of Bank safeguards policies). Implementation arrangements are included in these documents and completion of this work, to the satisfaction of the Bank, would be a pre-requisite for Bank consideration of the NT2 project.

14. A strong dialogue is in progress with both the Developer and the Government on project quality and safeguard issues and there is a clear understanding by all parties on the what must be done to comply with the Bank's guidelines and standards in this regard.

15. ***Broad-based Support for the Government's Development Strategy and the NT2 Project.*** Burden-sharing with other international donors is a critical element of the Bank's decision-making framework because of two factors. First, it is critical to the success of the project that sustained progress on reforms be maintained over the long-run. The Government would receive revenues for several decades and most of the policy and institutional reforms would also take several years to complete. The reforms are more likely to be fully carried out if major donors are also deeply committed to the policy and institutional reform package while also supporting the implementation of NT2-related conditionality. Second, the NT2 project requires substantial external support, through grants (to finance the Government's contribution to equity in the project), export credits, financial transfers, and technical assistance from donors other than the Bank.

16. These requirements put the international donor community in a crucial role going forward. The Government will need to develop a detailed program (building on *ad hoc* measures taken so far) for systematic consultations with key international stakeholders to keep them informed. For bilateral donors and the multilaterals, this will need to include briefing missions to important donor capitals as well as informal meetings in Vientiane. The UNDP supported round table mechanism would also be used to keep donors informed and engaged. This paper is therefore being distributed to the Round Table meeting being held in Vientiane on July 3, 2002.

17. International civil society has a legitimate and strong interest in the project as well -- particularly since local civil society is not developed and there are no local NGOs. Local consultations have been remarkable in the Lao context, but fall short of the expectations of the

international community. Broad support from international NGOs, particularly those involved with environmental and social issues, provides much-needed comfort that the environmental and social issues relating to the project will be successfully managed in the event. It is, however, highly unlikely that anti-dam NGOs would cease to attack this project. They likely will continue to launch focused campaigns against NT2 -- including website appeals reaching large audiences.

18. A series of seminars on NT2 led by the Lao PDR Government would be proposed to engage international NGOs on the project. The tone of these seminars is likely to be set by the on-going debate on the World Commission on Dams report. The expertise of the International Advisory Group of the Bank and the Panel of Environmental and Social experts, engaged by the Government, would be made available at these seminars.

19. The importance of broad-based international support is well understood by the Government but their capacity to network is severely limited. The Government is seeking Bank advice on its communications plan.

20. Project preparation continues within the framework described above. Emphasis going forward will be on further development by the Government of specifics relating to safeguards, fiduciary elements, use of revenues, a strong communications plan, and monitorable benchmarks for determining Lao PDR's policy and institutional readiness for the NT2 project.