"THE ARGENTINE CONTRACTUAL BREACH IN THE UTILITY SECTOR.
After 5 years, is there any way out?

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"THE ARGENTINE CONTRACTUAL BREACH IN THE UTILITY SECTOR.
After 5 years, is there any way out?

Gabriel Wilkinson
Director Legal Department
Gas Natural BAN, S.A.

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The purpose of this presentation is to submit to you a case – the Argentine Case – with all the facts, to answer the above and further questions.

What has the administration of Argentina performed during these last 5 years in connection with the general breach of contracts in the country.

This presentation is not a claim to the government although it will show you that Argentina has neglected a cure to its non fulfillment

What were the options available to an international utility company when "emergency" declared by law, stroke its major project in Argentina?

Did the 2001 crisis affecting investments come suddenly and unexpectedly? or was the government responsible for (by action or omission) evolving the crisis gradually with social confrontations?

Although administration responsibility may be shown almost clear, at this point, since no immediate remedies were accomplished, Argentina 's position before ICSID could have become critical.

1. **The Emergency and subsequent contractual breach:**

EMERGENCY DECLARED BY LAW

- Reflects POLITICAL and ECONOMIC needs
  - Political: Authorities' own will (option)
  - Economic: Aspects that MAY BE considered further the government's domain.
- In all cases: Government strategies, actions, policies and plans intended to be performed by a sole and unique entity.

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It was said that, to fight the economic crisis, the interim government of President Duhalde, proposed the Congress an Emergency Law.

This Law, critical decision of a Nation, was passed in 20 minutes with no major debate.

This law was intended to reflect political and economic needs in a country that has had before several emergency laws and provisions.

You will agree with me, that any legal frame under the Constitution rules human relations, probably designed to match the local social and economic environment. Including, emergencies.

It is very difficult to define why there is a need to proclaim an emergency by law, if it is not to justify certain extraordinary acts rejected by ordinary law.

If the economic crisis is the argument, causes of such a crisis may be attributed to aspects further the government's domain, but in fact, most of such causes in Argentina are connected to a bad administration or worse.

It has been very common in Argentina, that to excuse this chronic illness, most politicians historically claim that everything done by the previous administration is not valid and that their own administration will bring legal certainty to investors.

In all cases, and from such investors' point of view, Government strategies, actions, policies and plans are intended to be performed by a sole and unique entity with continuity.

LAW No. 25561

- Section 8: Upon the enactment of this law, **US currency, other foreign currencies or price indexes adjustment provisions and any other mechanisms** provided for in agreements entered into by the Government under public law, including public works and services contracts, **are no longer in effect. Prices and rates resulting from such provisions are to be reset in pesos at the rate of exchange of ONE PESO ($1) = ONE UNITED STATES DOLLAR (US$1).**

Article 8 of the law constitutes the official declaration of the breach of contracts.

The end of convertibility provided for in a previous law, repealed a guaranty presented to the investors.

Freezing tariffs at a $1 = 1 US dollar rate of exchange when devaluation rated the US dollar to nearly $4, forced all international loans to triple their debts.

The end of CPI / PPI as an index indicator repealed another guaranty for the international investor.

Last but not least, Article 9 (as we will see), provided the need of a Renegotiation process, a legal promise to be accomplished by the Administration, that gave the companies some hope.

Civil Law on breach of contract

General Principle: In the event of non-fulfilment of the agreement by either party, the non-defaulting party is entitled, upon prior notice, to terminate it and to be compensated for any damages arising therefrom.

Non-Defaulting Party's Choice: The non-defaulting party may demand fulfilment of assumed obligations plus a compensation for such damages caused by the delay. As a result, the non-defaulting party may admit contract continuity (partial performance) in different (less favorable) terms plus the compensation for delay and for the difference arising from the change in the economic equation.

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Although the administrative law regulating public works and utilities has a specific different legal regime where the private will is in a way submitted to the administration will, or in other words there will never be a complete autonomy for the parties involved, it is very useful to review the general principle of civil law, that states that In the event of non-fulfillment of the agreement by either party, the non-defaulting party is entitled, upon prior notice, to terminate the agreement and be further compensated for any damage arising therefrom.

But also this party may request fulfillment of the non performed obligations to the other party plus a compensation for damages caused by the delay and or the change in the economic equation.

Therefore the contract continuity (partial performance) is a right of the non-defaulting party.

The Public Law limitations

Decree 1090/2002 and Resolution 308/02 established restrictions on licensees to file judicial or arbitration actions.

CAUSES:

- Although negotiation was not available, Licensees refrained from bringing claims locally due to the consequences of the recent laws.
- Their investors (shareholders) – however - filed claims before ICSID.

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However, such general civil law principle usually involves complete autonomy for the parties involved, without intervention of third parties, while the public law will not.

Decree 1090/2002 and Resolution 308/02 established restrictions to file actions in accordance with the general principle.

Consequently, although negotiation was not available, Licensees were not able to claim locally. Nobody wanted to be excluded from a possible negotiation process, since the other alternative was the complete (no partial) termination of the license. Partial expropriation vs. total expropriation. Not everything was lost at that time.

Their investors did claim before ICSID since the provisions were directed to the local companies, not to their shareholders.

Further pressure was imposed by the government to get releases from ICSID claimants as a condition for approval of the renegotiation.

We will get to this in a minute.

What was expressly repealed in the License:

In SECTION 41.-

PPI: Rates shall be adjusted pursuant to a methodology based on international market indexes reflecting changes in the value of assets and services representing the involved business.

X & K FACTORS: Such indexes will further be adjusted, downwards or upwards, by a factor aimed to encourage respectively, efficiency and investments in construction, operation and maintenance of facilities.

TAX STABILITY: This methodology shall reflect any change in taxes on rates.

COSTS: Transporters and distributors **may** fully or partially reduce the profitability contemplated in their maximum rates but may, not be prevented from recovering their costs.

CROSS SUBSIDIES: Costs attributable to the service provided to a consumer or consumer category, may not be recovered through rates charged to other consumers.

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Law 24.076, the main legal provision ruling the gas transportation and distribution license, was affected specifically in what refers to the building process of the rate or tariff.

As a consequence of this, rates were frozen with no possible alternative to have any kind of profit, in some cases resulting in the default of large international loan contracts where the debt was multiplied by three from one day to the other, becoming due by action of the usual acceleration clauses.

What the courts have understood that was repealed:

- The Convertibility Law forbids adjustments (DoPico/PPI)
- No emergency rate may be applied without full contract renegotiation
- PAST profitability should be reviewed (Rod.de Vidal)
- Validity of section 46 of Law 24.076 and Resolution487/02 were rejected, thus the Public Hearing called by ENARGAS suspended by judicial order. (Rod. de Vidal 2)
- Suspension of Decree (DNU) 2437/02 on a provisional rate increase. Requirements were not met. The companies have failed to file applicable legal remedies (Córdoba)
- Suspension of Decree (DNU)120/03. The Administration shall meet certain information requirements on the renegotiation process (Rossi)
- Suspension of Decrees (DNU) 2437/02,120/03 and 146/03 ((Rod.de Vidal 3)
- Suspension of Decrees (DNU)120/03 and 146/03 (Carrión de Lorente)

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To get things worse, and although there were some alternatives to diminish the damage while waiting for the final renegotiation of the contract, the Judicial Power came into the scene, with really hard decisions, going further from the law.

Some of the decisions related to this license, conducted through the "Amparo" proceeding which resulted in an "inaudita parte" action, with injunctions where the constitutional right of defense was absolutely affected.

Decisions in most of the cases anticipated the final criteria of the Judge, as a prejudicial or preconceived judgment without factual basis, affecting the constitutional right of due process.

TO CONCLUDE, while LAW No. 25561
only DEFINES:

- The end of convertibility
- Tariffs at a $1/US$1 rate of exchange
- End of CPI / PPI
- the need to Renegotiate

JUSTICE went further…

WAS THERE ANY REAL POLITICAL
INTEREST IN PURSUING A SOLUTION?

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To conclude with this picture...

There were no political signs of good will from the government to get to a final agreement.

2. **Renegotiation:**

Renegotiation under Law No. 25561

Section 9: **The Argentine Administration (hereinafter PEN) is authorized to renegotiate the agreements provided for in section 8 of this law.** In the case of utility contracts, the following criteria shall be considered:

1) Impact of rates on economy competitiveness and on income distribution;

2) Service quality and investment plans, when they are contractually provided for;

3) The interest of users and accessibility to services;

4) Security; and

5) Companies profitability.

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Rules to negotiate with the government were clear… for the government.

The President was authorized to conduct something that was already under the administration legal duties.

There was no need to state such an authorization by law.

However, this legal duty was neglected.

WHAT DO WE MEAN WHEN TALKING ABOUT RENEGOTIATION

Negotiation: "… A consensual bargaining process in which the parties attempt to reach agreement on a disputed or potentially disputed matter. Usually involves complete autonomy for the parties involved, without intervention of third parties…"

Renegotiation: "… The act or process of negotiating again or on different terms; a second or further negotiation. The reexamination and adjustment of a government contract to eliminate or recover excess profits by the contractor…"

Black's Law Dictionary

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When talking about public contracts executed during the early nineties, Argentina conducted very different proceedings.

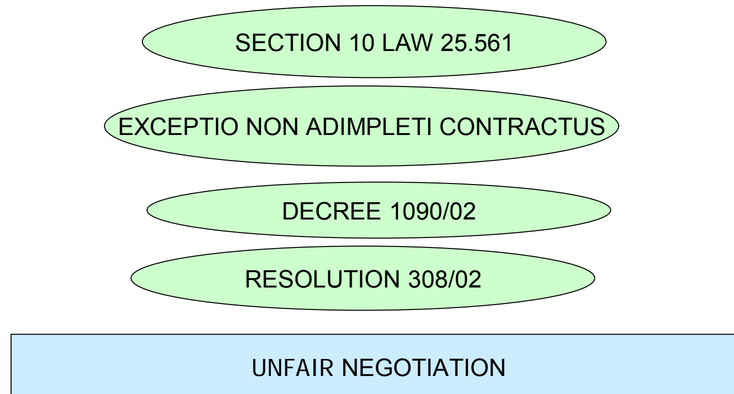
Some were executed along with a Presidential Decree, other were organized under a legal frame ruled by a Congress Law, in public biding.

Some were construed and agreed in dynamic modifications from time to time, meaning a continuing reexamination and adjustment of its terms to eliminate or recover excess profits by the contractor. Renegotiation was not new for such contracts.

Other contracts, like the one ruled by Law 24.074 for the Gas Transport and Distribution, needed no renegotiation. Freezing of rates, prices control and regulatory modifications were provided in the legal frame, with contractual alternatives.

The industry needed no negotiation further than the compliance of the law.

COMPULSORY RENEGOTIATION VS. FRIENDLY NEGOTIATION



GOOD FAITH NEGLECTED

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Renegotiation pretended a political reexamination and adjustment of a government contract to eliminate excess profits attributed to the contractor as part of a political argument.

Any rate increase was unpopular.

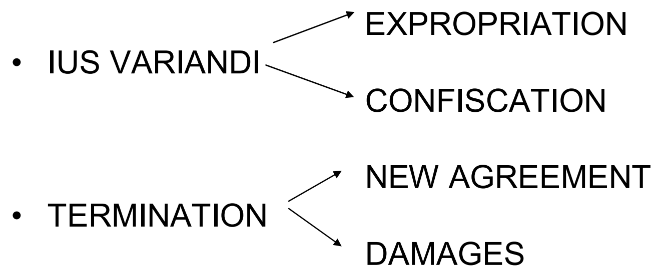
There was no good faith, the result of such process was already politically directed.

Arguments were such as to reject excessive past profitability of the companies on NO technical or economic grounds.

CONTRACT ADAPTATION
DUE TO CHANGED CIRCUMSTANCES

- “Imprevisión” Civil Law Doctrine (lack of foresight) = Is the maxim *Rebus Sic Standibus* honestly applicable to the Argentine case?

- SHARED SACRIFICE? New theory = Political notion that is legally undefinable



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To justify and accomplish such renegotiation, the Administration argued Shared Sacrifice Doctrine pretending its validity as a derivation of the Imprevision Doctrine provided for in the Civil Code.

However, there is a substantial difference between both doctrines. The first one was designed to match political needs. Who directs which party has to share what? In my book: A judge, not the political power.

The Rebus sic Standibus principle needs no fault in any of the parties related to a contract, and if so, then the judge will adjust the obligations to compensate any difference arising from the change in the economic equation in a way to return the initial balance of the contract.

On the other hand, public law admits the so called ius variandi, as a right for the administration to change the conditions of a contract. However, this decision is not for free. Damages will have to be compensated. This is the difference between EXPROPIATION and CONFISCATION the latter forbidden in all modern democratic constitutions recognizing property right as a basic guaranty of human beings.

3. Damages and the claim:

DIFFICULTIES TO ENTER INTO AN AGREEMENT IN THIS ENVIRONMENT

- UNRELIABILITY IN COMPANIES
- LACK OF OBJECTIVE REFERENCE ITEMS
- IMPOSSIBILITY TO RESTORE INITIAL TERMS
- UNRELIABILITY IN THE POLITICAL STRUCTURE

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What were the main difficulties to enter into an agreement in this environment?

UNRELIABILITY IN COMPANIES: Meaning, facing the investors, that the main errors of the political power were at that time, on the one hand "A TWO FACED SPEECH" (most Presidents speeches rejected publicly – even today - any kind of rate increase) and on the other hand, the popular argument to find someone guilty DEMONIZING the foreign companies.

THE LACK OF OBJECTIVE REFERENCES ITEMS, means that there were no international parameters to compare Argentina with, due to the grave economic crisis.

THE IMPOSSIBILITY TO RESTORE INITIAL TERMS means that some legal provisions were STONE DEAD, It had no sense to claim a restoration in this respect.

TO WIT

• Institutional Instability:

Renegotiation Committee in Duhalde's Administration followed by UNIREN in Kirchner's Administration.

• Extension of process terms:

Initial term of 120 days (Decree No. 293/02) resulted in almost 5 years (1.800 days)

• Provisional Tariff Adjustments to help the companies to diminish damages while negotiating were not effective due to judicial intrusion in the so-called "reserved area" of the PEN.

On the other hand… Gas License and its regulation provided contractual alternatives to keep the contract alive without damage to the investment and protecting the users.

While Institutional Instability prevented any understanding, note that the initial Renegotiation Committee in Duhalde's Administration was followed by UNIREN in Kirchner's government.

The extension of the process terms had an Initial term of 120 days (Decree No. 293/02) resulting with the last law in almost 5 years (1.800 days and counting)

Provisional Tariff Adjustments to help the companies to diminish damages while negotiating were not effective due to judicial intrusion in the so-called "reserved area" of the PEN.

On the other hand… Gas License and its regulation provided contractual alternatives to keep the contract alive without damage to the investment and protecting the users.

By ignoring this contractual alternative, crisis was worsened resulting in:

- Broken Game Rules.
- Rates frozen since July 1999 (PPI)
- Natural Gas supply uncertainty.

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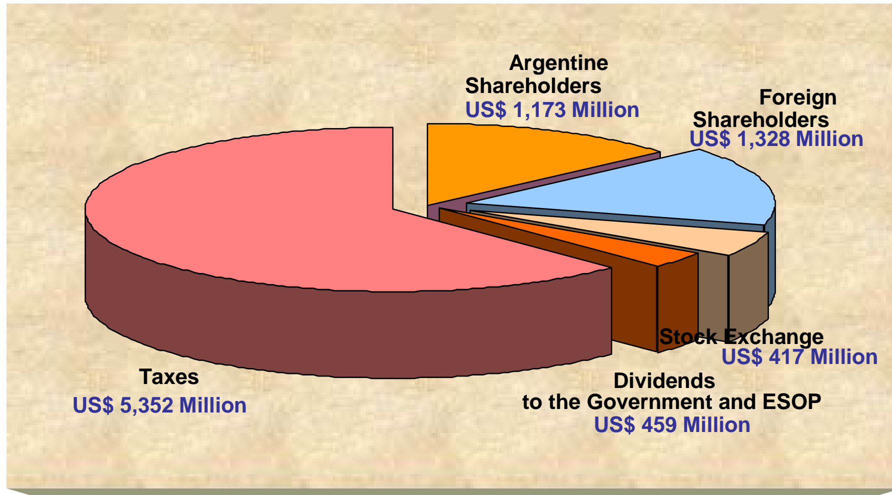
By ignoring not only this contractual alternative, but also the Emergency Law 25.561 provisions, crisis was worsened resulting in:

- Non-performed regulatory agreements and broken game rules.
- Rates of regulated segments frozen and converted to pesos since January 2002 and not adjusted since July 1999 (PPI)
- Insufficient well-head gas prices (which discourage investments) generating supply uncertainty.

The US$ 2,400 million sector foreign pending debt was one of the main arguments to DEMONIZE the industry and the truth is that the US$ 3,900 million investments in infrastructure were financed by international financing institutions because the local market did not offer equivalent rates or terms.

Was this privatization a good deal for Argentina?
Dividends to Shareholders vis a vis Taxes 1993-2001



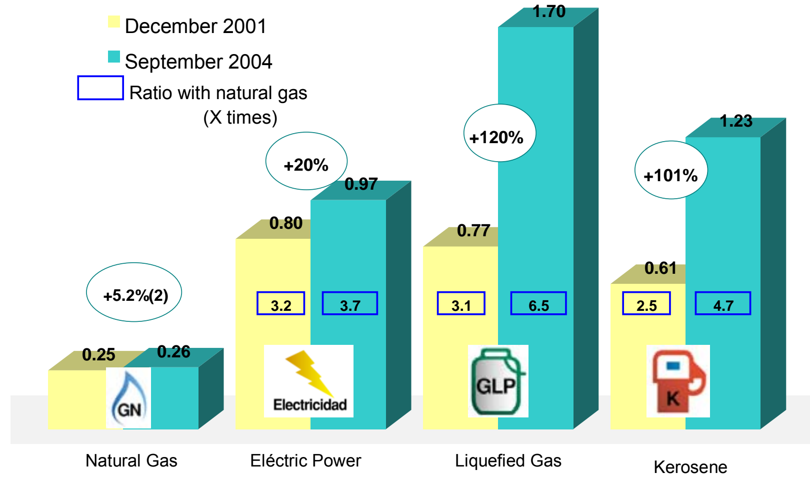
The answer to this question is clear…

Taxes and dividends for Argentina amounted approx. 5.600 MM dollars (66%) while local and foreign shareholders earned 2.500 MM dollars.

Was this privatization a good deal for Argentina?

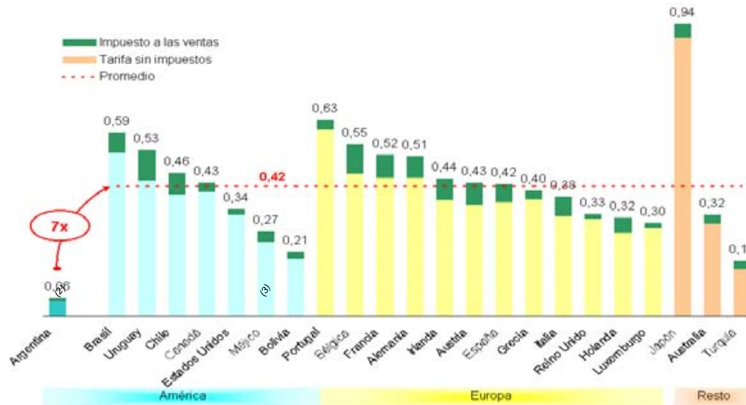
In the following three slides, you will see clearly the damage

Natural Gas Residential Rates in Argentina (City of Buenos Aires):
Comparison with alternative energy sources(1) ($/m3)



References: (1) Final Consumer Rates, with taxes.
(2) Annual Consumption: 962 m³. Including increases in non-regulated components, taxes and specific funds.
Source: Energy Secretariat, ENARGAS, ENRE and private sources.

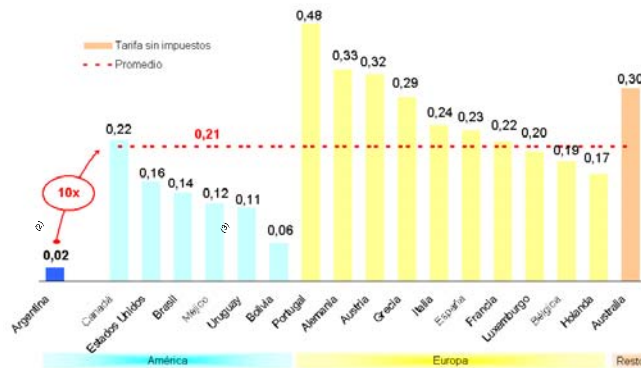
Natural Gas Residential Rate: International Comparison
August 2002(1) (US$/m3)



References: (1) Rates with turnover taxes and Argentine sales taxes (VAT) . Excluding other provincial and/or municipal taxes
Annual Consumption: 1200 m³. Exchange Rate: $3.635 / US$.
(2) As at February 2003, the residential rate in Argentina grew by 7%
(3) As of such date, in Mexico, the residential rate grew by 57.2%.
Source: Prepared by ADIGAS based on miscellaneous national sources as at August 2002.

The average rate in sample countries is seven times higher than the comparable value in Argentina where, as economic costs are not reflected, the gas industry feasibility is threatened.

Natural Gas Industrial Rate (Large Scale Users): International Comparison August 2002(1) (US$/m3)



References: (1) Rates without taxes.
Annual Consumption: $10.8x10^6$ m^3. Load Factor 100%. Exchange Rate: $3.635 / US$
(2) As at February 2003, the industrial rate in Argentina grew by 13%
(3) As of such date, the industrial rate in Mexico grew by 100%.
Source: Prepared by ADIGAS based on miscellaneous national sources as at August 2002.

The average rate in sample countries is ten times higher than the comparable value in Argentina where, as economic costs are not reflected, the gas industry feasibility is threatened.

Conclusions I

- **Privatization of the natural gas industry resulted in:**
  - A strong investment in infrastructure.
  - *Full* compliance with all bidding specifications.
  - System expansion
  - Competitive rates
  - International Quality and Safety levels.
  - Importation reverted to exportation.
  - Expansion and modernization of the electric power generation.
  - Profitability similar to worldwide companies in equivalent conditions.

Privatization resulted in:

A strong investment in infrastructure.

Full compliance with all bidding specifications.

System expansion allowing access by 6 million people.
Competitive rates (in all its segments both against local substitutes and at international level)

Achievement of International Quality and Safety levels.

The foreign commercial balance was reverted and Argentina switched from importation to exportation.

Expansion and modernization of the electric power generation grid.

Everything performed with a profitability below those of similar worldwide companies in equivalent conditions.

Conclusions II

● **The breach of the regulatory framework, the legal insecurity, the distortion of variables by the action of devaluation and the delays to put an end to the crisis:**

- Natural gas industry at its capacity limit to keep service quality and safety,
- Well-head gas problems due to insufficient investments in exploration and in their maintenance.
- Deterioration in the service quality,
- No expansion against Argentine citizens interest
- Argentina's loss of positioning in the power integration scenario.

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The Breach placed the natural gas industry at its capacity limit to keep service quality and safety, making the sector unsustainable. Consequently resulting in insufficient investments in exploration and maintenance.

Well-head gas problems, deterioration in the service quality, no expansion against Argentine citizens interest and Argentina's loss of positioning in the power integration scenario.

Conclusions III

- **What needs to be done?**

- Restore contracts with a fair and reasonable profitability.
- Allow the sector's sustainability adjusting to the people's paying capacity.
- System for gradual recovery of rates including the social rate as a mechanism for lower income clients.

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We needed the urgent restoration of the contracts, with a rate of return capable to earn a fair and reasonable profitability.

Facing the society we were willing to search for mechanisms allowing sector sustainability in accordance with the people's paying capacity, together with a gradual system for recovery of rates including the social rate as a mechanism for lower income clients.

4. The Current Negotiations:

The Negotiation Road

1. Once an understanding has been reached with the officer of UNIREN
2. Execution of a Memorandum of Agreement with the UNIREN
3. Public Hearing.
4. Closing Report from UNIREN.
5. Opinion from the General Auditory Office (Sindicatura General de la Nación SIGEN)
6. Legal Attorney General's Opinion (Procuración del Tesoro de la Nación.
7. Congress participation (at least three opinions)
8. Execution of the Agreement by both the Economy Ministry and the Planning and Public Works Ministry.
9. Decree approving the Agreement

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At present UNIREN has achieved a few agreements, most of them with no Approval Decree issued.

This proceeding, provided for in Decree 311 issued on July 3, 2003 admits all kind of interpretations in relation to the several steps to follow before different governmental offices.

Most of the opinions required, are not binding for the President, and major discussions were brought in relation to the legal effects and constitutionality of the 60 days term for the Congress to issue its opinion. Silence in this case, is to be construed as approval according to the Law.

A general opinion in this regard, rejected the validity of this "fictio juris" approval to be contrary to the Constitution in the wrong assumption that this opinion was to be treated as a law passing proceeding. In fact, we believe that the opinion required to the Congress is only that: AN OPINION just like the one required to the rest of the offices involved.

To get things worse, the Amparo proceeding threat, available for any individual, the Ombuds Man, or even Consumer Associations claiming ability to ask for an injunction on the grounds of the non fulfillment of the law.

The first approach for an understanding
The Gas Natural BAN experience

1. A Transition Period

- **Income recovery path through partial increases until reaching a fair and reasonable rate.**
- **To consider the existence of a group of users in poor economic condition.**
- **To take advantage of the payment capacity of such sectors as benefit from the new economic scheme.**

2. New contract to provide:

- **Fair and Reasonable rate resulting from a Full Rate Case.**
- **Recovery of the asset base value representing the Rate Base.**
- **Determination of the capital cost for the new economic situation using the WACC methodology.**
- **To implement a mechanism allowing identification and then recovery of the caused Damage until expiration of the emergency period and/or during transition**

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In November 2004 a Non Paper proposal was delivered to a high ranking officer from the government offering a Transition Period followed by a New contract to provide a Fair and Reasonable rate and (with no lack at all) the implementation of a mechanism allowing identification and then recovery of the damage until expiration of the emergency period and/or during transition.

Some risks were to be assumed, such as the eventuality of insufficient rate increases. Or the possibility of loosing any increase due to the creation of the so called trust funds, the ability of certain government officer to issue new regulations increasing the uncertainty (Decrees 180 and 181 issued while negotiating with the UNIREN) and the main obstacle: To convince the shareholders to resign the ICSID claims.

There was also another hidden risk. Most of the claimants in ICSID are arguing the lack of renegotiation will by the Government. This Non Paper could have been eventually used against a Shareholder at Court… and it was (LG&E hearing)

The Final Agreement I

- Tariff increase in effect as from NOV 2005 for Non-Residential Clients.
- Tariff increase to All customers as from JAN 2006
- A Full Rate Revision (RTI) within one year term.
- Return to Law 24.076 to every possible extent.
- Specific Regulation of the RTI
- Service quality level.
- Initial investment plan.
- RTI valid for five years followed by the regular Five Year Rate Review (RQT) of Law 24.076
- Definition of the Asset Base and Profitability Rate (WACC)
- Rate in pesos and local adjustment variables
- Initial rate not to be reduced by the RTI
- Implementation of a Social Rate
- Most Favorable Agreement Treatment
- The ICSID issue.

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However, an agreement was executed in July 2005 ad referendum from the referred proceeding of approval.

Restoration of the economic-financial equation was agreed through an initial rate increase with a Full Rate Revision within one year term (RTI in August 2006).

In every provision of the agreement, the preservation of the current Regulatory Framework to every possible extent is implied, through a gradual return to Law No. 24076, as regulated and supplemented.

The agreement provides guidelines for the RTI, specially related to Asset Base and Profitability.

The Licensee assumed to operate within the original license standard basis with an initial investment plan.

The Licensee was to provide the Argentine Executive with a feasible way out in respect to ICSID.

The Waiver of the Claim filed with the ICSID

LICENSEE AGREED TO OBTAIN FROM:

- Shareholders holding the Majority Shares of Stock (70% of shares)
  - Suspension of claims before the Decree.
  - Waiver of claims after Tariff Increase resulting from RTI
  - Indemnity clause in favor of Argentina shall be granted against reluctant shareholders.

- Remaining shareholders until completing 94% of the shares (Pension Funds)
  - Full consent to the agreement before the Decree.
  - Waiver of any right to claim due to Emergency, in relation to their Gas Natural BAN stockholding.

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Shareholders holding the Majority Shares of Stock (70% of shares) were to suspend claims before the Decree ratifying the Agreement and waive claims ten days after Tariff Increase resulting from the RTI are effective.

In both cases an indemnity in favor of the Argentine Nation was to be granted in case of reluctant shareholders not willing to waive ICSID

Remaining shareholders until completing 94% of the shares (Pension Funds) were to render its full consent to the agreement prior to the Decree and a further (RTI) waiver of rights to claim by reason of the Emergency Law

Now, after this brief introduction to "the case" Dr. Uriel O'Farrell will probably let you answer the following question. "Was ICSID a convenient way out?

Thank you very much.